

Bankruptcy 101 for Mortgage Lenders

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In the summer of 2022, First Guarantee Mortgage Company filed for bankruptcy in the District of Delaware. Mortgage market analysts forecast a string of mortgage companies to file for bankruptcy in the months or years ahead. Hence, this is an excellent time to remind mortgage lenders and those that might be impacted by their bankruptcy proceedings of the limitations that the Bankruptcy Code places on sales of consumer credit transactions and the cloud hanging over the mortgage lenders' metaphorical heads after the decision denying confirmation of the *Second Amended Joint Chapter*

11 Plan of Ditech Holding Corporation and its Affiliated Debtors (the "Second Amended Plan") *In re Ditech Holding Corp.*, 606 B.R. 544 (S.D.N.Y. 2019).

The vast majority of Chapter 11 cases involve early sales of all assets to a strategic or financial buyer free and clear of liens, encumbrances and interests under Section 363 of the Bankruptcy Code. With a 363 sale, a distressed company can expeditiously and effectively separate the debtor's past troubles from its future success without going through the process of proposing a Chapter 11 plan and meeting all prerequisites to confirm a plan. The benefit for a potential buyer is that a 363 sale can "cleanse" the assets and eliminate or, at least, minimize successor liability claims.

In the context of a mortgage lender bankruptcy, this benefit is somewhat limited. In 2005, Congress added Section 363(o) to the provisions governing asset sales outside of a Chapter 11 plan. Under that section, (a) if a person purchases (i) any interest in a consumer credit transaction that is subject to the Truth in Lending Act or (ii) any interest in a consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time), and (b) if that interest is purchased through a sale under section 363 of the Bankruptcy Code, then, notwithstanding the "free and clear" language in section 363(f), such person remains subject to all claims and defenses assertible by the consumer that is related to such consumer credit contracts and transactions to the same extent as such person would be subject to such claims and defenses had the person acquired the interest pursuant to a sale not under section 363.

The reasoning behind the amendment is illustrated with a statement by Sen. Chuck Schumer (NY-D).

We have a new problem with these predatory lenders . . . In recent months, several large subprime lenders have obtained orders from bankruptcy courts, providing for the sale of their loans or the servicing rights associated with them under section 363 of the bankruptcy code. Consumers who have attempted to challenge these loans or their servicing obligations based on violations of fair lending laws have been told by the purchasers of these loans they were sold free and clear of any consumer claims and defenses. The fact that innocent borrowers can be left in the lurch is flat-out wrong.

147 CONG. REC. 2018, at *2032 (March 8, 2001). Accordingly, the buyer of a mortgage lender business would inherit

consumer claims and defenses to the same extent it would under applicable non-bankruptcy law.

Then one may ask, “could a mortgage lender accomplish a free and clear sale through a full-blown confirmation process by incorporating the sale in the Chapter 11 plan?” Judge Garrity said, “maybe” with some caveats when Ditech Holding Corp. and its affiliated debtors (“Ditech”) were pursuing such a sale. Ditech operated as an independent servicer and originator of mortgage loans and servicer of reverse mortgage loans. Accordingly, the bulk of the assets to be transferred were consumer credit transactions. Ditech offered a variety of residential mortgage loans to consumers for its own portfolio and for government-sponsored enterprises, government agencies, third-party securitization trusts, and other credit owners. Ditech was comprised of three primary segments: (i) forward mortgage originations through Ditech Financial LLC (“DFL”); (ii) forward mortgage servicing through DFL; and (iii) reverse mortgage servicing through Reverse Mortgage Solutions, Inc.

The Consumer Creditors Committee appointed by the U.S. Trustee in the Ditech case objected to the confirmation of the Second Amended Plan because it did not comply with Section 363(o). Ditech countered that it was free to sell the consumer credit contracts free and clear of consumer claims and interests not expressly assumed by the buyers pursuant to Sections 1123(b)(4) and 1141(c) of the Bankruptcy Code. While the Court agreed that Section 1123 and Section 1141(c) provide an independent basis to accomplish free and clear sale, the plan did not meet the best interest test under Section 1129(a)(7). Judge Garrity held:

To satisfy the best interest test, the Debtors must prove that the holders of Class 6 claims will “receive or retain property having a present value, as of the effective date of the plan, not less than the amount such holder would receive or retain if the debtor were liquidated under Chapter 7.” *In re Drexel Burnham Lambert Grp., Inc.*, 138 B.R. at 761. It is undisputed that if the Debtors were liquidated under chapter 7, sections 363(f) and (o) would apply to a sale of the Consumer Creditor Agreements. The Court must apply those provisions in determining whether the Debtors have met their burden under section 1129(a)(7), notwithstanding that the Court has determined that sections 363(f) and (o) are not applicable to the Plan Sale Transactions, and nothing in the Code says otherwise.

In a liquidation under Chapter 7, the liquidation analysis has to take into account the consumer claims because these claims: (i) fit the definition of “property,” (ii) have “value,” and (iii) although they are unliquidated, they are “neither speculative nor incapable of estimation.” Ditech’s liquidation analysis failed to do so.

The takeaway is that mortgage lenders and buyers of mortgage lenders want to keep in mind that a free and clear sale might be attainable through a planned sale if the liquidation analysis factors in the limitations of Section 363(o).

For further information, please feel free to reach out to [Albena Petrakov](#).