The Cases, Clients, and Challenges of Filing a Chapter 13: A Forward-Looking Approach

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Introduction

In our current financial landscape, many clients are not looking to file Chapter 13 bankruptcy cases. In prior years, it had been the case that we, as consumer bankruptcy lawyers, filed Chapter 13 bankruptcies to stop tomorrow's foreclosure on a home or force the vehicle lender to return yesterday's repossessed vehicle. We would then cram down the vehicle loan to pay only the value of the vehicle at a reduced interest rate over a longer period of time, and that often enabled us to use the savings to pay the mortgage arrearage. The Chapter 13 case law that developed was, in many cases, over the nuances of how to accomplish this. We do still file cases for these reasons, but these are few and far between. The current economic climate has severely depressed the market value of homes to where most homes have a negative equity. Clients have abandoned the American goal of homeownership, as they feel that the home values will not recover fast or sufficiently enough to warrant further homeownership. For those who still desire to keep the home, it is a matter of wanting to reduce the negative equity of the mortgage(s) and/or lower the payment(s).

The federal Home Affordable Modification Program (HAMP) has had little success. In many circumstances, it has had the opposite effect of creating foreclosures. Homeowners have been encouraged to fall behind in their mortgage payments to qualify for home loan modifications. They have been informed that a home loan modification will not be discussed unless their mortgage is in default. They therefore create the default. Once the default is created, they teeter on the edge of foreclosure not knowing whether a modification will be approved or their home foreclosed. In the event they receive a modification, the reduction in payment is not significant. There are no reductions in mortgage principal balances unless the properties are in extremely distressed low-income areas. Some lenders may bargain for lump-sum buyouts with owners, but they are few and far between. The challenge for Chapter 13 consumer bankruptcy attorneys is to reengage their clients with the goal of homeownership and create strategies that will enable their reengaged clients to keep their homes, as well as to offer other strategies to reach goals relevant to our hard economic times.

Home Loans: Having It Both Ways

Clients must be made aware that there is a deadline by which they must file a bankruptcy case to save their home from foreclosure despite assurances from the lender that it will forbear from foreclosure during the loan modification process. Most clients do not understand how the mortgage servicer enters the process of home foreclosure. The mortgage servicer is independent of the lender, who owns the beneficial interest in the mortgage instrument. There may be miscommunication with the lender and servicer about any forbearance, which will cause the deadline of the foreclosure sale date to be passed. However, there is nothing incompatible with simultaneously filing a Chapter 13 case and seeking a home loan modification. Chapter 13 cases have been successfully performed in conjunction with obtaining a home loan modification. The home loan modification can be assisted by the Chapter 13 case, as it contains much routine income information upon which a home loan modification may be granted. The debtor's attorney can facilitate the modification process by communicating with the mortgagee's attorney and learning who the players are in the process and be the "go-to guy."

The client does not necessarily need a lot of participation from counsel to apply for a home loan modification, other than accommodating the mortgagee with written permission to discuss loan modification, entering into a stipulated order lifting the automatic stay for the limited purpose of discussing a loan modification, and/or assisting the debtor by providing the lender financial information, much of which has already been provided for in preparation of the Chapter 13 petition and schedules. Debtor's counsel involvement may be limited to seeking court approval for the incurrence of the new debt. Permit the mortgagee to speak directly to your clients while they seek home loan modifications. Monitoring the modification process is essential, as it may affect confirmation. At times, it requires an adjournment of the confirmation hearing while the application is processed. Debtor's counsel must be prepared in the event that either a modification or a denial of modification occurs to amend the Chapter 13 plan to accommodate the modified mortgage or the denial.

Saving the Home

We are evolving the process by which people can keep their homes as part of a Chapter 13 filing. The major development in the retention of homeownership has been the ability to strip away a totally undersecured residential junior mortgage. A "strip-away" or "strip-off" occurs where the principle balance of a first mortgage exceeds the value of the residence, rendering the junior mortgage wholly unsupported by the value of the collateral. The debtor may strip away a junior second, third, etc. mortgage despite 11 U.S.C. § 1322(b)(2), which prohibits a modification of a residential mortgage, and treat all junior mortgages as unsecured debts. A majority of the circuit courts of appeal have supported this ability in reliance upon 11 U.S.C. § 506(d), which provides that a creditor is secured to the extent of the value. *Pond v. Farm Specialist Realty (In re Pond)*, 252 F.3d 122 (2d Cir. 2001); *McDonald v. Master Fin. Inc. (In re McDonald)*, 205 F.3d 606, 611–13 (3d Cir. 2000); *Bartee v. Tara Colony Homeowners Ass'n (In re Bartee)*, 212 F.3d 277, 293–95 (5th Cir. 2000); *Lane v. Western Interstate Bank Corp. (In re Lane)*, 280 F.3d 663 (6th Cir. 2002); *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir. 2002); *Bank of the Prairie v. Picht (In re Picht)*, 428 B.R. 885, 890–93 (B.A.P. 10th Cir. 2010); *Tanner v. First Plus Fin. Inc. (In re Tanner)*, 217 F.3d 1357, 1359–60 (11th Cir. 2000). In *Nobelman v. American Savings Bank*, 508 U.S. 324, 113 S. Ct. 2106, 124 L. Ed. 2d 228 (1993), the Supreme Court rejected the application of § 506(d) where the collateral at least partially supported the mortgage. It did not permit a "cram-down" of a residential mortgage. However, a mortgage cannot be a secured claim if the value of its collateral is insufficient to support its claim even partially, so say the majority.

Is a Chapter 20 Alive?

The frequency of filing a bankruptcy and obtaining the benefit of the automatic stay was targeted by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). 11 U.S.C. § 362(c)(3) limits the imposition of the automatic stay to thirty days after the filing of a subsequent bankruptcy within a year unless reimposed by the court within thirty days upon a finding that the latter case was filed in good faith. Pursuant to 11 U.S.C. § 362(c)(4), there is no automatic stay imposed by filing a bankruptcy in which there were two or more pending cases in the prior year unless imposed by the court within thirty days upon a finding

that the latter case was filed in good faith. The aim of BAPCPA was to curb the perceived abuse of filing subsequent Chapter 13 cases without any hope of reorganization, but to merely have the benefit of the automatic stay to prevent enforcement of a debt, most especially a foreclosure. Despite these limitations on the automatic stay discouraging the serial filing of bankruptcy cases, consumer bankruptcy practitioners have found a new motivation for filing a Chapter 13 case following the filing of a Chapter 7.

The so-called "Chapter 20" occurs even though the debtor is ineligible for a discharge in a subsequent Chapter 13. Following the reasoning of *Johnson v. Home State Bank*, 501 U.S. 78, 111 S. Ct. 2150, 115 L. Ed. 2d 66 (1991), courts have determined that the unavailability of a discharge in a Chapter 13 case does not prohibit the stripping away of the wholly unsecured second mortgage that has survived the discharge of the debtor in the prior Chapter 7 case. *In re Jennings*, 454 B.R. 252, (Bankr. N.D. Ga. 2011); *In re Victorio*, 2011 WL 2746054 (Bankr. S.D. Cal. 2011). However, the debtor's filing of the subsequent Chapter 13 would be subject to the good faith standard. Four factors are examined to determine good faith:

1. The proximity in time of the Chapter 13 filing to the Chapter 7 filing
2. Whether the debtor has incurred some change in circumstances between the filings that suggests a second filing was appropriate and that the debtor will be able to comply with the terms of a Chapter 13 plan
3. Whether the two filings accomplish a result that is not permitted in either chapter standing alone
4. Whether the two filings treat creditors in a fundamentally fair and equitable manner or whether they are rather an attempt to manipulate the bankruptcy system or are an abuse of the purpose and spirit of the Bankruptcy Code

In re Pollard, 2011 WL 576599 (Bankr. D. Md. 2011).

Note the third factor. Does not a Chapter 20 accomplish a strip-away of a junior mortgage in a Chapter 13 that could not have been accomplished in a standalone Chapter 7 according to *Dewsnup v. Timm*, 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed. 2d 903 (1992)? While this factor may weigh against the

debtor, some commentators have said that "the filing of a Chapter 13 case after a Chapter 7 case will almost always 'accomplish a result that is not permitted in either chapter standing alone' because the chapters are fundamentally different with respect to the rights and powers of creditors and debtors." Keith M. Lundin & William H. Brown, *Chapter 13 Bankruptcy, 4th Edition*, § 179.1, at ¶ 5, Sec. Rev. (June 15, 2004), www.Ch13online.com. If the debtor was unaware of the ability to strip away or the wholly unsecured junior mortgage did not exist at the time of the filing of the Chapter 7, either of these may be the change in circumstance where the filing will be proposed in good faith. Courts have disagreed whether the inability to receive a discharge in a subsequent Chapter 13 prevents a debtor from stripping wholly unsecured liens in a Chapter 13 plan. These courts state that the actual strip-away only occurs at discharge and therefore cannot occur if a discharge is unavailable. *In re Gerardin*, 447 B.R. 342, (Bankr. S.D. Fla. 2011); *In re Fenn*, 428 B.R. 494 (Bankr. N.D. Ill. 2010).

A burgeoning issue is whether a joint tenant of a tenancy by the entirety can effectuate the strip-away of a wholly unsecured residential mortgage by filing an individual Chapter 13 bankruptcy. Finding that a spouse can, in an individual bankruptcy, strip away the mortgage, the court in *Strausbough v. Co-op Servs. Credit Union*, 426 B.R. 243, 248 (Bankr. E.D. Mich. 2010), emphasized that the estate's interest in the debtor's bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case in the entireties property," citing *Liberty State Bank & Trust v. Grosslight (In re Grosslight)*, 757 F.2d 773, 775 (6th Cir. 1985). The court disagreed with a contrary finding in *Hunter v. Citifinancial Inc. (In re Hunter)*, 284 B.R. 806 (Bankr. E.D. Va. 2002), which found that the strip of the lien effectuated a severance of the tenancy by the entirety. It concluded that an analysis of state law would not permit the severance without the participation of the non-filing spouse. The *Hunter* decision has been criticized as being inconsistent with other provisions of the Bankruptcy Code, which affect the interests of non-filing co-owners. Non-filing co-owners of vehicles are routinely benefited by the individual filing of the other co-owner in a Chapter 13 plan that crams down an undersecured car loan. A removal of a lien on the joint property does not sever the joint owner's interest.

How Do You Strip Away the Wholly Unsecured Residential Mortgage?

How the strip-away of the wholly unsecured residential mortgage occurs procedurally is in some dispute. Such mortgages have been stripped away by an adversary case, motion, and a Chapter 13 plan provision. Those courts that have determined that an adversary case is required have found so pursuant to FED. R. BANKR. P. 7001(2), which requires an adversary case to "determine the…extent of a lien or other interest in property." In the Eastern District of Michigan, an adversary lawsuit is required by local court rule. The loss of a property interest of the mortgagee appears to be the concern requiring what some might say is a heightened level of due process. There is something to be said for the entry of an order at the end of an adversary case, which clearly determines the termination of the lien for title insurance examiners and establishing a clean chain of title. If the lien strip provision is contained in a plan or a motion, multiple documents and a search of their content would be necessary to establish the disposition of the lien. Courts permitting the strip-away by motion say that FED. R. BANKR. P. 7001(2) is inapplicable, as the process is a determination of the value of the collateral rather than the extent of the lien. Such valuation motions are routinely brought pursuant to FED. R. BANKR. P. 3012 and FED. R. BANKR. P. 9014. Due process is satisfied with an accurate description of real estate affected and serviced. *See In re Dziendziel*, 295 B.R. 184 (Bankr. W.D.N.Y. 2003). Courts permitting a provision in a Chapter 13 plan to strip away a wholly unsecured residential mortgage emphasize service of the Chapter 13 plan pursuant to FED. R. BANKR. P. 7004 and the clarity of the provision so that it is not lost among other provisions. Simply mailing the plan with notice of confirmation under FED. R. BANKR. P. 2002 will not be sufficient. *In re Millspaugh*, 302 B.R. 90 (Bankr. D. Id. 2003); *In re King,* 290 B.R. 641 (Bankr. C.D. Ill. 2003). However, when there are more than two "security interests" in a residential property, it has been determined that the provisions of FED. R. BANKR. P. 7001(2) must be followed to determine the priority of the mortgage interests in relation to the valuation sought to be enforced by the debtor. *Stewart v. JPMorgan Chase Bank (In re Stewart)*, 408 B.R. 215, 219 (Bankr. N.D. Ind. 2009). It has been pointed out that even one dollar of value over securing the first mortgage can deny the strip-away of the junior mortgage. *Dziendziel*, 295 B.R. at 188. Although the court can accept a real estate broker's price opinion or comparables to determine the fair market value of the residence, it is a best

practice to obtain an appraisal. An appraisal, which discloses little margin in negative equity between the fair market value of the residence and the principal balance of the senior mortgage, is valuable information for stripping the junior mortgage. Under those circumstances, the client would be advised to further default in the monthly mortgage payments, to increase the principal balance on the senior mortgage, thereby creating a larger margin of negative equity in order to prevail on the value at trial. A larger negative equity can also be created by failing to pay real property taxes or water bills, which form a super-priority lien ahead of the most senior mortgage. Indeed, an existing positive equity can be made into a negative equity by following such advice. When such an action is opposed, you should be flexible on a settlement when there is a close question on the value of a property. In the past, though it is not permitted by the Bankruptcy Code, the mortgagee has permitted a cram-down of the loan, so that if we were trying to strip away a second mortgage of $40,000, for instance, we have compromised with the mortgagees and they have settled for a secured debt for $5,000 or $10,000. In such a case, neither side wants to roll the dice on the judge's determination of the value of the house. There are accommodations and settlement. Even though you cannot have a cram-down per se in the Bankruptcy Code, it does not mean the mortgagee defendant cannot agree to the cram-down.

The Economy's Effect on Discharge

One of the difficult areas in filing Chapter 13 cases is helping people whose incomes have only somewhat recovered. Their cash resources remain low and their income remains fragile. They are out there in the working world with low income and new employment, and may be let go, too, at any time. A Chapter 13 plan of repayment requires a magnitude of income to sustain the plan. Many plans were created to save homes, but if there is no recovery of the former income, there is no way to make the regular mortgage payment. The loss of housing value gives those who have recovered an income even less reason to save a distressed mortgage loan. The challenge in a Chapter 13 is to return to what Chapter 13 meant before BAPCPA, which is providing help to families to keep their homes. Continuously monitoring the payments made in a Chapter 13 can increase the case's success. The consequences of a temporary loss of income or even an increase in the mortgage may be cured by a plan modification.

Reviewing Recent Cases

Certain recent cases have had an impact on Chapter 13 filings:

- *Milavetz v. United States*, 130 S.Ct. 1324 (2010).
- *United Student Aid Funds Inc. v. Espinosa*, 130 S. Ct. 1367 (2010).
- *Hamilton v. Lanning*, 130 S. Ct. 2464 (U.S. 2010).
- *Ransom v. FIA Card Servs., N.A.*, 131 S. Ct. 716 (U.S. 2011).

Milavetz: *Curbing the Advice of Debt Relief Agents*

BAPCPA heralded in a new relationship between the consumer bankruptcy attorney and their clients. No longer are consumer bankruptcy attorneys merely just subject to state bar association rules and/or FED. R. BANKR. P. 9011, but, because of perceived abuses, we are now considered a debt relief agency. 11 U.S.C. § 101(12A). In practical terms, it means we are subject to all of the restrictions, disclosures, and requirements that are associated with being a debt relief agency. *See* 11 U.S.C. § 526, 527; 528. For example, in our advertisements, we have to include a specific statement that "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code." 11 U.S.C. § 528(b)(2). In our television and newspaper advertisements, our Yellow Pages listings, and anywhere we advertise the fact that we are filing bankruptcy cases, we must state that we are a debt relief agency and that we file bankruptcies so as not to mislead anyone into thinking otherwise. Another restriction placed upon consumer bankruptcy attorneys by BAPCPA prohibits us from advising an assisted person or prospective assisted person (the client) to incur more debt in contemplation of filing a bankruptcy case. 11 U.S.C. § 526(a)(4). In other words, an attorney cannot advise that a client borrow money prior to filing Chapter 13 when the client knows the filing is to occur. Our status as a debt relief agency and the restriction on our First Amendment right were the subject of the decision in *Milavetz*. The *Milavetz* decision upheld our status as a debt relief agency and the restrictions on our freedom of speech, despite the fact that the latter restriction would impair a lawyer's appropriate advice to borrow money to avoid the filing of bankruptcy. In its opinion, the court alluded to unacceptable conduct such as borrowing money to create secured debt to game the means test to qualify for filing a Chapter 7 case or lower the projected disposable income in a Chapter 13 case. The court

resolved the constitutionality challenge by narrowly interpreting the restriction as prohibiting the debt relief agency only from advising a debtor to incur more debt because the debtor is filing for bankruptcy, rather than for a valid purpose. The guidelines of what is a valid purpose is left for us to advise at our own risk.

Espinosa: *Curbing Aggressive Chapter 13 Plan Drafting*

The debtor attorney in the *Espinosa* case drafted a plan provision proposing to pay the principal on his student loan debt and discharging the interest once the principal was repaid. The student loan creditor had received notice of the plan and did not object. Upon the debtor's completion of the plan, the student loan would be discharged. There was no actual finding of an undue hardship as required by 11 U.S.C. § 523(a)(8). The creditor then attempted to collect the unpaid portions of the student loans, consisting of unpaid interest and principal after discharge. The Supreme Court determined that the plan's provision was not void although it was devoid of the procedural requirement of an adversary lawsuit under FED. R. BANKR. P. 7001(6). It upheld the binding effect of 11 U.S.C. § 1327(a). The court would not overturn that plan's outcome because the student loan creditor had received due process by their receipt of notice. Creditors are thus warned that you ignore a Chapter 13 plan provision at your own risk. Besides upholding the finality of the confirmation order, *Espinosa* has other significance. It sends a warning to lawyers regarding what they may draft into a Chapter 13 plan by emphasizing the sanctions that may be involved by aggressive draftsmanship. There is also an emphasis to judges, in effect, to pay attention to the orders they are entering.

Lanning: *A Forward-Looking Approach to Projected Disposable Income*

The significance of *Lanning* was to reject the mechanical approach in determining the projected disposable income of the debtor. It established the forward-looking approach to determine the debtor's projected disposable income in payment to their unsecured creditors under a Chapter 13 plan. The forward-looking approach permitted the debtor to propose a plan that departed from the formula under 11 U.S.C.S. § 1325(b) and its incorporation of 11 U.S.C.S. § 707. It permitted bankruptcy judges to depart from the historic six-month window prior to filing to account for

known or virtually certain changes in income and adjust the payment to unsecured creditors in a Chapter 13 plan. The adoption of the forward-looking approach has permitted more access to Chapter 13, as there is no longer a disconnect between the historic income and the debtor's current income permitting the composition of more affordable plans.

Ransom: *A Forward-Looking Approach to Projected Expenses*

The Supreme Court in *Ransom* was called upon to decide whether, when calculating disposable income under 11 U.S.C.S. § 707(b), the debtor was entitled to deduct the motor vehicle expense specified in Internal Revenue Service standards when the debtor, in fact, had no vehicle expense as he owned the vehicle free and clear. The court decided the debtor was not entitled to take the expense. The court determined that vehicle ownership expenses covered only those costs associated with a car loan. The impact of this decision is that it increases the debtor's projected disposable income, thereby increasing the dividend payable to unsecured creditors in a Chapter 13 plan. It therefore may affect the debtor's ability to draft an affordable Chapter 13 plan. Although the decision involved a Chapter 13, arguably it is applicable to a Chapter 7, and decreases the likelihood that a debtor will be eligible for Chapter 7 relief, as the expense reduces the debtor's means test bottom line. This harkens back to *Milavetz* and the advice that one may be tempted to give to a client to take out a loan in order to have that vehicle ownership expense. There are legitimate reasons to take out a car loan immediately prior to filing a Chapter 13 bankruptcy case. A client's ability to obtain a loan to replace a car during a case that may last five years may be impacted by the filing. The client's credit may be impaired. The client may need court approval to obtain the credit. Thus, it would be advisable for the debtor to replace the car when credit is not impaired and court approval is not a factor, especially if the car needed imminent replacement. Without identifying their interpretation as a forward-looking approach, there appears to be a forward-looking approach, as the decision denies the debtor a future expense without, a least, a current payment. A forward-looking approach to expenses was present in the Sixth Circuit opinion in *Darrohn v. Hildebrand (In re Darrohn)*, 615 F.3d 470, 477 (6th Cir. 2010). Relying upon *Lanning*, the opinion stated that, because it was the undisputed intent of the debtors to surrender their mortgaged properties, it would be inappropriate to permit the mortgage payment as a reduction in projected disposable income. The

surrender was a known or virtually certain change of circumstances to occur at the time of confirmation, and the bankruptcy court should account for the change.

The Impact of BAPCPA

Loss of the Super Discharge

BAPCPA is still affecting lawyers and clients, and the loss of a super discharge is one of those effects. The super discharge was the former ability under 11 U.S.C. § 1328(a) to discharge debts that would not otherwise be dischargeable under a Chapter 7 filing. Such liabilities included those arising under 11 U.S.C. 523(a)(2) for a fraudulent debt, under 11 U.S.C. 523(a)(4) for a breach of a fiduciary duty, and under 11 U.S.C. 523(a)(6) for a malicious injury to person or property. The ability to discharge the aforementioned debts and receive a discharge was part of what was considered the "carrot" for doing a payment plan under a Chapter 13. We no longer have the carrot, only the stick. We now have to develop strategies around BAPCPA's impact.

The Loss of Cram-Down

The biggest winner of BAPCPA was the auto lending industry. The loss of the cram-down of personal vehicle loans financed by a purchase money security interest within a 910-day period of time prior to the filing of the bankruptcy has had a direct impact on writing affordable Chapter 13 plans. 11 U.S.C. § 1325(a)(9). This uniquely affects auto workers who have the vehicle loan payments deducted from their paychecks. Auto workers typically purchase a car under a company discount plan. Buying more car than they can afford, they pay for the car by amortizing loans with payments over five or six years. When they decide they need a new car in four years, they take a rollover on the previously unpaid balance of the car loan into a new vehicle loan. Now they are making a super payment on a vehicle that should have had a much smaller payment, but they do not see the full impact, since the car payment is deducted from their paychecks. The cram-down permitted the debtor to pay the value of the vehicle rather than the amount owed. Its use lowered the car payment, freeing cash flow to allow the debtor

income to catch up on mortgage arrears, pay priority debts, and address other debts more important than the unsecured portion of the vehicle loan. Payment to the vehicle lender under BAPCPA must be made directly by the debtor prior to confirmation. 11 U.S.C. § 1326(a)(1)(C). This makes the vehicle loan lender the winner of the dispute prior to BAPCPA as to who received the first payments prior to confirmation, the attorney, mortgage payment, or vehicle lender. 11 U.S.C. § 1325(a)(5)(B)(iii)(I) also made the vehicle lender the winner as to which creditor received the initial stream of payments after confirmation by requiring the debtor to compose a Chapter 13 plan with equal monthly payments. A payment cannot be equal unless a payment is made every month of the plan in the same amount. However, some courts have determined that the equal monthly payment does not have to begin right away as long as the vehicle lender receives adequate protection payments in the meantime. 11 U.S.C. § 1325(a)(5)(B)(iii)(II); *In re Marks*, 394 B.R. 198 (Bankr. N.D. Ill. Sept. 25, 2008); *In re Hill*, No. 06-80502, 2007 WL 499622, (Bankr. M.D.N.C. Feb. 12, 2007); *In re Desardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006).