The Plight of the Defaulting Mortgagor

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As any practitioner who has ever represented a bankrupt knows, there is one question that invariably arises at some time during the course of the first interview: "What about the house, can I keep it?" The response to this question requires thoughtful consideration of both the circumstances of the bankrupt[1] and the state of the law of bankruptcy in light of the Bankruptcy Reform Act of 1978.[2]

This Article will focus on the latter of the above considerations. Specifically, this Article examines the ability of a homeowner to use Chapter 13 to effect reinstatement of a mortgage upon which he is in default at the time he files bankruptcy.

In previous years, a homeowner who encountered financial difficulties, fell behind in his mortgage payments, and filed bankruptcy, had no difficulty in reinstating the mortgage provided he could assure the mortgagee of his continued earning capacity and ability to meet the payments. Savings and loan institutions and banks were only too willing to have a solid loan on their books.

With lending institutions now encountering financial difficulties of their own because of the high cost of money and the low fixed rates on outstanding mortgages, it is understandable that mortgagees desire to call the loan, if at all possible.

It is apparent that the filing of a Chapter 7 petition will in no way aid the embattled homeowner where default has occurred and the debt has been accelerated,[3] whether or not foreclosure has been instituted or judgment of foreclosure obtained. It is true that the right of redemption would be available to the debtor even after the filing of the petition. There is, however, little likelihood that redemption would be practical because new financing would be as difficult to obtain as restructuring the loan at a rate that would enable the debtor to consistently meet the payments due.

However, all is not lost.

Chapter 13 is being invoked by mortgagors at every

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[1]This Article does not attempt to treat problems relating to the distinctive economic realities of any particular situation, tenancy by the entirety, or exemptions.

[2]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-151326 (Supp. IV 1980)) (enacted November 6, 1978, applicable to cases filed after September 30, 1979).

[3]*See, e.g.*, Cowan v. Murphy, 165 Ind. App. 566, 333 N.E.2d 802 (1975); Huston v. Fatka, 30 Ind. App. 693, 66 N.E. 74 (1903).

> stage of default: those who are only a few months in default; those whose mortgages have been accelerated, pursuant to contractual provisions authorizing such acceleration; those against whom judgments of foreclosure have been entered; and those whose property has already been sold.[4]

The use of Chapter 13 by debtors wishing to reinstate their mortgages has brought forth a number of interesting, as well as conflicting, decisions.

It is clear that Congress intended Chapter 13 to provide the individual who has regular income[5] a means to safeguard assets while rearranging debts, thereby according the individual relief comparable to that provided businesses under Chapter 11.[6] The provisions relating to the contents of a plan under Chapter 13 may be found in section 1322(b).[7] The applicable provisions should be compared with analogous provisions under Chapter 11: section 1123 discussing the contents of a plan[8] and section 1124 treating impair-

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[4] *In re* Pearson, 10 Bankr. 189, 193 (E.D.N.Y. 1981).

[5] 11 U.S.C. § 101(24) (Supp. IV 1980) defines "individual with regular income." "The definition encompasses all individuals with incomes that are sufficiently stable and regular to enable them to make payments under a chapter 13 plan." S. REP. No. 989, 95th Cong., 2d Sess. 24, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5810.

11 U.S.C. § 109(e) (Supp. IV 1980) specifies that an individual with regular income, or an individual with regular income and the individual's spouse, may proceed under Chapter 13.

"Increased access to the simpler, speedier, and less expensive debtor relief provisions of chapter 13 is accomplished by permitting debtors engaged in business to proceed under chapter 13." S. REP. No. 989, 95th Cong., 2d Sess. 140, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5926.

[6] *See* Di Pierro v. Cullen (*In re* Toddeo), 9 Bankr. 299, 303 (E.D.N.Y. 1981).

[7] 11 U.S.C. § 1322(b) (Supp. IV 1980) provides in part that the contents of a plan may:

> (2) modify the rights of holders of secured claims, other than a claim secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims;
>
> (3) provide for the curing or waiving of any default;
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> . . .
>
> (5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due . . . .

[8] 11 U.S.C. § 1123(a) (Supp. IV 1980) provides in part that a plan shall:

ment of claims or interests.[9] Although the treatment of secured debts is comparable under Chapters 11 and 13, mortgaged debt on the debtor's principal residence was intended to be covered by section 1322(b)(5).[10]

If one assumes, as has Bankruptcy Judge Parente of the Eastern District of New York, that the Chapter 13 debtor should have the same benefits as a Chapter 11 debtor, then reinstatement of the mortgage should be allowed on the same terms and conditions, including the contracted interest rate, upon curing the default.[11] Accordingly, it should be "the right of the Chapter 13 debtor, at any time prior to actual sale of the foreclosed property, to attempt cure of the pre-acceleration defaults and to reinstate the original mortgage payment schedule."[12]

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(5) provide adequate means for the plan's execution, such as—

. . .

(E) satisfaction or modification of any lien;

(F) cancellation or modification of any indenture or similar instrument;

(G) curing or waiving any default . . . .

[9]11 U.S.C. § 1124 (Supp. IV 1980) concerning impairment of claims or interests provides in part:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest;
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> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
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> (A) cures any such default, other than a default of a kind specified in section 365(b)(2) of this title, that occurred before or after the commencement of the case under this title;
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> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
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> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law; and
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> (D) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest . . . .

[10]*See* 124 CONG. REC. 32,409 (1978); *see also* H.R. REP. No. 595, 95th Cong., 1st Sess. 429 (1977).

[11]"Chapter 11 extends the right of post-acceleration cure to the business debtor, *a fortiori* the generally more liberal Chapter 13 provisions should do the same for the consumer debtor." Di Pierro v. Cullen (*In re* Toddeo), 9 Bankr. 299, 303 (E.D.N.Y. 1981).

[12]*Id.* at 302.

All is not that simple or clear, however. At the time of the drafting of this Article, there appeared to be no disagreement among courts that once a sale of the foreclosed property had been effected, Chapter 13 would avail the debtor little redress.[13] When nothing more has happened than a default in payment and no acceleration has taken place, it should not be too difficult to reach a decision that the debtor may cure the default.[14] Precedent has been established in previous cases under former Chapters X, XI, XII, and XIII, as well as in analogous cases relating to termination and default respecting leases under Chapter 11.[15] When, however, a foreclosure, but not a sale, has taken place, courts are in disagreement regarding the rights of the debtor under Chapter 13.

If Congress intended to help the honest debtor provide a way for repayment of his debt and at the same time retain his home, then regardless of whether a judgment of foreclosure or its equivalent had been entered, it would seem that payment of the back indebtedness should suffice to reinstate the mortgage.[16] This view must be contrasted with that of courts favoring the mortgagees and requiring full payment of the mortgaged debt where foreclosure has taken place.[17]

One court has apparently attempted to take a middle ground in concluding

> that after a judgment of foreclosure has been entered and a secured claim based on that judgment has been filed, a Chapter 13 plan, in order to satisfy the Code, must provide for the payment of that judgment *in full* over the life of the plan. Section 1325(a)(5)(B) is not satisfied simply by paying the arrearages that trigger the judgment. It is the judgment, not the mortgage, that now defines the lien of the judgment creditor.[18]

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[13]*See In re* Butchman, 4 Bankr. 379 (S.D.N.Y. 1980). *But see* cases cited at note 24 *infra*.

[14]*See In re* Hartford, 7 Bankr. 914 (D. Me. 1981); *In re* Johnson, 6 Bankr. 34 (N.D. Ill. 1980).

[15]*See* Hallenbeck v. Penn Mut. Life Ins. Co., 323 F.2d 566 (4th Cir. 1964).

[16]*See* United Cos. Fin. Corp. v. Brantley, 6 Bankr. 178 (N.D. Fla. 1980); *In re* Breuer, 4 Bankr. 499 (S.D.N.Y. 1980).

[17]*See* Coleman v. Brown, 5 Bankr. 812 (W.D. Ky. 1980); Benford-Whiting Co. v. Robertson, 4 Bankr. 213 (D. Colo. 1980); *cf.* Retreat Inv. Corp. v. Canady (*In re* Canady), 9 Bankr. 428 (D. Conn. 1981) (reinstatement refused after acceleration); *In re* LaPaglia, 8 Bankr. 937 (E.D.N.Y. 1981) (reinstatement refused after acceleration). *But cf. In re* Soderlund, 7 Bankr. 44 (S.D. Ohio 1980) (reinstatement permitted after acceleration).

[18]*In re* Pearson, 109 Bankr. 189, 195 (E.D.N.Y. 1981) (emphasis by the court).

It would appear that this court has joined the philosophical group favoring mortgagees because there is little likelihood that a debtor seeking the aid of the Bankruptcy Court could manage to compress long term mortgage payments into a three year program.[19]

The question of which judicial view best implements the views of Congress depends upon which side of the aisle one favors. Judge Schwartzberg of Connecticut contends that there is no authority under Chapter 13 comparable to section 1124(2)(B) whereby an accelerated mortgage on a principal residence can be reinstated to take advantage of the extended date that existed before default.[20]

Contrast that with the view of the New York Judge Schwartzberg who apparently subscribes to the view that city dwellers ought not be pushed out of their homesteads any more than farmers.[21] He agrees that Chapter 13 does not permit a cure of the acceleration of a mortgage reduced to judgment prior to the filing of a petition.[22] But hold on to your hat: if the mortgage has been reduced to judgment, it merges into the judgment and the mortgagee can "no longer assert that its rights in the real estate are 'secured only by a security interest' under an existing consensual mortgage."[23] The mortgagee's rights are thus subject to modification under section 1322(b)(2).[24] In essence, a cramdown results.

From the discussion at the beginning of this Article,[25] it would appear that Judge Parente is favorably disposed toward the mortgagor. However, consider his decision precluding the debtor from attempting to cure a mortgage default in a plan by ruling that the mortgagee bank had a right to vacate the stay where there was no

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[19]11 U.S.C. § 1322(c) (Supp. IV 1980) requires that a Chapter 13 repayment plan not provide for payments over a period longer than three years unless the court approves a longer period not exceeding five years. Though the provision works against the debtor in this instance, Congress' intent in enacting the provision was to eliminate practices under the old Act which resulted in extended repayment plans that were "the closest thing there is to indentured servitude . . . ." H.R. REP. No. 595, 95th Cong., 1st Sess. 117 (1977).

[20]Retreat Inv. Corp. v. Canady (*In re* Canady), 9 Bankr. 428, 430 (D. Conn. 1981). Section 1124(2)(B) is reprinted at note 9 *supra*.

[21]*See* Act of March 3, 1933, Pub. L. No. 420, 47 Stat. 1467. This law was originally passed to provide a moratorium on dispossession of farmers by mortgagees. It was successively amended to become § 75 of Chapter VIII of the former Bankruptcy Act.

[22]*In re* Garner, 13 Bankr. 799, 801 (S.D.N.Y. 1981).

[23]*Id.*

[24]*Id.*; *see also In re* Lynch, 12 Bankr. 533 (W.D. Wis. 1981) (Wisconsin law permits redemption after foreclosure sale by sheriff but before confirmation of sale); *cf.* Advance Mortgage Corp. v. Land (*In re* Land), 14 Bankr. 132 (N.D. Ohio 1981) (where petition was filed before confirmation of sheriff's sale, debtor could cure provided the judgment in entirety was paid in full over the life of the plan).

[25]*See* notes 11-12 *supra* and accompanying text.

equity available to the debtor in the residence.[26] Judge Parente also determined that the 362(d)(2)(B) proviso that "such property is not necessary to an effective reorganization" is not applicable in a Chapter 13 case.[27]

No consideration seems to have been given by the courts that favor mortgagees to the provision of section 1322(b)(5) "for the curing of *any default within a reasonable time*."[28] The attention of those courts has focused primarily on the ability of a debtor under 1322(b)(2) to modify the rights of all other secured claims. It is axiomatic that although liens are determined by state law, the latter cannot be applied where the effect is to frustrate federal policy.[29] If the intent of Congress was to help the homeowner save his home, then certainly 1322(b)(5) should at least be as powerful a tool to aid the debtor as 1322(b)(2).

The application of section 1322(b)(5) in this context, however, raises a new issue for consideration by the court—that is, whether the debtor's proposed cure is reasonable. The following factors have been cited as relevent in resolving this issue: "(1) amount in arrears; (2) the nature of the obligation; (3) the nature of the property held as security, if any; and (4) the degree of the debtor's effort to effect prompt cure."[30] Those cases interpreting what constitutes a "reasonable time" have generally agreed that it is a fact question that must be decided on a case-by-case basis.[31]

A practical issue raised by the application of section 1322(b)(5) to the defaulting mortgagor is the financial ability of the debtor to cure the default, pay the current installments, and make payments to his other creditors which satisfy the Chapter 13 requirement of "good faith."[32] To discuss the question of good faith as applicable to a Chapter 13 proceeding would require another Article much leng-

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[26]Roosevelt Sav. Bank v. Branch (*In re* Branch), 10 Bankr. 227, 229 (S.D.N.Y. 1981).

[27]*Id.* (citing *In re* Sulzer, 2 Bankr. 630 (S.D.N.Y. 1980)). *Contra*, *In re* Zellmer, 6 Bankr. 497, 500 (N.D. Ill. 1980).

[28]11 U.S.C. § 1322(b)(5) (Supp. IV 1980) (emphasis added).

[29]J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 117 (1956).

[30]*In re* Acevedo, 9 Bankr. 852, 854 (E.D.N.Y. 1981); *see also In re* King, 7 Bankr. 110 (S.D. Cal. 1980) (30 months of arrearages reasonable); Fishman v. Epps, [1978-1981 Transfer Binder] BANKR. L. REP. (CCH) ¶ 67,438 (S.D.N.Y. May 15, 1980) (balloon payment unreasonable).

[31]*See* Home Fed. Sav. & Loan Ass'n v. Beckman (*In re* Beckman), 9 Bankr. 193 (N.D. Iowa 1981) (allowed payment of arrearages over a 30 month plan period); Coleman v. Brown (*In re* Coleman), 5 Bankr. 812 (W.D. Ky. 1980), *aff'g* 2 Bankr. 348 (W.D. Ky. 1980).

[32]*See* 11 U.S.C. § 1325(a)(3) (Supp. IV 1980).

thier than this.[33] It is, however, interesting to note that one court, in discussing the relationship between good faith and payments to unsecured creditors, indicated that the congressional mandate of receiving not less than what could be received in a Chapter 7 liquidation proceeding establishes all that is required and that "[i]ndeed, the bottom line of most Chapter 13 cases is to preserve and avoid foreclosure of the family house."[34]

In addition to the controversy regarding what constitutes a default that can be cured, and the tangential question of good faith in the proposal of a plan, consider the skirmish involving payment of interest on arrearages to be cured in installments. It would seem appropriate that the court grant adequate protection in the form of interest to be paid the mortgagee based on the delay alone. For the most part, the courts agree.[35]

Undoubtedly we shall hear more from the appellate courts in the near future. It is also possible that we may yet hear from Congress. If legislation introduced in the 1981 session is of any guidance,[36] sad tidings may impend for the consumer debtor. If so, financially overburdened homeowners must hope that interest rates decline, so as to place the individual debtor with a stable income in a more competitive position to retain his castle in stormy weather.

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[33]The judicial opinions range in their diversity from plans being confirmed when nothing is paid to unsecured creditors to rejections being upheld when 10% has been offered to unsecured creditors. Confirmed plans: *In re* Johnson, 6 Bankr. 34 (N.D. Ill. 1980) (cure default on home, 1% to unsecured creditors); *In re* Bellgraph, 4 Bankr. 421 (W.D.N.Y. 1980) (pay secured, zero to unsecured, 100% for home mortgage). Plans lacked good faith: *In re* Harbison, 9 Bankr. 205 (N.D. Ill. 1981) (100% to secured, 10% to unsecured); *In re* Hobday, 4 Bankr. 417 (N.D. Ohio 1980) (zero to unsecured, full arrearages on home); *In re* Seman, 4 Bankr. 568 (S.D.N.Y. 1980) (pay secured, zero to unsecured, confirmation refused "for cause" instead of bad faith).

[34]*In re* Thacker, 6 Bankr. 861, 865 (W.D. Va. 1980).

[35]*In re* Marx, 11 Bankr. 819 (S.D. Ohio 1981); *In re* Gregory, 8 Bankr. 256 (S.D.N.Y. 1981). *But see In re* King, 7 Bankr. 110 (S.D. Cal. 1980).

[36]H.R. 4786, 97th Cong., 1st Sess. § 2 (1981) proposes to amend Bankruptcy Code section 109 by adding the following subsection: "(f) an individual may be a debtor under chapter 7 of this title only if such individual cannot pay a reasonable portion of his debts out of anticipated future income." This amendment would make Chapter 13 mandatory for substantially all consumer debtors who wish to declare bankruptcy.