

Legal analysis to guide the mortgage industry and protect its interests.

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## More Confusion as to Post-Petition Expenses by Meaghan E. Ryan

Recently, a federal bankruptcy judge in Pennsylvania sided with the mortgage industry, holding that a mortgage servicer had no duty to notify the debtor or seek court approval before assessing post-petition legal expenses and dismissing the majority of the debtor's allegations that the servicer had violated her rights.

### The problem: post-petition fees

Mortgages are a unique type of debt in the Chapter 13 context because, unlike most other debts, the mortgage debt is not typically discharged at the conclusion of the bankruptcy plan. Instead, if a debtor successfully completes the bankruptcy plan, the mortgage is reinstated as it existed pre-petition—the mortgage passes through the bankruptcy intact.

A Chapter 13 debtor must make his mortgage payments as they fall due post-petition while also making payments to the Chapter 13 trustee to cure the pre-petition default. There are, however, instances in which a debtor's post-petition obligations change during the bankruptcy. In particular, changes in escrow requirements for taxes and insurance and interest rate adjustments in ARMs may cause the debtor's mortgage payment to fluctuate. Also, many mortgages contain a provision that allows the servicer to recover its legal fees. Thus, when dealing with mortgages, the debtor's obligations (and, consequently, the servicer's rights) may change during the pendency of the bankruptcy case.

In some cases, mortgage lenders wait until after the bankruptcy has been discharged to state their claim for attorneys fees and other amounts that were assessed during the bankruptcy period. When this happens, debtors can complete their plans by paying off the entire pre-petition arrearage, but find themselves in default/foreclosure the day after discharge because of unpaid, and sometimes undisclosed, post-petition legal fees. Some servicers are reluctant to send notice to the debtor of some post-petition fees for fear of being accused of trying to collect on the fees in violation of the stay.

Courts have been troubled by the debtor emerging from bankruptcy still owing the servicer for the advances the servicer had to make on the debtor's behalf. These courts are also concerned that the borrower's due process rights are violated if he is never notified that these charges have been assessed to his account. Recently, several bankruptcy courts have ruled that mortgage servicers must make a claim for attorneys fees before the debtor's bankruptcy is discharged, finding that a creditor should not be able to assess fees to the debtor's account while in bankruptcy without the debtor's knowledge. These courts reason that (1) post-petition/pre-confirmation legal expenses may be included in the secured creditor's claim and must be allowed by the court, which would satisfy the due process requirements of notice to the debtor; and (2) although post-petition/post-confirmation legal fees are not specifically governed by the Bankruptcy Code, they must be disclosed because they may be treated in the Chapter 13 plan, making it necessary for a servicer to disclose when fees and charges are assessed against a debtor's account.

### In re Padilla: no notice required

Recently, however, a bankruptcy court in Pennsylvania found that the Bankruptcy Code does not impose a duty on servicers to disclose post-petition assessed fees. In *In re Padilla*, 389 B.R. 409 (Bankr. E.D. Pa. 2008), a Chapter 13 debtor who had successfully completed her cure-and-maintenance plan and received a discharge from bankruptcy moved to reopen her bankruptcy case to bring an adversary proceeding against the servicer of her loan. Bringing her claims as a class action, she argued that the servicer had violated various bankruptcy rules by seeking to recover pre-petition and post-petition/pre-confirmation fees.

A number of the debtor's claims were based on the theory that the servicer attempted to collect charges that had been discharged by the Chapter 13 discharge order, and thus, her discharge rights had been violated. The court found these allegations without merit because the mortgage was not discharged at the conclusion of the bankruptcy case. In the absence of a discharge of the mortgage, the debtor could not claim that her discharge rights had been violated. The court also dismissed the debtor's argument that the servicer's conduct constituted a contempt of court. The court found that, even if the creditor had breached the confirmed plan, a breach would not be a per se violation of the court's confirmation order. The confirmation order is a new contract between the debtor and his creditors, not a coercive court order directing creditors to act in conformity with the plan. The confirmation order is merely a judicial validation of the new contract, much like a court's approval of a settlement agreement.

The court disagreed with the other bankruptcy courts that have held that a servicer is required to notify the debtor when post-petition legal expenses have been incurred while the debtor is curing a default. The *Padilla* court found that such a duty must come from one of four sources: the confirmed plan, the Bankruptcy Code, the rules of court or the mortgage itself. Neither the confirmed plan nor the mortgage imposed any duty on the mortgagee or servicer to notify the debtor of post-petition assessments. After examining the Bankruptcy Code and rules of court, the *Padilla* court found nothing in the text of any applicable statute that establishes notice obligations or deadlines for a servicer to seek payment of post-petition legal expenses. In the absence of a duty to disclose, and because the mortgage debt is not discharged and passes through the Chapter 13 plan unaffected, the court found it logically follows that the servicer may collect all charges lawfully due under the contract that were not paid during the pendency of the bankruptcy plan. In support of its position, the court noted that changes in interest rate and escrow amounts create the same risk of adverse consequences as the nondisclosure of post-petition legal expenses, yet these changes undeniably fall outside the scope of the bankruptcy rules.

The court did, however, leave one claim intact (and that claim's class action status): the debtor's claim that the servicer's demand for payment of pre-petition charges violated the debtor's rights. The *Padilla* court found that after a debtor has cured his pre-petition default, a subsequent demand for additional delinquent pre-petition charges is inherently inconsistent with the cure of the pre-petition default. If the debtor's proposed plan is confirmed, it becomes a court-validated contract between the debtor and his creditors and the pre-petition relationships are restructured. Thus, the confirmed plan creates obligations that are judicially enforceable by compensatory damages and equitable relief.

### To notify or not?

The 60-page *Padilla* decision is a well-reasoned interpretation of the bankruptcy rules. At this point, it is unclear whether other bankruptcy courts that have not yet ruled on disclosure of assessed legal fees will follow the *Padilla* court's reasoning. Already, several other courts have found an implied duty to disclose these fees or to seek court approval for their assessment—in fact, one such bankruptcy decision was recently affirmed by a federal district court. *In re Jones*, 2007 WL 2480494 (Bkrcty. E.D. La. Aug. 29, 2007) (*affirmed in part, reversed in part on other grounds*, 2008 WL 2635369 (E.D. La. July 1, 2008)). Even the *Padilla* court seemed convinced, at least from a policy perspective, that a servicer should notify the debtor or seek court approval for post-petition fees. In fact, it appears that several jurisdictions across the country, including the Southern District of Florida, South Carolina and Kansas, are developing post-petition notice procedures.

Until a uniform procedure is established, the real dilemma for national mortgage servicers is the insurmountable task of developing a bankruptcy accounting system that will comply with the dozens of processes the bankruptcy courts are mandating with respect to post-petition fees.