

## The Foreclosure Ultimatum: Can a Debtor Use Bankruptcy to Compel a Lender to Foreclose or Discharge Its Mortgage?

By:



STEPHEN J. QUEENAN, ESQ.

### The Issue

The United States Court of Appeals For the First Circuit recently confronted an unusual situation in [In Re: Ralph G. Canning, III, et al.](#), No. 12-9002.<sup>1</sup> Ralph G. Canning, III and Megan L. Canning (collectively, the “Debtors”), recipients of a discharge in a Chapter 7 bankruptcy proceeding, accused their mortgage lenders, Beneficial Maine, Inc., HSBC Mortgage Services, Inc., and HSBC Mortgage Corporation (collectively, the “Lender”) of violating the discharge injunction under § 524(a) of the Bankruptcy Code by refusing to commence foreclosure on, take title of, or release their lien on the Debtors’ abandoned residence. The Court addressed this foreclosure ultimatum: Can a debtor use bankruptcy to compel a lender to foreclose or discharge its mortgage?

### The Decision

Prior to filing their bankruptcy petition, the Debtors defaulted on their loan with the Lender, and the Lender commenced foreclosure proceedings in state court. The Debtors filed a Chapter 7 bankruptcy proceeding which stayed the foreclosure proceeding, and the Lender voluntarily dismissed the foreclosure proceeding. The Debtors indicated in their bankruptcy schedules that their outstanding loan balance exceeded the market value of their residence. The Debtors also indicated that they intended to surrender their residence to the Lender in accordance with § 521(a)(2) of the Bankruptcy Code. The Debtors desperately wanted to rid themselves of their vacated residence, even informing the municipal authorities and sewerage company that the Lender was the responsible party for any obligations pertaining to the residence.

<sup>1</sup> 706 F.3d 64 (1st Cir. 2013)

Following entry of the Debtors' discharge in the bankruptcy proceeding, the Lender informed the Debtors that it would not complete foreclosure proceedings and would no longer advance tax or insurance payments on the property. In response, the Debtors demanded that the Lender "(1) immediately commence foreclosure proceedings or (2) immediately discharge the mortgage on the property." The Lender responded by stating that it was "unable to honor [the Debtors'] request to release the lien until the lien balance is satisfied . . . . However, [the Lender] could consider a settlement option or a short sale." The Lender further explained to the Debtors that the Debtors had no personal obligation to pay the lien balance because of the bankruptcy discharge, and that its correspondence was not an attempt to collect from the Debtors personally.<sup>2</sup>

Confronting the Lender's refusal to comply with their demands, the Debtors reopened their bankruptcy case and brought an adversary proceeding against the Lender claiming actual and punitive damages caused by the Lender's violation of the discharge injunction established by § 524(a).<sup>3</sup> The Debtors based their assertion on the authority of Pratt v. General Motors Acceptance Corp. (In Re Pratt), 462 F. 3d 14 (1st Cir. 2006). In Pratt, the First Circuit Court of Appeals held that a secured creditor intended to coerce a debtor into paying a discharged debt in violation of the discharge injunction by refusing to foreclose or release its lien on an inoperable, worthless car. The secured creditor in Pratt informed the debtors that

<sup>2</sup> A bankruptcy discharge eliminates a debtor's personal liability on dischargeable debts but does not terminate liens on the debtor's property. Surviving liens are collectible to the extent of the collateral's value.

<sup>3</sup> The discharge injunction established by § 524(a) succeeds the automatic stay that exists prior to the discharge. The discharge injunction serves as a permanent bar on collection activity pertaining to discharged debts. Bankruptcy courts may find a violator of the discharge injunction in civil contempt under § 105 of the Bankruptcy Code.

its lien would be released only upon full payment of the outstanding loan amount, and the debtors were unable to dispose of the car while the secured creditor's lien remained in effect.

Unlike Pratt, the Canning Court ruled in favor of the Lender finding no violation of the discharge injunction. The Court stated that despite a debtor's intent to surrender collateral under § 521(a)(2), a secured creditor "has the prerogative to decide whether to accept or reject the surrendered collateral[.]" However, the Court explained that a secured creditor's reluctance to accept surrendered collateral "must not constitute a subterfuge intended to coerce payment of a discharged debt." The Court distinguished Pratt by noting that the Lender had not conditioned release of its lien on payment in full of the outstanding indebtedness. Instead, the Lender had indicated its willingness to consider a settlement offer or short sale. The Court stated that such willingness "not only indicates the intent to collect no more than the value secured by the underlying lien . . . but also denotes a willingness to negotiate a palatable solution for all involved." The secured creditor in Pratt relegated the debtors to payment in full of a discharged debt or indefinite ownership of an inoperable, worthless car. The real estate in Canning, on the other hand, was not worthless and could even increase in value over time. Further, the Canning Court explained that the Lender, having offered to negotiate a compromise with the Debtors, had not exhibited any indicia of coerciveness. In fact, it was the Debtors who "employed a 'take it or leave it' approach in negotiating with [the Lender], who, given its state-law rights over the collateral, did not have to accept the two choices presented." The Court criticized the Debtors for failing "to advance any legal authority . . . to support the proposition that a homeowner may walk away, with no strings attached, from their legally owned residence. But even worse, in vacating their residence, [the Debtors] placed many of the burdens of

dealing with an abandoned property on their neighbors . . . and their city – in other words, on everyone but them. The ‘fresh start’ does not countenance that result.”

### **The Takeaway**

Although the Lender in Canning obtained a favorable result, the Court warned that creditors may not exploit its decision to sidestep the bargaining table following a debtor’s discharge in bankruptcy. While a creditor need not cave to a debtor’s foreclose-or-release demand, a creditor may not manipulate circumstances so that the debtor is left with the choice of payment in full of a discharged debt or the indefinite retention of assets that the debtor seeks to surrender.

Return to:

IN THE  
NEWS

---

THIS BULLETIN IS PROVIDED FOR INFORMATIONAL PURPOSES ONLY, AS A SERVICE TO OUR LOYAL CLIENTS. IT SHOULD NOT BE CONSTRUED AS LEGAL ADVICE, AND IS NOT A SUBSTITUTE FOR THE ADVICE OF A QUALIFIED ATTORNEY FAMILIAR WITH YOUR PARTICULAR SITUATION. FOR ADVICE ABOUT YOUR SITUATION, PLEASE CONTACT AN ATTORNEY FROM RCFP.

© 2013 ROBERTS, CARROLL, FELDSTEIN & PEIRCE, INC. ALL RIGHTS RESERVED.