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No Good Deed Goes Unpunished as COVID Forbearances Come Due

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The Coronavirus Aid, Relief and Economic Security (CARES) Act created an option for homeowners in distress or claiming distress during the COVID-19 pandemic.[1] The CARES Act, along with the accompanying rules and regulations stemming from the attendant social and political pressures, imposed an expedited procedure for the granting of forbearances to consumers. The expedited procedures in the CARES Act have caused unintended consequences for various stakeholders in the mortgage industry.

Between April 2020 and December 2021, 16 percent of homeowners were in an active forbearance.[2] This enabled borrowers with federally backed mortgage loans[3] who were dealing with financial hardship relief for up to 18 months, "regardless of delinquency status," by submitting a request to their servicer.[4] Under the CARES Act, if the borrower requested, the servicer had to oblige. With the CARES Act-mandated forbearances having expired or expiring no later than six months from Sept. 30, 2022, this article will examine the various options available to a borrower after the forbearance provisions of the CARES Act sunset. Mortgagors are seeking options to avoid immediate repayment of the forborne delinquencies and ultimately foreclosure.

Mortgagors have a number of loss-mitigation options available, including repayment plans, deferrals or partial claims, and modifications, all of which predated COVID-19 legislation. Under the CARES Act, federally backed loan programs rushed additional repayment programs into existence. This article focuses on the already-realized problems and potential risks of the loss-mitigation process, particularly through partial claims, for debtors (and those soon-to-be debtors) as their COVID-19 forbearances come due.

Partial Claims

The partial-claim cure has unique appeal and distinctive features, so it must be thoroughly reviewed. For example, any amount that was the subject of the forbearance would be captured in the new partial-claim agreement, with a note payable to the insuring government department or government-sponsored enterprise, secured by a subordinate mortgage or deed of trustee on the debtor's home.

The subordinated amount bears no interest and is usually not due until the primary mortgage is paid off, the maturity date of the senior mortgage agreement is accelerated, or at the time the borrower refinances or sells the subject property. The mortgagee/servicer benefits not only from the payment of the loan's delinquency, it may receive a monetary incentive to funnel mortgagors into this loss-mitigation program. Although resolution through a partial claim is overall beneficial to eligible[5] borrowers, its utilization in loss-mitigation has led to unanticipated, and sometimes seemingly unjust, outcomes.

Automatic Stay, Discharge Injunction and Violations Thereof

As was the case pre-COVID, the partial-claim process is rife with opportunities to violate the automatic stay of § 362 and the discharge injunction of § 524. While these legal traps endure and the consequences are nothing new, the COVID-19 forbearance-resolution process has highlighted these risks and bear reminding.

In re Eppolito[6] best exemplifies the interplay of the Code's automatic stay provisions and the partial claims mortgage being offered to avoid foreclosure. More than four years after her chapter 7 discharge, the debtor and the mortgagee entered into a modification agreement requiring the debtor to execute a partial claim note and subordinate mortgage in favor of the U.S. Department of Housing and Urban Development (HUD).[7]

Aided by new bankruptcy counsel in the reopened case, the debtor asked the court to hold the mortgagee in contempt for violating the discharge injunction,[8] arguing that the proposed loan modification was a veiled attempt to reaffirm the discharged mortgage liability.[9] The mortgagee argued that when the loan-modification documents were read together and in context, the modification clear-

1 Pub. L. No. 116-136, 134 Stat. 281 (2020).
2 Juan M. Sánchez & Olivia Wilkinson, "Forbearance During COVID-19: How Many Borrowers Used It, and for How Long?," Fed. Rsrv. Bank of St. Louis (May 31, 2022), *available at* stlouisfed.org/on-the-economy/2022/may/forbearance-covid19-how-many-borrowers-how-long (last visited Sept. 19, 2022).
3 *See* 15 U.S.C. § 9056(a)(2) (defining "federally backed mortgage loan").
4 *See* 15 U.S.C. § 9056(b)(1).
5 To be eligible for a partial claim under the Federal Housing Administration (FHA) guidelines, a borrower must "have the ability to resume making on-time Mortgage Payments," and the property must be owner-occupied. *FHA Single Family Housing Policy Handbook*, pt. III.A.2.o.iii (Oct. 21, 2021).
6 583 B.R. 822 (Bankr. S.D.N.Y. 2018).
7 *Id.* at 824.
8 *See* 11 U.S.C. § 524(a)(2), (c)(1).
9 *Eppolito*, 583 B.R. at 824-25.

ly did not renew personal liability.[10] Indeed, the accompanying loan-modification agreement contained specific language excluding post-discharge liability.[11] The mortgagee argued that this release language in the modification extended to the subordinate partial claim.[12] Because the subordinate note contained a portion of the discharged debt, the court disagreed, holding the mortgagee in contempt of the discharge order and awarding sanctions against the mortgagee for the debtor's legal fees.[13] Based on *Eppolito*, any lender hoping to avoid discharge violations should hesitate to offer a partial claim to a discharged chapter 7 debtor.

Each time the mortgagee endeavors to offer and finalize a partial claim with a consumer, risks regarding violations of the automatic stay permeate the partial-claims process. For example, in *Gordon v. Wells Fargo Bank NA (In re Banks)*, the chapter 7 debtor agreed post-petition to a loan modification by which the debtor's mortgage delinquency was cured in part through the execution of a junior deed of trust in HUD's favor.[14] Although the loan modification and the junior deed of trust were executed on Jan. 26, 2014, the junior deed of trust was not recorded until June 3, 2014, and the loan modification was not recorded until Aug. 18, 2014.[15]

Because the loan-modification documents were not recorded expeditiously, the trustee's initial title investigation determined (albeit erroneously) that there was equity in the property.[16] Accordingly, the trustee began efforts to sell the property, resulting in litigation with the debtor that cost the bankruptcy estate more than $30,000 in professional fees.[17] The trustee later discovered the post-petition loan modification and junior lien, which evidenced that there was about $15,000 less equity than originally believed.[18] The trustee asserted that if the pre-petition arrears or the post-filing transactions had been properly disclosed, the estate would not have incurred the professional fees.[19]

Following a storied procedural history in an adversary proceeding initiated by the trustee seeking damages under § 362(k) for the post-petition loan modification, the court allowed the trustee to amend his complaint to include a claim under § 105(a) for punitive damages for the alleged stay violation.[20] Subsequently, the parties jointly moved for mediation,[21] which resulted in a settlement approved by the court on June 28, 2021, by which time the debtor's home had been sold with proceeds held by the trustee.[22] The settlement provided that the mortgagee would release any lien on the sale proceeds, the mortgagee would receive no distribution in the bankruptcy case, and the mortgagee would pay the trustee $37,500.[23] Further, HUD would relinquish any claim against the bankruptcy estate and would cancel its junior lien.[24] The parties exchanged mutual releases, and the trustee would remit the debtor's exempt funds.[25]

What started as a good-faith attempt by the parties to permit the debtor to retain her home resulted in the debtor losing her home, the lender losing the debt it was owed and its lien, HUD losing the debt it was owed and its lien, and the lender paying out an additional $37,500. None of the intended parties benefited from the partial-claim process.

Lien-Stripping

Partial-claim liens are fair game for strip-offs. In jurisdictions that permit stripping off wholly unsecured liens, a chapter 13 debtor, for example, may seek to avoid a partial claim deed of trust through the application of §§ 506 and 1322(b)(2). Specifically, if the value of the real property is lower than the total amount of mortgage debt senior to the amounts owed under the newly created subordinate agreement, debtors can (and will) file for bankruptcy to employ § 506(d) to strip off the newly recorded subordinate deeds of trust. This process converts the secured partial claim for the COVID-19 forbearance amount into a dischargeable unsecured claim, with the lien to be voided at the end of the case.

Borrowers currently outside of bankruptcy may find bankruptcy relief an extremely attractive option for addressing the newly created lien after resolving a COVID-19 forbearance through the partial-claim process. For those debtors who have resolved the forborne amounts post-petition, depending on the amount of the partial claim, it will prove tempting to allow the case to be dismissed and refile a new case to avoid the lien. Given that 16 percent of homeowners (in or outside of bankruptcy) have utilized a COVID-19 forbearance,[26] this may be good business news for debtors' counsel.

Anecdotally, these actions thus far appear to be resolved with entities like HUD without the need for a contested adversary proceeding and accompanying published opinion. Albeit a consolation prize for its efforts, the creditor will still hold an unsecured claim to be paid pursuant to the chapter 13 plan, and the debtor will still need to complete the plan for the lien-stripping to remain effective.

Potential Bad-Faith Forbearance Requests

In re Ilyev[27] illustrates the unanticipated consequences from COVID-19 forbearances for chapter 13 debtors. In this case, the debtor was performing under a confirmed chapter 13 plan when the COVID-19 pandemic struck.[28] His plan required that he maintain monthly mortgage payments.[29] Unlike many debtors actually affected by the pandemic, the

10 *Id.* at 825.
11 *Id.*
12 *Id.*
13 *See id.* at 828-29.
14 Adv. P. No. 19-05172, 2020 WL 5807520, at *1 (Bankr. N.D. Ga. Sept. 29, 2020).
15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.*
19 *Id.* at *2.
20 *Id.* at *10. The court based its holding on the Eleventh Circuit's *Jove Eng'g Inc. v. IRS*, 92 F.3d 1539, 1554 (11th Cir. 1996), which observed that "the plain meaning of § 105(a) encompasses any type of order, whether injunctive, compensative or punitive, as long as it is 'necessary or appropriate to carry out the provisions of the Bankruptcy Code.'"
21 Joint Mot. for Mediation, *Gordon v. Wells Fargo Bank NA (In re Banks)*, Adv. P. No. 19-05172 (Feb. 16, 2021), ECF Doc. No. 51.
22 *See* Order Approving Settlement Agreement, *In re Banks*, Case No. 13-77274-LRC (June 28, 2021), ECF Doc. No. 129.
23 *Id.*
24 *Id.*
25 *Id.*
26 *See* Sánchez & Wilkinson, *supra* n.2.
27 Case No. 17-12987-KHK, 2022 WL 2965029 (Bankr. E.D. Va. July 26, 2022).
28 *Id.* at *1.
29 *Id.*

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debtor experienced no interruption in his employment as a systems administrator at a law firm.[30]

Nonetheless, the debtor requested and obtained a COVID-19 forbearance for a period of 18 months.[31] To cure the COVID-19 forbearance, the debtor (at the lender's request) filed a motion to approve a payment deferral of the forborne amounts.[32] The chapter 13 trustee opposed the motion and filed a motion to modify the debtor's chapter 13 plan to increase the base gross, asserting that the forbearance created a "substantial and unanticipated"[33] change in the debtor's financial circumstances.[34]

As it turned out, of the approximately $29,250[35] "relief" in his budget from the forborne payments, the debtor "spent $17,000 of the funds on his wife's education, child care and acting lessons for his step-daughter."[36] The debtor "claimed, with respect to the remaining $11,000 or so, that he has outstanding medical bills of $10,000."[37] The debtor "did not, however, provide any supporting documentation to the Trustee, nor did he present any evidence of such expenses at the hearing."[38]

30 *Id.* at *1-2 ("In fact, the Debtor did not present any evidence at the hearing that he was adversely affected by [COVID-19] at all. He is still employed by the law firm and does not appear to have suffered any decrease in income as a result of [COVID-19] (it is not clear to the Court why the Debtor applied for [COVID-19] relief in the first place).").
31 *Id.* at *1-2 ("[The] Debtor was not making mortgage payments from September 2020 to February 2022.").
32 *See id.* at *1-2, *4.
33 In the Fourth Circuit, the first step in reviewing a motion to modify under § 1329 is to determine whether "the debtor experienced both a substantial and unanticipated change in his post-confirmation financial condition." *See Murphy v. O'Donnell (In re Murphy)*, 474 F.3d 143, 150 (4th Cir. 2007).
34 *Ilyev*, 2022 WL 2965029, at *1-2.
35 *Id.* at *4.
36 *Id.* at *2.
37 *Id.*
38 *Id.*

Ultimately, the debtor withdrew at a hearing his motion for approval of the loss-mitigation option.[39] However, the damage had already been done: The forbearance had come to light, and the trustee's motion to modify remained. The court found that the debtor's forbearance was a change in circumstances justifying plan modification.[40] In granting the trustee's motion, the court directed the debtor to file a modified plan and instructed that "[t]he Plan does not have to recapture the entire $29,250, but it must be a good-faith effort to repay the lion's share of the funds to the Trustee."[41] Finally, the court admonished that failure to file an amended plan may result in dismissal of the case.[42] It remains unclear whether the debtor found the forbearance worth the effort in the end.

Practical Recommendations

With the COVID-19 pandemic creating a new avenue of loss-mitigation alternatives and its unintended consequences, litigation on some of these open issues will be sure to follow. Mortgagees must regularly monitor a mortgagor's bankruptcy filings and act with all haste to record the agreements and liens. A bankruptcy filing, as in most matters, requires the mortgagee to work within the confines of the Bankruptcy Code to exercise its rights, including seeking relief from the automatic stay where appropriate and timely seeking reaffirmation of debt where possible. As a result of these loss-mitigation efforts, neither mortgagor nor mortgagee may escape the consequences. Vigilance and caution are key. abi

39 *Id.* at *1.
40 *Id.* at *5.
41 *Id.* at *6.
42 *Id.*