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First Circuit Reverses Nosek Bankruptcy Court by Colleen E. McCullough and Stephen G. Collins

In re Nosek, 2008 WL 4445707 (C.A. 1 (Mass.) October 3, 2008) (No. 07-2173, 07-2174).

A national servicer appealed the Bankruptcy Court's award of compensatory and punitive damages pursuant to 11 USC § 105(a) of the Bankruptcy Code. The Court had awarded Nosek \$250,000 in emotional distress damages and \$500,000 in punitive damages for the national servicer's alleged violations of 11 USC § 1322(b), as well as violations of the Chapter 13 plan itself. The alleged violations stemmed from the national servicer's accounting practices related to payments made by Nosek pursuant to her Chapter 13 plan. While the District Court upheld the original award, the Appellate Court vacated the award, as well as the confirmation of the amended Chapter 13 plan which reflected the monetary award.

Nosek had entered into a \$90,000 secured adjustable rate note with the lender, and used the funds to pay off several outstanding bills and to invest in an Internet marketing scheme. Nosek fell behind on her payments and filed bankruptcy to avoid foreclosure on three separate occasions, with the last filing at issue here. Towards the end of 2003, Nosek contacted a different lender about refinancing her mortgage. As part of that refinance discussion, Nosek requested a payment history from the servicer. The payment history reflected the use of a "suspense account," a term which the servicer used to refer to "funds credited to a debtor's account not sufficient to make a full mortgage payment." The parties disagreed as to whether this payment history accurately reflected Nosek's post-petition payments.

The Bankruptcy Court ultimately found that the servicer had violated its implied covenant of good faith and fair dealing by acting contrary to the text of Section 1322(b), which offers a Chapter 13 debtor flexibility in the formulation of their bankruptcy plan by listing various elements that may be included in the plan. Although the Court concluded that Nosek had not shown any economic harm resulting from the servicer's accounting practices, it still concluded that the servicer's accounting practices violated her cure rights pursuant to Section 1322(b) and her Chapter 13 plan, providing a predicate for the damage award under Section 105(a) of the Code and awarded monetary damages.

The servicer appealed to the District Court, who affirmed the decision. While the servicer's first appeal to the District Court was pending, Nosek submitted a third amended plan to the Court. This plan stated that the damages owed by the servicer would fund 100 percent of the Chapter 13 Plan. Despite the servicer's objections, both the Bankruptcy and District Courts respectively confirmed and affirmed this plan. The servicer appealed to the U.S. Court of Appeals, arguing that Section 1322(b) merely lists certain optional elements that may be included in a Chapter 13 plan, but does not place specific duties or obligations on the creditor. Nosek's Chapter 13 plan did not explicitly describe how and by when the various payments would be credited to her account and, the national servicer contended that there was no basis for finding that it had violated either the text of Section 1322(b) or the Plan. Specifically, the servicer asserted that neither Section 1322(b) of the Bankruptcy Code nor the terms of Nosek's Chapter 13 plan offered sufficiently concrete directives, such that its conduct would violate the terms of the provisions. The Appellate Court agreed that Section 1322(b) provides plan flexibility for Chapter 13 debtors by listing a number of permissive elements that may be included in the plan. The same language in Section 1322(b), which was relied upon by the Bankruptcy Court to find a violation of the Code, does not impose any specific duties on a lender.

The plain language of Nosek's plan was silent as to how the servicer was to account for pre or post-petition payments or if the payments were short, late or not made at all. Furthermore, the Appellate Court found that the terms of the Plan itself did not provide the specificity required to invoke the enforcement and authority of Section 105(a), the Bankruptcy Code. The Appellate Court noted that although Nosek did not need to show proof of economic damages to establish that her cure rights had been violated, she had to have at least established that her right to cure the default had been impaired or threatened by the creditor's actions. The Court found that even if the payment history could somehow be construed as a threat to Nosek's right to cure, the proper response from the bankruptcy court would have been to amend the plan to specify the accounting practices necessary to eliminate the threat.

Interestingly, the Chapter 13 plan that the court found that the servicer had violated was confirmed on Jan. 16, 2004; however, the payment history that Nosek received covered the period from March 10, 2003 to May 4, 2004. Most of the payments included in the payment history were processed prior to the Plan's confirmation and therefore were not specifically governed by the terms of the Plan. In sum, because there was no language in Nosek's plan or in Section 1322(b) that addressed how the servicer was to apply the payments it received from Nosek or from the trustee, the court rejected the bankruptcy court's award for emotional distress and punitive damages against the servicer. This First Circuit opinion provides important clarity for servicers servicing loans in bankruptcy in Massachusetts, Rhode Island, New Hampshire and Maine, and it also highlights the importance of careful pre-confirmation plan review.