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BANKRUPTCY LAW

Refinancing Can Be a Risky Proposition

Can a mortgage lender refinance a prepetition mortgage and note that was discharged?

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Homeowners often refinance their mortgages with their original mortgagee for a variety of reasons — usually because they are satisfied with the relationship and want to obtain a lower interest rate or monthly payment or cash out their equity.

But when the mortgagor has been through bankruptcy, the original mortgage's refinancing of the mortgage may be a risky proposition. Can a lender refinance an individual's mortgage and note where the note was discharged in bankruptcy without violating the Bankruptcy Code's discharge injunction and while ensuring that the new mortgage and note are fully enforceable? While a refinancing is typically accomplished by the execution of a new mortgage and note with different terms (including generally a lower interest rate) by the same lender, it is unclear if this constitutes sufficient new consideration to make the new mortgage and note fully enforceable without violating the Bankruptcy Code's discharge injunction.

A discharge in bankruptcy relieves an individual debtor of future personal liability on all claims arising from or before the date the bankruptcy proceeding is commenced. See 11 U.S.C. § 524. Creditors are prohibited from collecting, or attempting to collect, a discharged debt. A debtor may reaffirm a dischargeable debt by entering into a "reaffirmation agreement" with a creditor. See 11 U.S.C. § 524(c). Reaffirmation agreements must meet the requirements of Bankruptcy Code section 524(c). Thus, how can a mortgage lender who wants to refinance a prepetition mortgage and note after the individual debtor was granted a discharge do so without running afoul of the Bankruptcy Code? The answer lies in when and how the lender approaches a debtor (or vice versa) to refinance or restructure a mortgage and note. Where no part of the consideration for a post-discharge agreement is based upon a dischargeable debt, the post-discharge agreement is not a reaffirmation agreement and is not necessary to meet the requirements of section 524(c). Thus, such a new mortgage and note executed by a discharged debtor will not violate section 524 of the Bankruptcy Code. Section 524 is implicated because if the debt was discharged in bankruptcy, the creditor is prohibited from seeking to enforce the terms of the note unless the debtor executed a reaffirmation agreement that was approved by the Bankruptcy Court.

Whether a court will require compliance with the reaffirmation rules of section 524(c) when determining whether a post-discharge refinancing of a mortgage and note is enforceable or violative of the discharge injunction depends largely on whether the court sits in a "Code Option" or "Non-Code Option" jurisdiction. The Bankruptcy Code provides that a debtor must specify the treatment of property of the debtor's estate that is subject to liens or security interests of secured creditors. See 11 U.S.C. § 521(2)(A). Section 521 provides a debtor with three options: (i) surrender the collateral to the secured party; (ii) redeem the collateral by paying any arrears and continuing to make all required payments; or (iii) reaffirm the obligation.

Code Option jurisdictions, which include the First, Fifth, Seventh and Eleventh Circuits, follow the rule that the options contained in Bankruptcy Code section 521 are the sole options available to the debtor. Lower courts in the Third and Sixth Circuits have also held that the options set forth in section 521 are exclusive. The Third Circuit has yet to address this question. In these jurisdictions, the reaffirmation requirements set forth in Bankruptcy Code section 524(c) must be satisfied if a debtor elects to reaffirm an obligation.

In contrast to the Code Option jurisdictions, the Second, Fourth, Ninth and Tenth Circuits are Non-Code Option jurisdictions. These Circuits follow the rule that

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the section 521 options are *not* exclusive. In Non-Code Option jurisdictions, in addition to the three alternatives set forth in section 521, debtors also have the option of keeping the property and paying the secured debt as required under the note or other loan documents. In addition, lower courts in the Third and Eighth Circuits have followed this rule. Again, the Third Circuit has not addressed this question, so the obvious split among the lower courts remains unresolved. Cases decided by courts in these jurisdictions generally hold that a secured creditor has no right to proceed against the discharged debtor to the extent of any deficiency between the amount of its claim and the value of the collateral.

Section 524(c) of the Bankruptcy Code provides that a postpetition agreement between a holder of a claim and the debtor, *the consideration for which, in whole or in part, is based on a debt that is dischargeable in bankruptcy*, is enforceable only if five requirements are satisfied: 1) the agreement must be made prior to discharge; 2) the agreement must advise the debtor that the reaffirmation may be rescinded up to 60 days after it is filed; 3) the agreement must be filed with the court; 4) the debtor cannot already have rescinded the agreement within the proper time frame; 5) the agreement must be in the best interest of the debtor. *See* 11 U.S.C. § 524(c). *See also In re Daily*, 47 F.3d 365, 367 (9th Cir.1995); *In re Heirholzer*, 170 B.R. 938, 940 (Bankr. N.D. Ohio 1994); *In re Bowling*, 116 B.R. 659, 663 (Bankr. S.D. Ind. 1990). Courts in Code Option jurisdictions generally require strict compliance with the elements of section 524(c).

The reaffirmation rules are intended to protect debtors from compromising their fresh start by making unwise agreements to repay dischargeable debts. *See In re Martin*, 761 F.2d 1163, 1168 (9th Cir.1985); *In re Fernandez-Lopez*, 37 B.R. 664, 667 n. 1 (9th Cir. BAP 1984). Due to the danger that creditors may coerce debtors into undesirable reaffirmation agreements, they are not favored under the Bankruptcy Code and strict compliance with the specific terms in section 524 are mandatory. *See In re Cherry*, 247 B.R. 176, 183 (Bankr. E.D. Va. 2000); *In re Artzt*, 145 B.R. 866, 868 (Bankr. E.D. Tex.1992); *In re Petersen*, 110 B.R. 946, 949 (Bankr. D. Colo. 1990); *In re Gardner*, 57 B.R. 609, 611 (Bankr. D. Me. 1986). Most crucially, if any part of the consideration for the agreement is based on dischargeable debt, the agreement must comply with section 524(c). *See In re Stevens*, 217 B.R. 757, 761 (Bankr. D. Md. 1998).

There is a dearth of case law on the issue of the kind or type of consideration that is sufficient to support a post-discharge agreement. However, the cases that have been decided generally hold that (i) none of the consideration for the agreement can be based upon a dischargeable debt, and (ii) if any of the consideration is based upon a dischargeable debt, the agreement must comply strictly with section 524(c). *See*, *e.g.*, *In re Stevens*, 217 B.R. 757 (Bankr. D. Md. 1998); *In re Getzoff*, 180 B.R. 572 (9th Cir. B.A.P. 1995); *In re Heirholzer*, 170 B.R. 938 (Bankr. N.D. Ohio 1994); *In re Artzt*, 145 B.R. 866 (Bankr. E.D. Tex. 1992); *In re Petersen*, 110 B.R. 946 (Bankr. D. Colo. 1990).

For example, In *Heirholzer*, the debtor executed a $15,000 promissory note to Minster State Bank secured by a second mortgage on real property owned by the debtor. Subsequently, the debtor filed bankruptcy and received a discharge. Three weeks after the discharge, the parties executed a new promissory note with accompanying new mortgage in consideration of the Minster State Bank agreeing not to foreclose on its original mortgage. This subsequent note was for the sum of $15,000, and its proceeds were used by Minster State Bank to pay off the debtor's original note. The debtor defaulted on the second note.

The Bankruptcy Court held that the second promissory note was supported by sufficient consideration and did not constitute an invalid reaffirmation agreement. The court held that after the debtor received his bankruptcy discharge, Minster State Bank had every right to proceed in foreclosure on the mortgage. 170 B.R. at 941. The court relied on the principal that a decision to forbear a valid legal claim provides sufficient consideration to support an agreement between two parties. Thus, the court viewed the second note as a "valid contract that is completely separate from the initial note that was discharged in bankruptcy." The court found it significant that the debtor and Minster State Bank executed a "completely new set of paperwork to initiate their subsequent agreement [the second note]."

In contrast, the court in *Getzoff* held that if the debtor's consideration is based in whole or in part on a discharged debt, then a reaffirmation agreement must be filed with the court. In *Getzoff*, a creditor whose claim was secured, in part by the debtor's personal guaranty, and the debtor renegotiated the debtor's obligations after the debtor received a discharge in bankruptcy. The new instrument included a replacement personal guaranty by the debtor. The court held that this was insufficient new consideration: "the fact that the Bank gave new consideration in exchange for the replacement guaranty does not change the fact that the consideration given by Getzoff was his promise to honor a discharged debt, the [original] Guaranty." Thus, the rule in the Ninth Circuit appears to be that the measure of consideration sufficient to support a postpetition agreement must flow from the debtor, *not* the lender.

Viewing *Heirholzer* and *Getzoff* in juxtaposition, it becomes clear that lenders must beware the nature and sufficiency of new consideration they give as well as the new consideration they receive from the borrower. While the case law remains far from settled, lenders would do well to remember that consideration, where the borrower has taken the mortgage and note through a personal bankruptcy, is a two-way street.

Real estate mortgage lenders can be badly burned by mortgages and notes that are unenforceable against a former debtor, plus face possible sanctions by a bankruptcy court for violating the Bankruptcy Code's discharge injunction. To avoid this, real estate mortgage lenders must be vigilant about ensuring that any post-discharge refinancing of mortgages and notes include sufficient new consideration — such as a better interest rate, longer term or lower monthly payments) to avoid the Bankruptcy Code's discharge and reaffirmation rules. ■