Creditor's Foreclosure Rights after Chapter 7 Bankruptcy

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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%, and bankruptcies rose to record levels. It is now 2018, 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. They have not heard from the second lien holder since they filed Bankruptcy as much as ten years ago. Are they in the clear? Are they at risk of losing their home? This article will explore the current state of the law in Arizona on foreclosures and statutes of limitations and the impact of Bankruptcy and how Arizona state law may be impacted by recent 9th Circuit Court of Appeals case law.

Many homeowners filed for relief under Chapter 13, in which they were permitted to "strip" liens that were wholly unsecured. 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 lien holder was treated as a general unsecured creditor and had its debt discharged at the end of the Chapter 13 proceeding. *See* 11 U.S.C.§1322(b)(2) and §506(a). *See also In re Zimmer*, 313 F 3rd 1220 (CA 9th 2002). 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 lien holder. They were the lucky ones.

Most homeowners, however, simply filed for relief under Chapter 7, did not reaffirm the mortgages on their homes, and obtained a discharge. A Bankruptcy Discharge does not avoid a lien and a Chapter 7 debtor lacks standing to avoid a lien, unlike the Chapter 13 debtor. *Dewsnup v Timm*, 502 U.S. 410 (US S Ct 1992). Those debtors, therefore, emerged from Chapter 7 with no further financial obligation to the second lien holder 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 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. *Gust, Rosenfeld & Henderson v. Prudential Ins. Co. of Am.*, 182 Ariz. 586, 898 P.2d 964 (1995).

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. *Porter v. Spader*, 225 Ariz. 424, 239 P.3d 743 (App. 2010).

Prior to 1974, Arizona Courts did not provide any guidance on how the statute of limitations applied to mortgage foreclosure. Then in 1974 the Arizona 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. *Atlee Credit Corporation v Quetulio*, 22 Ariz. App. 116 (App. 1974); *De Anza Land and Leisure Corporation v Raineri,* 137 Ariz. 262 (App. 1983). Both of these cases held that 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 Arizona 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 ten-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. *Navy Federal Credit Union v Jones,* 187 Ariz. 493, 930 P.2d 1007 (App. 1996). But accrual commences on the unmatured future installments when the creditor exercises the optional acceleration clause. *Id.* The Court reasoned that this interpretation forced a damaged party to act timely to enforce its rights but 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. *Baseline fin. Servs. v. Madison,* 229 Ariz. 543, 544 ¶ 8, 278 P.3d 321, 322 (App. 2012). 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. *See Jones*, 187 Ariz. at 495, 930 P.2d at 1009 (App. 1996). 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.

The lender does however 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. ARS §33-816. 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. ARS §33-813. *Andra R. Miller Designs, LLC v. U.S. Bank, N.A.*, 244 Ariz. 265, 418 P.3d 1038 (App. 2018).

That analysis is pretty straight forward. 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 on-going contractual obligation between the parties. So when does the clock start ticking?

In *Ortiz v. Trinity Fin. Servs. LLC*, 98 F. Supp. 3d 1037 (D. Ariz. 2015), the Arizona District Court adopted the reasoning of *Navy Federal Credit Union, supra* as it relates to the commencement of the statute of limitations in a foreclosure. The Court held that neither *Atlee supra* nor *De Anza, supra* 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 which 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 which 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 upon 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 Court of Appeals. *Jarvis v Federal National Mortgage Association,* 2017 WL 1438040); aff'd 2018 WL 2979017 (CA 9th 2018). In *Jarvis, supra*, the homeowners obtained a loan on their home from Federal 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.

Washington law is virtually identical to Arizona in this area. Like Arizona, Washington law recognizes that each installment due on an installment note represents its own statute of limitations for its enforcement. *Herzog v Herzog*, 23 Wash. 2d 382 (1945). 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. Arizona Courts will look to guidance from Washington decisions, since the laws of the two states are almost identical. *In re Stark's Estate,* 52 Ariz. 416, 82 P 2d 894 (Supreme Court 1938); *Solana Land C. v Murphey*, 69 Ariz. 117, 210 P 3d 593 (Supreme Court 1949).

The District Court decision in *Ortiz, supra* predates the Ninth Circuit *Jarvis* decision. *Jarvis* is not a published 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. How will an Arizona Court (State or Federal) determine this issue? Arizona Courts should strongly consider *Jarvis* as a guidepost in ruling on these issues that will arise in the near future. Considering the "perfect storm" of recession, bankruptcy and real estate appreciation, we are certainly going to find out shortly.

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