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STORY BY // PATRICIA ANTONELLI, ESQ. AND THOMAS J. ENRIGHT, ESQ. EXCLUSIVE TO DS *News*

BANKRUPTCY IN REVIEW

Where the Danger is Great

In light of the subprime crisis, servicing practices of lenders in the bankruptcy context are coming under fire in the nation's courtrooms. Increased foreclosures have led to increased bankruptcy petitions as day leads to night, and more of both are expected.

FEROCIOUS BK RATES CALL FOR CAUTION

In spite of the prohibitions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), statistics from the Administrative Office of the U.S. Courts indicate a dramatic increase in bankruptcy filings from the significant decrease that initially occurred after BAPCPA first became effective in 2005.

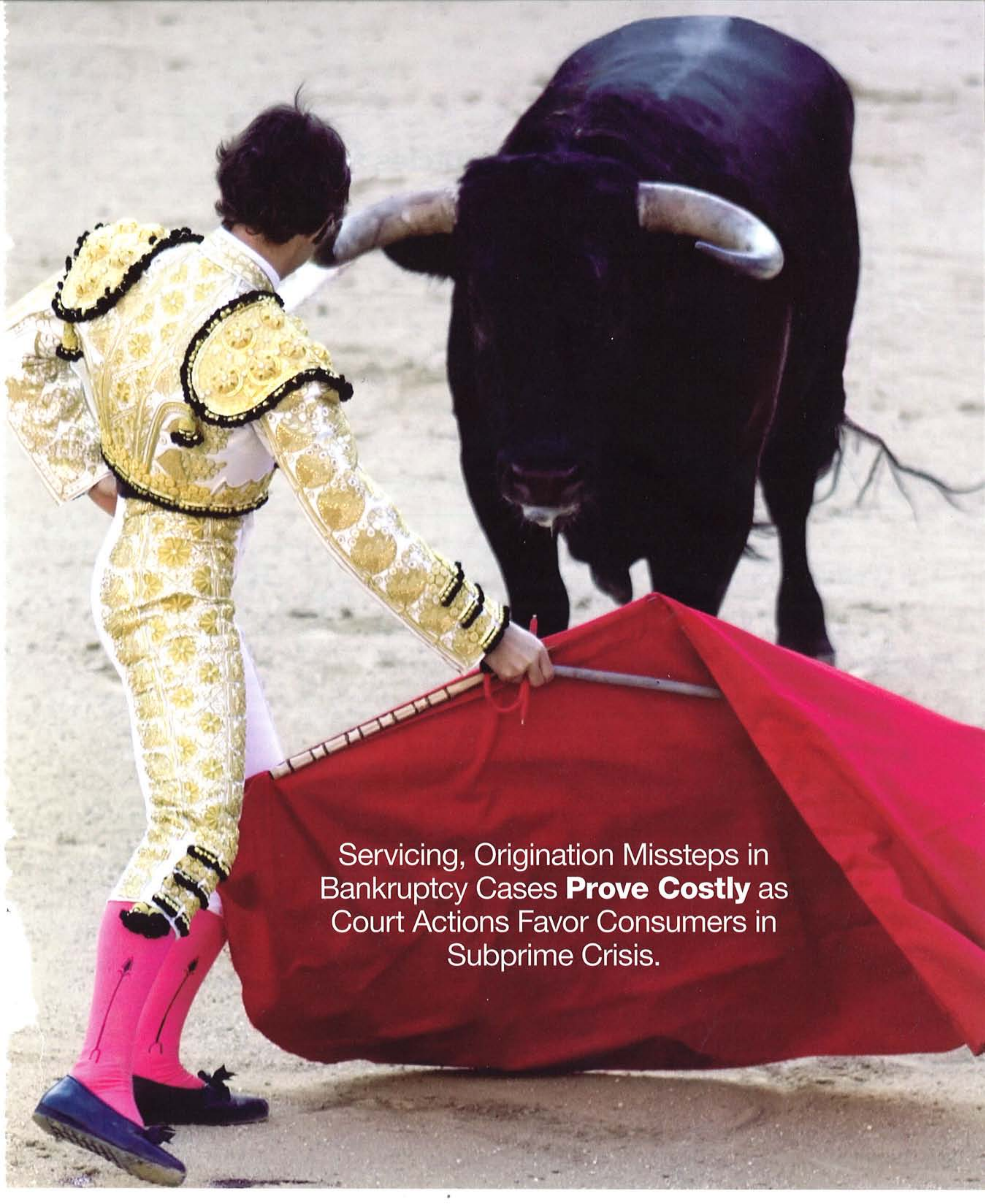
While many in the mortgage industry lived through the downturn in the real estate market in the late '80s and early '90s, the current decline in real estate values is affecting homeowners, as opposed to real estate speculators and investors, because the loosening of credit standards and introduction of so many exotic loan products allowed more consumers to become home buyers. With the subsequent tightening back up of credit and a decline in home values almost across the board, millions of Americans are faced with the prospect of losing their homes to foreclosure—a process that has become more difficult with sweeping legislation regarding bankruptcy cases filed on or after October 17, 2005.

The Cons of 'Protection'

These days, bankruptcy protection is considered more costly and difficult for consumers to obtain, a result that does not sit well with many bankruptcy judges, bankruptcy professionals, and consumer advocates, many of whom see the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) as providing creditors with preferential treatment at the expense of consumer and small business debtors. Provisions of the new law force consumer debtors to pay more in the way of legal fees, undergo credit counseling before filing, go through a means test to determine if they will be eligible for a discharge of their debts, and provide more detailed financial records. In consumer circles, the lobby for the banking and lending industry is widely credited with achieving what's perceived as an anti-consumer debtor statutory scheme.

The Uptick Continues

However, in spite of the prohibitions in BAPCPA, statistics from the Administrative Office of the U.S. Courts indicate a dramatic increase in bankruptcy filings from the significant decrease that initially occurred after BAPCPA first became effective in 2005. In fact, the statistics show a 48.3 percent increase in the number of cases filed in the first six months of this year, as compared with the number of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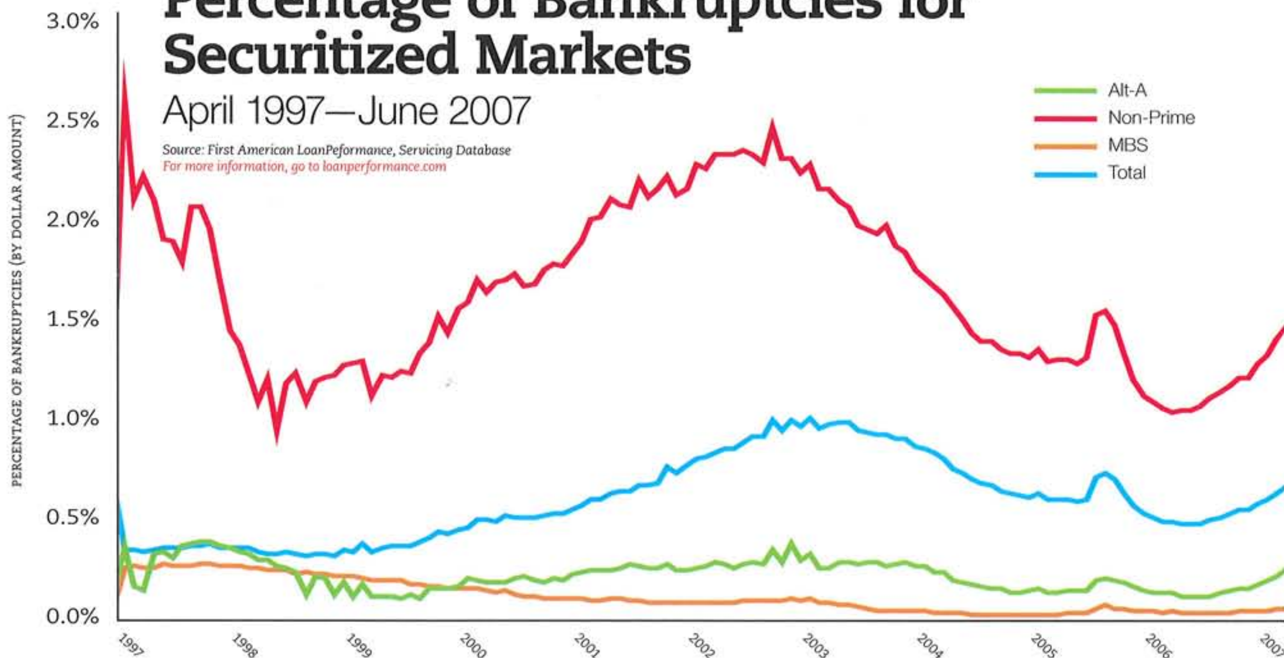

cases filed in the first six months of 2006.

The reason for bankruptcy's newfound popularity is clear. One of the most important tools at a consumer's disposal to stop or delay foreclosure proceedings is taking advantage of the ability to file bankruptcy, with its automatic stay that takes effect immediately upon a bankruptcy filing. The stay operates to prohibit creditors from taking any collection-related action, including foreclosure, the prosecution of lawsuits, the enforcement of judgments, and lien creation and enforcement. Bankruptcy is on the rise and becoming an option, if not a necessity, for many consumers again. In fact, many bankruptcy practitioners believe that the filing numbers will increase to pre-BAPCPA levels in the not-so-distant future.

No Quick Fix

As a result of the subprime crisis, the impetus for many consumers to file bankruptcy will be to attempt to save their homes. Although countless foreclosure sales were averted in the past five years or so without resorting to the bankruptcy-induced stay, the tightening-up of lending standards, coupled with the loss of a large portion of the mortgage finance sector, has resulted in the near extinction of those popular quick refinance loans and equity lines. Without such tools, consumers who are desperate to save their homes will be steered toward the bankruptcy courts and the brief but sometimes successful safe haven they provide. Those who have refinanced in the past several years may raise a variety of claims against their lenders and servicers. Those claims may include allegations that their current mortgage loans are the result of predatory lending tactics. Such claims may specify unfair and deceptive practice claims, Fair Debt Collection Practice Act (FDCPA) claims, Truth In Lending Act (TILA) claims, and your basic, run-of-the-mill "you should not have made this loan to me as you should have known that I would not be able to afford it" claims. A bankruptcy filing is a useful tool for the consumer as he or she can utilize the bankruptcy stay, stop foreclosure, and bring any of the above-mentioned claims by way of an adversary proceeding or an objection to claims procedure. Although lenders and servicers should expect to see a rash of these predatory-lending-type claims that center around loan origination and the related circumstances, origination practices are not the only area that will be under attack.

Paying the Price

Loans in default are always more costly to service, but for those that are being cured or dealt with in bankruptcy, the costs are even greater. Recent bankruptcy court decisions from across the country should serve to caution servicers just how costly servicing a mortgage loan in a bankruptcy case can be and how lenders and servicers can pay dearly for servicing mishaps.

In 1997, Jacalyn Nosek executed a $90,000 note to one of America's foremost residential lenders, secured by a mortgage on her Massachusetts residence. After falling behind on her mortgage payments, and facing foreclosure, Nosek sought the protections of the Bankruptcy Code and Chapter 13 provisions, which provide a mechanism for curing defaults through a bankruptcy plan. The suit claimed the servicer mishandled its treatment of Nosek's relevant payments, and that in contravention of the Bankruptcy Code's mandates, the servicer would apply the funds to the oldest outstanding contractual obligation due on the note.

Ultimately, Nosek sought to refinance the loan with another lender while in bankruptcy. The new lender required a payoff statement as well as a payment history from the current lender. The payment history that was provided failed to accurately represent the payments Nosek had made. The court found

several flaws with the servicer's accounting system and an overall failure to properly and timely account for payments. The servicer had utilized a legally questionable suspense account system from which it failed to timely post payments; and the payoff information that was generated gave the impression that Nosek was delinquent in her payments when, in fact, she was not.

Although these types of servicing errors are not particularly uncommon in bankruptcy cases, the penalty handed down was. The Bankruptcy Court was outraged by the actions of "one of the largest and oldest home mortgage lenders and loan servicers in the U.S." Ultimately, Nosek was awarded $250,000 in emotional distress damages and $500,000 in punitive damages.

The servicer argued that Chapter 13 did not require it to change its accounting procedures and that under the Nosek decisions, servicers would be forced to constantly monitor each debtor's bankruptcy case, readjust their internal accounting, and continually recalculate how payments should be applied. In imposing the penalty, the Court responded "[t]hat is exactly the point; [the servicer] must adjust its accounting practices because of Nosek's bankruptcy. The Bankruptcy Code is not a cafeteria; lenders do not decide which of its provisions apply to them. Once a debtor files for Chapter 13, the Bankruptcy Code, and only the Bankruptcy Code, dictates the protections ... afforded to the lender and the obligations required of them." The bankruptcy court's ultimate $750,000 award was appealed to the U.S. District Court, which affirmed the award on June 27, 2007. The matter has been appealed to the First Circuit Court of Appeals.

Order of the Courts

Massachusetts is not the only state whose bankruptcy courts have recently scrutinized servicing practices. On July 24, 2007, the bankruptcy court for the Southern District of Texas issued an order in *In re Sanchez* denying the servicer's motion for summary judgment in an adversary proceeding wherein the plaintiff debtors made numerous claims alleging wrongdoing on the part of the servicer. The allegations included the misapplication of payments, the mis-use of forbearance agreements, and the use of a suspense account, and questioned the legality of the servicer's payment of unpaid real estate taxes, which the bankruptcy court characterized as "the defendant's purchase of plaintiffs' tax claims without this court's approval." Trial has been scheduled for December 2007.

Decisions also came down this spring from the Southern District of Texas Bankruptcy Court, where in the case of *In re Campbell*, the bankruptcy court ruled that the servicer had willfully violated the automatic stay when it required the Campbells' monthly post-petition escrow payment to include the amount needed to pay the Campbells' 2006 real estate taxes, instead of including the 2006 tax amount in its proof of claim. Also at issue was the computation of figures in the servicer's proof of claim, inspection fees, and attorneys' fees. A direct appeal of the decision has been taken to the Fifth Circuit Court of Appeals.

In September 2006, in the case of *In re Thompson* from the Eastern District of Wisconsin's bankruptcy court, bankruptcy Judge Susan V. Kelly began her decision by writing, "Is it too much to ask a consumer mortgage lender to provide the debtor with a

clear and unambiguous explanation of the debtor's default prior to foreclosing on the debtor's house?" In ordering the servicer's claim reduced by $1,000, plus assessing $7,500 for payment of the Thompsons' legal fees, the court stated, "The debtors should not have been required to file another bankruptcy proceeding, object to [the servicer's] claim, and appear at numerous hearings, just to learn the correct status of their mortgage account." The $8,500 sanction apparently did not completely resolve the matter, however, as a review of the case docket shows an amended order reducing the sanction from $8,500 to $7,500, but that reduction was followed by the filing by the Thompsons of two letter motions (they are pro se debtors and thus not represented by counsel) seeking additional sanctions for the servicer's failure to comply with the court's orders. An evidentiary hearing is scheduled for October 2007.

This recent judicial scrutiny was not without warning. For several years, bankruptcy judges have routinely taken issue with the practices of servicers. In the 2003 case *In re Riser*, the bankruptcy court for the Middle District of Florida sanctioned a loan servicer $23,076.28 for Riser's missed work, time spent contacting the servicer, and Riser's attorney's fees resulting from an approximate $11,000 discrepancy between the actual mortgage debt owed to and the amounts set forth on the mortgage statements.

More than five years have passed since the case of *In re Maxwell*, a Massachusetts bankruptcy court decision. The debtors executed a note, which was then refinanced with the same lender. As a result, the annual payments on the refinanced loan totaled 98.5 percent of the combined income of the debtor and her granddaughter. The servicer of the loan at the time of bankruptcy was not the original lender or servicer and had never received any payment history for the loan from its predecessors. The servicer's testimony in court was that it was determining the amounts due by whatever information it could obtain from its computer. Moreover, the servicer failed to submit any

SIDEBAR

Within Reason —Or Not?

Trends in Recent Bankruptcy Court Rulings Realign Reasonableness of Borrowers' Fees and Costs

STORY BY // JANE FAIA MENTZ, ESQ.

The ever-increasing national trend of defaults continues to present issues for lenders to grapple with, particularly if the debtor files a Chapter 13 bankruptcy. So great is the number of loans in default that it has even caught the attention of Capitol Hill. Congress is considering various proposals regarding what to do about the growing rate of delinquencies. According to the Mortgage Bankers Association's latest National Delinquency Survey, the delinquency rate for mortgage loans on one-to-four-unit residential properties stood at 5.12 percent of all loans outstanding in the second quarter of 2007, 73 basis points higher than the delinquency rate recorded during the same period last year. Many in the industry are anticipating the increase in bankruptcies as the number of foreclosures continues to swell.

Yesterday vs. Today

Chapter 13 bankruptcy used to be a win-win for both the debtor and the lender. The debtor was offered the opportunity to save his or her home from foreclosure by formulating a plan of reorganization that provided for a series of payments usually over a period of time, which could be as long as five years, to cure his delinquent mortgage payments. Both parties were focused on a plan, which would obtain the desired result, that the debtors' loan would be current upon conclusion of the plan and discharge of the bankruptcy. With regard to same, the lender was able to include amounts in its proof of claim and/or have the debtors incorporate language in the plan to cover expenses incurred prior to the filing of the bankruptcy petition and those anticipated during the plan. These myriad fees included attorney foreclosure fees and costs, if same had been initiated, as well as attorney's fees for preparation of a proof of claim and/or the objection to the confirmation of the plan. Additional amounts were also included for such items as any escrow advances, appraisals, property preservation costs, and property inspection fees. The actual amounts and enumeration in the lender's proof of claim was rarely scrutinized, much less challenged. Further, if same were not included in the debtors' plan, an objection to the confirmation of the plan usually resulted in an amended plan.

The More Things Change

A recent decision in the Eastern District of Louisiana United States Bankruptcy Court demonstrates a shift in the handling of these types of fees, costs, and charges, in a Chapter 13 bankruptcy. In the past, courts rarely scrutinized lenders' inclusion of such items and the necessity to charge borrowers' accounts with these costs. Lenders previously enjoyed a "hands-off" approach by the courts and were allowed a sort of self-rule of reasonableness in decision making as to what could be charged to a debtor's account. However, as evidenced by *Jones v. Wells Fargo Home Mortgage, 366 B.R. 584* (2007), such a practice is developing into one that is not quite so lender-friendly; now courts are asking the lenders to explain the reasonableness of the expenses they are charging borrowers' accounts. In particular, courts are requiring that lenders provide a detailed description regarding services performed, time spent, or amounts charged before determining whether these fees and charges are

evidence that it maintained any procedures for servicing loans. The demand letters and other correspondence sent to Maxwell contained what the court labeled as "wildly divergent figures it concocted." The servicer, the court wrote, "in a shocking display of corporate irresponsibility, repeatedly fabricated the amount of the [Maxwell's] obligation to it out of thin air." The court ultimately found the loan to be unconscionable and assessed liability, the result of which would be rescission at trial. Before a full trial ensued, Maxwell settled, requiring the servicer to not only discharge the mortgage, but it also had to pay the plaintiff $125,000.

In re Hart is still another case where servicing practices were at odds with those required by the Massachusetts bankruptcy courts. The court found the servicer's loan audit department had notified Hart that he was obligated to repay a negative suspense amount without indicating it was attempting to collect a debt; couched its demand for payment by presenting three options to Hart for repayment of the suspense; and included in the letter, which lacked legally mandated disclosures, were material misrepresentations as to the existence, character, and legal status of the debt. The servicer's collection department also ignored Hart's requests for clarification on where to send his payments, provided him with conflicting instructions, and sent correspondence from four different departments. The servicer subsequently misapplied his payments and proceeded with foreclosure after being advised that Hart had actually complied with his obligations under the forbearance agreement and after its attorneys had also been provided with proof of payment. The court awarded Hart actual damages, which included damages for mental anguish and frustration, along with statutory damages, and attorneys' fees. In so holding, the court found that the servicer had "in effect, abandoned the debtor, the consumer, to the ambiguities and vagaries of its computer system and muddled internal operations."

The decision was appealed to the United States District

reasonable, should have been incurred, and whether they should be included in amounts due and owed by the debtors.

Once the debtor initiates a complaint about the fees assessed by the lender, the burden of proof then shifts to the lender to provide documentation of fees and costs and reasonableness of same. A court will not unilaterally look into a lender's actions unless the debtor alleges that the lender improperly incurred expenses as to a borrower's loan, which in turn would result in payments that were more than what is recoverable. Only then will a court look to Bankruptcy Rule 2016(a), which requires that an entity seeking compensation for services, or reimbursement for expenses, file an application setting forth a detailed statement of (1) the services rendered, time expensed, and expenses incurred, and (2) the amounts requested. This requires that the lender provide not only an accounting of all the services rendered, but also an explanation of why these expenses were necessary and reasonable.

Court Says No to Wells Fargo

A mortgage traditionally provides that the lender or its agent may charge a borrower for such costs that are necessary in order to protect the lender's interest in the property, which would include reasonable inspections of the property. While the judge's opinion in the Jones case may impact lenders and servicers on several fronts, it is not yet clear, as to the matter of expenditures of amounts and what the lender must show to be entitled to recovery of same. In Jones, Wells Fargo ordered the inspection of the property on 14 consecutive occasions, regardless of the fact that each of these inspections resulted in reports showing that the home was maintained in "good" or "fair" condition. The borrower in Jones asserted that such inspection fees were unreasonable and excessive, having been imposed on a continuous monthly basis without any foundation for requiring same. Wells Fargo attempted to argue that these inspections were reasonable due to the borrower's default on the loan and concern that the property would be poorly maintained. However, when questioned further, Wells Fargo stated that these inspections were in fact discretionary and their frequency may vary depending on the circumstances. Simply, Wells Fargo failed to justify the reasonableness of its inspection fees. The court held in part that given a failure by the lender to explain the necessity of the services or their reasonableness, such charges may not be assessed against a debtor's account. The right to collect "unreasonable fees" is not inherent in the underlying mortgage loan agreement and, as ruled by the court, is not permitted.

A Changing Chapter

The Jones case addresses many issues and has only been discussed as to this particular issue. Additionally, it is one of the few cases that has been reported regarding this issue; however, it is not an isolated case. This issue has become one that debtors are consistently raising as objections to a proof of claim or in a response to an objection to a confirmation of a plan. It is prudent and should become a routine practice that upon referral of a Chapter 13 bankruptcy case, all supporting documents as to the amounts claimed as due and owing by the debtor, excluding principal, interest, monthly payment amounts, and late charges, should be forwarded to counsel. It has become routine for debtor's counsel to demand copies of paid invoices, which as a practical matter is often impossible for a servicer to produce on a single loan transaction. However, if any such copies are available, or copies of invoices are available, they should be attached and utilized as an exhibit to the proof of claim.

The courts appear to be attempting to not only qualify what is reasonable, but they have appeared to go a step further in unreported cases to address what should be considered a cost of doing business by mortgage servicers and what should actually be recoverable from debtors as a necessary charge to their account for which they should be liable. There is no doubt that lenders should be cognizant of the trends and prepare accordingly. Attorneys are consistently asked to give opinions as to what is recoverable in bankruptcies, and in light of Jones, the answer has become more objective, requiring lenders to be prepared to document fees and costs and reasonableness of same. DS

Court, where the servicer was unable to find a sympathetic ear. Judge Stearns of the District Court affirmed the award of $1,000 in statutory damages, $3,000 in emotional damages, and $68,680.06 in attorneys' fees and costs. Judge Stearns' opinion neatly summarizes the issue presented in the Hart case: "This case arose out of defendants' relentless efforts to foreclose on a debt not due."

Breaking It Down

What these decisions make clear, especially those handed down within the last year, is that servicers nationwide will do well to heed the warnings and directions of judges. As Bankruptcy Judge Hardin in the Southern District of New York forewarned in the cases of *In re Gorshtein*, *In re Abreu*, and *In re Saunders*, each case involving different lenders and servicers, "Secured creditors and their counsel would be well advised to exercise due care in moving for stay relief; to examine, distinguish between, and provide details of pre-petition arrears, if any, and post-petition arrears, late fees, escrow payments, attorneys' fees, or other charges; to determine whether any post-petition payments actually received by check, money order, or electronic transfer have not been credited to the debtor's account because, for example, the payments were erroneously applied to pre-petition arrears or were held or deposited in a suspense account or returned to the debtor ... "

In the years to follow, servicers must adapt to the demands placed upon them by the courts, because as Judge Hardin put it, excuses by servicers for non-compliance such as a "defective computer system" or a missed decimal point, are beginning to be considered "explanations ... of the 'dog ate my homework' variety."

Considering the increased volume of defaulting borrowers seeking bankruptcy protection and the problems inherent with the modification of accounting practices, adaptation will be difficult and costly. But if a lesson is to be taken from the recent judicial trend, it is that the alternative to compliance may be far more frightening. DS

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