

DIRT Periodic Development for Thursday, June 5, 2014
In re Traverse

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In re Traverse, Superior Court of New Jersey, 2014 WL 2142521, 2014 BL 144725 (1st Cir. May 23, 2014)

Link to Opinion: <http://media.ca1.uscourts.gov/pdf/opinions/13-9002P-01A.pdf>

SYNOPSIS: Where Chapter 7 debtor is current on its existing mortgages, Chapter 7 trustee may not sell a debtor's home when no equity remains for the estate beyond the claims of secured creditors and debtor's own exempt interest - even under circumstances when the trustee could avoid the otherwise-senior mortgage lender's mortgage because it had not been recorded.

FACTS: In 1999, Virginia Traverse acquired a home in Lynn, MA. In July 2005, Traverse obtained a \$200,000 mortgage loan from WaMu, but neither WaMu nor its successor, JP Morgan Chase, recorded the mortgage. Later, in March 2007, Traverse executed a second mortgage to Citibank to secure a loan of \$31,000, and Citibank timely recorded the mortgage.

In August 2011, Traverse filed a Chapter 7 bankruptcy petition. She valued her home at \$223,500, listed both JPMorgan (which was owed \$185,777) and Citibank (which was owed \$29,431) as secured creditors, and claimed a homestead exemption pursuant to Massachusetts law in the amount of \$500,000. At the time of her petition, Traverse was current in her payments on both mortgage loans and remained so throughout her Chapter 7 case.

In December 2011, the Chapter 7 trustee filed an adversary proceeding to avoid JP Morgan's unrecorded mortgage under 11 U.S.C. § 544(a)(3), preserve it for the benefit of the estate under 11 U.S.C. § 551, and sell the home. Traverse filed a counterclaim seeking a judgment that even if the trustee could avoid the WaMu/JP Morgan mortgage and preserve it for the benefit of the estate, the trustee could sell only the mortgage itself and not her home. She argued that because the trustee's ability to preserve the JP Morgan mortgage gave the estate only the rights of the original mortgagee, the trustee could not sell her home because she had not defaulted on her payments and triggered the right of foreclosure.

The trustee moved for summary judgment. The bankruptcy court granted summary judgment, concluding that the trustee, having preserved JP Morgan's interest in Traverse's home for the benefit of the estate, was entitled to sell the home to liquidate

that interest. The Bankruptcy Appellate Panel for the First Circuit affirmed, and Traverse appealed.

HOLDING: The First Circuit reversed. The court noted that because a debtor's exempt property interests are effectively removed from the bankruptcy estate, the Bankruptcy Code does not empower the trustee to sell exempt interests. Thus, where a debtor claims a homestead exemption in her home, a trustee can typically sell the home only where its value exceeds both any mortgage liens on the property and the debtor's homestead exemption. The court noted that where a home has no equity beyond the value of liens and the debtor's homestead exemption, the trustee should not sell the home but "leave the secured creditors to their own legal means of recovering their claims." This would mean, the court noted, that where the debtor continues to satisfy her contractual obligations to the lienholders, the lienholders have no grounds to foreclose and the debtor may retain her home through the bankruptcy proceedings.

The court then considered and rejected the trustee's argument that the failure to record the WaMu/JP Morgan mortgage (which otherwise would have had first priority) justified allowing the sale. The trustee argued that it had properly avoided the unrecorded WaMu/JP Morgan mortgage lien under Bankruptcy Code § 544(a)(3) and preserved the avoided lien for the benefit of the estate under Bankruptcy Code § 551, thus giving the estate effective priority over junior lienholders. The trustee thus argued that even in the absence of default by Traverse, the preservation of the mortgage gave the bankruptcy estate an equity interest in the home that triggered the trustee's core power of sale under Bankruptcy Code § 363(b). Essentially, the trustee argued that "the preserved [WaMu/JP Morgan] mortgage has turned some corresponding share of the home's value into the 'property of the estate' to be liquidated through sale."

The First Circuit rejected this argument, correctly holding that the trustee's preservation of an undefaulted mortgage on Traverse's home for the benefit of the estate was "not co-extensive with an ownership right over the underlying property." As the court noted, what was preserved for the estate under § 551 was the mortgage, not an ownership interest in the underlying asset. This would have authorized the trustee to sell the WaMu/JPMorgan Chase mortgage as property of the estate — but because the home had been exempted and withdrawn from the estate by Traverse's uncontested homestead declaration, the preservation of the WaMu/JP Morgan Chase mortgage did not resurrect the trustee's power of sale over the home itself.

The trustee sought to sustain the bankruptcy court's judgment by reference to the Supreme Court's decision in *Schwab v. Reilly*, 560 U.S. 770 (2010), that exemptions under the Bankruptcy Code remove only a monetary interest in a debtor's asset from the estate, rather than the asset itself. The trustee argued that if the home remained part of the estate despite Traverse's homestead exemption, the trustee could dispose of it like any other property so long as the trustee repaid Traverse the value of her exemption

from the sale proceeds. The court rejected *Schwab* as inapplicable where a debtor's homestead exemption equals or surpasses the total value of her property, concluding that in such a context, the exemption protects the debtor's "physical ownership of as well as her financial rights in her home."

COMMENT 1: In not permitting an immediate sale of the home, the First Circuit plainly reached the correct result. By itself, the mortgage does not create a right of immediate ownership of Traverse's home, nor a right to immediate payment of the secured loan's outstanding value from Traverse, but only (a) the right to collect continuing installments from Traverse as they come due and (b) the right to foreclose on the home if Traverse defaults. As the First Circuit correctly explained, just because the preserved mortgage promises the bankruptcy estate a benefit from the sale of Traverse's home does not mean that the preserved mortgage creates 'equity' for the estate:

[H]aving avoided and preserved JP Morgan's mortgage for the benefit of the bankruptcy estate, the trustee has inherited the standing of the secured creditor. But he has not changed the status of the lien as a secured lien, to be subtracted from the value of the asset before any remaining equity may be calculated. In this sense, for the very reason that the preserved mortgage entitles the bankruptcy estate to any proceeds from Traverse's property, as a senior secured claim overriding Traverse's claimed homestead exemption, it cannot double as the unsecured equity triggering the trustee's sale powers under § 363....

The objective behind the trustee's powers of avoidance and preservation is to change the priority of creditors' claims to property falling under a debtor's estate, boosting the standing of unsecured creditors against both illegitimate secured claims and junior secured creditors. It remains a mystery to us why a provision clearly aimed at regulating the distribution of a debtor's estate among her creditors should exacerbate the debtor's substantive obligations and vulnerabilities in bankruptcy.

COMMENT 2: At that point, the First Circuit should have stopped. Unfortunately, it went on:

We affirm today the principle that the preservation of a lien entitles a bankruptcy estate to the full value of the preserved lien – no more and no less. Where this lien is an undefaulted mortgage on otherwise exempted property, the trustee may for the benefit of the estate enjoy the liquid market value of that mortgage, claim the first proceeds from a voluntary sale, or wait to exercise the rights of a mortgagee in the event of a default.

Then, at this point, in a footnote, the court observed:

The parties in this case have presented to us no issue regarding who is entitled to Traverse's post-petition payments. Absent a separate agreement to the contrary, avoidance and preservation of a security interest do not entitle the trustee to payments on the underlying debt.

Well, then So JP Morgan holds an unrecorded mortgage that the trustee can avoid for the benefit of the estate. And if Traverse defaulted on that mortgage, the trustee could have the property sold and apply the proceeds (up to the unpaid balance of that mortgage) toward payment of unsecured claims. Or if Traverse voluntarily sold the home, the trustee could claim the proceeds (again, up to the unpaid balance of that mortgage). But until then, the trustee has no right to collect Traverse's payments on the avoided WaMu/JP Morgan mortgage?

That can't be right, as it would effectively split the note and the mortgage (and to no purpose). Earlier in the opinion, the court noted that Section 551, by preserving the benefit of an avoided interest for the estate, "puts the estate in the shoes of the creditor whose lien is avoided." [Citing *In re Carvell*, 222 B.R. 178, 180 (B.A.P. 1st Cir. 1998).] This means that the trustee's avoidance and preservation of the lien effectively operates to assign the loan by operation of law to the trustee, and thus the trustee should be entitled to collect the remaining payments for the benefit of the bankruptcy estate. [See, e.g., Restatement (Third) of Property – Mortgages § 5.4(b) (transfer of a mortgage also transfers the obligation the mortgage secures unless the parties to the transfer agree otherwise, i.e., "not only does the mortgage follow the note, but the note also follows the mortgage").] As Dale Whitman noted after reading the case, "To say that [the trustee] has the lien, but not the right to the payments that the lien secures, is nonsensical."