

SERVICING MANAGEMENT[®]

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Keep An Eye On Section 524(i) While Servicing Defaulted Mortgages

*A tricky provision in BAPCPA requires keen oversight
from default servicing managers.*

It is a new era in default mortgage servicing since the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) went into effect. Most of us have acclimated to the many changes that BAPCPA brought about, but one great mystery is Section 524(i) and its effect upon the default mortgage servicing arena.

Section 524(i) is a consumer protection remedy added to the bankruptcy code by BAPCPA that provides for sanctions against a creditor for violation of the discharge injunction. Specifically, the section provides that the willful failure of a creditor to credit payments received under the terms of the confirmed plan shall constitute a violation of the discharge injunction if the failure causes material injury to the debtor. The only statutory exceptions are when the order confirming the plan has been revoked, the plan is in default or the creditor has not received payments required by the plan.

The effect of 524(i) remains to be seen. Research suggests that only one case mentions the statute (in a footnote), and this case preceded the effective date of BAPCPA. The repercussions of 524(i) will begin, at the latest, when cases filed after Oct. 17, 2005, begin to prepare for discharge. This does not mean, however, that servicers need to wait for discharge to ensure that they are in compliance.

In fact, now is the time to act. Loans should be reviewed to ensure that payments are being properly tracked and applied to pre-petition

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and post-petition payments, and that the trustee, debtor and debtor's attorney are notified of changes to escrow and payment amounts.

One of the questions that will need to be addressed is what will constitute a willful violation under this provision. Like so many other new provisions of BAPCPA, this section will be litigated and most likely interpreted in several different ways by different courts across the country. The recent Nosek case out of Massachusetts can shed some light on how a court may choose to deal with a willful violation of the discharge injunction.

Sanctions and motions

In Nosek, the creditor was sanctioned in the amount of \$750,000 for failing to properly and timely account for the debtor's payments during the Chapter 13 bankruptcy. Specifically, the court held that the creditor's accounting practices, in failing to account for pre-petition versus post-petition payments and failing to timely post payments from suspense accounts, were wholly unacceptable for a national mortgage lender.

The court further noted that payments made during a Chapter 13 plan should be applied by a lender to the current payments due and owing, with the arrearage amounts received from the Chapter 13 trustee applied to the arrearage. Read another way, pre-petition and post-petition pay-

ments should not be commingled. To do otherwise, the court held, contravenes the terms of a confirmed Chapter 13 plan. Although the Nosek case did not involve a willful failure under Section 524(i), the scenario is similar to what we may expect to see in future Section 524(i) litigation.

Another contested area for 524(i) may come in the form of motions requesting that the mortgage account be deemed current. Default mortgage servicers are cautioned to carefully respond to these motions. A motion to deem the account current may be filed by either the debtor or trustee and is a request for the court to make a finding that as of the date of the order, the debtor's mortgage account is contractually current, in all respects, and that no arrearages exist.

These types of motions are more frequently seen in "trustee pay all" or "conduit" districts, where the trustee is responsible for making both the arrearage and ongoing monthly mortgage payment during the term of the bankruptcy and, therefore, has complete records of all payments made to the mortgage creditor.

Problems arise, however, when the Chapter 13 trustee or debtor is not timely informed of alterations to the ongoing mortgage payment caused by either a change in an adjustable inter-

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est rate, escrow advances or escrow changes. This lack of notification often results in a post-petition delinquency because the creditor has not received the full amount of the monthly mortgage payment or an escrow deficiency is apparent - which, in turn, frustrates the debtor's fresh start emerging from bankruptcy. As a result, many bankruptcy districts are tightening their requirements for mortgage creditors while a borrower is in an active bankruptcy.

North Carolina and 524(i)

For example, the U.S. Bankruptcy Court for the Middle District of North Carolina, a conduit district, recently revamped its typical proposed plan and confirmation order as it pertains to claims secured by a mortgage on real property of the debtor. These changes, in the opinion of these writers, appear - at least in part - to have been written with 524(i) in mind.

Under the revised confirmation order, mortgage creditors are required to submit changes to the monthly payment, in writing, to both the debtor and trustee, either before the effective date of the change or within 30 days thereafter. Failure to provide such notice "shall result in a waiver by the creditor of the right to collect any increase in the monthly payment for which notice thereof was not provided."

In addition, prior to discharge of any case, the trustee will issue to the mortgage creditor a notice stating that all amounts owed have been paid. Should the creditor fail to respond to the trustee within the prescribed time, the mortgage shall be deemed current without further order of the court as of the date of the trustee's notice. Failing to respond to such notice will not only lead to the mortgage loan account being deemed current in all respects, but it may also open the door for a motion for sanctions or adversary proceeding for violating the discharge injunction if the mortgage servicer later informs the debtor of a delinquency resulting from money not paid during the debtor's bankruptcy case.

The new confirmation order also

directs the trustee, within 30 days of issuing the last payment required by the plan, to serve on the "mortgagee, the debtor, and any attorney for the debtor a notice stating (1) that the cure amount has been paid, satisfying all pre-petition mortgage obligations of the debtor, (2) that all post-petition mortgage obligations have been paid, (3) that the mortgagee is required to treat the mortgage as reinstated and fully current in all obligations under the mortgage, (4) that if any post-petition obligations have not been timely paid, the mortgagee is required to itemize all outstanding obligations as of the date of the notice, and file a statement of these obligations with the court, giving notice to the trustee, the debtor, and any attorney for the debtor, within 60 days of service of the notice from the trustee."

Failure of the servicer to respond timely to the trustee's notice will result in the servicer being required to treat the mortgage as being fully reinstated according to its original terms and current in all obligations as of the date of the trustee's notice.

If the servicer timely responds to the trustee's notice, the debtor or trustee may, within 30 days of service of the servicer's statement, challenge the accuracy of the statement by motion. Such a challenge will be resolved by the court as a contested matter. The debtor or the trustee may also propose a modified plan to provide for payment of those amounts that the debtor admits to being owed or that the court determines to be due.

Finally, any amounts set forth by the servicer that are not to be repaid by a modified plan or not found to be invalid by the court may be collected by the servicer in accordance with the terms of its security instruments and in accordance with applicable state law.

One final note of caution to default mortgage servicers when responding

to the trustee's notice or a motion to deem a mortgage account current: Depending on the jurisdiction, not all fees or costs assessed against the debtor's mortgage loan account are recoverable.

Servicers are advised to check with local counsel in order to determine if any such fees or costs are allowed and whether they require approval of the bankruptcy court. Failure to ensure that charges for attorneys' fees, drive-by inspections, broker price opinions, etc., are allowable in a certain jurisdiction could create unnecessary litigation.



tion for the servicer in the form of a motion for sanctions or an adversary proceeding for violating either the automatic stay or the discharge injunction.

Strategies

So, what should mortgage creditors be doing now to protect themselves in light of 524(i) and the many changes to local rules and forms occurring across the country?

Begin each case by starting off on the right foot, ensuring that a proof of claim detailing the arrearage is timely and accurately filed. Also, the creditor should verify that a valid address for receiving correspondence, other than one for payments, has been provided to the Chapter 13 trustee. This is an important point, as frequently the Chapter 13 trustee will only have a creditor's payment or drop box address to send pleadings or other correspondence related to the case.

After the proof of claim has been filed, the debtor's proposed plan - as well as the trustee's final plan (if appli-

cable) - should be carefully reviewed to ensure that the servicer's system tracks with what the plan calls for as the first post-petition payment and to check whether any months have been added to the pre-petition claim. In addition, it is important to look for any language that stipulates how the mortgage loan should be serviced, whether any valuation issues exist, whether the interest rate is being crammed down or whether the debtor is an abusive filer - all things that may warrant an objection to confirmation.

Servicers should keep in mind that once the plan is confirmed, the creditor is bound by the terms of that plan

and, therefore, must comply with the plan terms as confirmed.

Following confirmation of the plan, servicers should conduct annual escrow analyses and inform the trustee, debtor and debtor's attorney of any changes in payments in a timely manner. Additionally, servicers should also audit mortgage loan accounts in bankruptcy to ensure that all fees and costs assessed against the debtor's mortgage account are assessed in accordance with applicable bankruptcy law and principles. For example, if attorneys fees are charged back to the account, were the amounts assessed awarded by court

order, and is the amount assessed the amount awarded?

Finally, it is also important - especially in conduit jurisdictions - for servicers to annually compare their account records with the trustee's ledger to ensure that the servicer's system shows that payments were received and applied in accordance with the provisions of the confirmed plan.

Periodic review of a mortgage account in bankruptcy to ensure that the account is being serviced in accordance with the provisions of a confirmed plan and applicable bankruptcy law is the best way to protect against potential Section 524(i) violations. **SM**