Client Alert

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Debtor-Filed Proof of Claim in Chapter 13 Bankruptcy Case Leads to Modification of Lien on Principal Residence

The Bankruptcy Code prohibits a chapter 13 debtor from modifying a mortgage lien on the debtor's principal residence. Even in situations in which a secured creditor fails to file a proof of claim or otherwise participate in the bankruptcy proceeding, the Bankruptcy Code allows a secured creditor's lien on a primary residence to pass through the bankruptcy unaffected. However, a recent decision from a bankruptcy court in Texas illustrates the risks to secured creditors of blind reliance on these statutory protections.

In the chapter 13 case, the debtors filed a proof of claim on behalf of the secured creditor that provided a different interest rate than the contract rate on their homestead mortgage. The debtors' chapter 13 plan also proposed payment at the reduced interest rate. The secured creditor never filed its own proof of claim and did not object to the chapter 13 plan, which was confirmed. After the debtors made all payments required by the plan, the bankruptcy court held that the mortgage had been paid in full and ordered that the lien be released upon entry of the discharge, concluding that the secured creditor received adequate notice of the chapter 13 plan and failed to object. To potentially avoid this result, secured creditors should carefully examine the contents of any proofs of claim filed on their behalf as well as the terms of chapter 13 plans to ensure the treatment set forth in those filings is consistent with the creditor's expectations. If a creditor disputes the treatment proposed by a proof of claim or plan, the creditor should carefully consider its potential responses, including objecting to the proof of claim filed on its behalf, filing an objection to the proposed plan or appealing an order confirming that plan.

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The Bankruptcy Filing and Chapter 13 Plan

Husband and wife debtors filed for relief under chapter 13 of the Bankruptcy Code.[1] They listed on their bankruptcy schedules a homestead property, that was subject to a first mortgage in the approximate amount of $23,000 in favor of Montanaro Investments (*Montanaro*). The debtors' chapter 13 plan proposed to pay Montanaro the full $23,000 over 54 months, plus interest at a rate of 5.25 percent rather than at the 14 percent contractual rate. The plan also provided that "[s]ubject to disposition of a timely filed motion to avoid a lien … or a complaint to determine the validity of a lien … each secured creditor shall retain the lien securing its claim."[2] The plan further stated that "[t]he lien shall be enforceable to secure payment of the claim the lien secures, as that claim may be modified by the plan."[3] Montanaro received notice of the bankruptcy filing and the plan, but failed to file a proof of claim or object to the terms of the plan. After the bar date for filing proofs of claim, the debtors filed a proof of claim on behalf of Montanaro that, consistent with the plan, stated an interest rate of 5.25 percent. No one objected to the proof of claim, so it became allowed. Thereafter, Montanaro accepted plan payments directly from the chapter 13 trustee.

[1] The case is reported as *In re Shank*, 569 B.R. 238 (Bankr. S.D. Tex. 2017).

[2] *Id*. at 242.

[3] *Id*.

The debtors completed the scheduled payments under the plan. Thereafter, Montanaro contacted the debtors, claiming that a balance was still owed on the debt. Recognizing that a dispute existed over whether the mortgage was fully satisfied, the debtors sought to delay entry of a discharge in order to resolve the dispute. The debtors then filed a motion to deem the Montanaro mortgage fully paid.

The Bankruptcy Court's Ruling That the Mortgage Was Fully Satisfied at the Lower Interest Rate

The debtors asserted that the doctrine of *res judicata* bound Montanaro to the terms of the plan and prevented it from re-litigating the terms of the plan. As such, the debtor asserted that because they had paid Montanaro's claim in full under the terms of their plan, Montanaro's claim was satisfied in full, entry of the discharge was appropriate and Montanaro should release its lien.

Montanaro argued that there remained a balance of $30,000 due on the mortgage when calculated at the 14 percent contractual rate. Montanaro asserted that *res judicata* did not apply in this case and as such, it was not bound by the terms of the plan. Specifically, Montanaro asserted that under Fifth Circuit precedent, when a plan proposes to void a creditor's lien, the creditor must participate in the plan confirmation process in order to be bound by the terms of the plan. Montanaro argued that because (i) the debtors' plan voided its lien and (ii) it did not participate in the plan process, the doctrine of *res judicata* does not apply to bind Montanaro to the plan.

Initially, the bankruptcy court recognized that a secured creditor that does not file a proof of claim will have its lien pass through bankruptcy unaffected. A secured creditor need only file a proof of claim if it wishes to receive payments under a plan. The court noted that if a secured creditor does not file a proof of claim, a debtor or the trustee may file such a proof of claim on behalf of the creditor.[4]

In response to Montanaro's arguments, the bankruptcy court first considered whether Montanaro's lien was voided under the plan. The bankruptcy court acknowledged that a confirmed plan "may void liens not specifically preserved" but "the lien holder must participate in the reorganization" in order for the creditor to be bound by the plan.[5] Under Fifth Circuit law applicable to chapter 11 cases, active participation required something more than passive receipt of notice.[6] Fifth Circuit precedent has established that filing a proof of claim is sufficient participation.[7] The bankruptcy court avoided squarely addressing the impact of Montanaro's lack of participation in the case. Rather, the court determined that the plan did *not* void Montanaro's lien but rather provide for full payment of the mortgage in accordance with the proof of claim filed by the debtors, to which Montanaro did not object, and preserved Montanaro's lien until discharge. That Montanaro disagreed with the payment terms set forth in the plan did not equate to the debtors' *voiding* Montanaro's lien.

Additionally, the bankruptcy court found that Montanaro received adequate notice of the chapter 13 plan, the confirmation order and the debtor-filed proof of claim. Yet, Montanaro neither objected nor sought to appeal the court's order confirming the debtors' chapter 13 plan.

Analogizing the case to the Supreme Court's decision in *Espinosa*,[8] the bankruptcy court concluded that, despite Montanaro's nonparticipation in the chapter 13 plan confirmation process, the doctrine of *res*

[4] *See* 11 U.S.C. § 501(c); Fed. R. Bankr. P. 3004.

[5] *Shank*, 2017 Bankr. LEXIS 1827, at *17 (citing *In re Ahern Enters. Inc.*, 507 F.3d 817, 822 (5th Cir. 2007)).

[6] *See In re S. White Transp.*, 725 F.3d 494 at 498 (5th Cir. 2013).

[7] *See In re Vitro Asset Corp.*, 656 F. App'x 717, 723-24 (5th Cir. 2016).

[8] *See United Student Aid Funds, Ins. v. Espinosa*, 559 U.S. 260, 269 (2010) (holding that bankruptcy court's legal error in confirming a chapter 13 plan that discharged student loan debt without making statutorily mandated undue hardship finding did not render confirmation order void).

judicata barred re-litigation of confirmation and Montanaro was bound by the terms of the debtors' plan. As Montanaro was bound by the terms of the plan, its claim had been fully satisfied and it was required to release its lien on the debtors' property.

In reaching its conclusion, the court noted that there remained a question as to the propriety of confirming the debtors' plan given that the plan proposed to modify Montanaro's interest in the debtor's residence, a treatment prohibited by Section 1322 of the Bankruptcy Code. While such question existed, the court still found that, in light of the *Espinosa* decision, Montanaro's repeated failure to object to the plan or proof of claim did not bar the application of *res judicata* to hold Montanaro to the terms of the plan.

Takeaways for Secured Creditors and the Decision to File Proofs of Claim

In hindsight, Montanaro may have been able to better protect its interests in the case if it had filed a proof of claim or taken some action at all in the bankruptcy case.

The question of whether and when a secured creditor should file a proof of claim has been fraught with uncertainty. The current version of Bankruptcy Rule 3002 provides that only "[a]n unsecured creditor or an equity security holder must file a proof of claim or interest for the claim or interest to be allowed." Secured claims are not addressed. Bankruptcy Rule 3021 permits distributions to creditors "whose claims have been allowed." Most courts reading these sections conclude that a secured creditor must file a proof of claim—unless a proof of claim is filed on its behalf—in order to participate in chapter 13 plan distributions.[9] The new amendment to Bankruptcy Rule 3002(a), effective December 1, 2017, will clarify that a secured creditor must comply with the bar date provided in Rule 3002(c) if it wishes to file a proof of claim and receive distributions under the plan.[10]

Whether a creditor should file a proof of claim depends on several factors. A creditor that believes the collateral value may be worth less than the debt may want to participate in a bankruptcy case to maximize the distributions the creditor will receive compared to what it would receive if it solely exercised its lien rights. Alternatively, in a minority of jurisdictions a secured creditor may be required to file a proof of claim to exercise rights against collateral immediately upon a payment default by seeking relief from the automatic stay. Further, a secured creditor may want to file a proof of claim to participate in the bankruptcy case to protect against adverse treatment of the collateral through the administration of the case.

However, the filing of a proof of claim without additional vigilance in a case may expose a creditor to being subject to the doctrine of *res judicata* in cases where the debtor proposes to avoid the creditor's lien. While certain liens—such as a mortgage on a chapter 13 debtor's principal residence like the one held by Montanaro— are subject to additional protection under the Bankruptcy Code against impairment of lien rights, the *Shank* case shows how such rights can be eroded if the creditor does not adequately protect its own interests.

Even if a secured creditor elects not to file a proof of claim, it should nonetheless remain vigilant and monitor the bankruptcy case to protect its rights. As the case involving Montanaro illustrates, passive reliance on a secured creditor's lien rights riding through bankruptcy unaffected may not work as planned in all circumstances, such as where a proof of claim is filed on behalf of the secured creditor with different terms than provided in the mortgage loan documents.

[9] *See, e.g., In re Pajian*, 785 F.3d 1161, 1163 (7th Cir. 2015).

[10] Amended Rule 3002(a) will provide that failure to file a proof of claim will not void a creditor's lien.

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