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When a Borrower Files Bankruptcy

As any mortgage lender or servicer is aware, the automatic stay[1] provisions contained in Section 362(a) of the U.S. Bankruptcy Code (herein "the Code"), 11 U.S.C. §§ 101, *et seq.*, provide eligible debtors,[2] and most notably individual homeowners, with a powerful weapon in stopping a foreclosure sale. In the short term, the lender will want to ensure that it complies with the automatic stay by halting any scheduled foreclosure, preventing telephone calls and notices of default, and otherwise canceling any activities to collect the debt or recover the collateral.

Although courts differ about the level of willfulness required to recover damages for a violation of the automatic stay, whether debtors can recover damages for emotional distress,[3] or whether there is a duty to attempt to mitigate before filing a motion for sanctions or contempt,[4] in general, once a creditor has "knowledge" of the bankruptcy filing, any act to recover a pre-petition claim of the debtor will be considered a violation of the automatic stay.[5]

This is true even if there is no actual intent by the creditor to violate the automatic stay or if the creditor in good faith believes in the propriety of its actions.[6] Therefore, creditors have an obligation to adopt policies and procedures to minimize and prevent violations of the automatic stay, including the prevention of computer-generated collection notices being sent to debtors in bankruptcy. Actual damages, attorneys' fees, and punitive damages (in appropriate circumstances, such as when a pattern of conduct is established) may be awarded where creditors ignore this responsibility.[7]

In the long term, the lender should ensure not only that its collateral is preserved, but also that it receives payments on the mortgage, and sets up appropriate bankruptcy processing for the loan. Bankruptcy courts around the country have held that lenders have a duty to adjust their accounting practices to recognize and accommodate a borrower's bankruptcy filing.[8]

For example, since a debtor under Chapter 13 is permitted to cure a default under a mortgage by paying the pre-petition arrears through the plan of reorganization and making the ongoing or post-petition payments directly to the servicer (or through the trustee - the growing trend),[9] servicers must use separate tracking during the pendency of a debtor's Chapter 13 case for pre- and post-petition debt to ensure that the due dates for post-petition mortgage payments are not calculated together with pre-petition debt.[10] In addition, servicers must "zero out" a borrower's escrow account upon the filing of a bankruptcy case, and servicers must limit post-petition escrow shortages to post-petition escrow liability.[11] In other words, because a servicer's proof of claim in connection with a debtor's plan of reorganization is intended to resolve the debtor's pre-petition default, including any pre-petition escrow deficiency, the lender should determine the status of an escrow account by assuming that the debtor has made or will make all defaulted pre-petition payments through the bankruptcy plan.

As a practical matter, servicers should apply trustee payments to pre-petition escrow shortages first in an effort to prevent improper payment increases. Furthermore, servicers should apply funds in suspense as soon as sufficient funds have accumulated to satisfy a full payment.[12] Accumulation of excess funds in suspense could result in premature referrals for motions for relief from the automatic stay, or an improper assessment of late fees.[13]

Courts have held that internal bookkeeping errors or improper handling of debtor payments and trustee disbursements (e.g., incorrect accounting or processing of suspense or escrow accounts) that result in inaccurate payment changes or collection attempts violate the automatic stay (during a bankruptcy case) or violate the discharge injunction (after the debtor has been granted a discharge).[14] For example, a servicer violates the discharge injunction when, due to errors in accounting or the improper handling of debtor payments or trustee disbursements, default or foreclosure notices are sent post-discharge or the servicer increases the debtor's regular monthly payment post-discharge.[15]

For this reason, servicers should schedule an audit and reconciliation of the mortgagor's account at least ninety (90) days prior to the discharge date so the lender may discover and address any discrepancies in post- and pre-petition debt prior to the discharge. In addition, servicers should file a quick response to any plan provisions that automatically deem a mortgage current as of discharge,[16] as well as debtor or trustee motions filed shortly before discharge that declare all defaults under the mortgage cured, or otherwise deem the mortgage current as of discharge.

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1. *See In re Flores*, 291 B.R. 44, 49 (Bankr. S.D.N.Y. 2003)("The automatic stay is the essential mechanism by which the debtor is afforded protection of his property and time to accomplish the objectives of the Bankruptcy Code for the benefit of both the debtor and all creditors.").

2. *See, e.g., Casse v. Key Bank Nat'l Ass'n (In re Casse)*, 198 F.3d 327, 342 (2d Cir. 1999)(After dismissal of prior Chapter 11 case "with prejudice" on basis of debtor's bad faith serial filings, bankruptcy court was justified in treating debtor's subsequent Chapter 13 filing as void *ab initio*); *Rowe v. Ocwen Federal Bank & Trust (In re Rowe)*, 220 B.R. 591, 595 (E.D. Tex. 1997)("Debtor who filed a fifth, successive Chapter 13 petition, less than 180 days after dismissal of prior case with prejudice to debtor' refiling, was not an eligible debtor under the Bankruptcy Code, and could not assert the statutory rights accorded to such eligible debtors to an evidentiary hearing before their Chapter 13 cases are dismissed."), *aff'd without published opinion*, 178 F.3d 1290 (5th Cir. 1990); *In re Lami*, 2003 WL 262484, at *2 (Bankr. E.D. Pa. Jan. 2. 2003)(unpublished)(the automatic stay did "not attach" when debtor filed his new petition after dismissal of his eighth bankruptcy case for willful failure to comply with the order requiring documents to be filed and properly prosecute the prior case). *But see Flores*, 291 B.R. at 47, 52-62 (Bankr. S.D.N.Y. 2003)(refiling within 180 days of dismissal under § 109(g) is not void and does invoke automatic stay); *Shaw v. Ehrlich*, 294 B.R. 260, 265-67 (W.D. Va. 2003)(Automatic stay arose upon the filing of the debtors' Chapter 13 petition, regardless of whether the debtors, whose noncontingent, liquidated debts exceeded statutory ceiling, were eligible for Chapter 13 relief.).

3. Compare *Aiello v. Providian Fin. Corp.*, 239 F. 3d 876 (7th Cir. 2001)(debtors can only "piggyback" claims for emotional distress if they have suffered financial injuries) with *Fleet*

Mortgage Group v. Kaneb, 196 F.3d 265 (1st Cir. 1999)(emotional distress damages qualify as "actual damages" under § 362(h)).

4. Compare *Shadduck v. Rodolakis*, 21 B.R. 573, 585 (D. Mass. 1998)(courts have ruled that attorney's fees are insufficient to satisfy the damages element of § 362(h) unless the debtor attempts to resolve the dispute prior to filing a motion for contempt and sanctions); *In re Brock Utils. & Grading, Inc.*, 185 B.R. 719 (Bankr. E.D.N.C. 1995) with *Price v. Pediatric Academic Assoc., Inc.*, 175 B.R. 219 (S.D. Ohio 1994)("it is improper to impose a blanket rule on all debtors requiring them to notify creditors to try to resolve the violations prior to filing a contempt motion").

5. 11 U.S.C. § 362(a)(6).

6. *In re Ryan*, 156 B.R. 321 (Bankr. M.D. Fla. 1993), *affirmed in part, remanded in part*, 183 B.R. 288. *See also In re Kilby*, 100 B.R. 579 (Bankr. M.D. Fla. 1989) (willfulness requirement supporting recovery of damages for violations of stay refers to deliberateness of conduct and knowledge of bankruptcy filing, not to specific intent to violate court order); *In re Grau*, 172 B.R. 686 (Bankr. S.D. Fla. 1994) ("willful" violation of stay, for which damages may be awarded, does not require intent to violate specific provisions of Bankruptcy Code, but mere deliberateness of conduct coupled with knowledge of debtor's bankruptcy filing); *In re Alberto*, 119 B.R. 985 (Bankr. N.D. Ill. 1990) (creditor acts in "willful" violation if stay, so as to be liable for damages, when creditor acts deliberately with knowledge that act is in violation of stay); *In re Seal*, 192 B.R. 442 (Bankr. W.D. Mich. 1996) ("willful violation" of automatic stay, for which actual damages must be awarded, does not require specific intent to violate stay; it is enough that defendant knew of automatic stay and that creditor's actions violating stay were intentional); *In re Meis-Nachtrab*, 190 B.R. 302 (Bankr. N.D. Ohio 1995) ("willful violation" does not require specific intent to violate automatic stay); *In re Walker*, 168 B.R. 114 (E.D. La. 1994) (willfulness of automatic stay provision is not measured by specific intent to violate court order; it merely speaks to deliberateness of violator's conduct and knowledge of bankruptcy filing), *aff'd*, 51 F.3d 562; *In re Manuel*, 212 B.R. 517, 519 (Bankr. E.D. Va. 1997) ("willful violation" does not require specific intent to violate automatic stay; rather, Bankruptcy Code provides for damages upon finding that defendant knew of automatic stay and that defendant's actions which violated stay were intentional)(*citing Goichman v. Bloom (In re Bloom)*, 875 F.2d 224, 227 (9th Cir. 1989)).

7. *See Brock Utils. & Grading*, 185 B.R. at 720 (*citing In re Hamrick*, 175 B.R. 890 (W.D.N.C. 1994)).

8. *See, e.g., McCormack v. Federal Home Loan Mortgage Corporation,* 203 B.R 521 (Bankr. D.N.H. 1996). The *McCormack* case also stands for the proposition that using the computer defense, or rather, that a violation was the result of a computer error, is a nonstarter, "since intelligent beings still control the computer and could have altered the programming appropriately." *Id.,* at 524, *citing In re Price*, 103 B.R. 989, 992 (Bankr. N.D. Ill. 1989). Moreover, "sophisticated commercial enterprises have a clear obligation to adjust their programming and procedures and their instruction to employees to handle complex matters correctly." *Id., at 525. See also In re Campion,* 294 B.R. 313, 317 (9th Cir. B.A.P. 2003)(stay violations attributable to a computer are not "inadvertent" acts taken without knowledge of the existence of the stay)(*citing Franchise Tax Bd. v. Roberts (In re Roberts),* 175 B.R. 339, 344 (9th Cir. B.A.P. 1994); *In re Rijos*, 263 B.R. 383 (1st Cir. B.A.P. 2001)(same); *In re Alcock*, 2003 WL 22110446 (Bankr. N.D. Iowa 2003) (a creditor's sophisticated

status is a factor to be considered in assessing damages for violation of the automatic stay).

9. In the Chapter 7 setting, a debtor who wishes to retain the collateral securing a loan must continue to make payments to the servicer post-petition and post-discharge. On the other hand, in Chapter 13, a trustee will make monthly disbursements to the servicer from payments made by the debtor, and after the servicer has filed a claim setting forth the amount of pre-petition arrears and other allowable amounts. In many instances, the debtor makes the ongoing or post-petition mortgage payments directly to the servicer, although in many instances the debtor's payments to the trustee will include a component for the trustee to make the post-petition payments directly to the servicer. *See* 11 U.S.C. § 1326(a) (A debtor under Chapter 13 is required to commence making timely payments to the trustee within 30 days of filing the plan of reorganization).

10. *See, e.g., In re Wines*, 239 B.R. 703 (Bankr. D.N.J. 1999)("Payments made during the pendency of the Chapter 13 plan should have been applied by [the lender] to the current payments due and owing with the arrearage amounts to be applied to the back payments. [The lender] cannot use its accounting procedures to contravene the terms of a confirmed Chapter 13 plan and the Bankruptcy Code.")(*quoting In re Rathe*, 114 B.R. 253 (Bankr. S.D. Ohio 1990); *In re Gorshtein*, 285 B.R. 118, 127 (Bankr. S.D.N.Y. 2002)(payments were erroneously applied to pre-petition arrears or were held or deposited in a suspense account or returned to the debtor).

11. *McCormack,* 203 B.R. at 526 *(citing In re Davideit*, 1995 WL 912451 (Bankr. D.N.H. 1995)(unpublished)).

12. *See, e.g., Gorshtein*, 285 at 127; *In re Ronemus*, 201 B.R. 458 (Bankr. N.D. Tex. 1996) (mortgagee's attempt to evade its obligation to promptly apply suspense payments by blaming its actions on a computer could not be tolerated).

13. *See, e.g., Ronemus*, 201 B.R. at 460.

14. *See, e.g., In re Christensen,* 106 B.R. 689, 691 (Bankr. D. Colo. 1989)(mortgagee's increasing of loan payments to recover pre-petition escrow deficiency violated the provisions of Section 362(a)(6) of the Code); *In re Dunn*, 202 B.R. 530 (bank violated automatic stay in attempting to collect pre-petition and post-petition taxes directly from debtors, contrary to terms of Chapter 13 plan and confirming order).

15. *Id.*

16. *See, e.g., In re Riser*, 289 B.R. 201, 204-05 (Bankr. M.D. Fla. 2003) (Confirmation order stating the exact amount of mortgage claim and arrearage was binding, barring mortgagee from seeking to recover any alleged debt in excess of that remaining after application of debtor's payments to mortgage debt as set forth in plan), *after hearing on sanctions*, 298 B.R. 469 (Bankr. M.D. Fla. 2003).