Servicing Post-Discharge Residential Mortgage Debt

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A Practice Note providing guidance to mortgage servicers when servicing the residential mortgage debt of a discharged debtor-borrower. This Note highlights the risks that servicers encounter from continued relationships with post-discharge debtor-borrowers, and gives recommended language for post-discharge communications to help servicers mitigate the risk of violating the discharge injunction.

After an individual debtor receives a bankruptcy discharge, a creditor may not seek to recover the discharged debt. Under section 524(a)(2) of the Bankruptcy Code, a discharge injunction permanently enjoins creditors from trying to collect discharged debts and prohibits a creditor from collecting any debt where the debtor has been discharged of personal liability.

A bankruptcy discharge does not completely extinguish the prepetition debt. While the debtor's in personam (personal) liability for the debt is discharged, the discharge does not extinguish a creditor's in rem rights to foreclose on the property against which it holds a lien (see *Johnson v. Home State Bank*, 501 U.S. 78, 82–83 (1991); *Long v. Bullard*, 117 U.S. 617, 620–21 (1886)).

When the mortgage against the debtor's home remains enforceable *in rem*, and the debtor wants to keep its residence and continues to engage with its mortgage servicer by making monthly payments or participating in a loss mitigation program, the mortgage servicer is in a complicated situation. The mortgage servicer must balance trying to communicate with the discharged debtor about the mortgage without engaging in collection attempts that may violate the discharge injunction or other law. Mortgage servicers can face potential sanctions and damages for engaging with discharged debtor-borrowers and should therefore have clearly outlined policies and protocols for addressing these scenarios based on the servicer's risk tolerance.

This Note provides guidance to mortgage servicers when servicing the residential mortgage debt of a discharged debtor-borrower, highlights the risks that servicers encounter from this continued relationship, and provides recommended language for post-discharge communications to help servicers mitigate the risk of discharge injunction violations.

UNDERSTANDING A RESIDENTIAL MORTGAGE

Residential mortgages involve several key parties. These include:

- The lender, who is the original entity (originator) that lends the money to the borrower.
- The investor, who owns the mortgage loan. Investors can be government-sponsored entities (GSEs) such as the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) or privately owned. Often, the originator sells the loan to an investor.
- A mortgage servicer who manages the loan account. The servicer can be the loan owner or the owner can sell the right to service the loan to another company. The duties of the servicer include:
  - collecting and processing payments;
  - sending monthly billing statements;
  - managing escrow accounts;
  - communicating with borrowers;
  - reviewing borrowers' loss mitigation applications;
  - managing the property if abandoned by the borrower; and
  - managing foreclosures.

DISCHARGED DEBT IN INDIVIDUAL BANKRUPTCY CASES

Debtors in both Chapter 7 and Chapter 13 bankruptcy may seek to retain their primary residence in bankruptcy. While debtors in a Chapter 11 or 12 bankruptcy may also seek to retain their residence, this Note addresses only individual Chapter 7 and 13 bankruptcies because individual Chapter 11 and Chapter 12 cases are less common.

DISCHARGING DEBT UNDER CHAPTER 7

A Chapter 7 debtor has several options to retain real property encumbered by a loan. A Chapter 7 debtor may:

- Redeem the loan and pay it off.
- Reaffirm the loan and agree under contract to be personally liable for the debt (despite the discharge of other debts) while maintaining ownership and possession of the property.
- If the debtor is current on its loan, convert the mortgage into a non-recourse obligation through a "ride-through" and remain in the property while continuing to make regularly scheduled mortgage payments.

Unless the debt has been reaffirmed, a Chapter 7 discharge relieves an individual debtor from personal liability for mortgage debt and prevents the mortgage servicer from taking any collection actions against the debtor personally.

For more information on Chapter 7 bankruptcy, see Practice Note, Chapter 7 Liquidation: Overview (W-000-6231).

DISCHARGING DEBT UNDER CHAPTER 13

A Chapter 13 debtor will typically elect to file a Chapter 13 case to keep the family home. Generally, this is done when a Chapter 13 debtor chooses to catch up on past due payments and make go forward payments under the terms of the Chapter 13 plan of repayment.

A Chapter 13 debtor can also elect to surrender the property through the Chapter 13 bankruptcy plan. If the debtor receives a discharge but remains in possession of the property despite an intent to surrender in the confirmed plan, the debtor is discharged of personal liability. However, the security interest survives the discharge.

For more information on Chapter 13 bankruptcy, see Chapter 13 Bankruptcy Timeline (W-019-8355).

SECTION 524(J) SAFE HARBOR

Section 524(j) of the Bankruptcy Code provides a limited safe harbor for a creditor holding a secured claim on the debtor's principal residence that seeks to collect periodic payments from the debtor in the ordinary course in lieu of foreclosure relief. Under particular circumstances, a creditor may take certain actions with respect to the mortgage outside of foreclosure without violating the discharge injunction.

Section 524(j) does not completely protect against allegations of discharge injunction violations that can arise from communications relating to collecting payments on the mortgage debt. If servicers elect to accept payments in lieu of foreclosing on the property post-discharge, it is critical to ensure that all servicing activity, particularly communications:

- Are narrowly tailored to eliminate the risk that they are viewed as coercive.
- Attempt to inform of, rather than demand, payments.

POST-DISCHARGE COMMUNICATION

While it is widely accepted that a mortgage servicer may send informational statements to a discharged debtor (see *Best v. Nationstar Mortg. LLC*, 540 B.R. 1, 10-11 (B.A.P. 1st Cir. 2015)), statements that attempt to coerce payment violate the discharge injunction. Therefore, servicers must adapt servicing correspondence to avoid a discharge violation through routine correspondence such as:

- Periodic statements.
- Default and foreclosure notices.
- Loss mitigation solicitations. Loss mitigation is generally governed by investor requirements whereby the loan servicer solicits the borrower for information to evaluate it for potential loss mitigation options. This can mitigate or lessen the loss to the investor resulting from a borrower's default. In some circumstances, loss mitigation can help a borrower keep its home through a loan modification (see Guidelines For Post-Discharge Loan Modification).
- Force-placed insurance notices (where the lender must place an insurance policy on a property when the homeowners' own property insurance has lapsed or is insufficient).

The only way to fully eliminate the risk of violating the bankruptcy discharge injunction is to cease all communications with debtor-borrowers who receive a discharge. This drastic change in practice is not realistic because:

- Where a debtor-borrower still lives in the home and pays on the loan, the debtor-borrower may seek additional information about the loan, including how much the debtor-borrower must pay to avoid foreclosure. Additionally, the discharge injunction does not absolve the servicer of sending escrow statements as required by the Real Estate Settlement Procedures Act (12 U.S.C. §§ 2601–2617).
- Other non-bankruptcy laws may require certain communications. For example, the servicer may have a statutory requirement to send the debtor-borrower pre-foreclosure notices and information (see *In re Kirby*, 589 B.R. 456 (Bankr. D. Me. 2018) (post-discharge default letter sent by mortgagee to Chapter 7 debtors that included information required under Maine law to preserve mortgagee's *in rem* right to foreclose, contained bankruptcy disclaimer in bold type and indicated that it was not attempt to collect a debt that might have been discharged in bankruptcy, did not violate the discharge injunction)).

Servicers must balance between providing statutorily mandated correspondence to debtor-borrowers and avoiding allegations that the correspondence violates the discharge injunction. In these cases, a carefully worded, narrowly tailored disclaimer is advisable.

BANKRUPTCY DISCLAIMER WORDING

To determine whether a post-discharge communication violates the discharge injunction, courts conduct a fact-intensive inquiry into whether the communication was an attempt to collect the debt from the debtor-borrower personally. Courts heavily scrutinize the existence of and language within bankruptcy disclaimers on debtor-borrower communications. As part of this scrutiny, courts view these communications from the perspective of the unsophisticated consumer.

Courts have found discharge violations where correspondence with a debtor-borrower following the debtor's discharge included:

- Due dates.
- Amounts owed.
- A statement that a late fee would be charged for untimely payment.

Where courts have found violations for correspondence containing these items, the correspondence has typically been coupled with other conduct that could be viewed as coercive or harassing (see *In re Forson*, 583 B.R. 704 (Bankr. S.D. Ohio 2018); *In re Sharak*, 571 B.R. 13 (Bankr. N.D. N.Y. 2017); *In re Vanamann*, 561 B.R. 106 (Bankr. D. Nev. 2016); *In re Brown*, 481 B.R. 351 (Bankr. W.D. Pa. 2012); *In re Bruce*, 2000 WL 33673773 (Bankr. M.D. N.C. 2000)).

Courts are less likely to find a violation if the statement:

- Is for informational purposes only.
- Has a proper disclaimer that includes a statement:
  - acknowledging the effect of the discharge;
  - that the creditor is not attempting to collect discharged debt against the debtor-borrower personally; and
  - that any payments would be voluntary.
- (See *In re McConnie Navarro*, 563 B.R. 127 (Bankr. D. P.R. 2017) (monthly statements to debtor indicated, in multiple places and in all capital letters, that they were being sent for informational purposes only); *In re Best*, 2015 WL 6643649 (B.A.P. 1st Cir. 2015) (correspondence containing language stating that, if the debtor had received a discharge in bankruptcy, the communication was not an attempt to collect a debt and was provided for informational purposes only); *In re Lemieux*, 520 B.R. 361 (Bankr. D. Mass. 2014) (mortgagee's notice of change in interest rate mailed to Chapter 7 debtor post-discharge did not violate discharge injunction because notice indicated that, if debtor had received a bankruptcy discharge, then notice was not intended to collect a debt, and mortgagee would "only exercise rights as against the property").)

Mortgage servicers should be mindful that there is no language that has been deemed an absolute shield for a bankruptcy disclaimer. Even innocuous statements under the right facts may be found to violate the discharge injunction.

CIRCUMSTANCES OF COMMUNICATION

The specific circumstances of the borrower-servicer relationship, and the facts presented by the debtor-borrower, weigh heavily in a court's analysis of whether the servicer has violated the discharge injunction. For example, if:

- A servicer sends a large quantity of letters offering alternatives to foreclosure in a short period of time, it will look more like coercive behavior than sending similar correspondence once (see *In re Nordlund*, 494 B.R. 507 (Bankr. E.D. Cal. 2011) (lender sent 24 letters over ten-month period in post-discharge communication); *In re Nibbelink*, 403 B.R. 113 (Bankr. M.D. Fla. 2009) (mortgagee violated the discharge injunction by making numerous telephone calls and sending numerous letters to debtors post discharge, demanding that they become current or face foreclosure)).
- The debtor-borrower indicated an intent to surrender the property, that fact will often weights in favor of a finding of a discharge injunction violation during a review of the servicer's correspondence with the debtor-borrower (see *In re Plummer*, 513 B.R. 135 (Bankr. M.D. Fla. 2014); *In re Nordlund*, 494 B.R. 507 (Bankr. E.D. Cal. 2011); *In re Bruce*, 2000 WL 33673773 (Bankr. M.D. N.C. 2000)).
- The debtor-borrower previously requested that the servicer cease sending post-discharge correspondence, the court is more likely to find a violation (see *In re Szenes*, 515 B.R. 1 (Bankr. E.D. N.Y. 2014) (bank's conduct of sending two letters to debtor inquiring about payment of debt, the second of which was mailed after debtors' counsel had contacted bank and pointed out that the first letter violated discharge injunction, violated the discharge injunction); *In re Nordlund*, 494 B.R. 507 (Bankr. E.D. Cal. 2011) (debtors had requested that communications cease and had filed contempt motion against lender for excessive post-discharge communications)).

FDCPA DISCLAIMER

Under the Fair Debt Collection Practices Act (FDCPA), when a third-party debt collector makes any communication with a debtor, they must include a disclaimer that the correspondence:

- Is a communication from a debt collector.
- Is for collecting a debt.
- Will use information obtained from the communication only for that purpose.

(15 USC § 1692e(11)).

Crafting correspondence to discharged debtor-borrowers is complicated when both an FDCPA disclaimer and a bankruptcy disclaimer are necessary. The servicer can appear to tell the debtor-borrower that it intends to collect the debt (under the FDCPA disclaimer) while also recognizing that they cannot do so (under the bankruptcy disclaimer). This has led some courts to find this type of double disclaimer misleading to the least sophisticated consumer.

Some courts find it permissible to include both FDCPA disclaimers and significant and prominent bankruptcy disclaimers (see *Whalen v. Specialized Loan Servicing, LLC*, 155 F.Supp.3d 905, 908 (W.D. Wis. 2016) (where the notice contained both FDCPA and bankruptcy discharge disclaimer language as follows: "Bankruptcy notice—if you are a customer in bankruptcy or a customer who has received a bankruptcy discharge of this debt, please be advised that this notice is sent to comply with the requirements of the Fair Debt Collection Practices Act ('FDCPA'). This notice constitutes neither a demand for payment nor a notice of personal liability to any recipient hereof, who might have received a discharge of such debt in accordance with applicable bankruptcy laws or who might be subject to the automatic stay of section 362 of the United States Bankruptcy Code. However, it is being sent to you as the lien against the collateral property has not been discharged in your bankruptcy.")).

For more information on the FDCPA, see Practice Note, FDCPA Litigation: Key Issues and Considerations (W-007-2315).

DRAFTING A DISCLAIMER: PRACTICE POINTERS

To help mitigate the risk of discharge injunction violation allegations, mortgage servicers should ensure that all communications to discharged debtor-borrowers:

- Acknowledge the bankruptcy discharge.
- State the voluntary nature of continued payments.
- Confirm that the debtor-borrower has no personal obligation to pay the servicer.
- Prominently display any disclaimer, rather than include it as a part of the fine print.

- Are specific and personalized, not generic or hypothetical.
- Include repeated disclaimers on correspondence related to payments of any type.

Servicers should also consider the totality of the communications with debtor-borrowers, including quantity and frequency of the following:

- All letters.
- Loss mitigation overtures.
- Monthly statements.
- Escrow statements.
- Phone calls.

Servicers should avoid sending any unnecessary letters to discharged debtor-borrowers, including letters not otherwise required by non-bankruptcy law.

GUIDELINES FOR POST-DISCHARGE LOAN MODIFICATION

A bankruptcy discharge of personal liability does not preclude a debtor-borrower from seeking a loan modification.

LOAN MODIFICATION GENERALLY

A loan modification permanently restructures the terms of a mortgage, which often provides a more affordable payment to the borrower. A loan modification can reduce monthly payments by:

- Reducing the borrower's interest rate.
- Converting a variable interest rate to a fixed interest rate.
- Extending the term of the loan.

There are many different loan modification programs available. While debtors may seek a loan modification following discharge, a servicer is not required by law to modify the loan. Instead, the servicer is directed through the modification process by investor guidelines such as the Department of the Treasury's Home Affordable Modifications Program (HAMP) or a servicer's own policies.

HAMP GUIDELINES FOR LOAN MODIFICATIONS

The now expired HAMP program provided clear and consistent loan modification guidelines when the debtor-borrower had discharged its personal liability.

The HAMP guidelines encouraged loan modification language to include:

- A disclaimer that all payments are voluntary.
- An acknowledgement that the servicer cannot seek to collect against the debtor-borrower personally.

Fannie Mae and Freddie Mac have both given guidance that loan modification documents include similar suggested language.

SERVICER GUIDELINES FOR LOAN MODIFICATIONS

Where a debtor has received a discharge of personal liability, servicers are often wary of violating the discharge injunction and offering loan modifications in general. To protect themselves, servicers that offer loan modifications to post-discharge debtors should:

- Tailor the loan modification offerings to only those debtor-borrowers who have indicated an intent to retain the property. Discharge violations are often found where a debtor-borrower surrenders the property and a servicer solicits that debtor-borrower for loss mitigation. Upon surrender, the debtor-borrower indicates intent to sever the relationship with the servicer, and the servicer should not offer loss mitigation to that borrower.
- Carefully consider which products are offered to borrowers who have discharged personal liability. Investors, particularly GSEs, offer partial claim modification, which involves the borrower entering into a separate note, with a second lien position, in favor of the Department of Housing and Urban Development (HUD). When considered within the context of a bankruptcy discharge, the second lien note may be viewed as an impermissible post-discharge reaffirmation if it lacks language acknowledging the bankruptcy discharge. The standard subordinate note provided by HUD does not currently contain this acknowledgement language.
- Take care when deciding whether, and how, to modify a discharged debtor-borrower's loan. Servicers should ensure the loan modification process is tailored to mitigate risk of other discharge injunction violations.

BEST PRACTICES FOR OFFERING LOSS MITIGATION TO DISCHARGED DEBTOR-BORROWERS

As a practical matter, regulators, investors, and bankruptcy courts expect lenders and servicers to evaluate debtor-borrowers for possible loan modifications post-discharge. Notwithstanding this expectation, lenders and servicers should proceed with caution when processing post-discharge requests for loss mitigation assistance, as courts are unlikely to accept widespread industry practice as a defense to discharge injunction violations.

BE CAUTIOUS WHEN USING TEMPLATES

Investors often provide templates or required language to document loan modification agreements. Some specifically include language to reflect a bankruptcy discharge. For example, the Fannie Mae loan modification agreement (Fannie Mae Form 3179) provides:

> Notwithstanding anything to the contrary contained in this Agreement, Borrower and Lender acknowledge the effect of a discharge in bankruptcy that has been granted to Borrower prior to the execution of this Agreement and that Lender may not pursue Borrower for personal liability. However, Borrower acknowledges that Lender retains certain rights, including but not limited to the right to foreclose its lien evidenced by the Security Instrument under appropriate circumstances. The parties agree that the consideration for this Agreement is Lender's forbearance from presently exercising its rights and pursuing its remedies under the Security Instrument as a result of Borrower's default thereunder. Nothing in this Agreement shall be construed to be an attempt to collect against Borrower personally or an attempt to revive personal liability.

If templates do not include similar disclaimers:

- Servicers should consider discussing and seeking approval from the investor to incorporate these disclaimers.

- Servicers can send separate correspondence to the debtor-borrower confirming that personal liability has been extinguished by the bankruptcy discharge and including an acknowledgement to be signed by both parties.

EVALUATE TREATMENT OF DEBTOR-BORROWERS WHO HAVE SURRENDERED

Courts generally view a debtor-borrower's statement of intention to surrender property under Chapter 7 or intent to surrender property in a confirmed plan under Chapter 13 as evidence that the debtor-borrower no longer wants to continue the relationship with the servicer or stay in the property. To eliminate risk, servicers should avoid soliciting and entering into loan modifications following a debtor-borrower's stated intent to surrender the property. These broad prohibitions are likely impractical because:

- Many discharged debtor-borrowers who have surrendered property continue to make voluntary payments and may even seek loan modifications.
- Some states such as California and Nevada have statutory pre-foreclosure requirements that include loss mitigation solicitation (see Practice Notes, Residential Foreclosures (CA): Pre-Foreclosure Requirements and Considerations (W-013-8580), Residential Foreclosures (Nonjudicial) (NV): Pre-Foreclosure Requirements and Considerations (W-010-1072), and Residential Foreclosures (Judicial) (NV): Pre-Foreclosure Requirements and Considerations (W-019-0178)).

Because of these situations, servicers should mitigate risk by developing robust procedures regarding solicitation of discharged debtor-borrowers for loss mitigation to avoid soliciting debtor-borrowers who have surrendered. This will allow servicers to:

- Outline their process for credit pulls (even soft credit pulls) for debtor-borrowers who have indicated an intent to surrender. Under the Fair Credit Reporting Act, credit pulls are only permissible where there is a "legitimate business need for the information." If the debtor-borrower has indicated it does not want the property anymore, there is arguably no legitimate business need for the mortgage servicer to pull that borrower's credit.
- Tailor communications to minimize the risk of violating the discharge injunction by drafting and reviewing these communications on a one-off basis rather than relying on forms to ensure all of the debtor-borrower's specific circumstances are considered.

Personalized, individual analysis and communication decreases the likelihood of complaints or litigation by the debtor-borrower for post-discharge conduct relating to loan modification outreach.

BEWARE OF COURT-SPECIFIC LOSS MITIGATION REQUIREMENTS

Among the nearly 100 bankruptcy courts across the country, approximately only two dozen courts or individual bankruptcy judges have programs permitting debtors and creditors to engage in loss-mitigation negotiations under court supervision. These have been published as:

- Local rules.
- Administrative orders.
- Published formal guidelines.

These bankruptcy loss-mitigation programs share some common traits, such as the entry of an order setting deadlines and establishing certain ground rules for the process. However, many variations exist, including the use of an electronic portal for all communications related to the loss-mitigation process and the appointment of a mediator.

While many post-discharge loss mitigation efforts occur after a bankruptcy case has closed, servicers should stay apprised of all local court requirements related to loan modifications.

For more information on the local bankruptcy rules in bankruptcy courts across the jurisdictions, see Local Bankruptcy Rules Toolkit (W-001-4018).

CONDUCT SPECIALIZED TRAINING FOR CUSTOMER-FACING EMPLOYEES

To mitigate risk, lenders and servicers must develop and conduct cross-department training to educate employees on the complexity and risks of solicitation and loan modifications for discharged debtor-borrowers. Key concepts can also be memorialized in an FAQ or talking points, particularly for employees handling customer calls or complaints.

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