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# Think Again Before Walking Away from Second Trust Deeds in Bankruptcy

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Banks and credit unions routinely walk away from second trust deeds where there isn't enough equity to cover the outstanding loan balance plus interest, arrears, costs of sale and attorneys' fees. This is especially true where the borrower files a chapter 13 bankruptcy case, which allows certain secured liens to be completely avoided.[1]

But there is no reason for banks or credit unions to unknowingly and prematurely walk away from second trust deeds that are given special protections in bankruptcy.

The problem for borrowers who file a chapter 13 bankruptcy case is the "anti-modification provision" of Bankruptcy Code section 1322(b)(2), which protects second trust deed holders from having their loans modified if both:
(1) the property securing the lien is the debtor's principal residence and
(2) there is any value, even $1, to support the lien.[2]

**Expected Procedure in Chapter 13 Cases**

In practice, a debtor may file a chapter 13 case and move the court to avoid her second trust deed on 14 to 21 days' notice. These motions are usually supported by a declaration of the debtor stating some self-serving belief that her residence is worth a few thousand dollars less than the amount owed on the first trust deed (so as to avoid the anti-modification provision). Prudent banks and credit unions will
(1) quickly determine whether there is any equity to support their second trust deeds[3] and
(2) if so, file an opposition to the debtor's motion (often due within 7 to 14 days of the notice) and request an opportunity to appraise the property.

Bankruptcy courts typically respond to objections by continuing the hearing on debtor's motion and setting an "evidentiary hearing" to allow the parties to file declarations of appraisers (with full appraisal reports) and request cross-examination of the other side's appraiser. These evidentiary hearings can be costly and extremely risky to both sides (and the judges often disdain hearing them). In essence, if the bankruptcy court finds any equity to support the second trust deed then the entire loan is preserved. But if the court finds no equity, then the entire loan is avoided. In essence, bankruptcy law creates an all-or nothing proposition that often can (and should) be avoided.

**Striking Deals to Get Around the All-or-Nothing Proposition**

With increased frequency, informed banks and credit unions make deals with borrowers to reduce the cost and risk of evidentiary hearings for both sides. For example, on a $100,000 Home Equity Line of Credit with a 10 percent interest rate, the bank or credit union may agree to payments of $1,000/month over five years in full satisfaction of the note,[4] netting $60,000 on the loan and giving the debtor substantial debt relief through an effectively interest-free loan that is satisfied in five years—instead of 15-30 years—where total payments are less than half of what would otherwise be required under the promissory note. Banks and credit unions understandably prefer payments while the debtor (who likely filed chapter 13 and a motion to avoid the second trust deed in order to save her residence) still really wants the property. Striking a reasonable deal can result in the quintessential win-win situation for both sides.

**Overcoming Hurdles to Preserve the Deal**

In theory, everyone benefits from a deal as outlined above, including the bankruptcy court, for not having to decide an all-or-nothing proposition, other creditors, who generally must be paid more in chapter 13 than a chapter 7 liquidation case, and the chapter 13 trustee, who continues to get commissions on plan payments over 3-5 years. In practice, however, some trustees insist that where payment terms are modified, payments to the bank or credit union on second trust deeds must be made through the plan, with the chapter 13 trustee's commission, often 11 percent, assessed thereon.

Although the bankruptcy code,[5] local bankruptcy rules[6] and trustee guidelines[7] in the Central District of California all suggest direct payments in these instances is proper, trustees (and judges) may be reluctant to allow this out-of-the-box approach. This is true despite relevant appellate law giving bankruptcy courts considerable discretion in allowing these practical deals in chapter 13 plans and requiring articulated standards whenever direct payments are not allowed.[8]

Even in these instances in which the trustee and court are reluctant to allow direct payments from the debtor to the bank or credit union, opposing counsel will often agree to either dismiss the chapter 13 case or convert it to one under chapter 7. By doing so, **the debtor keeps her property (which is usually the reason for filing chapter 13 in the first place) and the bank or credit union gets payments in a deal that substantially benefits both sides** (and often only financially hurts the trustee and certain unsecured and/or priority creditors).

**Summary**

There is no reason for banks or credit unions to unknowingly and prematurely walk away from second trust deeds that are given special protections in bankruptcy. As outlined above, bankruptcy does not have to be all-or-nothing. Instead, striking a deal early in a bankruptcy case can avoid a costly and risky evidentiary hearing and result in regular monthly mortgage payments, as well as an increased bottom-line, especially where most banks and credit unions would still prefer payments over property.

1 Note: Secured liens in chapter 7 (liquidation) cases generally pass through unaffected, so, to avoid second trust deeds in bankruptcy, debtors must generally file a chapter 13 (reorganization) case and a motion or adversary case. *See Dewsnup v. Timm*, 502 U.S. 410, 418 (1992) and Federal Rule of Bankruptcy Procedure 3012 and 7001(2).

2 *See Lam v. Investors Thrift (In re Lam)*, 211 B.R. 36, 40-41 (9th Cir. B.A.P. 1997) and *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220, 1227 (9th Cir. 2002).

3 Costs of sale are not considered where the debtor intends to keep her property. *Taffi v. United States (In re Taffi)*, 68 F.3d 306, 309-310 (9th Cir. 1995).

4 Pending completion of payments under a settlement, the lien remains valid and, only if and when the debtor makes all agreed-upon payments, will the second trust deed be reconveyed.

5 11 U.S.C. §§ 1322(a)(1) and 1326(c) limit required plan payments to those "necessary for the execution of the plan" and specifically contemplate that certain payments will not be made by the trustee.

6 Local Bankruptcy Rule 3015-1(m)(3) in the Central District of California allows the debtor to elect to pay post-petition mortgage payments through the plan.

7 Many chapter 13 trustees publish guidelines that specifically address (and authorize) direct payments to secured creditors. In addition, the handbook for chapter 7 trustees issued by the United States Trustee admonishes trustees to not administer fully secured assets of nominal value to the estate. See, e.g., sections 6.A., 8.D and 8.K.4 of the U.S. Trustee handbook available online.

8 *See Lopez v. Cohen (In re Lopez)*, 372 B.R. 40, 56 (9th Cir. B.A.P. 2007), *aff'd* at 550 F.3d 1202 (9th Cir. 2008) and *Giesbrecht v. Fitzgerald (In re Giesbrecht)*, 429 B.R. 682, 691-692 (9th Cir. B.A.P. 2010).

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