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**Messing with Mortgages:  
Continuing Consumer  
and Creditor Confusion**

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CONTINUING CONSUMER AND CREDITOR CONFUSION**

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May 2, 2008**

This portion of the materials will provide readers with a sampling of bankruptcy cases that illustrate the recent trends that have emerged, by the courts sua sponte, by novel arguments of practitioners and by innovative investigations by the trustees, to address or at the least delay, the soaring number of foreclosures resulting from the “mortgage mess”.

**Make Sure Your Pleading Contains Accurate Information Regarding The Identity Of The  
Real Party In Interest**

On April 25, 2008, Judge Rosenthal issued an memorandum of decision regarding an order to show cause why sanctions should not be imposed in the matter of Nosek v. Ameriquest Mortgage Company, 2008 Bankr. LEXIS 1251 (Bankr. D. Mass. 2008). Ameriquest had maintained throughout a prior adversary proceeding and bankruptcy case that it was the “holder” of the note and mortgage. When the debtor filed a second adversary proceeding requesting trustee process from two Chapter 13 Trustees to collect payment on the judgment issued in the prior case, Ameriquest argued that it was merely the servicer of the loans and that it was not the owner of the funds sought to be collected. The court noted that Ameriquest and its attorneys had made misrepresentations to the court throughout the prior proceedings regarding its status as noteholder. Wells Fargo, NA as Trustee for Amresco Residential Securities Corp. Mortgage Loan Trust, Series 1998-2 was the real holder of the note. The Court issued a Notice to Show Cause why sanctions should not be imposed on account of the misrepresentations made to the Court and to determine if the misrepresentations were “indicative of very sloppy practice at best

or an intentionally deceptive practice at worst”. A hearing on the matter was held. The Court dismissed Ameriquest’s arguments that the Debtor had knowledge of the real noteholder as the assignment of mortgage was recorded with the Registry of Deeds, that it was industry practice for an original noteholder to take back a note when a borrower defaulted and that it, as servicer, was allowed to proceed in its name pursuant to the Pooling and Servicing Agreement. Ameriquest was sanctioned \$250,000 for its misrepresentations. The local law firm and one of its partners was each sanctioned \$25,000 as the firm had institutional knowledge of the actual identity of the holder of note on account of previous filings within the Debtor’s earlier bankruptcy cases. Ameriquest’s national counsel was sanctioned \$100,000 for its failure to probe the information given to it by the lender. Finally, Wells Fargo was sanctioned \$250,000. The Court stated that a note holder cannot hide behind the Pooling and Servicing Agreement and try to “bifurcate the benefits of the note, namely its right to receive repayment of the loan, from all responsibilities associated with servicing and collecting payments”.

**Make Sure Your Pleading Contains Accurate Financial Information or Fed. R. Bankr. P. 9011 May Be Imposed**

Along with the drastic increase in foreclosures and bankruptcy filings came an influx of motions for relief from the automatic stay. Judge Bohm asked counsel why a motion from relief from stay was being withdrawn. The lawyer’s answer resulted in the judge issuing two show cause orders in In re Parsley, 2008 Bankr. LEXIS 593 (Bankr. S.D. Texas 2008). The real answer should have been that the motion for relief was filed in error on account of an erroneous payment history. Unfortunately, counsel misrepresented to the court that it was a “good motion” and that set off an explosion, leading to evidence of other misrepresentations.

In this case, Countrywide Home Loans referred a motion for relief from stay to its national counsel who in turn referred the matter to local counsel. Testimony of associates

employed by the national counsel revealed confusion amongst themselves over who the actual client was and who the attorney in charge was. Further investigation revealed that only national counsel was permitted to speak to Countrywide but that national counsel was not required to monitor post-petition payments. The Court expressed concern that local counsel could not comply with Fed. R. Bankr. P. 9011 with respect to checking the financial information contained in the motion under this arrangement.

The Court also inquired about the passing along of legal fees to the borrower in situations where the motion for relief was improperly filed. Countrywide testified that a review of fees would be done at the time of the bankruptcy discharge to classify whether the fees were recoverable or non-recoverable. The judge expressed disdain for this procedure and had high doubts that the classification would ever take place. Testimony also revealed that the payment histories were prepared by paralegals and were not reviewed by any attorneys. Countrywide did not review the loan histories either. No one was catching the errors under this system. Judge Bohm wrote “what kind of culture condones its lawyers lying to the court and then retreating to the office hoping that the Court will forget about the whole matter.” Ultimately, no sanctions were imposed by the Court as the firms and Countrywide vowed to “mend their broken practices.”

In an earlier matter, also in the Southern District of Texas, the Court sanctioned a law firm in the amount of \$75,000 for filing an objection to plan and subsequent withdrawal of the objection that was deemed to be “gibberish.” In re Allen, 2007 Bankr. LEXIS 2063 (Bankr. S.D. Texas 2007). It was clear to the Court that the pleadings were not being reviewed by an attorney after being generated by a computer as the objection listed reasons that were completely unrelated or blatantly opposite of the contents of the Chapter 13 plan filed by the debtor. The

Court's decision recited a string of prior instances of violations of Fed. R. Bankr. P. 9011 with the law firm and had even imposed a previous sanction of \$65,000. Undeterred, the Court imposed the \$75,000 sanction, reducing it from \$150,000 due to significant measures undertaken by the law firm to prevent the mistakes from reoccurring.

On April 10, 2008, Judge Morris, a bankruptcy court judge for the Southern District of New York, issued a decision in the case of In re Schuessler, 2008 Bankr. LEXIS 1000 (Bankr. S.D. NY. 2008) regarding an order to show cause why Chase Home Finance, LLC should not be sanctioned for submitting pleadings that were misleading and that had no factual support. Chase filed a motion citing minimal payment defaults with no recitation of the large equity cushion in the real estate. The motion also left out pertinent facts regarding Chase's refusal to accept a payment at a branch office. The Court stated that the decision was "intended to serve as a warning to all creditors that the conduct of the mortgage servicer constituted an abuse of process" and that a "creditor's inattentiveness can be just as abusive as an intentional act of misconduct". Id. The order did not impose monetary sanctions on Chase, other than payment of the debtor's legal fees and the disallowal of any charges to the debtor's account resulting from the motion to lift stay. The Court also denied a motion to lift stay. The Court warned that the sanction was an extremely mild one and that the exercise in restraint by the Court should not limit the Court's ability to impose greater sanctions on any mortgage servicer in future cases of this nature. Id.

### **Standing Challenges: Make Sure The Company Bringing The Action Has The Legal Right**

#### **To Do So**

Another trend is to challenge a creditor's standing or right to file pleadings within a bankruptcy case. The court said in In re Schwartz, 366 BR 265 (Bankr. D. Mass. 2007) that

parties who do not hold the note or mortgage and who do not service the mortgage do not have standing to pursue motions for relief or other actions arising out of the mortgage obligation. In Schwartz the creditor was seeking relief to pursue an eviction action following a foreclosure sale. The assignment of mortgage into the foreclosing mortgagee was executed four days *after* the foreclosure sale took place. The Court stated that while the term “mortgagee”, as used in M.G.L. c. 244 §1, “has been defined to include assignees of a mortgage, there is nothing to suggest that one who expects to receive the mortgage by assignment may undertake any foreclosure activity.” Id. at 269. The motion for relief was denied.

The Schwartz Court also decided In re Maisel, 378 B.R. 19 (Bankr. D. Mass. 2007). A creditor filed a motion for relief from the automatic stay and produced an assignment of mortgage dated four days after the motion for relief from stay was filed. The creditor argued that standing should be assessed from the time of the entry of an order granting relief from stay and argued that Saffron v. Novastar Mortgage, Inc., No. 07-40257, slip op. (D. Mass. Oct. 18, 2007) stood for that proposition. Judge Rosenthal distinguished Saffron from the facts present in Maisel as Novastar was always the holder of the note, regardless of the date of the assignment of mortgage. He further remarked that Saffron did not hold that standing is assessed at the time of entry of the order granting relief from stay. The Court reiterated the language contained within Fed. R. Bankr. P. 9011 (b)(3), and called upon parties filing pleadings with the court to ensure that the “allegations and other factual contentions (recited in a motion presented to the Court) have evidentiary support” at the time the motion is filed. Maisel at 22.

The Bankruptcy Court in South Carolina recently addressed the issue of standing in In re Woodberry, 383 B.R. 373 (Bankr. D.S.C. 2008). In Woodberry, America’s Servicing Co. as servicer for US Bank National Association, as Trustee for the Structured Asset Investment Loan

Trust, 2005-8, and its successors and/or assigns (“ASC”), filed a motion for relief from the automatic stay. The Debtor challenged ASC’s right to file the pleading. The Court required the creditor to prove that it was a party in interest at the time the motion was filed. In this case, ASC was able to prove ownership of the note and mortgage by producing the original documents and introducing them into evidence at an evidentiary hearing on the issue. South Carolina state law did not require that a creditor have a written assignment of mortgage to prove ownership.

While not a bankruptcy court case, a United States District Court case worthy of inclusion in this section is In re Foreclosure Cases, 2007 WL 3232430 (N.D. Ohio 2007). The District Court issued an order covering numerous foreclosure cases that were pending in the state. The creditor was ordered by the Court to produce evidence that the named plaintiff was the holder and owner of the note and mortgage as of the date the foreclosure complaint was filed. The court dismissed the foreclosure complaints when the lenders were unable to produce the assignments.

### **How Many Times Can A Lender Continue a Foreclosure Sale?**

For several years since 2001, the continuation of a foreclosure sale upon the filing of a bankruptcy petition was essentially unchallenged by the debtors’ bar largely on account of Judge Hillman’s decision in In re Heron Pond, LLC, 258 B.R. 529 (Bankr. D. Mass. 2001). In conjunction with Judge Feeney’s decision in Hart v. GMAC Mortgage Corp., 246 B.R. 709 (Bankr. D. Mass. 2000), the consensus in the courts was that there was no absolute rule regarding the continuation or postponement of a foreclosure sale by a creditor. Each case would have to be evaluated on a case-by-case basis although the general directive was that “one” postponement by a creditor would be blessed by the court. Practitioners are once again challenging the repeated postponement of foreclosure sales by creditors. The Massachusetts Bankruptcy Courts have addressed this issue twice in 2008. The first case was In re Soderman, 2008 Bankr. LEXIS 384

(Bankr. D. Mass. 2008). In Soderman the court recited the “one-time” postponement blessing in order to seek relief from stay but that repeated continuances may be a violation of the automatic stay. The repeated continuances will be deemed a violation of the stay if the postponements are made in order to harass the debtor, gain an advantage for the creditor or renew the financial strain that led the debtor to file for bankruptcy protection. Id. One month after the decision in Soderman was released, Judge Hillman also ruled that repeated continuances of a foreclosure sale was a violation of the automatic stay. In re Lynn-Weaver, 2008 Bankr. LEXIS 1101 (Bankr. D. Mass 2008). In Lynn-Weaver, the sale was continued twice before the lender filed a motion for relief from the automatic stay. The motion for relief from stay was denied since the debtor was only delinquent for one post-petition payment. The sale was continued three more times after the relief from stay denial was entered. The Court ruled that “on the undisputed and uncontroverted facts, the Defendant's five continuances were, as a matter of law, violations of the automatic stay.” Id.

**Challenging the Assessment of Mortgage Fees to a Loan and the United States Trustee’s Office’s Investigation of Countrywide Home Loans, Inc.**

In an unprecedented move, Judge Agresti of the Pennsylvania Bankruptcy Court, in April 2008, approved the Justice Department’s further investigation of Countrywide due to widespread allegations that the lender is filing false or inaccurate claims, misapplying funds, assessing unreasonable fees to borrowers’ accounts or ignoring the discharge injunction and other court orders. Countrywide Homes Loans, Inc. f/k/a Countrywide Funding Corp., 2008 Bankr. LEXIS 1023 (Bankr. W.D. PA. 2008).

This matter was precipitated by a Standing Chapter 13 Trustee in Pennsylvania originally filing for sanctions against Countrywide Home Loans, Inc. due to her experience with the lender

not cashing disbursement checks exceeding \$500,000 that her office had sent to Countrywide for application to various borrowers' accounts. She surmised that the lender would have assessed late charges and legal fees to the borrowers' account since the accounts would appear to be delinquent.

During the investigation of the Standing Chapter 13 Trustee in the matter of In re Hill, Docket #01-22574, Chapter 13 (Bankr. W.D. PA 2007), Countrywide produced letters that indicated an escrow change in the debtor's payments, which led to the debtor owing money to the lender at the conclusion of her Chapter 13 plan. Unfortunately for Countrywide, the dated letter listed a mailing address for Debtor's counsel for office space that he would not move into for another year. Countrywide ultimately testified that it "recreated" the letters to show the amount of the mortgage payment that would have been due at various times during the Chapter 13 case and was not admitting the letters as evidence that the letters had actually been sent. The Hill case was one of hundreds of cases in Pennsylvania demonstrating that the Standing Chapter 13 Trustee had legitimate concerns regarding Countrywide's practices.

The Pennsylvania matters have led the United States Trustee's Office to file similar suits in Georgia<sup>1</sup> and Ohio<sup>2</sup> seeking to investigate the servicing practices of Countrywide. Various subpoenas have also been served by the United States Trustee's office upon Countrywide in Florida regarding the assessment of fees on borrower's accounts.

### **ALL LENDERS ARE FAIR GAME**

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<sup>1</sup> The United States Trustee's Office filed a complaint on February 28, 2008 styled as Walton v. Countrywide Home Loans, Inc., 08-06092-mhm in the Northern District of Georgia. The related bankruptcy case is In re Atchley, 05-79232-mhm. In Atchley, the homeowners eventually sold their home to avoid foreclosure but believe the payoff amount cited by Countrywide contained excessive fees and that Countrywide continued to accept trustee payments after the loan paid off.

<sup>2</sup> The United States Trustee's Office filed a complaint on February 28, 2008 styled as Fokkena v. Countrywide Homes Loans, Inc., 08-05031-mss in the Northern District of Ohio. The related bankruptcy case is In re O'Neal, 07-51027. In O'Neal, Countrywide filed a proof of claim and objection to plan when it had already accepted a short sale on the property prior to the bankruptcy filing.

Other lenders are also assessing fees to borrowers' account without telling the borrowers. In reaction to the assessment of unwarranted fees and charges to an elderly debtor's loan in the matter of In re Dorothy Stewart Chase, Docket 07-11113, Chapter 13 (Bankr. E.D. LA 2008), Judge Magner issued a 49 page decision on April 10, 2008 which ordered Wells Fargo to audit every proof of claim it filed in the district since April 13, 2007 and to provide a complete loan history on every account. If the audits reveal additional concerns, the judge reserved the right to appoint experts to do forensic accountings at the expense of Wells Fargo. She also ruled that Wells Fargo was negligent in the loan servicing of Ms. Chase's loan and assessed damages of \$10,000, legal fees of \$12,350 and sanctioned Wells Fargo \$5,000 for filing a consent order that did not reflect the agreement of the parties and for filing erroneous proofs of claim.

The decision in Chase was on the heels of Judge Magner's earlier decision in In re Jones, 2007 Bankr. LEXIS 2984 (Bankr. E.D. LA. 2007). In Jones, Judge Magner sanctioned Wells Fargo \$67,202.45 for violating the order of confirmation and the automatic stay by improperly assessing the debtor's loan with fees in the amount of \$16,852.01 and diverting payments made by the Chapter 13 trustee and the Debtor to satisfy fees that had not been authorized by the Court. The judge stated that the Jones case would provide guidance in the post-petition administration of home mortgage loans to a degree that, until this decision issued, had been lacking in the industry. In order to avoid additional monetary sanctions, Wells Fargo agreed to revise its post-petition practice in all loans administered in the Eastern District of Louisiana and was ordered to implement and use accounting procedures set for in the decision. That accounting procedure sets forth in detail the procedure to be followed in order to assess and collect post-petition fees post-discharge. Of particular note, Wells Fargo has to file with the Court a yearly statement of any post-petition charges it seeks to assess to a loan. A debtor or

other party can object to the statement and a hearing on the matter will be held to determine the appropriateness of the assessment. While the bankruptcy case is pending, Wells can only collect the amount approved by the court if the debtor voluntarily submits separate payment for the charges. Reimbursement of taxes and insurance follows a slightly different noticing procedure. If no statement of charges is filed, the charges are deemed uncollectible post-discharge.

Finally in April of 2008, the Bankruptcy Court for the District of Delaware heard In re Steven E. Watson, 2008 Bankr. LEXIS 1011 (Bankr. D. DE 2008). The decision addressed issues common in several debtors' cases where the proposed Chapter 13 Plan included provisions requiring that notice be provided to debtors of costs and fees that were being assessed against them by their residential mortgage holders. The plans provided that lenders who failed to notify debtors of assessed fees, were consequently prohibited from collection of those costs under forfeiture provisions. Lenders objected to the plans, arguing that the forfeiture and disallowance provisions violated protections afforded to the mortgage lenders by 11 U.S.C. section 1322(b)(2), a provision of the Code prohibiting modification of mortgage lender's contractual rights.

The Court held that the proposed plans, which contained procedures for timely notice of fees and charges, application of payments and adjudication of claim disputes by the bankruptcy court, may be confirmed without violating section 1322(b)(2). In his reasoning, Judge Shannon, addressing the concept that mortgage lenders who fail to give notice of post-confirmation fees and charges are thereby compromising the purpose of the bankruptcy system, stated, "If the Court and the Chapter 13 Trustee fully administer a case through completion of a 60-month Chapter 13 plan, only to have the debtor promptly re-file on account of accrued, undisclosed fees

and charges on her mortgage, it could fairly be said that we have all been on a fool's errand for five years." Id at 26.

### **CONCLUSION**

The mortgage industry and how it functions will continue to evolve as more decisions regarding its conduct are released by the courts. Stay tuned...

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## **MODIFYING MORTGAGES IN CHAPTER 13**

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Bankruptcy Code § 1322(b)(2) permits a chapter 13 plan that modifies “the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor’s principal residence...”. [emphasis added]. In the 1993 decision of Nobelman v. American Savings Bank, the US Supreme Court ruled that § 1322(b)(2) prohibits the modification of a claim secured by the debtor’s principal residence is not permitted by Chapter 13, even if the value of the residence is not sufficient to secure the entire note.<sup>1</sup> The case involved a condominium that was secured by a mortgage and note in the amount of \$71,335, but only had a value of \$23,500. The Nobelman’s unsuccessfully attempted to bifurcate the mortgage and treat the amount over the value of the condominium as unsecured. Yet despite the ruling and the code, modifications of claims secured by the debtor’s home may be permissible in limited circumstances.

If the debtor resides in a single family house or condominium, the question turns on whether the claim is actually secured, and if so, to what extent. The debtor may have modification options if the interest is secured by property that includes other property, such as a multifamily dwelling. In addition to these issues there is also an emerging trend to include additional provisions in chapter 13 plans, the effect of which some lenders have argued impermissibly modifies

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<sup>1</sup> See Nobelman v. American Savings Bank, et al., 508 U.S. 324, 113 S.Ct. 2106, 1254, 113 L.Ed.2d 229 (1993); and see also 11 U.S.C. § 1322 (b)(2).

the rights of the holders of those secured claims. This article explores the recent case law surrounding these issues.

a. When you can: The wholly unsecured second mortgage.

In In re Pelosi<sup>2</sup>, the Massachusetts Bankruptcy Court was called upon to determine whether a debtor may “modify the rights of the [second mortgagee] who holds a lien against the [p]roperty but has an ‘unsecured claim’ under 11 U.S.C. § 506(a) because there is no value to its interest in the [p]roperty.”<sup>3</sup> The debtor’s principal residence was valued at \$370,000 which was supported by an appraisal.<sup>4</sup> The first mortgage was valued at \$375,201.20 and the balance on the second mortgage was listed as \$94,843.14. Debtor filed a Motion to Determine Secured Status under § 506(a) of the Second Mortgagee, along with her Chapter 13 plan.<sup>5</sup>

Under Nobleman and § 1322(b)(2), the debtor was unable to “cram down” the first mortgage. Instead, the debtor proposed to “cram down” the second mortgage and treat the claim as unsecured.<sup>6</sup>

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<sup>2</sup> 382 B.R. 582 (Bankr.D.Mass.2008).

<sup>3</sup> Id., at 583.

<sup>4</sup> Id. The case originally commenced in chapter 7, but was later converted to chapter 13. In the original Schedule A, the debtor valued the property at \$480,000. However, after conversion, the debtor’s amended Schedule a reflected a value of \$370,000. This new valuation was supported by the appraisal.

<sup>5</sup> Id. The second mortgagee never responded to the motion or filed an objection to confirmation of the Chapter 13 plan. By the time of the ruling on the motion, the mortgagee had not yet filed a proof of claim (although the objection deadline had not passed). The Bankruptcy Court found that the respondent had adequate and proper notice.

<sup>6</sup> In re Pelosi, 382 B.R. 582, 583 (Bankr.D.Mass. 2008).

In the analysis that followed, the Court examined the First Circuit Bankruptcy Appellate Panel's decision in In re Mann<sup>7</sup>, and noted that while there was a split in the courts, Mann had adopted the view of the Third and Fifth Circuit Courts of Appeals, along with that of the Ninth Circuit Bankruptcy Appellate Panel's view that a chapter 13 debtor may void a residential real property lien that is wholly unsecured.<sup>8</sup> Since In re Mann, "the Second, Sixth, Ninth and Eleventh Circuits have joined the Third and Fifth Circuits and the Ninth Circuit Bankruptcy Appellate Panel in adopting the majority position."<sup>9</sup>

The Pelosi court noted that the First Circuit cited Mann in the 2007 case of Eastern Savings Bank v. LaFata.<sup>10</sup> The dispute in that case arose from a "bizarre set of facts" where the debtor's principal residence actually straddled the property line between two lots, only one of which was the mortgaged property.<sup>11</sup>

In discussing section 1322(b)(2) and Nobelman, the First Circuit stated:

We and other courts have interpreted § 1322(b)(2) narrowly, even after the Nobelman decision. See, e.g., Scarborough v. Chase Manhattan Mortgage Corp. (In re Scarborough), 461 F.3d 406, 411

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<sup>7</sup> In re Mann, 249 B.R. 831, 840 (1st Cir.BAP, 2000) ("Any interpretation of the Bankruptcy Code which relies on a suspension of reality deserves to be subjected to a significant level of skepticism.")

<sup>8</sup> In re Pelosi, 382 B.R. at 584. See also Bartee v. Tara Colony Homeowners Ass'n (In re Bartee), 212 F.3d 277 (5th Cir.2000); McDonald v. Master Fin., Inc. (In re McDonald), 205 F.3d 606 (3rd Cir.2000); and Lam v. Investors Thrift (In re Lam), 211 B.R. 36 (9th Cir. BAP 1997).

<sup>9</sup> See Zimmer v. PSB Lending Corp. (In re Zimmer), 313 F.3d 1220 (9th Cir.2002); Lane v. Western Interstate Bancorp (In re Lane), 280 F.3d 663 (6th Cir.2002); Pond v. Farm Specialist Realty (In re Pond), 252 F.3d 122 (2nd Cir.2001); Tanner v. FirstPlus Fin., Inc. (In re Tanner), 217 F.3d 1357 (11th Cir.2000). But see Am. Gen. Fin., Inc. v. Dickerson (In re Dickerson), 222 F.3d 924, 926 (11th Cir.2000) (following Tanner because the panel was bound by it but stating: "[W]ere we to decide this issue on a clean slate, we would not so hold."). In re Pelosi, 382 B.R. at 584-5.

<sup>10</sup> 483 F.3d 13 (1<sup>st</sup> Cir. 2007).

<sup>11</sup> 483 F.3d at 15.

(3d Cir.2006) (§ 1322(b)(2) does not bar modification where claim secured by multifamily dwelling, and noting policy of reading § 1322(b)(2) “literally and narrowly”); Zimmer v. PSB Lending Corp. (In re Zimmer), 313 F.3d 1220, 1226-27 (9th Cir.2002) (§ 1322(b)(2) does not bar modification where claim is wholly unsecured because of prior lien on primary residence); In re Mann, 249 B.R. 831, 835-37 (1st Cir. BAP 2000) (same, and collecting cases); Lomas [Mortg. Inc. v. Louis], 82 F.3d at 4. The policy of encouraging mortgage lending does not require § 1322(b)(2) to be interpreted expansively.

In re Pelosi, 382 B.R. 582, 585 [quoting In re Mann, 483 F.3d at 20].

Following this line of cases, a wholly unsecured mortgagee is not protected by § 1322(b)(2).

- b. “Only by security interest in real property that is debtor’s principal residence”

The protections afforded creditors by § 1322(b)(2) apply in cases where the security interest is the debtor’s principal residence. However, if the debtor’s real property “includes the debtor’s principal residence as well as other income-producing rental property”, § 1322(b)(2) does not apply.<sup>12</sup>

The limitation is based on plain language of the statute itself. As the Third Circuit noted in In re Scarborough:

By using the word “is” in the phrase “real property that *is* the debtor’s principal residence,” Congress equated the terms “real property” and “principal residence.” Put differently, the use of “is”

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<sup>12</sup>Some courts have held that a mobile home, or any other personal property that is not real property but nevertheless serves as the “debtor’s principal residence” as contemplated by § 101 (13A), does not alter the requirement of § 1322(b)(2) that the property be real property. See, e.g. In re Shepherd, 381 B.R. 675, 678 (E.D.Tenn. 2008) [and citations therein] (finding that § 1322(b)(2) did not extend to cover property that was the debtor’s residence but was not real property); see also In re Oliveira, 378 B.R. 789 (Bankr.E.D.Tex. 2007). This article however focuses on only on modifying security interests in real estate.

means that the real property that secures the mortgage must *be only* the debtor's principal residence in order for the anti-modification provision to apply.<sup>13</sup>

The property in question was a “two story semi detached residence that was converted to a multi-unit dwelling prior to Scarborough’s purchase, with one apartment on the first floor and one apartment on the second floor.”<sup>14</sup>

Scarborough resided in one of the units.<sup>15</sup>

In short, the court found that “[a] claim secured by real property that is, even in part, not the debtor’s principal residence does not fall under the terms of § 1322(b)(2).”<sup>16</sup> Unless 1322(b)(2) is amended, the hands of consumer debtors who seek to modify mortgages secured only by single family residences will be tied to the extent that the property value secures the note.<sup>17</sup>

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<sup>13</sup> In re Scarborough, 461 F.3d 406, 411 (3<sup>rd</sup> Cir. 2006); see also In re Adebajo, 15 B.R. 98, 104 (Bankr.D.Conn. 1994); In re Maddaloni, 225 B.R. 277, 280 (D.Conn 1998); In re McGregor, 172 B.R. 718, 720 (Bankr.D.Mass 1994).

<sup>14</sup> Id., 461 F.3d at 409.

<sup>15</sup> Id.

<sup>16</sup> In re Scarborough, 461 F.3d at 411; see also Lomas Mortg., Inc. v. Louis, 82 F.3d 1 (1<sup>st</sup> Cir. 1996)

<sup>17</sup> The Scarborough court addressed a concern that “a debtor could easily sidestep the ... home mortgage exception by adding a second living unit to the property on the even of the commencement of [the] Chapter 13 proceeding.” In re Scarborough, 461 F.3d at 412 [citing In re Bulson, 327 B.R. 830, 846 (Bankr.W.D.Mich.2005) and In re Guilbert 176 B.R. 302, 305 (D.R.I. 1995)]. Before debtors start considering building that in-law apartment, or converting the attic above the garage into fashionable studio space, they should be mindful that “for the purposes of § 1322(b)(2), the critical moment” is when the underwriting decision is ultimately made. “[I]t is therefore at that point in time that the lender must know whether the loan it is making may be subject to modification in a Chapter 13 proceeding at some later date.” Id., [citing In re Bulson, 327 B.R. at 846].

c. Determining Value

If modification is desired, it is important to remember that if the junior lien(s) have even a scintilla of value, it will be considered a secured claim and the lienholder's rights cannot be modified by a chapter 13 plan.<sup>18</sup> Perhaps an indication of the existence of a secured-to-value interest can be found by contemplating what would happen outside of bankruptcy. As noted in Mann:

Outside of bankruptcy, a lien with no collateral value cannot deliver any funds to the lienholder upon foreclosure. Such a lien should not deliver better rights in the bankruptcy court.

In re Mann, 249 B.R. 831, 838 [citing In re McCarron, 242 B.R. 479 at 484 (Bankr.W.D.Mo. 2000); In re Johnson, 266 BR 367 at 369 (Bankr.N.D.Ohio 2000)].

Bankruptcy Rule 3012 provides the procedural mechanism to determine value: “[t]he court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct.”

Notwithstanding the available procedural tools, there has been some reluctance to impose the duty to value real estate on the courts, when the result could be the substantial modification of the lenders rights. As the 11<sup>th</sup> Circuit opined in In re Dickerson:

...[P]roviding “anti-modification” protection to junior mortgagees where the value of the mortgaged property exceeds the senior mortgagee's claim by at least one cent, as prescribed by the

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<sup>18</sup> See e.g. In re Grimes, 376 B.R. 811, 813 (Bankr.W.D.Ky. 2007) [citing In re Lane, 280 F.3d. 663, 663 (6<sup>th</sup> Cir. 2002)].

Supreme Court's decision in [Nobelman] but denying that same protection to junior mortgagees who lack that penny of equity, places too much weight upon the valuation process. As we have noted “[v]aluation outside the actual market place is inherently inexact.” Rushton v. Commissioner of Internal Revenue, 498 F.2d 88, 95 (5th Cir.1974). Given the unavoidable imprecision and uncertainty of the valuation process, we think that choosing to draw a bright line at this point is akin to attempting to draw a bright line in the fog.

In re Dickerson, 222 F.3d 924, 926 (11<sup>th</sup> Cir. 2000)(Holding that precedent required finding that § 1322(b)(2) protects only those mortgages that are secured by existing equity in the debtor's principal residence. See In re Tanner, 217 F.3d 1357 (11<sup>th</sup> Cir. 2000).

The Mann court entertained a similar argument where the appellants expressed concerns that court decisions might end up being made on what could “very well be a swing of \$1.00 in value.”

With the collateral worth \$1.00 to the junior mortgagee, Nobelman teaches that the lien may not be avoided. With the collateral worth \$1.00 less, the junior lien would be voided in full. That distinction, they say, would be unfair; and judges, they feel, do not have a level of valuation expertise that would justify distinctions that finely made. In answer, we respond that bankruptcy judges make distinctions of similar import in a variety of other contexts. As the McDonald<sup>19</sup> court aptly noted:

Bright-line rules that use a seemingly arbitrary cut-off point are common in the law. A day beyond the statute of limitations and the plaintiff must lose, even if the claim was otherwise unquestionably a winning one. If the evidence is just over a preponderance, the plaintiff wins full damages; just under, the plaintiff gets nothing. In bankruptcy law a Chapter 7 trustee cannot contest the validity of a debtor's claimed exemption when the 30-day period for objecting has expired and the trustee failed to obtain an extension; and this is true even if the debtor has no colorable basis for claiming the exemption..... What these examples show is that line drawing is often required in the law and, at the boundary, the appearance of unfairness is unavoidable.

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<sup>19</sup> In re McDonald, 205 F3d at 611-612.

Simply pointing out that some arbitrariness occurs is not a compelling objection.

In re Mann, 249 B.R. 831, 839.

Assuming the value of the subject real estate cannot be stipulated, interested parties must turn to the courts for a determination of the value of the real estate. Practitioners are encouraged to be mindful of the concerns courts have expressed of its role in that process.

d. Plan Language: Are debtors modifying the rights without really modifying the rights?

More and more case law is emerging over chapter 13 plans that contain added terms that seek to delineate the rights and obligations of the parties. Perhaps more succinctly stated: debtors are including miscellaneous plan provisions that seek to spell out certain rights, duties and obligations of parties in chapter 13 cases, and in some cases, lenders are not happy about it.

The case law varies by court and by district, and there is no bright line rule. There are however, issues, concerns and potential remedies that debtors, lenders and trustees have.

In an April 7, 2008 decision, the US Bankruptcy Court for the District of Delaware was called upon to determine two separate issues in the case of In re Watson.<sup>20</sup> The first was whether a chapter 13 plan could be confirmed if it included “provisions governing application of mortgage payments and requiring a home mortgage lender to provide timely notice of post-petition fees and charges

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<sup>20</sup> 2008 WL 934771 (Bankr.D.Del. April 7, 2008). The case citation involves four consolidated chapter 13 cases.

assessed pursuant to the relevant loan and security documents.” The second was “whether an order ...awarding a mortgage lender its fees, costs or other charges in a set amount operates as a bar to the lender’s ability to recover fees and costs in excess of what is allowed by the Court.” These issues were raised by language included in the plans.<sup>21</sup>

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<sup>21</sup> The District of Delaware’s model Chapter 13 plan did not contain terms that addressed the debtors’ concerns. The Watson debtors proposed plan language:

(1a) Long term or mortgage debt-ARREARAGE ONLY to be paid to [mortgage holder] on the mortgage in the amount of \$-. Regular monthly payment to be made directly by Debtor beginning [date]. Debtor(s) reserves the right to contest the amount of arrears filed by creditor on the proof of claim. Confirmation of the plan shall impose an affirmative duty on the holders and/or servicers of any claims secured by the liens, mortgages and/or deeds of trust and/or note on the principal residence of the Debtor(s) to do all of the following:

- (a) To apply the payments received from the trustee on the pre-petition arrearages, if any, only to such arrearages. For the purposes of this plan, the “pre-petition” arrearages shall include all sums included in the “allowed” proof of claim and shall have a “0” balance upon entry of the Discharge Order in this case.
- (b) To deem the pre-petition arrearages as contractually current upon confirmation of the plan, thereby precluding imposition of late payment charges or other default-related fees and services based solely on the pre-petition default or defaults.
- (c) To apply the direct post-petition monthly mortgage payments paid by the trustee or by the Debtor(s) to the month in which each payment was designated to be made under the plan or directly by the Debtor(s), whether or not such payments are immediately applied by the creditor to the outstanding loan balance or are placed into some type of suspense, forbearance or similar account.
- (d) To notify the trustee, the Debtor(s), and the attorney for the Debtor(s) in writing of any changes in the interest rate for any non-fixed rate or any adjustable rate mortgages and the effective date of any such adjustment or adjustments, not less than 60 days in advance of such change or at such time as the change becomes known to the holder if the change is to be implemented in less than 60 days.
- (e) To notify the trustee, the Debtor(s) and the attorney for the Debtor(s) in writing of any changes in the property taxes and/or property insurance premiums that would either increase or reduce the escrow portion, if any, of the monthly mortgage payments and the effective date of any such adjustment or adjustments no less than 60 days in advance of such change or at such time as the change becomes known to the holder if the change is to be implemented in less than 60 days.

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(f) MODIFICATIONS. The holders of the claims secured by a mortgage on real property of the Debtor(s), proposed to be cured in section 1(a) above of this plan shall adhere to and shall be governed by the following:

(i) Pre-petition Defaults. If the Debtor(s) pay the cure amount specified in section (1a) above, or in such amount as may be established by the creditor's proof of claim, while timely making all required post-petition payments, the mortgage will be reinstated according to its original terms, extinguishing any right of the holder to recover any amount alleged to have arisen prior to the filing of the petition.

(ii) Post-petition defaults. Within 30 days of issuing the final payment of the cure amount specified in section (1a) above, the trustee shall serve upon the holder, the Debtor, and the Debtor's attorney a notice stating that (1) the cure amount has been paid, satisfying all pre-petition arrearage obligations of the Debtor(s); (2) the holder is required to treat the mortgage as reinstated and fully current unless the Debtor failed to make timely payments of post-petition obligations; (3) if the Debtor failed to make timely payments of post-petition obligations, within 60 days after the trustee's notice, the holder is required to file a Statement of Outstanding Obligations, consisting of an itemization of all outstanding payment obligations which it contends are due as of the date of its statement, with service on the trustee, the Debtor(s), and the Debtor'(s) attorney; (4) if the holder fails to file and serve a Statement of Outstanding Obligations within the required time, the holder is required to treat the mortgage as reinstated according to its original terms and fully current as of the date of the trustee's notice; and (5) if the holder does serve a Statement of Outstanding Obligations within the required time, the Debtor(s) may (i) within 30 days of service of the Statement, challenge the accuracy thereof by motion filed with the Court, to be served upon the holder and the trustee, or (ii) propose a modified plan to provide for payment of the additional amounts that the Debtor acknowledges or the court determines to be due. To the extent that amounts set forth on a timely filed Statement of Obligations are not determined by the court to be invalid or are not paid by the Debtor through a modified plan, the right of the holder to collect these amounts will be unaffected. No liability shall result from any nonwillful failure of the trustee to serve the notice required by this subparagraph.

(iii) Costs of collection. Costs of collection including attorneys' fees incurred by the holder after the filing of this bankruptcy case shall be claimed pursuant to section 1(a)(6)(B) above.

(iv) In the event of a default on the regular monthly payment by Debtor after all pre-petition arrears have been paid by the trustee, and after the time set for the Statement of Obligations, the holder must submit a Statement of further Obligations within 30 days of the date in which said fees/costs were incurred for further fees and/or costs with notice to the trustee, Debtor and Debtor's attorney. (1) If the holder fails to file and serve a Statement of further Outstanding Obligations within the required time, the holder is required to treat the mortgage as reinstated according to its original terms and fully current; and (2) if the holder does serve a Statement of further Outstanding Obligations within the required time, the Debtor may (i) within 30 days of service of the Statement, challenge the accuracy thereof my motion filed with the Court, to be served upon the holder and the trustee, or (ii) propose a modified plan to provide for payment of the additional amounts that the Debtor acknowledges or the court determines to be due. To the extent that amounts set forth on a timely filed Statement of Obligations are not determined by the court to be invalid or are not paid by the

The Watson court noted one axiom about § 1322(b)(2): the Bankruptcy Code does not define the term “rights;” rather, court and parties need to turn to state law.<sup>22</sup>

The use of state law to determine property rights is not limited to ownership interests. It applies equally to security interests, including the interest of a mortgagee. In this case, therefore, the Mortgage Lenders' rights arise from the mortgage instruments, which are enforceable under state law. The rights of a mortgage lender generally include the right to repayment of the principal in monthly installments over a fixed term at specified adjustable rates of interest, the right to retain the lien until the debt is paid off, the right to accelerate the loan upon default and to proceed against petitioners' residence by foreclosure and public sale, and the right to bring an action to recover any deficiency remaining after foreclosure. Presumably, these are the sort of substantive economic rights Congress sought to protect when it enacted § 1322(b)(2). Allowing plans to modify such rights may potentially increase the risk borne by mortgage lenders and perhaps decrease the incentives in the financial marketplace to lend to potential home buyers.

Id., [citing Butner v. United States 440 U.S. 48, 54-55, 99 S.Ct. 914, 59 L. Ed.2d 136 (1979)].<sup>23</sup>

The debtors' proposed plans required lenders to give notice of any fees or charges to be assessed. If the lender failed to provide notice, the fees or

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Debtor through a modified plan, the right of the holder to collect these amounts will be unaffected.

Appendix A, In re Watson, 2008 WL 934771 (Bankr.D.Del. 2008)

<sup>22</sup> Id., [citing Nobelman v. American Sav. Bank, 508 U.S. 324, at 329] and see also Butner v. United States 440 U.S. 48, 54-55, 99 S.Ct. 914, 59 L. Ed.2d 136 (1979).

<sup>23</sup> See, e.g., In re Scarborough, 461 F.3d 406, 409-410 (3<sup>rd</sup> Circuit 2006) where the security instrument also included an assignment of rents to amend and supplement the mortgage. Debtor argued that the loan was subject to modification because the security interest extended beyond the “principal residence” and to the rents. Citing 21 Pa. Stat. Ann. § 3, the court noted that “under Pennsylvania law, real property is defined to include rents.” Modification was not permitted on that basis. However, because the claim was secured by the debtors principal residence as well as other income producing property, the creditor did not receive protection from the modification provisions of § 1322(b)(2).

charges would be disallowed or forfeited. The reason: it was necessary to ensure that at upon successful completion of the plan and receipt of the discharge, the debtors would not be saddled with a substantial amount of fees and costs accrued during the plan period. Notice, the debtors contended, would give the court an opportunity to rule on the fees and costs.

Lenders conceded that the “‘mere notice’ requirements were likely permissible” but argued that the disallowance or forfeiture of the fees and costs would amount to an impermissible modification of their contractual rights in violation of § 1322(b)(2). They also contended that the “‘rights’ which cannot be modified under § 1322(b)(2), survive to permit full recovery or collection after the Chapter 13 case is closed.” The Delaware Bankruptcy Court responded:

This cannot be. There is not a single reported decision from any court, anywhere, to support this remarkable proposition. Mortgage Lenders' argument rests on a flawed interpretation of the term “rights” as used in § 1322(b)(2). Those “rights” are determined according to state law and the contract terms. See Nobelman v. American Sav. Bank, 508 U.S. 324, 329, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993). When the Court, applying these principles, disallows a requested fee or charge, that is a determination that applicable law, or the mortgage contract, do not afford the Mortgage Lender a “right” to payment. At bottom, acknowledgment of the Court's exercise of its authority to rule conclusively upon asserted claims and charges is simply not an impermissible modification of the Mortgage Lenders' rights.

Id., [citing In re Wilson, 321 B.R. 222, 226 (Bankr.N.D.Ill.2005) (“While a court order may not be a prerequisite to the enforcement of a valid contract provisions allowing for attorneys' fees, ... neither is a court prohibited from fixing the amount of attorneys' fees even when a contractual agreement provides for the recovery of such fees.”)].

With that argument dispatched, the court faced the premise behind the plan terms. Relying on cases from Massachusetts, Illinois and Oregon, the court

found that “[p]lans containing procedures for timely notice of fees and charges, proper allocation of payments and adjudication by [the court] of disputes over assessed fees, costs and charges under a mortgage may be confirmed without running afoul of § 1322 (b)(2).” The... ‘language in a Chapter 13 plan burdening mortgagees with procedural obligations over the life of the plan does not, per se, violate § 1322 (b)(2)’s anti-modification provision and is permissible and even desirable.’”<sup>24</sup>

However, a word of caution: “the means [should not] unnecessarily confuse the process.”<sup>25</sup> It may be a commendable (if not entirely appropriate) goal to include plan provisions in an effort to ensure that debtors are not unpleasantly surprised when they have successfully completed their plan.<sup>26</sup>

There are publications-a-plenty that suggest plan language that might be worthy of inclusion in a chapter 13 plan. However, such verbatim “borrowing” may lead to unwelcome results.<sup>27</sup>

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<sup>24</sup> Id., [citing In re Collins, 2007 WL 2116416 (Bankr.E.D.Tenn. July 19, 2007)] [emphasis added]. See also, Nosek v. Ameriquet Mortgage Co., 363 B.R. 643 (Bankr.D.Mass.2007). A reading of the Nosek cases reveals why, in the absence of local rules or orders on certain mortgage servicing issues, such provisions might be “permissible and even desirable.” In that case, Ameriquet argued that there was nothing in Chapter 13 that required it to change its accounting practices simply because one of its customers filed for bankruptcy protection. In fact, it argued that if it were required to apply payments “in a manner different from the underlying contracts, Ameriquet...would be forced to constantly monitor each debtor’s bankruptcy case, readjust their accounting methodologies, and continually recalculate how payment should be applied.” Id., 363 B.R. at 649 [citing Ameriquet’s Reply Brief at p. 13]. Yet “[t]hat’s exactly the point; [the lender] must adjust its accounting practices because of [the debtor’s] bankruptcy. The Bankruptcy Code is not a cafeteria; lenders do not decide which of its provisions apply to them.” Id.

<sup>25</sup> In re Anderson, 382 B.R. 496, 509 (Bankr.D.Or. 2008).

<sup>26</sup> Id.

<sup>27</sup> Id., 382 B.R. at 503 (fn 12)(court ultimately sustained the objections to confirmation and ordered the debtors to amend the plan, but made specific mention that the “contested paragraphs are borrowed virtually verbatim from sample paragraphs suggested in the article Challenging

Certain districts have adopted model plans, rules or orders reflecting provisions addressing some of these issues,<sup>28</sup> while other districts are appointing committees to adopt plans to “ensure uniformity in Chapter 13 practice.”<sup>29</sup> In districts where there is no uniformity, there seem to be only cases to litigate which leads courts to suggest or order what might be an appropriate plan provision for inclusion in a confirmable chapter 13 plan. As the Anderson court stated:

The court would be remiss if it did not give some guidance as to what might be “appropriate” plan provisions to ensure no surprises at plan's end. [Local order] already provides a set of procedures. However, its scope is limited. A plan provision expanding that scope, such as: “The procedures set out in [the Local Order], shall apply to *all* arrearage amounts (pre and post-petition), including *all* fees and costs, claimed by [the lenders],” would likely be “appropriate.” However, the court thinks it fair to alert the parties that this District's Local Bankruptcy Rules are currently being revised ... \* \* \* The court further notes that the following language has been approved in other Chapter 13 plans in this district[:]

Post-petition mortgage payments to secured creditor shall be applied to the first post-petition payment due under the terms of the contract.

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Mortgage Servicer “Junk” Fees and Plan Payment Misapplication: Making Use of New Section 542(i), 25 NCLC Reports: Bankruptcy and Foreclosures Ed., Nov./Dec.2006)).

<sup>28</sup> See, e.g., In re Anderson, 382 B.R. 496, 501-502 (Bankr.D.Or. 2008)(Referring to the Bankruptcy Court for the District of Oregon's General Order 97-1 as amended by General Order 98-1.); see also In re Wilson., 321 B.R. 222, 228 (Bankr.N.D.Ill 2005)(“The Chapter 13 Model Plan affords a mechanism for debtors and lenders to achieve certainty regarding the amount and payment of postpetition arrearages, fees, and costs of collection. It does not change the original contract terms of the loan, the timing, or the amount of payments but directs disputes about these issues to be resolve in the bankruptcy court. Moreover, since the Code allows Chapter 13 plans to cure any default, even if the Model Plan's provisions ‘affected’ a debtors obligations to a home lender, the effect is nothing more than the permissible curing of postpetition defaults.”)

<sup>29</sup> In re Watson, 2008 WL 934771 (Bankr.D.Del)(Bankruptcy court directed the appointment of a Special Committee for the purpose of amending the Chapter 13 plan and “modifying such other of our Local Rules relating to consumer bankruptcy practice as may be necessary and appropriate.”)

Payments from the trustee to secured creditor shall be applied to its pre-petition loan arrears claim. As long as debtor timely pays all post-petition payments, secured creditor shall not assess any fees or other charges on the basis that a post-petition payment is late.

Lender shall send such billing statements, coupons and statements regarding post-petition advances and/or charges on the loan directly to the debtor as it customarily sends when no bankruptcy has been filed.<sup>30</sup>

e. The Outlook

The line between impermissible plan modification under § 1322(b)(2) and helpful plan provisions to further proper administration is not entirely clear from district to district (or from court to court). Unless and until there is uniformity in practice, either through statutory change or court rules and orders, these issues will continue to be litigated in the months and years ahead.

The only sure thing is that a debtor whose principal residence is a single family home or condo will not be able to modify any mortgage that is secured by even the smallest amount. As property prices and values continue their downward trend, it is possible that those junior mortgagees might find themselves wholly unsecured, and subject to modification. Unless and until Congress amends § 1322(b)(2), the best that future chapter 13 debtors can hope for is a further decline in property values as that will be the gauge for determining whether a mortgagee has anything secured.

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<sup>30</sup> In re Anderson, 382 B.R. at 509 (fn 21).

**MESSING WITH MORTGAGES**  
**PREDATORY LENDING PRACTICES &**  
**LOANS AIMED AT SUBPRIME BORROWERS**

**(A FEW) CASES AND STATUTES**

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Despite the onslaught of publicity about Predatory Lending and a veritable plethora of decisions in the Bankruptcy Courts dealing with the aftermath thereof, there is a dearth of decisions on the state and non-bankruptcy federal levels, particularly in the First, Second, and Third Circuits. Additionally, states are just now responding to the problems by passing law with a prospective effect, which will, hopefully, if not stop the practice of Predatory Lending, at least slow the Predators. The discussion which follows skims the highlights of state laws and of non-Bankruptcy Court decisions. (Per Westlaw, as of June 15, 2008, there are fewer than 100 cases in Federal District and Circuit Courts dealing with the issue)

**DEFINITIONS**

Before continuing on, it is important to understand some terminology:

1. There is no such thing as a “Predatory Loan”- even the statutes deal with **Predatory Lending** or, another misnomer, subprime loans. Loans are neutral; what is a good loan product for one borrower may be the financial undoing of another. Next, again except by recent statutes (discussed later), there is no such product as a “Sub-Prime Loan”. There are Sub-prime Borrowers<sup>1</sup> and even that label is artificial. Until the current “crisis” a so called “Sub-Prime Borrower” was a person who had a FICO (credit) score below FNMA or FHLMC guidelines (varying from 640 to 680).

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<sup>1</sup> FDIC Press Release PR 9-2001, 1-31-2001

2. “High Cost” Loans are typically those where the total of points and fees exceed 5% of the total loan amount, or have an interest rate of more than 8% over the US Treasury Securities with a maturity equal to that of the loan, or in some cases equal to that of the adjustment period.<sup>2</sup>

3. A high-cost or high-rate loan made to a sub-prime borrower, in the media, is being called a Predatory Loan.<sup>3</sup>

All of the states in the First Circuit have enacted essentially the same laws regarding Predatory Lending, so-called subprime loans, and the penalties levied against those who make such loans to borrowers. The penalties apply with only a few exceptions, the most common being a borrower’s high level of financial sophistication.<sup>4</sup>

### **OTHER STATUTES AND ENACTMENTS**

Each of the statutes in the 1<sup>st</sup> Circuit has, in addition to adding a statute governing “Predatory Lending” in particular, passed laws dealing with the related problems confronting both Borrowers and Lenders.

1. Assignees/Purchasers of Mortgages Subject to Borrowers Defenses (No BFP exception)

The protection afforded loan purchasers, in the past, from the foreclosure defenses of mortgagors, is being quickly eroded. If the Foreclosure defense in a particular situation is Predatory Lending practices, an assignee/purchaser will not be able to rely on BFP status automatically. The purchaser will have to show that it requires its originators and Sellers to certify

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<sup>2</sup> Rhode Island Title 34 Chapter 34-25.2 through 25.8 “Rhode Island Home Loan Protection Act”

Massachusetts General Laws Chapter 183c §2  
Maine Title 9A §8-103

<sup>3</sup> FDIC Press Release (infra)

<sup>4</sup> Mass MGL 183c and 93A; Maine M.R.S. 9-A §8-206; New Hampshire Title 35 Ch 397, Title 48 Ch 479, RSA 358-A; Rhode Island Title 34 Ch 34-25,2 et seq.

that no High-Cost High-Rate Loans are being sold by that Seller. Additionally the assignee/purchaser must certify that it will not knowingly purchase any such loans. Finally, the assignee must actually audit its purchased portfolio to deal with any high-cost and high-rate loans it holds.<sup>5</sup>

## 2. Foreclosure Prevention Companies

Exempting attorneys either by specific statutory exclusion or by oversight agency missive, many states nationwide, and all states in the Circuit are regulating “foreclosure consultants” or foreclosure rescue entities. Unfortunately many of these companies are preying on the very borrowers who have been the victim of a Predatory Lending practice, or who have just had bad luck or poor planning and cannot afford their mortgage payments.

The most common scheme is to have the Borrower convey the property to the foreclosure rescuer, without realizing what is happening. The pitch to the Borrower about to lose his/her home, is that he/she can rent from the rescuer for a brief period of time until the Borrower’s credit is better, and then re-purchase the property. The variations are numerous but the result is the same most of the time: The home is lost to the Borrower, who also loses his/her equity, while the rescuer resells the house for a profit, stripping the equity for him/herself.

The behavior of the “fixers” is now prescribed or proscribed with significant penalties for deviations<sup>6</sup>

## 3. Licensing Loan Originators

Until recently, loan originators, especially those not working for an insured financial institution, did not have to be licensed: in fact they did not even have to spend five (5) minutes learning the job. There was no mandated education, no testing, no CLE requirement (not unlike some state bars), and no regulation. In nearly all cases nationally, the only education came from

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<sup>5</sup> Rhode Island - Title 34 Ch 34-25, 2-7; Massachusetts - MGL 183C §15; Maine - MRS 9-A §8-209;

<sup>6</sup>Rhode Island Title 5 Chapter 5-79; New Hampshire Title 48 Chapter 479-B; Massachusetts 940 CMR 25.01 et seq ; Maine

the lender(s) with whom the mortgage broker dealt. IndyMac Bank, Bank of America, FHA, to name a few, had training sessions for originators. Most “Lenders” did not train, but they were actually intermediaries, using a credit line to fund loans, with the loans having been pre-sold to an “end Lender” which either took the loan into portfolio or resold it for securitization. The majority of first tier Lenders, did not keep what they wrote, and sold without recourse, so they cared little about Loan quality, or matching products to Borrowers. Think about it: the person selling someone else’s house, the realtor, has to be licensed; the homebuyer’s agent has to be licensed; in many states now home inspectors must at least be registered; yet the money person has gone without ANY oversight, training, regulation, or accountability, except for profit.

\_\_\_\_\_As it now stands, either the originator must be licensed independently, but work for a broker or other supervised entity, or the broker or supervised entity is fully responsible for the actions of the originator.<sup>7</sup>

#### 4. Miscellaneous

Massachusetts has also enacted a law which, effective, May 1, 2008 amends the states foreclosure law (MGL Ch 244 §35A) by requiring lenders to give mortgagors a 90 day right to cure a default. The lender is specifically prohibited from accelerating the note “or otherwise enforce the mortgage” until after the 90 cure period. The statute goes on to prescribe exactly what notice must be give, information that must accompany the notice, and significantly “the name and address of the mortgagee, or anyone holding thereunder, and the telephone number of a representative of the mortgagee whom the mortgagor may contact...” Further, the mortgagor “shall not be liable for any

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<sup>7</sup>Massachusetts - effective 11-1-2008 all mortgage originators must be licensed and must work only for one (1) mortgage broker or licensed financial institution MGL 255 F

Rhode Island - Title 19 Chapter 19-14-3 effective 3-31-2008 for existing originators and 1-1-09 for new licensees.

Maine - Categorizes “originators” as “loan officers”. They must work for a supervised entity. MRS 9A §1-301 @ 22-A, 9A §8-103, 9A § 10-303-A

New Hampshire - Requires originators work for only one broker or Lender (licensee) and the Licensee is supervised by the Commissioner of the Department of Banks Title 35 Ch 397A:1, A:5

attorneys' fees related to the mortgagor's default that are incurred by the mortgagee or anyone holding thereunder prior to or during the period set forth in the notice required by this section"

## **COURT DECISIONS**

### **STATE COURTS - 1<sup>ST</sup> CIRCUIT**

Commonwealth of Mass v Fremont Investment & Loan, Mass Appeals Court, 08-J-118

Fremont Investment & Loan ("FIL"), based in California, was marketing loans throughout the country.

On 10-4-07 the Commonwealth alleged unfair and deceptive practices, violating MGL 93A §2. On 12/28/07 the Commonwealth moved for a preliminary injunction to prevent foreclosures during the pending action. Further, all sales, assignments, or pooling of such loans, was also enjoined as was the transfer of servicing.

Four key loan characteristics were found, by the Superior Court Judge, to make loans "unfair" under the common law and statutes: (1) the loan is an adjustable note with initial period of 3 years or less (2) the loan has teaser rate at least 3% lower than the note when fully indexed (3) the borrower has debt to income ratio that would have exceeded 50% if the debt was measured under the fully indexed rate (4) loan to value ratio is 100% or the loan has substantial prepayment penalty."

To effect interim relief, the judge categorized loans into "presumptively unfair" and "not presumptively unfair". If all 4 characteristics are met, the loan is presumptively unfair. If loan is not presumptively unfair, then FIL must give the Attorney General an opportunity to dispute whether loan should be in this category. If it is unfair, then Fremont must give the Attorney General 45 days notice of the proposed foreclosure and explain why foreclosure is reasonable.

FIL argued, unsuccessfully, that the judge had to find that loans were high cost loans under MGL 183c which regulates fees, debt to income ratio, does not permit prepayment penalties, et al. In fact, the Judge did not find any of the loans to be high cost loans, this triggering MGL 183c which

is the Massachusetts Predatory Lending statute. Rather, he looked to find if FIL's loans were unfair under MGL 93A, the Mass Consumer Protection statute.

In essence, the judge looked to common law principles of unfairness, and determined that it is well established that it is unfair for a lender to make home mortgage loans that the lender does not reasonably believe can be paid and the homeowner avoid foreclosure.

FIL's protestations that they had done nothing illegal, that they were acting "under laws as administered by a regulatory board or officers of the Commonwealth or the United States" were parried by the Court. The judge considered "whether FIL's conduct could be found to be unfair even if the "four (4) loan characteristics in question were and are legal": "The judge correctly relied upon established case law holding "the fact that a particular conduct is permitted by statute should be considered but it is not dispositive on the question of fairness" *Shuback v Household finance 375/133, 137(1978)*"

Interestingly, and of major importance, is that it appears that no other court in the Circuit, federal (non-bankruptcy) or state, has taken any position (as of June 15, 2008) on what actually is a "Predatory Lending practice" in everyday life versus legal theory.

## **OTHER CIRCUITS**

### **2<sup>ND</sup> CIRCUIT**

Connecticut - In Bank of NY Trust Co successor to JP Morgan Chase v Ester GBEH et al, Superior Court of Connecticut District of Litchfield CV075002495S 2/28/2008

In this case, Mortgagors raised a number of defenses to foreclosure, most of which were rejected by the Court. The overlay was the theory of Predatory Lending Practices perpetrated by the Plaintiff on the Defendant.

A Motion for Summary Judgement in the foreclosure action was filed by the Plaintiffs, and answered by the Defendants with five (5) special defenses: breach of good faith and fair dealing; unconscionability of the mortgage; unclean hands; violations of TILA (Federal); and that the lending practices violated the Connecticut Unfair Trade Practices Act (CUTPA).

The Plaintiff argued for Summary Judgement stating that the defenses were legally insufficient and that legally invalid special defenses did not preclude Summary Judgment.

After dealing with important state procedural issues, the Court discussed the Plaintiff's case:

Plaintiff had presented credible evidence of a facially sufficient mortgage, mortgage note, and proof of non-payment. Essentially a prima facie case for foreclosure.

Connecticut law had been decided in 2001 in New Haven Savings Bank v La Place 66 Conn Appl 10, 783A.2d 1174 (2001) and later in LaSalle Nat'l BK v Freshfield Meadows LLC 69 Conn App. 824 835 (2002) that special defenses "alleging a breach of implied covenant of good faith and fair dealing ...are not equitable defenses to mortgage foreclosure".

1.) As to unconscionability, of the mortgage: it "... cannot be assessed against a successor in interest to the mortgage unless the assignee participated or had reason to know of the misconduct" The Court allowed amended pleadings.

2.) Unclean hands:" The Defendants allege that if the Plaintiff knew or should have known that at the time of the refinance the mortgagors could not afford the mortgage then it engaged in predatory lending. The Court countered by stating that the Defendant must show that they did have clean hands that the defense is a defense for the protection of the Court. Further, a mere allegation is not sufficient. The party invoking the doctrine must demonstrate the other's unclean acts. The Court granted leave to amend.

3.) TILA - The issue being Notice of Recision Rights, the Plaintiffs provided signed copies of the disclosures. It was deemed insufficient for the defendants to plead that they never received the disclosures. Further, the Court stated that such violations do not attack the validity or enforceability of the note or mortgage, but relate to the conduct of the lienholder. The defense was legally insufficient.

4.) CUTPA - Defendants did not allege specific facts of unfair and deceptive acts, just the general assertion. The Court granted leave to amend pleadings.

It is apparent here that the Court, though willing to entertain complaints to stop foreclosures for predatory practices, is not going to permit mortgagors to use broad generalities. Specific acts prohibited under CUTPA, or proof of an alleged wrong, not the mere possibility will be required. That the Plaintiff could not prove the Defendants received the recision notice, the Court moved the burden to the Defendant to prove they did not.

**New York - Supreme Court - Nassau County, NY New York - Alliance Mortgage Banking Corp, Wilshire Credit Joanne S. Dobkin 10625/06 3/28/08**

Here, the Defendant, as her foreclosure defense, claimed that she was the victim of Predatory Lending. The Court stated "However, absent some violation of some statute or other

relevant legal principle, the law does not permit judges to simply ignore payment obligations voluntarily taken on by mortgagors even if it should have been evident to both the lender and borrower that the loan was likely beyond the borrowers ability to repay" (emphasis needed)

The Court goes on to discuss that there is no demonstration of actual fraud. Its analysis went further calculating the amounts which would trigger protection under HOEPA and NY Banking Law § 6-1. Neither threshold was met. The Court found for the Plaintiff.

**New York - Supreme Court Richmond, County NY LaSalle Bank NA as Trustee MLMI Trust Services c/o Wilshire Credit v David Sharon et al**

Plaintiff brought action for summary judgment to foreclosure. The original lender Liberty Capital Mortgage d/b/a HCI Mortgage Company through a broker accepted Defendant Mortgagors' application. The Mortgagors' AGI was \$30,000 +/- . The Sharons were shown a house with a price of \$335,000 ( the P&S reflected \$355,100 with a seller concession of \$20,100)

Rather than a single loan, Sharons were "sold a first mortgage for \$284,000 and a second for \$71,000".

As a defense Sharons alleged

1. Excessive financing was approved to 106% of the purchase price.
2. No due diligence of Sharons' ability to pay.
3. Intentional placement into sub-prime loan products with high rates and longer terms.
4. No TILA disclosures, disclosure regarding costs, no counseling services offered nor disclosures concerning balloon payments (of which the would be one).
5. Forgeries on documents, especially the Application.
6. Coercive tactics.

Sharons allege Predatory Lending under NY Banking Law §6-L et seq. Specifically a high cost loan. The Plaintiff argued that the interest rates of 7.65% and 10.5%, were well under usury rates and therefore not high cost.

The Court dissected the Plaintiffs loan finding numerous violations of the statutes, most importantly a lack of the required due diligence regarding ability to pay. Additionally, after being promised a fixed rate loan with a maximum of 10.59%, the loan adjusted to 14.09%.

Making matters worse, no evidence was provided that the required disclosures were present

at any time

The Court denied Plaintiff's Motion For Summary Judgment.

### **3<sup>rd</sup> CIRCUIT**

**Pennsylvania - Reginald McGlawn, Petitioner v Pennsylvania Human Rights Commission, Respondent, The Commonwealth Court, 891 A.2d 757 Jan 2006**

This was a case of first impression for the Court and is the first such case in the 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> Circuits. It involves **REVERSE REDLINING**, where poor and primarily minority neighborhoods are targeted by Lenders as "ripe" for selling loans. After all, "why pay rent if you can own. Don't worry about the rate going up - you will refinance before then." This is the patter of the Lenders who truly practice Predatory lending. The market/demographic provides potential borrowers who have hope, want home ownership, but who do not have access to normal credit markets, and normally are unsophisticated.

#### **THE CASE (SYNOPSIS) PRESENTED BELOW SPEAKS FOR ITSELF**

Mortgage Broker and chief officer petitioned for a review of a decision finding them in violation of Human Relations Act due to Reverse Redlining.

Holdings: The Commonwealth Court, Nos. 2763 C.D. 2004 and 6 C.D. 2005, Simpson, J., held that:

- (1) As a matter of first impression, Act encompassed claims of reverse redlining;
- (2) evidence was sufficient to support determination that broker and officer engaged in brokering activities that resulted in predatory and unfair loans;
- (3) evidence was sufficient to support finding that broker engaged in predatory brokering activities which resulted in a predatory and unfair refinancing loans;
- (4) evidence was sufficient to support finding that broker engaged in intentional discrimination;
- (5) evidence was sufficient to support finding that broker's business activities had a disparate impact on African Americans and African American neighborhoods;
- (6) broker's predatory lending in connection with African Americans was not a legitimate practice;
- (7) Commission had authority to award borrowers reimbursement for monies paid to mortgage broker; and
- (8) evidence did not support Commission's finding that prevailing mortgage interest rate of 5% was available to borrowers.

“In its decision, the Commission found that Broker engaged in predatory brokering activities regarding all Complainants. Those actions resulted in unfair and predatory mortgage loans. It also found Broker engaged in an aggressive marketing plan targeting African Americans and African American neighborhoods in the Philadelphia area. Nearly all of Complainants contacted Broker in response to radio, television and newspaper advertisements.”

“.....Broker’s predatory practices, the Commission noted, included arranging loans containing onerous terms such as high interest rates, pre-payment penalties, balloon payments and mandatory arbitration clauses. In addition, Broker charged Complainants high broker fees, undisclosed 4 yield spread premiums and various other additional closing costs. Broker’s predatory practices also included falsification of information on loan documents, failure to disclose information regarding terms of the loan, and high pressure sales tactics.”

“..... the Commission contends this is a housing discrimination case. Section 3 of the Act recognizes an individual’s civil right to obtain any housing accommodation without discrimination because of race. 43P.S. § 953. The Act is an exercise of the Commonwealth’s police power “for the protection of the public welfare, prosperity, health and peace of the people of the Commonwealth ....”Sec 2( c) of the Act,43 P.S.§952( c).”

**“Reverse redlining is a recognized, if new, form a housing discrimination.** Hargraves.” *(Emphasis added)* ....Section 5(h)(4), the loan provisions, prohibits discrimination “against any person in the terms and conditions of any loan of money, whether or not secured by mortgage or otherwise for the acquisition, construction, rehabilitation, repair or maintenance of housing accommodation[s]...” 43 P.S. §955(h)(4).

“Broker arranged a 30-year mortgage loan for Taylor with Delta Funding Corporation (Delta) in the amount of \$20,500.00 with a 13.09% interest rate. R.R. at 681-82a. Taylor was not given an opportunity to review any of the documents before signing them. R.R. at 381-82a. Taylor was told to sign the documents. R.R. at 382a.”

“The Commission found Taylor’s loan transaction had several predatory characteristics. Taylor’s was charged \$4,276.60 in total settlement costs or approximately 20% of the loan. FN20 R.R. at 682a. Two days after Taylor signed the loan documents, her uncle reviewed them and advised her to cancel the loan. R.R. at 382-83a. Taylor called Aaron McGlawn, a Broker employee, and stated she did not want the loan. He did not advise Taylor she could legally rescind the loan within a three-day period; rather he told Taylor she could cancel the loan if she had the money to pay the people Broker already paid. R.R. at 383a.”

The record also indicates Broker's business activities have a disparate impact on African American neighborhoods. This can be established by statistical evidence. Hargraves. The Commission accepted the testimony of the Radcliffe Davis, a Commission investigator (Investigator). In response to Taylor and Poindexter's complaints. Investigator visited Broker's office and reviewed 100 customer loan applications for things such as refinancing, debt consolidation and home improvement. R.R. at 524a. Of those 100 applications, 66 identified the race of the applicant. Id. Of those 66 applicants, 65 were African American. R.R. at 524-25a.

In addition, Complainants' second expert testified he prepared a document mapping the 11 properties involved in this matter. R.R. at 1001a. Nine of these properties were in the areas that have at least a 90% African American population. R.R. at 1002-03a. The other two areas have a 50-75% African American population. Id.

**New Jersey - NowosLeska v Steele & Dorsey 400 NJ Supo 297, 946 A.2d 1097  
5/19/08**

This is the prototypical foreclosure scam case, but one that has been adjudicated, unfortunately after the loss of the property. The Case was to Vacate Default against Defendants who were victimized by Foreclosure Rescue scheme where rescuers, "Property Vestors", paid \$155,000 of Borrowers' (Defendants) debts, took a deed in lieu of foreclosure without Borrowers knowing and then selling the home for \$265,000 which was reconveyed for \$402,000 (*the timing qualified as a flip*). The Court vacated default, permitting the Defendants, the former homeowners, to proceed to obtain a recovery from the "rescuer".

### **FEDERAL DISTRICT COURTS**

The first case to be mentioned is United Cos. Lending Corp. V. Sargeant 20 F.Supp. 2d 192 D. Mass 1998. What is remarkable is that this 10 year old case touches on every issue with which we are dealing today.

The Plaintiff made and sold first lien residential mortgage loans. It operated in the "subprime market". The Court discussed the higher costs to the lender due to credit risk, and the components that establish the risk factor. The Court elaborates and details the cost of securitization being higher because most of the loans are non-conforming.

Sargeant borrowed \$134,700.00 with an adjustable rate of 11.99% (with a 6% increase cap). The APR, however, was 13.556%. “Broker Fees” were \$13,461 to United and \$4,150 to an intermediary broker. Sargeant’s payment went from \$956 per month to \$1281 due to the \$23,029 in closing costs - 17% of the total loan.

The points/fees were undisclosed until closing, thus violating the then applicable state law. Disclosure would have put the lender/broker in a good position, unless there was an unreasonableness to the amount charged. The Court cited a host a state and federal decisions supporting the unreasonableness of the charges

The case was decided based on a federal standard of Unfair and Deceptive practice enunciated and approved in Federal Trade Comm v. Sperry Hutchinson Co. 405 US 233, 244, 92 S.Ct. 898 (1972) The test established whether the practice 1) causes substantial injury to consumers, 2)violates established public policy, or 3) is immoral, unethical, oppressive or unscrupulous. The FTC, in 1980 gave a more detailed explanation of “injury to consumers.

The Court then gives a treatise on the unscrupulous behavior of brokers and lenders engage in “Predatory Lending” practices that included offering high rate high fee loans to borrowers who lacked access to mainstream banks, had marginal credit history and had limited financial sophistication”

In the end, Sargeant won a significant victory .The origination fee charged by United constituted an unfair and deceptive trade practice as the points charged substantially deviated from industry-wide practice in Massachusetts. Therefore, Sargeant is entitled to actual damages of \$13,461.40 plus interest. McIntyre was not entitled to a brokerage fee as he failed to provide Sargeant with the requisite disclosure. Such failure to disclose constitutes an unfair and deceptive trade practice in violation of Mass. Gen. Laws ch. 93A, § 2(a) and a violation of the disclosure requirements of Mass. Gen. Laws ch. 183, § 63. Therefore, Sargeant is entitled to actual damages of \$4,150.00 plus interest. Sargeant is also entitled to reasonable attorney's fees in prosecuting to her Chapter 93A claims. See Mass. Gen. Laws ch. 93A, § 9(4). ADDITIONALLY Sargeant was granted the RIGHT OF RECISION, only having to pay the then owed principal -no back interest, costs, fees etc.

The second case is Stone v. Household International Inc. and Beneficial Finance (9/22/05 Westlaw only 2005 WL 3728718 D. Mass.

The Plaintiffs had obtained a home-equity loan from Beneficial. The loan agreement called for arbitration in the case of a dispute. The Plaintiffs argued that the arbitration clause, itself, was unenforceable under the basis of unconscionability, fraud, and undue influence. The Court, taking each theory separately, found there was no cause of action except for unconscionability.

Under Massachusetts law, an unconscionable contract is one “such as no man in his senses and not under delusion would make on the one hand, and no honest and fair man would accept on the other” (quoting from *Waters v. Min Ltd.* 412 Mass. 64, 69 (1992)). The Court found that there was no unfair surprise, no language hidden in the text, that itself was improper, and the Plaintiffs had adequate time to review the agreement. Further, there was no allegation that the Arbitration clause was a contingency for the loan. The Court found for the Defendants, affirming its prior decision.

The critical issue for both Debtors’ and Creditors’ Counsel is that the boilerplate Arbitration clause might withstand scrutiny, but the Court in this case laid out the formula for unconscionability . Further, the Court dealt, in adequate detail, with the other grounds alleged to render the Arbitration clause unenforceable. This follows the reasoning in a 3<sup>rd</sup> Circuit case *Salley v. Option One Mortgage* regarding arbitration issues.

#### **OTHER CASES WORTH READING**

In *Re Ocwen Loan Servicing, LLC Mortg. Serv. Lit.*, (Appeal of Ocwen), U.S. Ct. App. 491 F.3d 368, 2007 (7<sup>th</sup> Cir) Ocwen tries, unsuccessfully dismiss this class action by arguing that the Office of Thrift Supervision (“OTS”) only allows certain claims and that state law based claims are preempted.

*Parker v Long Beach Mortgage Company*, 534 F. Supp. 2d 528 (E.D. Pa 2008). Plaintiffs obtained 4 mortgages on townhouses. The documents received as “early disclosure” showed figures differing from the Truth in Lending Disclosure signed at closing. Further, they claimed that they did not know that the package was an 80/20 loan, rather than one loan. It is important to take

note that as a part of the transactions, the Parkers received \$850,000 cash from closing. As the Court aptly put it, “ The dispute the Parkers have...embody many of the factors identified with predatory, subprime mortgage loans: an aggressive broker, balloon payments, prepayment penalties, and negative amortization. As distasteful as the practices may be, that odor of opportunism is not enough to save the Parkers, relatively sophisticated borrowers, from themselves”

The point, which is missed in the general press and sometimes by us, the Bar, , is that the current mortgage mess is just an exacerbation of what had gone before. We have new loans and regulations but the more things change...