

# **Bringing Down the House: Residential Mortgages**

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U.S. Bankruptcy Court, E.D. Mich.; Detroit

## **BRINGING DOWN THE HOUSE (OR NOT)**

### **ABI SEMINAR OUTLINE**

#### **Panelists:**

**Honorable Thomas Tucker, Bankruptcy Judge, EDM**

**Lawrence A. Friedman, Friedman Partners, LLC**

**Amy Aronson, Partner, Aronson & Walsh, P.C.**

**Marcy Ford, Partner, Trott & Trott, P.C.**

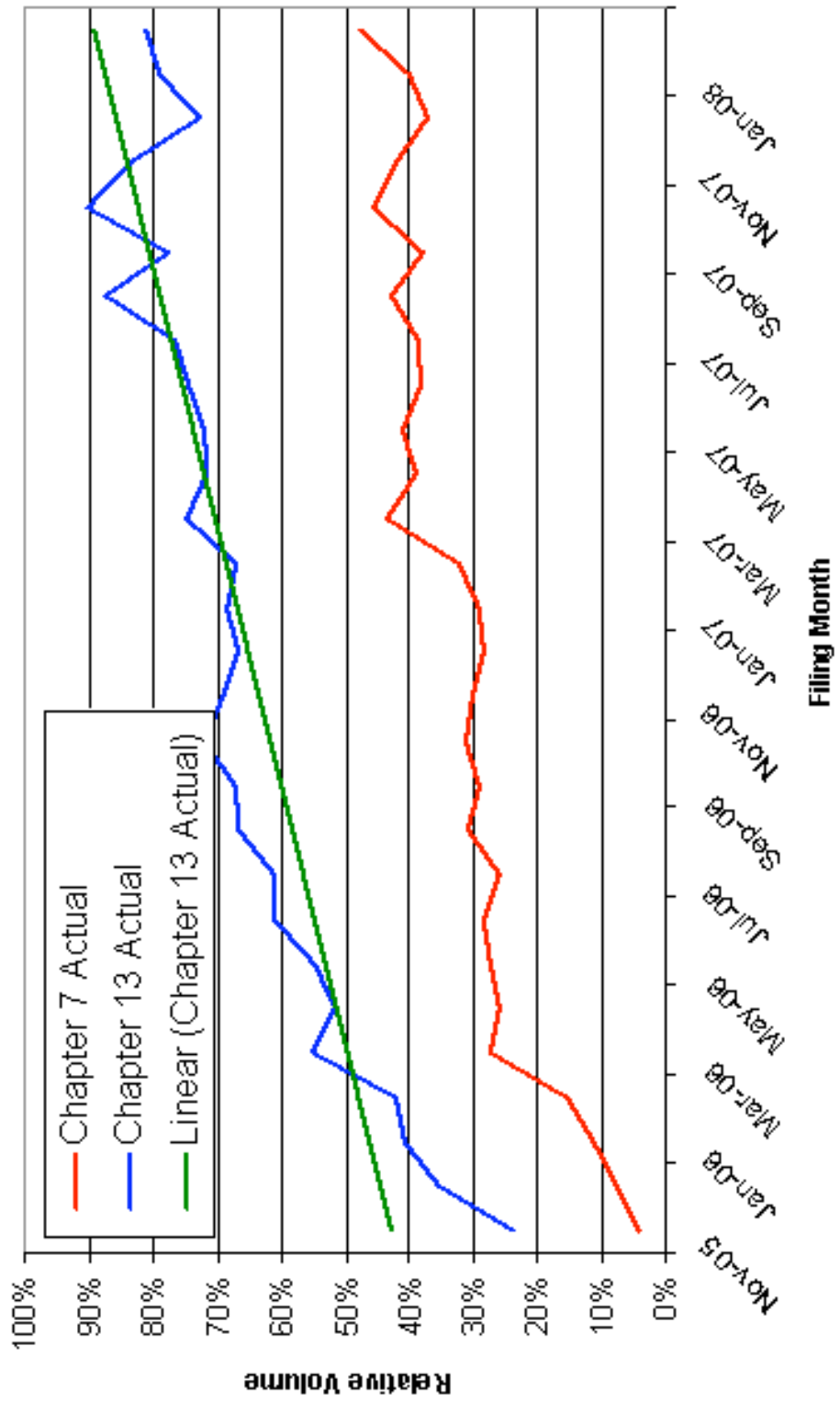
1. Subprime and prime mortgage crisis effect on bankruptcy filing volume
  - a. Filing statistics
  - b. Chapter 13 or Chapter 7 – Filing to save the house or walking away?
2. Pending bankruptcy legislation
  - a. Effects on bankruptcy filings
  - b. Effects on mortgage creditors and the mortgage industry
3. Is bankruptcy enough to save the house?
  - a. Loss Mitigation – a new tool in bankruptcy
    - i. Prime vs. Subprime world
    - ii. ARM forbearance
    - iii. Loan Modifications
    - iv. Short sales
    - v. Deed-in lieu of foreclosure – when all else fails
    - vi. Chapter 7 Trustee as sales agent
    - vii. Reaffirmation Agreements
  - b. Procedural requirements
    - i. Required documentation
    - ii. Court approval
4. New (or old) modification/avoidance opportunities as a result of mortgage fallout
  - a. Loan origination issues
  - b. Second liens and value
  - c. Non-owner occupied property – is bankruptcy a solution?

**ABI Central States Bankruptcy Workshop**  
**June 12-14, 2008**  
**Traverse City, Michigan**

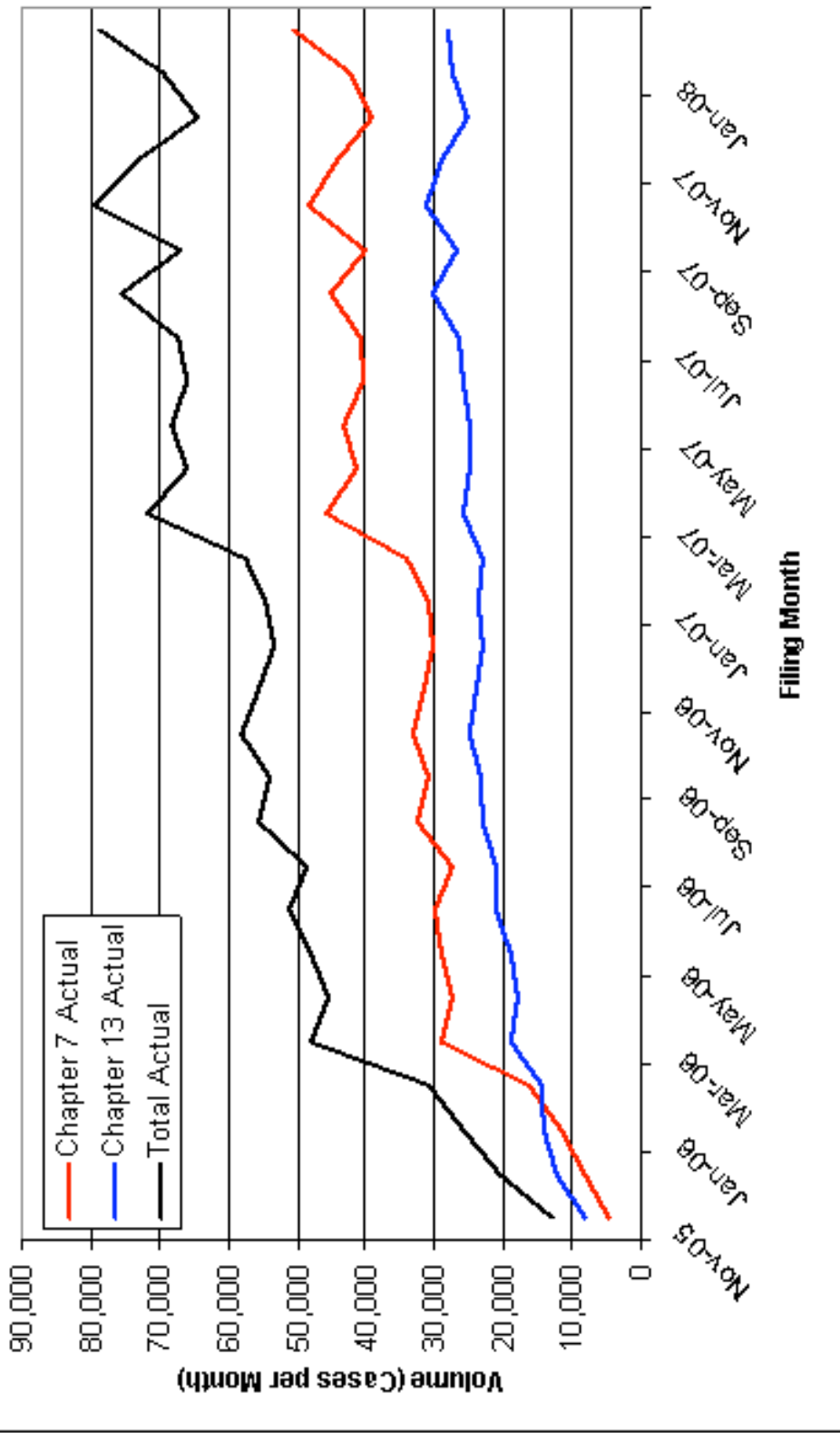
*Bringing Down the House*  
*Legislative Update and Filings*

Thomas J. Tucker  
Lawrence A. Friedman  
Marcy J. Ford  
Amy Aronson

**Post-BAPCPA BK Filings as % of Pre-BAPCPA Average - AIS Data**



### Post-BAPCPA Bankruptcy Case Filings - AIS Data



# Legislative Update

- Pending Bills
  - Durbin Bill S.2136
  - Specter Bill S.2133
  - Chabot Bill HR 3778
  - Miller Bill HR 3609
- Chabot Bill is identical to Durbin Bill except for cram down which does not require agreement by the mortgagee.

# Durbin Bill

- Allows modification of principal residence if debtor has insufficient current income to make payments and cure arrearages after deducting other expenses permitted under means test (707(b)(2)(A) and (B)).
- Generally authorizes modifying the mortgagee claim although does not specifically say cram down.
- Allows for payment of the modified mortgage beyond the duration of the plan.
  - Unclear if this is an exception to 1325 (a)(B)(I)(bb) to allow the lien to survive the discharge.
  - Does not specifically provide for discharge upon completion of other plan payments nor for mortgage to NOT be discharged as personal liability of debtor.

## Durbin Bill con't

- If modified mortgage can be extended to 30 years from date of original loan.
- Allows for interest modification at most recent annual Fed figure for yield on conventional mortgage plus risk premium.
- Allows for waiver of prepayment penalties without regard to modification.
- Allows for voiding of mortgage and claim if mortgage is subject to TILA or other consumer protection law violation.

# Durbin Bill con't

- Waives credit counseling requirement if home is scheduled for or has been foreclosed regardless of 7 or 13.
- Allows for trustee to pursue claims against mortgage. Eliminates defense of not real party in interest.
- Creates \$75,000 homestead exemption for debtors over 55 in 7 and 13 and could be read as in addition to state law where chosen.

# Specter Bill

- To modify mortgage must have been entered prior to 9/26/07 and CMI less than 150% of median.
- Cram down with mortgagee consent.
- Extends modification beyond plan. Unclear about lien retention and discharge as personal liability of debtor.
- No modification of term but if modified and ARM, the AR can be delayed and retroactively modified for adjustments that occurred in prior 2 years.
- No voiding of mortgage for TILA or other claims nor can trustee pursue.
- Comptroller General to conduct study on impact of allowing judges to modify within 180 days.

# Miller Bill H.R. 3609 (Sanchez)

- Deletes 1322(b)(2)
- Allows general modification but doesn't specifically mention cram-down.
- Allows for payments beyond duration of plan and expressly provides for lien retention after discharge is entered and provides that 13 discharge is not delayed as a result.
- Term can be extended without limitation.
- Rate can be modified but rules need to provide for full present value of secured claim.
- No voiding for consumer violations.
- Waives credit counseling if foreclosure is initiated.

# General Home Ownership, Foreclosure and Default Statistics

- Percent of Homeowners with no Mortgage 35%
- Percent of Loan Type of All Mortgages Held
  - Prime Fixed 65%
  - Prime ARM 15%
  - Subprime Fixed 6%
  - Subprime ARM 7%
  - FHA 7%

# Percentage of Foreclosures Started By Loan Type

- Prime Fixed 18%
- Prime ARM 20%
- Subprime Fixed 12%
- Subprime ARM 42%
- FHA 8%

# Home Retention in Bankruptcy

- Historical Challenges
  - Loss mitigation can be limited due to investor or insurer guidelines.
  - Turn times to reach resolution are too long for homeowners in immediate crisis.
  - Servicers may have focused on an “all or nothing approach.”
  - Loss mitigation in bankruptcy or without a reaffirmation after bankruptcy is not allowed.

# Current Focus on Home Retention

- Home retention is a win-win for the customer, the insurer, and the investor. Nothing is absolutely out of the question.
- Servicers/investors have a stake in maintaining home ownership.
- In the event that home retention is not feasible, helping the customer find a way to exit with dignity is the priority.
- Turn times are not immediate in all cases, but are vastly improved.

# The World of Mortgage Servicing

- Subprime vs. Prime
  - Subprime can be loosely described as loans which due to underwriting or program requirements could not be sold to Freddie Mac or Fannie Mae, nor insured by FHA or VA.
  - Subprime loans may or may not have private mortgage insurance (which may affect loss mitigation options).
  - Subprimes generally have more flexibility than federally insured or loans held by GSE's. This too is changing!

# Loss Mitigation During and After Bankruptcy

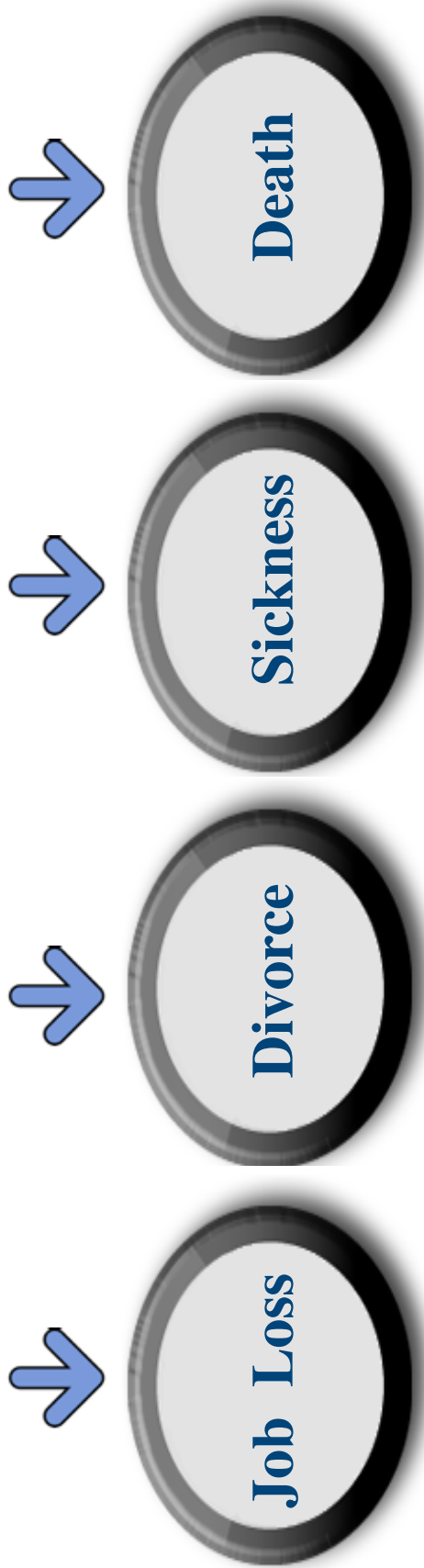
- Chapter 7
  - Use of reaffirmations for repayment agreements.
  - Short sales and deeds-in-lieu and working with the Chapter 7 Trustee.
  - Post stay termination and post-discharge repayment agreements and modifications.
    - *Some servicers will not provide repayment or modification options if the customer did not reaffirm.*

# Loss Mitigation During and After Bankruptcy

- Chapter 13
  - Loan modifications within Chapter 13
    - DSI to standard amortizing
  - Long term agreed orders to resolve post petition default.
  - ARM changes – modification or forbearance from ARM resets.
  - Short sales and deeds-in-lieu during the case.

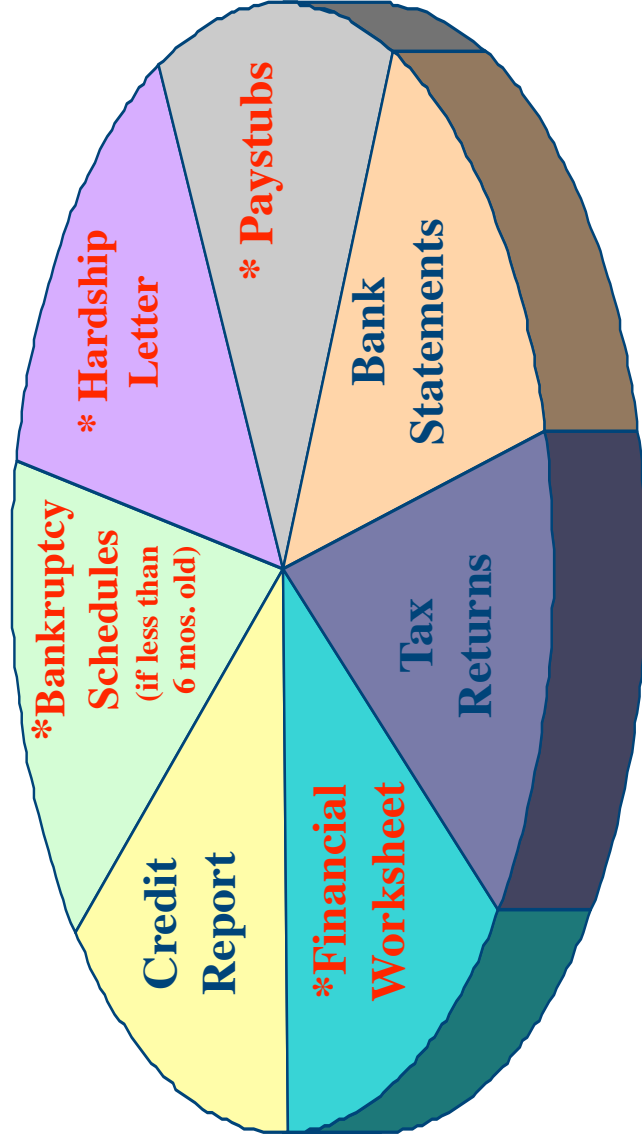
# What Does the Servicer Need to Consider Loss Mitigation Options

- Need to know reason for default.
  - Short term vs. long term.



# Documentation Possibilities

- Servicer may also need documentation to verify hardship and determine options most likely to succeed



**\* Items generally needed for loss mitigation during bankruptcy**

# **New (or Old) Modifications and Avoidance Opportunities as a Result of the Mortgage Fallout**



# Loan Origination Issues/Discussion Points

- Loan origination issues which affect a borrowers' ability to obtain loans are numerous. Three of the main issues are:
  - Loan to value ratio has increased;
  - Declining markets - due to loans obtained with inflated appraisals;
  - Lenders have lost certain products to offer to homebuyers, including 100% financing, 5% down payment on Jumbo loans, and no-document loans
- There is some good news, however. In certain areas, the FHA has increased it cap to \$410,000.00 with only 3 to 5% equity.
- Additionally, lenders statistics show that the housing crisis peaked in the early party of 2008, but is on a steady decline.
- The query is the direct effect of the foreclosure crisis on bankruptcy.

## Second Liens and Value – a Bankruptcy Debtor’s Ability to Avoid Mortgage and Judgment Liens

- ***In re Jean*** 306 B.R. 708 (S.D. Fla 2004): A plan which proposes the strip of a second mortgage lien is ineffective because it fails to provide notice of a lien avoidance under Bankr.R.Civ.Proc. 7004. Conversion to Chapter 7, absent a showing of bad faith, does allow the debtor to take advantage of the chapter 13 court's valuation of property and orders stripping liens.
- ***In re Fitzmaurice*** 248 B.R. 356, 36 Bankr.Ct.Dec.30 (W.D. MO 2000): Chapter 7 debtors unsuccessfully moved to strip off two wholly unsecured liens. Creditor brought a motion to dismiss pursuant to the Supreme Court's decision of *Dewsnup v. Timm*, 502 U.S. 410, 112 S. Ct. 773, 116 L.Ed.2d 903 (1992). A debtor cannot use 11 USC 506 to strip off even a wholly unsecured lien when the lien is based on an allowed secured claim pursuant to Section 502 of the Cankruptcy Code.
- ***In re Cervelli*** 213 B.R. 900 (Bankr.N.J. 1997): Chapter 13 debtor attempted to strip a mortgage lien under one of two theories. The first theory was that the mortgage was secured by something more than the real property because the mortgagee had an assignment of rents. The bankruptcy court rejected this argument. The second theory was that the second mortgage was wholly unsecured and could therefore be stripped off, despite the ruling of *Nobelman v. American Savings Bank* 508 US 324, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993). The court allowed the lien to be stripped, but required that the debtor complete the plan and obtain a discharge under Sec. 1328.

## Second Liens and Value – a Bankruptcy Debtor’s Ability to Avoid Mortgage and Judgment Liens

- ***In re Claar***, 368 B.R. 670 (S.D. Ohio 2007): the Chapter 13 Trustee brought an action to strip the second mortgage of the debtors' principal residence alleging lack of value to support the lien. The Court held that if the Plaintiff trustee could show that the value of the property was less than the amount owed to the first, the second mortgage would be unsecured under the combined operation of 506(a), 1322(b)(2), 1325(a)(5) and 1327(c). The plaintiff was successful and the mortgage was stripped, and deemed unsecured. The creditor's argument that the diminished value of the property was caused by the debtors' neglect failed to persuade the court to change its ruling.
- ***In re Grimes***, 376 B.R. 811, 58 Collier Bankr.Cas.2d 1094 (W.D. KY 2007): Anti-modification provisions in the Bankruptcy Code prohibited a debtor from stripping the lien off of his homestead property after it was shown that the value of the property exceeded the amount owed to the first mortgage.

## Second Liens and Value – a Bankruptcy Debtor’s Ability to Avoid Mortgage and Judgment Liens

### ▪ Limitations to Lien Avoidance

- **In re Scheuermann, No. 05-13562, 2006 WL 2475311 (Bankr. E.D. La August 25, 2006)**. Debtor cannot avoid judgment lien under Section 522(f) because after hearing on valuation, lien does not impair exemption.
- **In re Meeks, No. 06-10227-B-13, 2006 WL 2473002, AT \*3 (Bankr. E.D. Cal. August 24, 2006)**. Based on the evidence presented... the value of the residence is approximately \$320,000.00. The unavoidable liens plus the amended homestead exemption total \$305,308.11. The residence therefore has \$14,691.89 of non-exempt equity. Pacific Bell’s judgment lien impairs the Debtor’s homestead exemption to the extent that the value of its lien exceeds the non-exempt equity. Therefore, Pacific Bell’s judicial lien will be partially avoided, but will survive in the amount of \$14,691.89.
- **In re Olsen, 322 B.R. 400 (Bankr. E.D. Wis. 2005)**. Because at the chapter 13 petition date, the debtors had accepted an offer to sell their home without two acres that were subject to a judgment lien, the two acres were no longer homestead property, were not available for homestead exemption and the debtors could not sure Section 552(f) to avoid a judgment lien on the two acres.

## Second Liens and Value – a Bankruptcy Debtor’s Ability to Avoid Mortgage and Judgment Liens

- Limitations to Lien Avoidance
  - In re Gagnon, No. 03-10934, 2005 WL 133114 (Bankr. D.N.H. June 1, 2005) (unpublished). When the sum of all mortgages, liens and exemptions is \$248,267.94 and the value of the real property is \$240,750, a \$6,000 third lien impairs the debtor’s exemptions and is avoidable in its entirety under Section 522(f).

## Lien Avoidance on Household Goods Under 522(F)

### ▪ Definition of Household Good for Purposes of Lien

#### Avoidance

- Section 522(f)(4) limits the “household goods,” as to which non-possessory, non purchase – money security interest can be avoided under Section 521(f)(1)(B). The new definition limits electronic equipment to one radio, one television, one VCR, and one personal computer with related equipment; clothing, furniture, linens, china, crockery, kitchenware, educational materials and educational equipment primarily for the use of minor dependent children of the debtor. It excludes (among other things) works of art not created by the debtor (or relative), jewelry worth more than \$500.00 (except wedding rings) and motor vehicles.

## Lien Avoidance on Household Goods Under 522(F)

- **In re Mundy, 2006 Bankr. Lexis 109 (Bankr.S.SC 2006)**. Chapter 7 debtor filed a Motion to Avoid Lien under Section 522 (f)(1)(B). Creditor opposed claiming that certain items did not qualify as “household goods” and therefore its lien was not avoidable. Section 522(f)(1) sets forth a two-part test to determine if non-possessory, non purchase –money security is avoidable: (1) Debtor would be entitled to claim an exemption in the property under federal or state; and (2) the security interest in “household goods” held primarily for personal, family or household use of the debtor. The Court determined that discarded and nonfunctioning goods are not avoidable. Debtor’s Motion to Avoid Lien as to certain items granted in part and denied in part.

# Lien Avoidance on Household Goods Under 522(F)

## ▪ Timing and Procedure for Lien Avoidance

- **In re McCollum, No. 05-13697, 2006 WL 2391299 (Bank.E.D. La. Feb. 22, 2006).** Homestead exemption cannot be collaterally attacked when debtor moves to sell homestead six months after petition but no one objected to the homestead within the 30-day period in Bankruptcy Rule 4403(b).
- **In re Fonke, 321 B.R. 199, 204, 206 (Bankr. S.D. Tex. 2005).** The period of time to object to a debtor's exemption expires 30 days after the meeting of creditors, and conversion to Chapter 7 does not extend or renew this period. Under Section 522, the debtor may exempt property by filing the appropriate list. "At [such] time, the property is still considered property of the estate. The property may then only become exempt" if no party objects to the elected exemptions. Pursuant to Section 522(c), once a property is exempted, the property shall not be liable during or after the case for any debt of the debtor unless the case is dismissed. "Based on the plan reading of §522(c), the property that was previously exempted in the case cannot be subject to liability for pre-petition debts unless the case is dismissed." Accordingly, the Chapter 7 Trustee is not afforded a new period of time in which to object to the debtor's exemptions when the Chapter 13 trustee, and other parties in interest, failed to object to the debtor's elected exemptions within 30 days of the conclusion of the debtor's original creditor's meeting.

## Lien Avoidance on Household Goods Under 522(F)

### ▪ Timing and Procedure for Lien Avoidance

- In re Olsen, 322 B.R. 400 (Bankr. E.D. Wis. 2005). Lien holder can challenge exemption in objection to lien avoidance because objection was filed and heard within the time frame for objection to exemptions under Bankruptcy rule 4003(b). Debtors apparently filed motion to avoid judicial liens on real property before filing statements and schedules. When a lien holder objected to a lien avoidance, the debtor then filed their schedule of exempt property. At the hearing on the motion to avoid lien, which was held within the period for objection to exemptions under Bankruptcy Rule 4003(b), the lien holder argued that the property subject to its lien was not available as a homestead exemption. Bankruptcy court found that the objection to the exemption, in the form of an objection to the motion to avoid lien was, timely.