



Be Careful What You Wish For –
***In re Traverse* and the**
Perils of Lien Avoidance for Trustees

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On May 23, 2014, the First Circuit Court of Appeals issued an opinion that dramatically affects the benefit of the trustee's lien avoidance powers. Standing conventional wisdom on its head, the First Circuit ruled that a trustee who had successfully avoided and preserved a first mortgage on the debtor's principal residence for the benefit of the estate could not then sell the residence and use the funds generated by the sale to pay the first mortgage for the benefit of the estate. The Court further ruled that the trustee was not entitled to collect payments due on the promissory note secured by the avoided mortgage, leaving the trustee holding an avoided lien with little or no value. How was the First Circuit able to snatch defeat from the jaws of victory for the trustee, and what can trustees do to avoid a similar fate?

THE DILEMMA OF LIEN AVOIDANCE

Virginia Traverse filed a voluntary chapter 7 petition on August 14, 2011. Traverse scheduled a fee simple interest in her home with an estimated value of \$235,000.00. On Schedule F, Traverse listed JPMorgan Chase Bank ("Chase") as the holder of a general unsecured claim in the amount of \$185,777.30 stemming from an unrecorded first mortgage granted to Washington Mutual Bank, FA, Chase's predecessor-in-interest. Traverse also listed Citibank as the holder of a second mortgage in the amount of \$29,431.04 and claimed an exemption under M.G.L. ch. 188, § 1, *et seq.*, the Massachusetts homestead statute for \$500,000.00. Traverse was current on the two mortgages.

The chapter 7 trustee filed an adversary proceeding against Chase and Traverse seeking declaratory relief. He sought an order declaring the Chase mortgage avoided under § 544 of the Code because the mortgage was not recorded and a declaration that (1) the avoided mortgage was preserved for the benefit of the bankruptcy estate under § 551 of the Code, and (2) the avoided mortgage was senior in rank to the Citibank second mortgage and Traverse's homestead declaration. Chase admitted it held an unrecorded mortgage that should receive treatment as a general unsecured claim. Traverse's answer did not challenge the trustee's avoidance powers; rather, it sought to prevent the trustee from selling her home, essentially limiting the trustee's avoidance remedy to selling the avoided mortgage. Traverse reasoned that the trustee had no greater rights under the avoided mortgage than the original holder of the mortgage (i.e., Chase), and since Traverse was current on her mortgage payments, Chase could not foreclose and sell her home. Accordingly, Traverse concluded the trustee should not be permitted to do so either.

The trustee filed a motion for summary judgment on Traverse's counterclaim. Chase did not oppose summary judgment but Traverse did, arguing that the trustee could not sell her home. The bankruptcy court granted summary judgment in favor of the trustee and Traverse appealed to the First Circuit Bankruptcy Appellate Panel solely challenging the denial of the counterclaim.

The BAP affirmed the Bankruptcy Court's decision. *In re Traverse*, 485 B.R. 815 (B.A.P. 1st Cir. 2013). The Court explained that § 541 of the Code provides that all legal and equitable interests of a debtor become property of the estate. Prior to case commencement, Traverse had the right to sell her home and,

KEY POINTS

1. Avoiding and preserving a lien on real estate may not generate a prompt recovery for the bankruptcy estate.
2. Lien avoidance litigation is very costly. Careful negotiation with secured parties and the debtor prior to commencement of lien avoidance actions is essential.
3. Trustees in the First Circuit cannot collect payments from the debtor despite avoiding and preserving a mortgage lien for the benefit of the bankruptcy estate.

upon case commencement, that right passed to the trustee. Lien avoidance simply provided the trustee with an added benefit to be gained from exercising his sale right, namely the ability to capture funds for the benefit of the estate that would otherwise have been paid to a secured creditor. Addressing the impact of Traverse's homestead exemption, which Traverse argued had the effect of removing her home from the bankruptcy estate because it was not challenged, the Court found that "[w]ith a valid homestead exemption, Traverse extricated from the estate such value as might remain after the mortgages were satisfied," (*Id.* at 820), but the property otherwise remained property of the estate subject to the trustee's sale powers.

Traverse then appealed to the First Circuit Court of Appeals, which reversed and remanded the case back to the bankruptcy court. *In re Traverse*, 753 F.3d 19 (1st Cir. 2014), *cert. denied*, 2014 WL 4661084 (Nov. 3, 2014). The Court framed the issue as follows: "The issue raised by this case is not whether Traverse's homestead exemption withdrew her home or merely the right to its proceeds from the property of the estate. The issue is whether a trustee's powers of sale under § 363 justify selling a debtor's asset where no equity remains for the estate beyond the senior claims of secured creditors and the debtor's own exempt interest." *Id.* at 28.

The Court of Appeals held that a trustee cannot exercise the sale powers under § 363 for the benefit of secured creditors alone. *Id.* at 25-26. Because the sum of the secured encumbrances on Traverse's home and her exemption in the property plainly exceeded the value of the home, there was no benefit to unsecured creditors from a sale of the property. *Id.* at 29. The Court's deci-



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sion inexplicably overlooks the fact that the trustee, by avoiding the first mortgage, had become its holder. A § 363 sale of the debtor's real estate would generate sufficient funds to pay off the first mortgage and those funds would be available to satisfy the claims of unsecured creditors.

Traverse affords a trustee these options: sell the avoided mortgage, claim the proceeds from a subsequent sale of the property, or seek to foreclose should a default under the mortgage occur at some future date. In this case, the trustee cannot sell *Traverse's* home. The Court did not stop there however, dropping the other shoe on the trustee's avoidance victory in the final footnote of the decision and ruling that, although not presented with the issue of what happens to post-petition mortgage payments, the trustee is not entitled to collect them.

The Court's decision shifts the burden of a mortgagee's recording lapse from debtor to trustee; a startling result given that *Traverse* voluntarily chose to file bankruptcy and, in so doing, knew or should have known that the trustee had the power to sell her property under § 363.

Traverse and Massachusetts case law could create a windfall for debtors. In Massachusetts, residential mortgages are recourse obligations. Foreclosure in Massachusetts is permissible only if the mortgagee is in possession of both the debt instrument (e.g. a promissory note) and the security instrument (e.g. a mortgage). *Culhane v. Aurora Loan Servs. of Nebraska*, 708 F.3d 282, 288 (1st Cir. 2013), citing *Eaton v. Fed. Nat'l Mortg. Ass'n*, 462 Mass. 569, 969 N.E.2d 1118, 1129 and n. 20 (2012). The trustee in *Traverse* avoided the Chase mortgage, but the underlying debt instrument remained with Chase, subject to discharge and the discharge injunction. Therefore, the discharge injunction prevents Chase from pursuing *Traverse* for mortgage payments, *Traverse* prevents the trustee from the same pursuit and Massachusetts law prevents the trustee from foreclosing.

Should *Traverse* stop paying the first mortgage, what then are the consequences? The original note holder cannot pursue payment due to the discharge injunction. The trustee, who does not hold the note, is unable to foreclose, and if the trustee sells the mortgage, a buyer without the note cannot foreclose either. The marketability of a mortgage that is not entitled to payment and cannot be foreclosed upon is dubious at best and most likely worthless.

ALTERNATIVES TO LIEN PRESERVATION

In *Traverse*, the trustee sought only to preserve the avoided lien under § 551; the trustee did not seek relief under § 550. Relying on § 550, a trustee could seek to recover the value of the transferred property (i.e., a money judgment against the mortgagee), thereby avoiding the harsh result of *Traverse*. Unfortunately for trustees, two recent Massachusetts decisions, *PNC Mortgage vs. Agin*, 508 B.R. 252 (Bankr. D. Mass. 2014), and *Agin v. PNC Bank*, 516 B.R. 196 (Bankr. D. Mass. 2014) made in the same bankruptcy proceeding, *In re Spodris*, 11-15925, conclud-

ed that a monetary judgment was not available.

The Trustee in *Spodris* filed an adversary proceeding seeking to avoid the sole mortgage on the debtor's home, co-owned with her mother, as a preferential transfer because the mortgage was granted within 90 days of the bankruptcy filing and to recover all post-petition mortgage payments. The debtor was current on the mortgage payments and the mortgage was not in default. The trustee sought to recover the property transferred, or its value, under § 550. The trustee's adversary complaint did not reference § 551.

The holder of the avoidable mortgage, PNC Mortgage ("PNC"), did not answer the complaint and a default judgment entered. PNC did however file an opposition to the trustee's request for judgment on a separate document. It acknowledged that entry of default judgment as to liability was appropriate and contested the trustee's entitlement to a monetary judgment, suggesting that the sole remedy was avoidance of the PNC mortgage. The bankruptcy court agreed with the trustee, and PNC appealed. The district court reversed the bankruptcy court, finding that the bankruptcy court had failed to conduct an evidentiary hearing on damages. It remanded the case to the bankruptcy court to consider the appropriate remedy and to hold a hearing on damages if the Court decided that a monetary award was appropriate. In doing so the district court observed "... [G]iven that PNC had lent debtor the sum of \$282,000.00, it is unclear why it should pay an additional amount simply because the loan transaction occurred during the preference period." *PNC Mortgage vs. Agin*, 508 B.R. at 257.

On remand, the Bankruptcy Court focused its analysis on the proper remedy for the trustee under § 550 since the parties acknowledged that the mortgage was an avoidable preference. The trustee asserted that, based on *Traverse*, lien avoidance would leave him holding a valueless lien. The Court acknowledged that the difficulty in administering an avoided lien might constitute a special circumstance justifying entry of a monetary recovery, but found the trustee's concerns about marketability unconvincing and concluded that preservation of the avoided lien was sufficient. *Agin v. PNC Mortgage*, 516 B.R. at 204. The Court also denied the trustee's request for recovery of all post-petition mortgage payments because a non-debtor third party was also liable on the mortgage and remained liable independent of the bankruptcy discharge of the debtor's obligations.

RECOMMENDED BEST PRACTICES

Lien avoidance presents a dilemma in those cases where the debtor wants to retain the real estate and the mortgage payments are current. *Traverse* places a premium on settlement before initiating litigation, because once litigation is filed and the lien avoided, the trustee may hold a lien with little or no resale value. However, while *Traverse* may well be a game changer for trustees in the way they analyze lien avoidance cases, *Traverse* is not a game changer for mortgagees. Mortgagees should remain inclined

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to settle, having much to lose if their mortgage is avoided or if their mortgage remains separated from their promissory note. Lien avoidance relegates mortgagee claims to unsecured status and the mortgagee cannot collect post-petition mortgage payments. Because mortgagees will typically insist that confirmation of the validity and priority of the mortgage is an essential settlement term, settlement discussions will necessarily involve the debtor as well. Debtors who want to retain their home typically want to restore the status quo and continue making their normal monthly mortgage payments, so participation and assent by debtors should not be problematic. Nevertheless, the windfall for debtors that *Traverse* seemingly creates suggests that debtors may seek consideration of some kind in exchange for agreeing to acknowledge the validity and priority of the otherwise avoidable mortgage claim.

Debtor consent can be complicated in those cases where only one mortgagor/spouse has filed for bankruptcy protection. Usually, where a debtor and non-debtor are co-mortgagors, their interests are aligned, and consent for that reason can be readily obtained. Still, a trustee must be mindful of the complications that a non-debtor party may present. Settlement of lien avoidance actions can be further delayed or derailed if the avoidable lien is not the only lien on the property because consent of other lienholders may also be necessary, and is typically more difficult to obtain. While the parties may have little leverage to convince a consensual junior lienholder to agree to a settlement, non-consensual junior liens may be subject to the debtor's lien avoidance powers under § 522(f). However, the trustee must carefully consider the order in which various actions should take place in cases with multiple lienholders. For instance, the debtor's ability to avoid a lien under § 522 would seem to be blunted and the arithmetic calculation under § 522 substantially affected if, prior to commencement of the lien avoidance proceeding, the trustee has filed an adversary proceeding seeking to avoid a senior consensual lien.

If the trustee prevails on lien avoidance, what is the “value” of the avoided lien for negotiation purposes? One measure of recovery for lien avoidance under § 550, though seldom used,

avoided lien and, if so, what amount should be used? Is it the original principal balance of the mortgage (see *In re Schwartz*, 383 B.R. 119 (B.A.P. 8th Cir. 2008), the amount of the lien claim at the time the bankruptcy petition was filed but capped by the value of the collateral (See *Morris v. St. John Nat. Bank (In re Haberman)*, 347 B.R. 411, 417 (B.A.P. 10th Cir. 2006), or perhaps the amount of payments made on the mortgage? The valuation question becomes even more complicated in cases where a debtor is not the sole owner of the property, but rather owns the property in some form of joint ownership with a non-debtor or third party.

If a settlement cannot be achieved, a trustee should carefully consider the following issues prior to filing a lien avoidance action –

1. Should the trustee file a homestead objection to blunt the argument that, absent objection, exempt property is removed from the bankruptcy estate and cannot be sold by the trustee? Should the trustee make demand upon the debtor for the monthly mortgage payment due on the avoidable lien and should the trustee monitor and/or demand timely payment of insurance (the trustee must also determine an adequate amount of insurance) and real estate taxes since the real estate, unless abandoned, remains property of the estate during the pendency of the avoidance litigation?

2. Should the trustee object to the Statement of Intention because a debtor cannot reaffirm a debt secured by an avoidable lien?

3. The trustee must now carefully consider formulation of the request for relief made in an adversary proceeding. Certainly, the lien avoidance action should reference §§ 550 and 551 to preserve that trustee's ability to seek relief in the form of a monetary judgment, notwithstanding *Spodris*. Having successfully obtained a judgment for avoidance of a senior lien, might a Trustee be able to resort to state law in order to monetize its avoided lien position? In Massachusetts, a petition to partition under Chapter 241, § 2 may be filed by a co-owner of real estate to resolve differences between co-owners.

CONCLUSION

Recent decisions in the First Circuit have altered traditional thinking about the benefits of exercising the trustee's lien avoidance powers. Trustees must carefully weigh the costs and benefits of lien avoidance proceedings before commencing litigation. ☞

Lien avoidance relegates mortgagee claims to unsecured status and the mortgagee cannot collect post-petition mortgage payments.

is the value of the property transferred, but courts have struggled to determine an appropriate valuation method under this section. Is value determined by reference to the amount of the