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Building Blocks

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Reconciling Changing Loan-Servicing Regulations

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Filing a bankruptcy petition is a life-changing event for any consumer debtor. No matter the Bankruptcy Code chapter under which a debtor seeks relief, careful thought must be given during a period of crisis not only to the present, but also to the future. A primary decision that any debtor/homeowner must make is whether to retain or abandon his/her home. Similarly, a bankruptcy filing by a mortgagor is a critical event in the life of a mortgage loan, and upon its occurrence, the loan servicer must carefully consider how it will proceed. Neither of these decisions should be made in a vacuum; they are better made when the parties are well informed. Yet the exchange of information between the debtor and the debtor's servicer is a perennial source of problems in bankruptcy.

Whether during the pendency of a bankruptcy case or following discharge, when it comes to communications between a mortgage loan servicer and a debtor regarding his/her loan, the line between necessary, permissible contact and coercive, harassing behavior has always been blurry. Courts have also been hesitant to draw that line any brighter by carving out safe harbors or establishing hard-and-fast rules, opting instead for consideration of the unique facts and circumstances of each case. Although one can distill some guiding principles from the substantial body of case law addressing the subject, these principles must continually be reconciled with a highly complex, evolving regulatory scheme that governs mortgage loan servicing and increasingly commands interaction between borrowers and servicers. A recent proposal by the Consumer Financial Protection Bureau (CFPB) to amend the comprehensive set of mortgage servicing rules under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) that it promulgated in 2013 brings these tensions into sharp focus.

Bankruptcy Basics

In the bankruptcy context, creditor communications are tempered by the automatic stay of § 362 of the Bankruptcy Code and the discharge injunction. The automatic stay broadly prohibits a creditor from taking "any act to collect, assess or recover a claim against the debtor that arose before commencement of the case."[1] Although the stay is designed to afford a debtor with breathing room by precluding most formal and informal collection efforts, a debtor sometimes wants or needs communication with his/her creditor. In these instances, communication may be permissible. For example, it is generally agreed that a debtor and creditor may communicate regarding the possibility of a reaffirmation agreement and its terms.[2] Likewise, a number of courts have reasoned that certain communications between a mortgage loan servicer and a debtor that are truly informational in nature (a notice of interest rate changes, escrow analysis, etc.) do not violate the automatic stay *per se*.[3]

Similarly, the discharge injunction in § 524 of the Bankruptcy Code broadly enjoins any action to collect or recover a debt that was discharged as a personal liability of a debtor in bankruptcy. Even though a discharge releases a debtor from personal liability on a discharged debt, it does not extinguish the debt, so absent an order modifying or stripping a lien secured by the debtor's home, the secured creditor's lien survives the discharge unaffected.[4]

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1 11 U.S.C. § 362(a)(6).

2 *See, e.g., In re Duke*, 79 F.3d 43, 46 (7th Cir. 1996) (finding that creditor did not violate stay by sending noncoercive letter to debtor offering reaffirmation agreement).

3 *See, e.g., Knowles v. Bayview Loan Servicing (In re Knowles)*, 442 B.R. 150, 161 (B.A.P. 1st Cir. 2011) (finding servicer's annual tax statement to debtor permissible where it was "merely an informative document sent in the normal course of business that the Debtor needed in order to prepare her tax return"); *In re Whitmarsh*, 383 B.R. 735, 736-37 (Bankr. D. Neb. 2008) (letters that lender sent to debtor to comply with other state and federal collection laws were not prohibited).

4 *Johnson v. Home State Bank*, 501 U.S. 78, 83 (1991).

Rather than reaffirm a mortgage loan, some chapter 7 mortgage debtors opt to "ride through" bankruptcy by discharging their mortgage debt while retaining their homes and continuing to make monthly mortgage payments to avoid a foreclosure. Section 524(j) accommodates the interests of debtors and creditors in a ride-through scenario by carving out a limited exception to the discharge injunction to permit a creditor whose claim is secured by a valid lien against a debtor's home to seek or obtain periodic payments in lieu of foreclosing its mortgage in the ordinary course of business. Finding support from § 524(j), courts have found that certain communications between a servicer and a discharged debtor (*e.g.*, those that provide the debtor with information regarding the status of the loan or loss-mitigation options but do not demand payment or suggest personal liability) are permissible.[5]

While it is universally agreed that the automatic stay and discharge injunction do not prohibit all communication between a servicer and a debtor *per se*, there is no clear consensus on exactly what communications are permissible because courts have determined permissibility on the unique facts and circumstances of each case.[6] For instance, a letter noting a deficiency, notifying a borrower of possible workout options and inviting a debtor to contact the servicer may not be troublesome in a ride-through scenario where the debtor still resides in the property post-discharge, but it could rise to the level of harassment if the debtor indicated an intent to abandon the property in the bankruptcy case, vacated the property and requested that the servicer cease communications.[7] It is against this backdrop that the CFPB has proposed amendments that aspire to treat bankrupt borrowers who intend to retain their homes the same way as borrowers not in bankruptcy, to the extent not inconsistent with bankruptcy law.

The Servicing Rules

In 2013, the CFPB promulgated servicing rules to, among other things, implement sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act concerning the obligations of servicers with respect to information availability and loss mitigation related to residential mortgage loans. Among the key features of the CFPB servicing rules are the obligations that servicers engage in live and written "early intervention" efforts shortly after borrowers default to inform borrowers of loss-mitigation options and obligations to send periodic statements or coupon books to borrowers in default. Each of these features aims to provide borrowers with the necessary information to make informed decisions about the retention or surrender of their homes.

Since it initially issued its servicing rules, the CFPB has continued to revise the rules through notice and comment rulemaking. In October 2013, it issued an interim final rule (IFR) to address issues raised by industry and consumer advocacy groups, as well as clarify compliance requirements with respect to communications with borrowers in bankruptcy. The IFR provisionally suspended the effectiveness of the CFPB's servicing rules for bankrupt borrowers to allow the CFPB time to further evaluate the bankruptcy implications of its regulations. On Nov. 20, 2014, the CFPB proposed amendments to its servicing rules, which, if promulgated, will narrow the scope of the exemptions from early intervention and periodic statement obligations with respect to bankrupt borrowers.

Live Contact Requirements

The CFPB's servicing rules currently exempt servicers from undertaking early intervention efforts through either live contact or written notices if a principal obligor of the mortgage loan is in bankruptcy. Under the proposed amendments to the servicing rules, servicers would remain exempt from the requirement of live contact with respect to mortgagors who are in bankruptcy who have been discharged from personal liability through bankruptcy, or who are jointly liable with a debtor in a chapter 12 or 13 case.[8] However, if the mortgagor filed under chapter 7 or 11, a servicer would be required to make good-faith efforts to establish repeated live contact with a nonbankrupt co-borrower who is delinquent.[9]

Written Notice Requirements

The amendments also modify the general exemption for written notices to borrowers in bankruptcy, instead requiring servicers to send notices to borrowers in bankruptcy unless (1) no loss-mitigation options are available; (2) the borrower's confirmed plan provides for surrender of the property or avoidance of the mortgage lien or otherwise does not provide for payment of the pre-petition arrearage and maintenance of payments due under the loan; (3) the borrower files a statement of intention that indicates an intention to surrender the property; or (4) the bankruptcy court issues an order avoiding the lien or lifting the stay.[10]

Challenges Posed by the Amendments

The nuance to these amendments is indicative of the challenges that servicers face in accommodating borrowers in bankruptcy, yet not running afoul of bankruptcy law in the process. For example, to avert violations of the co-debtor stay of §§ 1201 and 1301 of the Bankruptcy Code, the amendments exempt servicers from establishing live contact with co-obligors of a mortgage loan when an obligor is a chapter 12 or 13 debtor. Since chapters 7 and 11 do not provide a co-debtor stay, the amendments require live contact with an obligor jointly liable with a chapter 7 or 11 debtor on a mortgage loan.

Although the Code does not prohibit communication with the nonbankrupt under these circumstances, requiring live contact still raises the specter of potential automatic stay violations because, in the residential mortgage loan context, co-borrowers often live together. Attempted live contact with the nonbankrupt borrower may lead to unintentional contact with the bankrupt, and the CFPB's servicing rules require repeated contact, increasing the like-

5 *See, e.g., Brown v. Bank of America (In re Brown)*, 481 B.R. 351, 359 (Bankr. W.D. Pa. 2012) (finding that servicer's general informational notices, such as notice of change of servicer, which did not demand payment, did not violate the discharge injunction).

6 *See, e.g., Pratt v. Gen. Motors Acceptance Corp. (In re Pratt)*, 462 F.3d 14, 19 (1st Cir. 2006).

7 *See Bibolotti v. American Home Servicing Inc.*, No. 4:11-CV-472, 2013 WL 2147949 *11-12 (E.D. Tex. 2013).

8 Amendments to the 2013 Mortgage Rules under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 79 *Fed. Reg.* 74176, 74201-02 (proposed Dec. 15, 2014).

9 *Id.*

10 *Id.* at 74286.

lihood of contact with the debtor. Repeated, unintentional contact might be perceived by a debtor as a violation of the automatic stay, and, to the extent that a servicer declines to speak with the debtor about the loan for that reason, a servicer also risks confusing the debtor about the availability of loss-mitigation options.[11]

Determining whether the exemption from early intervention applies is a complex and fact-intensive inquiry that requires a functional knowledge of consumer bankruptcy practice, which can vary by jurisdiction in certain contexts. In the chapter 13 context specifically, the amendments are likely to create confusion. Chapter 13 plans must generally be filed within 14 days of the petition date, but plan confirmation may occur much later. Some courts may also be inclined to enter interim confirmation orders or reserve the resolution of claims until after confirmation, each rendering the applicability of the early intervention exemption even more obscure.

Even where applicability is clear, compliance could place servicers at risk for violating the automatic stay. For instance, even if the debtor's proposed plan indicates an intention to surrender the property or cram down the mortgage, the servicer would be obligated to provide the debtor with written early-intervention notices unless another exemption applies. On the other hand, if the debtor confirms a plan that will cure the pre-petition arrearages and reinstate the loan, although the debtor is deemed current, the loan may remain in technical delinquency throughout the life of the plan, thus requiring that the servicer send early-intervention notices every 180 days to the confusion of the debtor who is current on his/her plan payments. Since repeated communications with a debtor often constitute willful violations of a debtor's bankruptcy protections if the communications are not wanted or needed by the debtor, the periodic nature of the early intervention notices potentially compounds the risk that a servicer will violate the debtor's stay.[12]

The required content of written early-intervention notices further highlights the tensions among the CFPB's servicing rules, bankruptcy law and other federal laws. For example, if a borrower has requested that a servicer cease communications pursuant to § 805(c) of the Fair Debt Collection Practices Act (FDCPA) prior to filing bankruptcy, the written notice must include "a statement that the servicer may or intends to invoke its specified remedy of foreclosure."[13] This statement might be necessary to ensure compliance with the FDCPA, but it raises significant issues when directed to a borrower in bankruptcy, not only because it may be perceived as an attempt to collect a debt, but also because the debtor may believe that the servicer intends to foreclose without first seeking relief from the bankruptcy court.

The CFPB's proposed comment 39(d)(2)(iii)-2 wrestles with this issue.[14] The comment provides that the notice need not be provided to a borrower in bankruptcy who is not represented by a person authorized to communicate with the servicer on his/her behalf; however, in the event that the borrower is represented by an authorized representative, the notice must be provided to that person.[15] This proposal is grounded in the notion that communication with an authorized representative mitigates the risk that the message will be perceived as a stay violation because courts have declined to find communications between bankruptcy counsel as violations of the automatic stay in some instances.[16] The proposal neglects to recognize that under the CFPB's servicing rules, an authorized representative is not necessarily a lawyer and courts have not created a blanket exemption that covers any and all communication among counsel.

Conclusion

Compliance with the proposed amendments to the CFPB's servicing rules will require significant implementation costs: Servicers will need to overhaul their systems, specially train staff and seek advice from bankruptcy counsel to ensure compliance. Servicers will also need to closely monitor each bankruptcy case to assess whether a borrower's exemption status has changed before sending any notice. Given that strict compliance with the proposed rules may implicate the automatic stay and discharge-injunction provisions and that bankruptcy courts have routinely declined to craft concrete rules in this context, it is worth considering whether these implementation costs will be well spent and borrowers' will have benefited, or whether compliance will instead only add to the volume of costly, fact-sensitive litigation between debtors and servicers that exists today. abi

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11 *Bibolotti*, 2013 WL 2147949, at *11-12; *Connor v. Countrywide Bank NA (In re Connor)*, 366 B.R. 133, 136 (Bankr. D. Haw. 2001); *In re Draper*, 237 B.R. 502 (M.D. Fla. 1999).

12 *See In re Baltzer*, No. 6:07-BK-04635-KSJ, 2014 WL 7149724, at *3 (Bankr. M.D. Fla. Dec. 11, 2014).

13 79 *Fed. Reg.* 74211, 74286.

14 *Id.* at 74292.

15 *Id.*

16 *Id.* at 74206, n.119 and 74207.