Impacts of Bankruptcy on the Mortgagee

Bankruptcy: Key Policies

• Individuals facing crushing debts may be unable to reorganize their financial affairs
  • Judgment liens would have lingering impact on access to credit that could prevent an individual from getting a “fresh start”
• Distressed business may have “going concern” value that is lost if business is “dismembered” by creditors exercising collection remedies
Chapter 7 Bankruptcy

• Chapter 7 is liquidation bankruptcy (businesses and individuals)
  • Debtor must surrender ALL of its nonexempt assets
  • Trustee sells these assets and uses sale proceeds to pay off creditor claims (typically at a discount, b/c debtor is insolvent)
  • Debtor then receives a discharge of any unpaid pre-bankruptcy debt (“fresh start”)

Chapter 11/12/13 Bankruptcy

• These chapters provide for “reorganization” bankruptcy
  • Ch. 11: businesses (incl. individuals)
  • Ch. 12: family farmers
  • Ch. 13: individual wage-earners
Chapter 11/12/13 Bankruptcy

• Reorganizing debtor keeps its pre-bankruptcy assets and puts together a “plan” for repaying its pre-bankruptcy debts
  • If court confirms this “plan,” the plan replaces the debtor’s pre-bankruptcy contracts with its creditors
  • This process gives debtor “space” and “time” (protection from collection efforts) to get back on its feet, protecting the “going concern” value of business debtors

• Uphoff owns home worth $150K
  • Bank has mortgage (debt = $100K)

• Uphoff defaults, Bank forecloses
  • November 1: foreclosure sale held
  • Litton purchased home at the sale for a price = $120K

• Also on Nov. 1: Uphoff filed Ch. 7 bankruptcy petition. What’s the effect on the foreclosure sale, if any?
• § 362(a): petition = injunction against creditor collection activity
  • (1) can’t sue on or enforce debt that arose pre-bankruptcy
  • (2) can’t enforce judgment obtained before bankruptcy
  • (3) can’t repossess or control property of the estate or debtor
  • (4) can’t perfect or enforce lien vs. estate property (e.g., can’t record or foreclose mortgage after bankruptcy petition is filed)
  • (6) can’t take any other action to collect pre-bankruptcy debt (e.g., dunning letters, sending bills, etc.)

The
“Automatic Stay”

• If Uphoff had filed his bankruptcy petition before the foreclosure sale took place, then the sale was stayed [§ 362(a)(4)], and had no legal effect
  • If land was still owned by Uphoff at time of bankruptcy petition, it became “property of the estate” [§ 541(a)]
  • Litton must turn over the home to trustee [§ 542(a)]
    (Litton’s BFP status is irrelevant)

• But if sale had already become final, home did not become property of the estate, and Litton has title
  • Whether sale had become “final” is question of state law
Problem

- Suppose the sale occurred and became final BEFORE Uphoff filed his bankruptcy petition
- Also suppose that under state law, there is a right of post-sale statutory redemption for mortgagor
  - This statutory redemption right would become property of the bankruptcy estate [§ 541(a)]
- Should Trustee exercise this redemption right?

- Trustee will exercise the redemption right only if there “equity” in the home (if the home’s value exceeds the balance of any valid liens on it)
- If Trustee redeems, then sells the home, proceeds must first be paid to persons holding valid liens
- Trustee thus won’t want to take back the home (and spend time trying to sell it) if there’s nothing there for general creditors
  - Thus, trustee “abandons” any property that has no value to the estate [§ 554]
Bankruptcy and Secured Parties

• Bankruptcy generally respects state law liens (e.g., mortgage, Article 9 security interest)
  • Liens “survive” the bankruptcy petition (i.e., they remain valid against the collateral)
  • This respects a secured creditor’s state law priority over unsecured/junior creditors
• But, the automatic stay blocks action to enforce lien, except as approved by bankruptcy court

Questions for Mortgagees

• Can the Mortgagee get “relief” from the stay and be allowed to complete foreclosure under state law?
• How, when, and how much does Mortgagee get paid in bankruptcy process?
• Can the Trustee or the Debtor invalidate a mortgage lien, or modify or change the mortgage terms over the Mortgagee’s objection?
**Problem**

- Uphoff owns home, subject to mortgage held by Bank
  - Mortgage balance = $100K
  - FMV of home = $150K
- Uphoff defaults, but files a Chapter 7 petition before Bank can foreclose
- Bank files a motion for relief from the stay to be allowed to foreclose the mortgage
- Should motion be granted?

**Relief from the Automatic Stay**

- Mortgagee can file motion for relief from stay; if granted by court, mortgagee can foreclosure
- Standards for relief are set forth in § 362(d)
  - (1) For “cause,” including lack of “adequate protection” of security interest
  - (2) Debtor lacks equity in the collateral, and the collateral is not “necessary for an effective reorganization” of debtor
Relief from Stay: § 362(d)(2)

• Bank not entitled to relief under § 362(d)(2), because Uphoff has “equity” in the home
  • A state law foreclosure sale might bring << $150K FMV
  • That would threaten (a) Uphoff’s exemption rights in his home, and/or (b) the interests of unsecured creditors (who have claims against nonexempt equity in home)
  • Liquidation should thus happen under supervision of bankruptcy court, to protect that equity

Relief from Stay: § 362(d)(1)

• Court will not conclude that Bank lacks “adequate protection” of its mortgage lien, because Bank has an “equity cushion”
  • Bank is an “oversecured” creditor [§ 506(a)] (its collateral has value >> debt balance)
  • Collateral is not *depreciating in value (if it was at such a risk, Bank would lack adequate protection)*
Relief from Stay

• Rationale: delay in enforcement is not sufficient harm to constitute “cause” for relief from stay, unless delay is threatening the value of the collateral
• But note: if Debtor is not making mortgage payments, Bank is not collecting its bargained-for interest!
• Thus, should the bankruptcy court order Debtor to make interest payments during bankruptcy to keep the benefit of the stay?

§ 506. Determination of secured status

(a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property ..., and is an unsecured claim to the extent that the value of such creditor’s interest ... is less than the amount of such allowed claim....

(b) To the extent that an allowed secured claim is secured by property the value of which ... is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement … under which such claim arose.
• In the Problem, Bank is an “oversecured” creditor, and thus is entitled to have interest accrue on its secured claim during the pendency of the bankruptcy case [§ 506(b)]
• Either:
  • Debtor must pay this interest to Bank while Debtor remains in bankruptcy (in which case Bank’s secured claim remains at $100,000), or
  • If Debtor does not pay it during bankruptcy, it is added onto the amount of the Bank’s secured claim

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Bifurcation of Undersecured Claims

• § 506(a) bifurcates Bank’s undersecured claims (i.e., it treats Bank as having 2 separate claims)

• Bank’s claim vs. Uphoff is a secured claim to extent of the value of the land ($100,000)
  • Bank retains its lien to secure payment of this claim

• But the rest of Bank’s claim ($50,000) is unsecured
  • This claim will be paid along with other unsecured creditors, from any available nonexempt assets
  • In Ch. 7, this means zero, or “pennies on the dollar”
Is Bank Entitled to Interest on Its Secured Claim?

• No
  • Bank is not oversecured, so its secured claim is not entitled to accrue interest [Timbers, § 506(b)]
    • “Adequate protection” does not require payment of interest on secured debt
  • Bankruptcy Code disallows claims for unmatured (“post-petition”) interest [§ 502(b)(2)], except as allowed by § 506(b)

How would Uphoff’s Chapter 7 Trustee respond to the Bank’s motion to lift the automatic stay?

• Trustee will not care and will not object to this motion
• There is no equity in the home that could benefit unsecured creditors, so Trustee will not want to keep any interest in the home (which Trustee would have to insure/maintain)
• Trustee will “abandon” home [§ 554], motion to lift stay will be granted
Ch. 7: Undersecured Mortgagee

• Because Uphoff has no equity in the home, and Ch. 7 involves liquidation, not “reorganization,” court should grant relief, let Bank foreclose [§ 362(d)(2)]

• But note: if Uphoff isn’t in default (if he has kept making his mortgage payments), Bank will probably let Uphoff continue making the payments rather than foreclose

• Can you explain why?

Ch. 7: Undersecured Mortgagee

• Note: If Bank does obtain relief from stay and does foreclose, and does sell the land for $100,000 (its FMV), Bank can’t recover a deficiency vs. Uphoff for the other $50K

  • Ch. 7 will likely discharge Uphoff’s liability on the debt (Bank will get paid on its unsecured claim only if trustee finds assets to distribute to unsecured creditors)

  • Thus, Bank is better off if Uphoff keeps paying
Trustee’s Avoiding Powers

• The trustee (or the debtor-in-possession in a Ch. 11 case) has the power to avoid, i.e., to invalidate, certain pre-bankruptcy transfers
• Rationale: trustee (or DIP) should be able to set aside transfers of the debtor’s property that either did diminish (or could have diminished) the estate and thus injured (or could have injured) general creditors

Trustee’s Strong-Arm Power

• § 544(a)(3): trustee/DIP can avoid any transfer of an interest in the debtor’s real estate that could’ve been avoided by a BFP of the debtor’s land under otherwise applicable law
  • Under state recording acts, a BFP of land takes free of an unrecorded mortgage
  • Thus, if mortgagee failed to record its mortgage prior to bankruptcy, trustee/DIP can invalidate it
Fraudulent Transfers

• Under state law, an injured creditor can void a transfer of property by the debtor that is either actually or constructively fraudulent
  • **Actual**: debtor had specific intent for transfer to hinder, delay, or defraud creditor(s)
  • **Constructive**: debtor received less than “reasonably equivalent value” in exchange for transfer, and debtor was either (a) insolvent at time of transfer or (b) became insolvent as a result of the transfer

• Classic fraudulent transfer: transfer by debtor in anticipation of judgment
  • E.g., Uphoff’s negligence injures Bailey, who files lawsuit vs. Uphoff
  • Before Bailey can get a judgment, Uphoff deeds his home to his son, via gift (son lets Uphoff stay in home)
  • Bailey can set aside Uphoff’s deed to his son as an actually fraudulent transfer (as Uphoff’s intent was to prevent Bailey’s anticipated judgment from attaching to the home)
• Another classic fraudulent transfer situation in bankruptcy: debtor transfers property for less than its fair market value, just prior to bankruptcy
  • E.g., Uphoff anticipates filing for bankruptcy because of unmanageable gambling debts
  • Prior to bankruptcy, Uphoff deeds his home (worth $300K) to son, who pays off $150K mortgage
  • Uphoff then files for bankruptcy
  • If deed stands, Uphoff’s creditors are harmed (Uphoff’s net worth was reduced by $150K)

Fraudulent Transfers in Bankruptcy

• Trustee in bankruptcy has power to set aside any pre-bankruptcy transfer of property by the debtor that was either actually fraudulent [§ 548(a)(1)] or constructively fraudulent [§ 548(a)(2)]
  • Trustee can “reach back” to avoid a fraudulent transfer that occurred up to 2 years prior to bankruptcy filing [§ 548(a)]
Pre-Bankruptcy Foreclosure Sale

• Suppose that a pre-bankruptcy foreclosure sale brought a sale price of only $100K, even though the fair market value of the land was $200K?

• After petition is filed, can trustee/DIP set aside the foreclosure sale as a constructively fraudulent?

• Pre-1994 (Durrett): if foreclosure sale price > 70% of FMV, sale price is “reasonably equivalent value” for purposes of § 548
  • If < 70%, trustee can set aside foreclosure sale if debtor was insolvent at time or was rendered insolvent by sale

• BFP: If foreclosure sale was “regularly conducted” and not “collusive,” sale price is conclusively presumed to be “reasonably equivalent value,” and thus trustee cannot avoid foreclosure sale as a fraudulent conveyance, regardless of land’s actual value
• Rationale 1: conclusive presumption encourages “finality” of foreclosure sales
  • Don’t want to encourage collateral attack on foreclosure sales, for fear of discouraging bidding (which would generate lower sale prices)
• Rationale 2: federalism concerns; if sale was not avoidable under state law, why allow avoidance in bankruptcy?
  • BFP presumption won’t apply if sale was defective, so trustee will look for procedural issues with sale