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Creditors' Foreclosure Rights After Chapter 7 Bankruptcy

Arizona, like several other areas in the country, was hit hard by the mortgage crisis and "the Great Recession" in 2007. Real estate values plummeted by as much as 50 percent, and bankruptcies rose to record levels. Many individuals had multiple loans on their homes, and they filed for bankruptcy to get out from under their financial burdens.

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It's now many years after the "crash." Real estate values are on the rise. Property owners are now seeing equity (or what they think is equity) in their homes.

Of course, we all know that if the homeowner does not pay the mortgage, the lender has the right to foreclose on the house. For those individuals who simply wanted to get out from under the obligations on their mortgages, they "walked away" from the house and simply waited for the lenders to foreclose. Some stayed in the house and tried to make deals or go through loan modification programs. Some were successful, and some not. If no payments were made on the mortgage, the house would eventually go into foreclosure and be sold at a trustee sale.

Many homeowners who filed for bankruptcy decided to maintain payments on their first mortgage. The house had no equity to secure the second mortgage due to the drop in value from the crash and recession. They continue to pay the first mortgage but stopped payments on the second. They have not heard from the second lienholder since they filed bankruptcy as much as 10 years ago. Perhaps they have not made a payment even on the first mortgage for years, but for some reason the lender has done nothing.

Are they in the clear? Are they at risk of losing their home?

This article explores the current state of the law in Arizona on foreclosures and statutes of limitations and the impact of bankruptcy and how Arizona law may be affected by recent Ninth Circuit case law. While we focus on second lienholders, the same analysis would apply to a first lienholder who simply took no action to foreclose its lien for many years.

The Recession's Impact

The recession had deep and lasting impacts on many states. Arizona was hit hard. Many people lost their jobs. Anyone in a construction-related business felt the impact. Real estate development came to a screeching halt. Developers shut down projects. The trickle-down effect was felt by contractors, sub-contractors, suppliers, investors and anyone who did business with those companies. Thousands of Arizonans turned to bankruptcy as a way out of the financial nightmare they faced.

In addition to losing jobs and the loss of income and the depletion of savings, many people lost hundreds of thousands of dollars in "paper equity" in real estate holdings. During the boom days, investors bought up lots, houses, strip centers and more in the expectation that values would continue to rise. When the "music stopped" in 2007, many of these individuals were left standing with no place to sit. They lost jobs. They depleted their savings, and the equity they thought they had in their real estate investments simply disappeared—virtually overnight.

Bankruptcy became an option for many people. Some used the bankruptcy laws to

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reorganize and try to keep assets. They used Chapter 11 (for larger investors) to restructure debts over a longer period of time and reduce the amount owed to lenders to the fair market value of the properties. Those people were able to save the properties by the reduction of debt. Time will tell whether their gamble was successful.

Homeowners who were not real estate investors and only had their family residence faced difficult choices. During the years in which real estate values were rising, they took out lines of credit and secured them by consensual liens on their homes. Those funds were sometimes used for home improvements and sometimes just to supplement income for living expenses. After the recession hit, their homes were no longer worth what was owed. Some houses weren't even worth what was owed on the original mortgage. Many people were out of work and unable to service the debts. Bankruptcy provided some options for them.

Many homeowners filed for relief under Chapter 13. A Chapter 13 bankruptcy is similar to a Chapter 11 but designed to be faster and less expensive. It is a reorganization for individuals (no corporations, partnerships or LLCs can file for relief under Chapter 13) and requires that the debtor make monthly payments to a trustee for between three and five years to pay back debt. A debtor in Chapter 13 commits to use his or her disposable income for the life of the plan to pay back creditors in an amount at least equal to the value of their non-exempt property. In exchange, the debtor is permitted to keep the non-exempt property and has rights and powers similar to those of a Chapter 7 or 11 trustee or a Chapter 11 debtor in possession. One of those powers is the ability to "strip" liens that were wholly unsecured. In other words, a Chapter 13 debtor has the power to get a court order removing a consensual lien on their home if there is no equity to secure that loan.

Those debtors stopped paying their second mortgages and filed motions or adversary proceedings in the bankruptcy court

to avoid the liens for which there was no equity. The lienholder was treated as a general unsecured creditor and had its debt discharged at the end of the Chapter 13 proceeding.[1] A discharge in bankruptcy is a permanent injunction against the attempt by a creditor to collect money on a pre-bankruptcy debt. A discharge is an *"in personam"* remedy. It merely enjoins a creditor from trying to collect money. It is not an *"in rem"* remedy—it does not void a lien. Therefore, even if a debt is "discharged," the lien survives unless it is removed by specific court proceedings. When a Chapter 11 or Chapter 13 debtor is able to "strip" a lien due to a complete lack of equity to secure the lien and then completes the case and gets a discharge, the debt is no longer collectible, and the lien is removed.

Those homeowners were able to capture for their own benefit the increase in value after the end of the recession and had no further obligation to the junior lienholder. They were the lucky ones.

The bankruptcy discharge may have created a false sense of security for some individuals. They may be in for a surprise.

However, most homeowners simply filed for relief under Chapter 7, did not reaffirm the mortgages on their homes, and obtained a discharge. A reaffirmation is a post-petition agreement between a debtor and a creditor in which the pre-bankruptcy contractual relationship survives. That agreement must be consented to by the debtors (and their attorney) and must be approved by the court at a separate hearing if the debtors are not represented or if the attorney does not certify that the reaffirmation is in the best interest of the debtors. A Chapter 7 debtor lacks standing to avoid a lien, unlike the Chapter 13 debtor.[2] Those debtors, therefore, emerged from Chapter 7 with no further financial obligation to the second lienholder but were still "stuck" with the lien on their home.

Few of those homeowners maintained payments on those discharged debts, thinking that their problems were behind them. The bankruptcy discharge created a false sense of security for these individuals. The believed that they were "done" and that they were safe and secure in their homes and had no further obligations to the lenders. They may be in for a surprise.

Current Foreclosure Laws

As a general rule, the statute of limitations begins to run when a party knows that its rights have somehow been violated and that a cause of action has arisen.[3]

The statute of limitations is designed to provide an outer limit by which time a claim must be preserved and prosecuted so that matters are prosecuted timely and that litigants do not sleep on their rights. It is also designed to provide comfort and security to potential defendants so that they know that, at some point in time, their exposure to damages has terminated.[4]

Prior to 1974, Arizona courts did not provide any guidance on how the statute of limitations applied to mortgage foreclosure. Then in 1974 the Court of Appeals ruled that judicial foreclosure actions are governed under the same statute of limitations as contracts in Arizona—six years—because a mortgage obligation is a contractual agreement.[5] Thus, a default in payment of the note triggered the running of the statute of limitations, and actions to foreclose were time-barred if commenced more than six years after the default.

In 1996 the Court of Appeals held that the statute of limitations on an installment note begins to run on each and every missed payment. In other words, in a 10-year installment payment note, there are actually 120 different "triggers" to the start of the statute of limitations—and each default can be independently enforced. The statute of limitations applies to each installment separately and does not begin to run on any installment until it is due.[6] But accrual commences on the unmatured future installments when the creditor exercises the optional acceleration clause. The court reasoned that this interpretation forced a damaged party to act timely to enforce its rights, but it also allowed for time for the parties to reach a resolution of the default.

How does this work with a note secured by a deed of trust? What happens when there is a default and the lender wants to commence a trustee's sale? Lenders, through their trustees, will provide a notice of default and exercise their rights to accelerate the note, which is now in default. To exercise the acceleration clause in the deed of trust, the lender must take the affirmative step to make clear to the borrower it has accelerated the obligation. This is required even if the parties contract out the notice requirement.[7] Demand of the balance in full before all installments are due satisfies the requirement, as well as commencing the foreclosure or recordation of a notice of trustee sale.[8] Once the lender has declared the default and exercised its rights to accelerate and go forward to sale, the limitation period has commenced, and the sale must be completed within the six-year limitation period.

However, the lender does have an opportunity to restart the clock on the six-year statute of limitations. If the lender cancels the notice of trustee sale with a clause revoking the acceleration, it is reinstating the obligations of the deed of trust, thereby restarting the statute of limitations on any new default.[9] The revocation of the acceleration requires an affirmative act by the lender to communicate this to the borrower.

Simply recording the cancellation notice does constitute the affirmative act to revoke the acceleration. The notice must contain a statement that the acceleration of the debt is withdrawn.[10]

That analysis is pretty straightforward. But in the context of bankruptcy, when a borrower discharges the debt obligation, the installment payments have been discharged and the lender cannot enforce the note. There is a permanent injunction barring the enforcement of any ongoing contractual obligation between the parties. So when does the clock start ticking?

In *Ortiz v. Trinity Fin. Servs. LLC*,[11] the federal district court in Arizona adopted the reasoning of *Navy Federal Credit Union*,[12] as it relates to the commencement of the statute of limitations in a foreclosure. The court held that neither *Atlee* nor *De Anza* specifically addressed the issue of whether the six-year limitation period arose from the first default or could be separately enforced on each default. Ortiz had filed for bankruptcy and had received a discharge more than six years prior to the notice of sale. However, the court did not examine the impact of the discharge on the running of the limitation period. Does that, in fact, make a difference?

If *Navy Federal* applies to a foreclosure, then the six-year statute of limitations would only terminate six years after the last payment is due or six years from a notice of sale and acceleration if not rescinded. Does a discharge in bankruptcy change that? In other words, must a lender start the countdown of six years to bring the foreclosure action (*in rem* claim) when the debtor misses the first payment that would have been "due" after the entry of discharge? The discharge permanently enjoins the enforcement of the debt obligation (*in personam*) and thereby extinguishes the concept that there can be an ongoing "default" in payments that would trigger the ongoing rights to enforce those defaults. The *in rem* remedy clock must start at that point because no further installment payments are due against the borrower/debtor.

Let's examine the foregoing based on the following hypothetical situation:

> Homeowner takes out a second mortgage in 2005. Homeowner goes into

default on the second mortgage in 2009 and filed for bankruptcy under Chapter 7 later that year. They never reaffirmed the debt on the second mortgage and received a discharge at the end of 2009. No payments were ever made on the second mortgage after the default arose. Homeowners never heard from the lender. In 2018, the lender gives notice of default and records a notice of trustee sale. In the lender's view, there was never an acceleration or notice of trustee sale, so the trigger for starting the six-year clock never commenced. Although the debt obligation under the promissory note has been discharged, the lender asserts it still has an *in rem* remedy to recover the property. Does it?

The last payment made on the mortgage was more than six years prior to the notice of trustee sale—early in 2009. The bankruptcy was filed more than six years prior to the notice of trustee sale. The discharge was entered more than six years prior to the notice of trustee sale, and the first payment due after discharge was more than six years prior to the notice of trustee sale. Even if the payment was due for the *in rem* obligation after the discharge, the last *in personam* obligation was made before the discharge occurred—at the end of 2009. No payments were made after discharge. Did the lender lose its right to foreclose?

The facts in our hypothetical are drawn from recent cases in Washington and the Ninth Circuit.[13] In *Jarvis*, the homeowners obtained a loan on their home from Federal National Mortgage Association in 2006. They defaulted on the loan and filed for relief under Chapter 7. They never reaffirmed the mortgage in the bankruptcy and obtained a discharge in 2009. They never made a payment on the loan after the discharge. Federal commenced a trustee sale more than six years after the entry of discharge and more than six years after the first post-discharge payment was missed. The lender asserted that it could wait until six years after the last payment on the original note became due to commence its sale and pursue its *in rem* remedy. In granting summary judgment to Jarvis, the district court held that the *in rem* remedy available to Federal runs from the first missed payment after discharge.

Like Arizona, Washington recognizes that each installment note represents its own statute of limitations.

Washington law is virtually identical to Arizona in this area, and Arizona courts will look to guidance from those decisions.[14] Like Arizona, Washington recognizes that each installment due on an installment note represents its own statute of limitations for its enforcement.[15] Washington also provides for a six-year limitation period for the enforcement of a contract in writing and the foreclosure of a deed of trust.

The district court decision in *Ortiz*[16] predates the unpublished Ninth Circuit *Jarvis* decision. There was no analysis by the court in *Ortiz* as to the impact of the discharge on the running of the statute of limitations. Arizona courts should strongly consider *Jarvis* as a guidepost in ruling on these issues that will arise in the near future.

How will an Arizona court (state or federal) determine this issue? Considering the "perfect storm" of recession, bankruptcy and real estate appreciation, we are certainly going to find out shortly.

endnotes

1. *See* 11 U.S.C. §§ 1322(b)(2) and 506(a). *See also In re Zimmer*, 313 F.3d 1220 (9th Cir. 2002).
2. *Dewsnup v. Timm*, 502 U.S. 410 (1992).
3. *Gust Rosenfeld & Henderson v. Prudential Ins. Co. of Am.*, 898 P.2d 964 (Ariz. 1995).
4. *Porter v. Spader*, 239 P.3d 743 (Ariz. Ct. App. 2010).
5. *Atlee Credit Corp. v. Quetulio*, 22 Ariz. App. 116 (Ct. App. 1974); *De Anza Land and Leisure Corp. v. Raineri*, 137 Ariz. 262 (Ct. App. 1983).
6. *Navy Fed. Credit Union v. Jones*, 930 P.2d 1007 (Ariz. Ct. App. 1996).
7. *Baseline Fin. Servs. v. Madison*, 278 P.3d 321, 322 (Ariz. Ct. App. 2012).
8. *See Jones*, 930 P.2d at 1009.
9. A.R.S. § 33-816.
10. *Id.* § 33-813; *Andra R. Miller Designs LLC v. US Bank, NA*, 418 P.3d 1038 (Ariz. Ct. App. 2018).
11. 98 F. Supp. 3d 1037 (D. Ariz. 2015).
12. 930 P.2d at 1007.
13. *Jarvis v. Federal Nat'l Mortgage Ass'n*, 2017 WL 1438040), *aff'd* 2018 WL 2979017 (9th Cir. 2018).
14. *In re Stark's Estate*, 82 P.2d 894 (Ariz. 1938); *Solana Land C. v. Murphey*, 210 P.3d 593 (Ariz. 1949).
15. *Herzog v. Herzog*, 23 Wash. 2d 382 (1945).
16. 98 F. Supp. 3d at 1037.