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Business Law Section
AMERICAN BAR ASSOCIATION

Newsletter of the ABA Business Law Section Committee on

Consumer Bankruptcy

February 2014

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Message from the Chair

Dear Fellow Consumer Bankruptcy Practitioners,

I want to welcome you to the inaugural Consumer Bankruptcy Newsletter. The newsletter will be distributed on a monthly basis and will be an avenue for committee members to submit original articles on current bankruptcy issues and to provide updates on consumer bankruptcy cases. We need your contributions to make this a success and we welcome any ideas as to how to improve the content of the newsletter.

We are pleased to present two articles in this issue. Christopher Priore authored an article entitled "Lending Intermediaries: The Implications of Fraud on Unsuspecting Debtors & Lessons from *In Re Montano*." Yasin Daneshfar contributed the article "The Loss Mitigation Mediation Program Comes to the United States Bankruptcy Court for the Southern District of Florida." Furthermore, we have also included information on the proposed amendments to the Federal Rules. Please note that the public comment period regarding these Rules expires on February 15, 2014.

Also, the ABA Business Law Section Spring Meeting is taking place in Los Angeles from April 10-12. The link to the information is below. The Consumer Bankruptcy Committee is co-sponsoring two programs: The View From the Bench: Judicial Perspective on Consumer Finance Litigation and The CFPB Rules on Debt Collection. Please plan on attending.

We hope that you enjoy this newsletter and find it beneficial to your practice.

Best Regards,

Ryan Starks, Esq.

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Proposed Amendments to the Federal Rules of Bankruptcy and Civil Procedure

The ABA has formed a legislative task force to comment on the proposed amendments to the Federal Rules of Bankruptcy Procedure. These changes will affect your bankruptcy practice. The Task Force will be meeting in January. You can review the proposed changes on the Federal Court website. Please provide your comments to us as soon as possible.

To comment on the proposed Rule Changes and the Proposed National Chapter 13 Plan please click here.

Dates to Remember:

> February 15, 2014: the time for public comment on the proposed amendments expires
> December 1, 2015: the proposed amendments would become effective
> December 1, 2014: the revisions to the Official Bankruptcy Forms would become effective on, except as otherwise noted

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Links of Interest

- CFPB Link - Information on the implementation of new mortgage rules effective January 10, 2014
- American Bar Association Business Law Section Spring Meeting Schedule
- Bankruptcy Statistics, Pt. 1
- Bankruptcy Statistics, Pt. 2 (posted by Bob Lawless on creditslips.org)

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Feature Articles

Lending Intermediaries: The Implications of Fraud on Unsuspecting Debtors & Lessons from *In Re Montano*

By Christopher Priore

Recall for a moment the first time you sought a loan to purchase a new car or home. Do you remember that voluminous mountain of forms needed to be filled out and signed before a bank agreed to lend you money? It is unlikely that the average consumer would take the time to read the fine print before placing their signature and initials all over these forms, especially when they have a skilled professional assisting in obtaining their financing.

Prior to 2008, the heyday of unscrupulous lending, a borrower (and arguably a lender) might solely rely upon a mortgage broker or car salesperson to present that potential borrower with the best financing options available to them. The only problem with this model is that an intermediary does not necessarily have the interest of the bank or the borrower at heart but rather closing as many loans as possible. According to the Ninth Circuit the absence of the borrower manually entering all of their financial histories and personal information on every line of every form, the veracity of these statements are ultimately on shaky footing. Read more...

The Loss Mitigation Mediation Program Comes to the United States Bankruptcy Court for the Southern District of Florida

By Yasin Daneshfar

The Southern District of Florida Bankruptcy Court has joined a wave of loss mitigation programs around the country by initiating the Loss Mitigation Mediation (the "LMM"), beginning April 30, 2013. The program is designed to facilitate communication and exchange of information in a confidential setting and encourage the parties to finalize a feasible and beneficial agreement with the assistance and supervision of the United States Bankruptcy Court for the Southern District of Florida. Loss mitigation options include modification of a mortgage or surrender of real property owned by an individual Debtor. Read more...

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LENDING INTERMEDIARIES: THE IMPLICATIONS OF
FRAUD ON UNSUSPECTING DEBTORS &
LESSONS FROM *IN RE MONTANO*[*]

I. INTRODUCTION:

Recall for a moment the first time you sought a loan to purchase a new car or home. Do you remember that voluminous mountain of forms needed to be filled out and signed before a bank agreed to lend you money? It is unlikely that the average consumer would take the time to read the fine print before placing their signature and initials all over these forms, especially when they have a skilled professional assisting in obtaining their financing.

Prior to 2008, the heyday of unscrupulous lending, a borrower (and arguably a lender) might solely rely upon a mortgage broker or car salesperson to present that potential borrower with the best financing options available to them. The only problem with this model is that an intermediary does not necessarily have the interest of the bank or the borrower at heart but rather closing as many loans as possible. According to the Ninth Circuit the absence of the borrower manually entering all of their financial histories and personal information on every line of every form, the veracity of these statements are ultimately on shaky footing.

In a recent case *Heritage Pacific Financial, LLC v. Montano* [1] the Ninth Circuit Bankruptcy Appellate Panel issued a ruling that may be cause for debtors to carefully examine every document that they execute in obtaining a secured or unsecured loan. These various loan applications are what lending institutions utilize to determine the credit worthiness of a borrower. When these statements are not accurate pictures of a borrowers ability to repay, it may present a higher than anticipated rate of default. This failure of accuracy raises concerns for debtors under the Bankruptcy Code § 523[2] as possibly non-dischargeable, which is an issue likely raised by a duped lender. However, the important question that remains is whether or not the fraudulent behavior of a lending intermediary such as a mortgage-broker or car sales financier can be imputed upon a debtor under § 523.

II. THE FACTS:

The Debtor in *Montano* was a native of El Salvador lacking sufficient English language skills for oral commutation and was unable to read or write English. In November 2006 the debtor purchased a home in Oakland, California. To secure a mortgage to finance the purchase of a home, the debtor contacted a mortgage broker who allegedly collected all necessary financial information via a phone conversation with the debtor. This information was subsequently "incorporated" (note that the Court did not use to phrase "transcribed" or similar word here) into a Universal Residential Loan Application (hereinafter "URLA"). The eventual lender turned out to be WMC Mortgage

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[1] *Heritage Pacific Financial, LLC v. Montano* [1](9th Circuit BAP Nov. 1, 2013).

[2] 11 U.S.C § 523.

Corporation who based upon the URLA loaned a primary principal sum of $348,750 and a second loan for the sum of $89,990.

The parties agreed during the litigation that the URLA contained incorrect and inaccurate information regarding the debtor's monthly income. The loan application also allegedly contained exhibits such as letters of reference by customers of the debtor's business and Craigslist advertisements showing that the debtor was currently self-employed. Furthermore, there was a letter from an accountant who provided tax services to the debtor's company. As it turns out these documents were apparently forgeries created by or at the direction of the mortgage broker to bolster the loan application sent to WMC. Both loans ultimately were approved by WMC in December 2006. The following June the debtor, after only having made five mortgage payments defaulted and the lender commenced foreclosure proceedings. The property was sold at a trustee sale. The now un-secured second loan was sold and assigned to Heritage Pacific Financial, LLC (hereafter "Heritage" or "Creditor").

In April 2010 Heritage commenced and action in California Superior Court against the debtor alleging that the second loan was obtained by the debtor through fraud. In October 2010 the debtor filed for Chapter 7 Bankruptcy protection listing the $89,990 loan on Schedule F of the Petition. The creditor then commenced an adversary proceeding seeking a determination as to whether the unsecured WMC loan was excepted from discharge based upon § 523(a)(2) (A) and (B). The creditor made the argument that the debtor had knowledge that the URLA and supporting documentation were materially false. After some preliminary motion practice the debtor brought a motion for summary judgment based on, among other things, the one action rule[3], which is California's anti-deficiency statute[4].

The Court granted the debtor's motion for summary judgment but did not award fees and costs under § 523 (d)[5]. The debtor filed a motion to reconsider the sole § 523(d) issue. Heritage submitted several declarations to the Court to make its showing of substantial justification.[6] Declarations submitted to the Court were made by Heritage's In-House Counsel, a Heritage employee as well as a former employee of WMC (the originating lender). The declarations attempted to illustrate that WMC had relied upon

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[3] CCCP § 726 (a), et seq.

[4] CCCP § 726. Form of action . . . (a) There can be but one form of action for the recovery of any debt or the enforcement of any right secured by mortgage upon real property or an estate for years therein, which action shall be in accordance with the provisions of this chapter. (f) …any person authorized by this state to make or arrange loans secured by real property or any successor in interest thereto, that originates, acquires, or purchases…any loan secured directly or collaterally, in whole or in part, by a mortgage or deed of trust on real property…may bring an action for recovery of damages…against a borrower where the action is based on fraud…and the fraudulent conduct by the borrower induced the original lender to make that loan.

[5] 11 U.S.C. § 523(d) requires that the Court issue an Order for an award of attorney's fees and costs if it finds on the facts that the creditor's position was not substantially justified.

[6] 11 U.S.C. § 523 (d) does not specify the extent or temporal period upon which a creditor must have been substantially justified, however, the Court noted that the creditor must have been justified at "all stages" of the litigation. *Heritage Pacific Financial, LLC. v. Montano* (9th Cir. BAP) at *9; s*ee e.g., AT&T Universal Card Servs. v. Williams* (In re Williams), 224 B.R. 523, 530 (2d Cir. BAP 1998)("We hold that the creditor must be substantially justified at all times through trial to be insulated from paying attorneys' fees under § 523(d).").

the URLA and that their internal process to determine creditworthiness was commonly accepted by the industry norms.

The Court did not find Heritage's statements adequate to show substantial reliance and thereafter the Bankruptcy Court issued an award of $69,782.19 to the debtor based on § 523(d). Heritage then sought review by the Bankruptcy Appellate Panel alleging abuse of discretion in reconsidering the § 523(d) issue and the anti-deficiency issue. The Bankruptcy Appellate Panel affirmed the Bankruptcy Court on the anti-deficiency issue finding that the California statute barred deficiency litigation premised upon a debt secured by a mortgage on real property for which had already been subject to an action to recover that debt and one that was statutorily exempt in any event.[7]

III. THE STANDARD UNDER § 523 (A)(2)(B)

The Bankruptcy Code Section 523 precludes a debtor from receiving a discharge of debts under 727, 1128, or 1328 among others. In order for this section to apply, a creditor must show a debt was incurred for money, property/services, or extensions of credit obtained by the debtor in a written statement. The statement must have been; (i) materially false; (ii) respecting the debtor's financial condition; (iii) upon which the creditor reasonably relied; and (iv) that the debtor caused to be made or published with the intent to deceive.[8]

The BAP in *Montano* did not necessarily have to take a hard look at the individual elements; however, it did focus on whether or not the creditor had reasonably relied upon the debtor's statements. The Court ultimately found that Heritage as the successor in interest to WMC could not prove that WMC had actually relied upon the URLA when making its loan to the debtor.[9]

For purposes of this article I would like to briefly linger on the fourth element of the § 523 analysis: a written statement the debtor caused to be made or published with the intent to deceive. What is exactly the standard a creditor must show in order to fulfill this element of the analysis? The Fourth Circuit has stated that intent to deceive can be inferred from the totality of the circumstances surrounding the debtor's knowledge or recklessness as to the accuracy of the financial information provided.[10] While the Third Circuit has laid out a clearer standard stating "[a] creditor can establish intent to deceive by proving reckless indifference to, or reckless disregard of, the accuracy of the information in the financial statement of the debtor when the totality of circumstances supports such an inference."[11]

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[7] CCCP § 726(g). Subdivision (f) does not apply to loans secured by single-family, owner-occupied residential real property, when the property is actually occupied by the borrower as represented to the lender in order to obtain the loan and the loan is for an amount of one-hundred thousand dollars ($150,000) or less.

[8] 11 U.S.C. § 523(a)(2)(B).

[9] *Heritage Pacific Financial, LLC. v. Montano* citing *AT&T Universal Card Servs. v. Mercer (In re Mercer),* 246 F.3d 391, 413 (5th Cir. 2001) (the "actual reliance" standard requires that the creditor prove that it, in fact, relied on representations of the debtor).

[10] *In re Dalton*, 205 F.3d 1332 (4th Cir. 2000).

[11] *In re Cohn*, 54 F.3d 1108, 1119 (3rd Cir. 1995).

IV. THIRD PARTY INTERMEDIARIES

The big question left unresolved by the Court is to what extent would the fraudulent conduct of a third party be imputed upon the debtor for purposes of § 523 (a)(2)(B). Assuming for a moment that the creditor was able to establish that WMC and indeed Heritage had reasonably relied upon the debtor's statements in the URLA (which all the parties concede were inaccurate at the very least) can an exception to discharge be founded upon the misstatement of the mortgage broker or third party unbeknownst to the debtor.

The language of § 523 does not provide a clear answer to this question. Arguably, the debtor is charged with knowledge of everything he places his signature on and the contents of each document. However, if the Court were to employ a negligence standard similar to the one found in the California Penal Code it would appear that the debtors recklessness would not be sufficient to except the debt.[12] In *Montano* the mere fact that the debtor did not review the URLA before having it submitted to WMC may be found sufficiently reckless to except the debt from discharge.

Modifying the facts just a bit, assume that the debtor had signed a blank URLA so that it would have been impossible for the debtor to verify or certify any information. This could raise two separate issues: (i) is signing a blank lenders form in and of itself reckless; and (ii) if so, should the debtor be held responsible for any fraudulent information contained on the form relating to their financial condition. It would appear to me that since excepting a debt from discharge is a drastic remedy than the Court would inquire into the specific facts of each case.

V. CONCLUSION

It will be interesting to see if Heritage Pacific pursues any causes of action for fraud against the mortgage broker. However, this still leaves open the possibility that the fraudulent nature of a lending intermediary such as a mortgage broker or even a car salesman could give rise to § 523 litigation. In the context of the unregulated intermediaries such as point of sale lenders (i.e. car dealerships) the intermediary prompts consumers to fill out loan applications without careful and laborious review to ensure full disclosure of the current financial condition. To me this is a gapping hole in the codes § 523 language which places a significant burden upon the debtor to defend costly adversary proceedings. Also subjecting debtors to the real possibility of an eventual exception claim for failure to fully and completely examine loan applications when using a third party-lending intermediary is cause for pause. I would think that best practices would dictate possibly avoiding the use of intermediaries all together. If in the *Montano* case the creditor had showed reasonable reliance, the outcome of the case could have been far graver for the debtor.

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[12] *See e.g.,* California Penal Code § 532a. (1) and (2). Section (1) makes a public offense when "any person who shall knowingly make or cause to be made, either directly or indirectly…any false statement in writing, with intent that is shall be relied upon, respecting the financial condition…for the purpose of procuring in any form…the extension of credit" while section (2) also a public offense uses the phrase "knowing that a false statement has been made…"

The Loss Mitigation Mediation Program Comes to the Southern District of Florida Bankruptcy Court

The Southern District of Florida Bankruptcy Court has joined a wave of loss mitigation programs around the country by initiating the Loss Mitigation Mediation (the "LMM"), beginning April 30, 2013. The program is designed to facilitate communication and exchange of information in a confidential setting and encourage the parties to finalize a feasible and beneficial agreement with the assistance and supervision of the United States Bankruptcy Court for the Southern District of Florida. Loss mitigation options include modification of a mortgage or surrender of real property owned by an individual Debtor.

A. What chapters is it available for?

The LMM is available for debtors in all chapters, similar to the programs in the Northern District of New York, Districts of Rhode Island, and New Jersey. It is in contrast to its sister district, the Middle District of Florida and the Eastern District of Wisconsin, where the program is available only for debtors in Chapter 13.

B. What is the time frame to apply for the LMM?

The LMM is available for the cases filed or reopened after April 30, 2013. For cases falling outside this time frame, the debtor needs to ask for the authorization of the court by motion and hearing.

The time frame to apply for the LMM is 90 days for all chapters. Therefore, unlike districts such as Rhode Island and New Jersey that have time limit only for Chapter 7 debtors, or Districts of New Jersey's of limit to file at least three days before the meeting of the credits, the deadline is uniform for all chapters.

C. How is the LMM implemented?

Following the steps of the Districts of New Jersey and the Eastern District of Wisconsin, the LMM in the Southern District is implemented by utilizing online softwares: a secure online portal (the "LMM Portal") and an on-line program that facilitates the preparation of the Debtor's loan modification package (Document Preparation Software).

Within 90 days from the date of filing the Voluntary Petition, the debtor or its attorney must file a verified motion for referral to the LMM (the "Verified Motion"), with an order of referral (the "Order") attachedas an exhibit. Prior to filing the Verified Motion, the debtor's information must be entered into the Document Preparation Software. The software prepares all the forms with the necessary information for the debtor to sign, and provides a list of required documents that the debtor will need to submit along with the signed forms.

The debtor must serve the Verified Motion on the lender and the mediator. The lender has 14 days from the date of service to respond to the debtor's Verified Motion. Upon entry of the Order, the debtor has seven days to upload all the forms and required documents to the LMM Portal. All communication between the parties to the mediation is done through the LMM Portal. The moving party also uploads a copy of the Order to the LMM Portal.

The mediation can occur in up to two sessions. The initial mediation conference should not exceed one hour. If the parties do not reach an agreement, the Mediator must schedule a final LMM conference not later than 30 days thereafter, not to exceed one hour.

D. What are the advantages of the LMM program?

The LMM program offers a few advantages. First, it provides a central portal where the documents are available to each party and the mediator, reducing the paperwork and the frustration of sending documents to multiple parties. Second, it brings the debtor and the lender before a neutral mediator, and under the supervision of the bankruptcy court, thus maximizing the probability of an out-of-court resolution. Finally, by imposing a good faith requirement, it encourages the parties to reach an agreement, and reduce the cost as a result. For more information on the LMM, you can visit http://www.flsb.uscourts.gov/FRAMES/Loss_Mitigation_Mediation.pl.