Mortgage borrowers who are granted Chapter 7 bankruptcy discharges and do not reaffirm their mortgages present unique issues for their lenders and mortgage servicers (collectively, mortgage lenders). When a loan secured by a mortgage on the borrower’s principal residence (the mortgage loan) is discharged in bankruptcy, the borrower’s personal liability on that loan is removed. The discharge injunction prohibits the mortgage lender from engaging in any act that constitutes an attempt to collect the mortgage loan as a personal obligation. 11 U.S.C. § 524. Under certain circumstances, routine servicing correspondence is perceived as pressuring discharged borrowers to make payments on their mortgage loans. This may be considered a discharge violation and expose the lender to damages and attorney fees.

Although the discharge removes a borrower’s personal liability, it does not affect the mortgage lender’s lien, which remains intact. After discharge, the mortgage lender may still proceed in rem (against the property only), and it may foreclose upon the mortgaged home after a default under the mortgage loan.

In 2005, Congress enacted § 524(j) of the U.S. Bankruptcy Code to exclude from the discharge injunction “act[s]” by mortgage lenders whose mortgage loans are secured by the borrower’s principal residence, as long as those acts are “in the ordinary course of business between the creditor and the debtor” and are “limited to seeking or obtaining periodic payments associated with a valid security interest in lieu of pursuit of in rem relief to enforce the lien.” This created a limited “safe harbor” that permits acts to collect payments that are due under discharged mortgage loans. However, the contours of this “safe harbor” are not yet well-defined. Mortgage lenders must therefore exercise caution when communicating with discharged borrowers.

Here’s the dilemma for mortgage lenders. Sometimes they face a discharged borrower who did not reaffirm the mortgage loan, continued to make payments and stayed in possession, but then became delinquent post-discharge. The borrower then requests a loan modification (the post-discharge mortgage modification). Under § 524(c) of the Bankruptcy Code, an agreement (e.g., mortgage loan modification) between the holder of claim (e.g., the mortgage lender) and the debtor (e.g., the borrower), the consideration for which, in whole or in part, is based on a debt (e.g., the mortgage loan) that is dischargeable “is enforceable only if [the agreement complies with certain very specific reaffirmation requirements] and is made before the granting of the discharge.” Post-discharge mortgage modifications are “agreements,” so if a bankruptcy court concludes (1) that the consideration for a modification is based at least in part of the discharged debt, and (2) entering into a modification agreement is not within the § 524(j) “safe harbor,” then the modification will likely be found to be unenforceable, and the lender may be exposed to damages for violating the discharge.

Although it does not appear that any court has concluded that non-recourse post-discharge mortgage modifications are unenforceable under § 524(c), the issue...
is not chimerical. At least one bankruptcy court has suggested, albeit in dicta, that if a Borrower enters into such an agreement, “its effect would be to revive all, or at least a portion, of [the] discharged debt to the bank.” In re Culpepper (Bankr. D. Ore. 2012) And there are many bankruptcy professionals who believe that, after the filing of a Chapter 7 bankruptcy case, reaffirmation under § 524(c) is the only way debtors can enter into a legally enforceable agreement to fulfill their desire to retain possession of their mortgaged home.

On the other hand, there are bankruptcy cases that expressly permit post-discharge mortgage modifications. In re Bates (Bankr. D. N.H. 2014) There, the court approved a post-discharge home affordable modification program (HAMP) modification that “by its express terms did not revive any personal liability for the mortgage debt.” The agreement was a standard form of HAMP loan modification with a rider that acknowledged the effect of the bankruptcy discharge. The court held that entering into the agreement was within the scope of § 524(j). Likewise, another bankruptcy court in Florida held (with little analysis) that neither the automatic stay nor the Chapter 7 discharge provisions prevent post-discharge mortgage modifications. In re Hairel, 2012 WL 2090435

In March 2010, in connection with administering HAMP, the U.S. Treasury Department issued Supplemental Directive 10-02, which makes it clear that (in its view) discharged borrowers are eligible for HAMP as long as the borrowers understand they are not personally liable for the modified debt. Several bankruptcy courts have cited this directive in denying motions to allow debtors to enter into post-discharge reaffirmation agreements. These cases suggest that those courts believe that post-discharge mortgage modifications are possible as long there is no attempt to revive personal liability. In fact, those cases may be read as an advisory to discharged borrowers to enter into post-discharge mortgage modifications instead of reaffirmation agreements.

This conflicting authority poses a problem. There is a legitimate concern that, under the plain language of § 524(c), post-discharge mortgage modifications are unenforceable if not formally submitted to the reaffirmation process. On the other hand, there are cases that specifically authorize them. Indeed, some courts have refused to allow reaffirmation because post-discharge mortgage modifications are a better option for discharged borrowers. So, what are mortgage lenders supposed to do?

Arguably, the safest thing is to refuse to modify non-reaffirmed mortgage loans. But that is contrary to the HAMP directive. Moreover, that position may be inconsistent with the CFPB’s proposed rules, which will (if enacted as proposed) require mortgage lenders to communicate with at least some discharged borrowers about loss mitigation options. Further, refusing to modify eliminates the possibility of converting discharged mortgage loans that are in default into performing “in rem” loans. For these reasons and others, some mortgage lenders have made the business decision to offer post-discharge mortgage modifications to discharged borrowers, despite the risks.

The case law is still developing. Lenders who decide to offer post-discharge modifications must actively monitor developments. It is not clear that § 524(j), standing alone, authorizes the execution of modifications. In re Bates seems to conclude that it does. But there is a legitimate question whether entering into a post-default mortgage modification (which is, at least, related to discharged debt, implicating § 524(c)) is an “act” that is “limited to seeking or obtaining periodic payments” in lieu of foreclosure. The “ordinary course of business between the creditor and the debtor” requirement in §524(j) is also concerning, because a non-recourse post-discharge mortgage modification is arguably outside of the ordinary course. Accordingly, one cannot assume blindly that such modifications are within the § 524(j) safe harbor.

There is nothing in the bankruptcy code that prevents a debtor from entering into new financing post-discharge. In addition, § 524(f) specifically permits voluntary repayment of discharged debt. Bankruptcy cases directly or indirectly supporting post-discharge modifications often highlight the fact that discharged borrowers voluntarily entered into those agreements. The dispositive issue is whether a payment made under these conditions is truly voluntary, or is the result of pressure or coercion by the creditor. Mortgage lenders who pressure discharged borrowers to modify are at risk of violating the discharge injunction. It should be made clear to discharged borrowers that they are not obligated to enter into any post-discharge modifications.

Further, borrowers should be clearly and routinely reminded in all documents and related communications that they are not personally liable for the discharged mortgage loan, and that the mortgage lender’s only recourse is “in rem.” It is questionable whether the existing HAMP forms for discharged borrowers (which essentially adds a bankruptcy disclaimer to an otherwise standard form of loan modification) does enough in this regard. The language of any proposed modification should be drafted carefully to reduce the risk of a discharge violation. Even then, under the current state of the law, there is no guarantee that the agreement will be enforceable, and that it will not violate the discharge injunction.

Finally, mortgage lenders who choose to enter into post-discharge mortgage modifications must pay special attention and care to loan servicing. Many cases that find discharge violations also rule that a lender’s communications (whether oral or written) with discharged borrowers were too harsh, or did not contain appropriate bankruptcy disclaimers. Even appropriately tailored communications can cause trouble depending on context. Any mortgage lender that is engaged in post-discharge loan servicing should take a very hard and careful look at its entire servicing program, and consult with knowledgeable legal professionals.

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