# An Alternative Approach to the RESPA Versus Chapter 13 Bankruptcy Unpaid Pre-Petition Escrow Amount Debate

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*ABSTRACT: Under the terms of the parties' loan documents, a lender may collect escrow funds to make the borrower's future tax and insurance payments. Understandably, when a borrower misses escrow payments, the escrow account may not contain enough funds for the lender to make the tax and insurance payments. Outside of bankruptcy, the Real Estate Settlement Procedures Act ("RESPA") and Regulation X provide the lender procedures to collect the missed payments. When a borrower files bankruptcy, however, an automatic stay takes effect. The courts that have addressed this issue make lenders claim these unpaid pre-petition escrow amounts, allowing Chapter 13 debtors to pay these missed payments over the life of the bankruptcy plan and treating the escrow account as current for post-petition calculations. This Note argues that creditors should not be denied their RESPA rights for all unpaid pre-petition escrow amounts in a Chapter 13 bankruptcy. The courts have not fully considered the effects of their decisions. Because lenders must treat post-petition escrow accounts as current, lenders are forced to make involuntary loans to debtors. This Note proposes an alternative approach: Courts should evaluate tax and insurance escrow obligations separately to balance the parties' interests and avoid related arguments.*



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## I. INTRODUCTION

When an individual files for bankruptcy, an automatic stay freezes all actions a creditor may take against the debtor and the debtor's property. The stay gives the debtor relief the instant he or she files for bankruptcy.[1] Section 362(a)(6) of the Bankruptcy Code provides that the debtor's bankruptcy petition "operates as a stay, applicable to all entities, of . . . any act to collect, assess, or recover a claim against the debtor that arose *before* the commencement of the case under this title."[2]

The automatic stay triggers a division between pre-petition and post-petition debtor obligations because "[t]he stay prohibits the collection of any pre-petition debt but does not apply to claims that arise post-petition."[3] For post-petition claims, the stay only prevents a creditor from enforcing the claim against the property of the estate during bankruptcy.[4] Thus, when debtors raise the issue of a creditor violating the automatic stay, a court's underlying determination may involve whether the creditor's claim arose pre-petition or post-petition.

There are various scenarios that cause debtors to seek bankruptcy relief. In some cases, a debtor homeowner may be able to make future payments but "cannot afford to pay [his or her] accumulated mortgage arrears in a lump sum."[5] In this situation, a debtor may choose a Chapter 13 bankruptcy.

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1. JOHN RAO ET AL., NAT'L CONSUMER LAW CTR., FORECLOSURES: DEFENSES, WORKOUTS, AND MORTGAGE SERVICING § 9.2.2.1 (2d ed. 2007). In cases, the language that appears in full or in part most often is from Senate Report 95-989:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

S. REP. NO. 95-989, at 54 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840–41; *see, e.g.*, *In re* Schaefer Salt Recovery, Inc., 542 F.3d 90, 100 (3d Cir. 2008) ("The purpose of the automatic stay is 'to afford the debtor a breathing spell by halting the collection process.'" (quoting *In re* Siciliano, 13 F.3d 748, 750 (3d Cir. 1994))); *In re* Chesnut, 422 F.3d 298, 301 (5th Cir. 2005) ("The automatic stay prevents such a scramble by providing 'breathing room' for a debtor and the bankruptcy court to institute an organized repayment plan." (quoting *In re* Stembridge, 394 F.3d 383, 387 (5th Cir. 2004))); Mar. Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1204 (3d Cir. 1991) ("The automatic stay . . . gives a bankrupt a breathing spell from creditors by stopping all collection efforts, all harassment, and all foreclosure actions.").

2. 11 U.S.C. § 362(a)(6) (2006) (emphasis added).

3. Campbell v. Countrywide Home Loans, Inc. (*Campbell II*), 545 F.3d 348, 353 (5th Cir. 2008) (reversing a bankruptcy court's finding of a willful violation).

4. *See* Campbell v. Countrywide Home Loans, Inc. (*In re* Campbell) (*Campbell I*), 361 B.R. 831, 839 (Bankr. S.D. Tex. 2007), *aff'd in part, rev'd in part*, 545 F.3d at 348 (5th Cir. 2008).

5. RAO ET AL., *supra* note 1, § 9.3.1.

But only an individual with regular income who has debts below a specified maximum dollar amount may file a Chapter 13 bankruptcy.[6]

Under Chapter 13, the debtor prepares a bankruptcy plan. In Chapter 13 plans involving home mortgages, courts "provide[] a homeowner with an opportunity to impose a plan on the lender to accept a cure of the default in installments over a reasonable period of time."[7] Thus, "[i]n chapter 13 plans, the stay protects the debtors' property, provides an opportunity to effectuate a debt adjustment plan, and if the plan is successful, gives the debtor a fresh start."[8] A Chapter 13 plan cannot modify a creditor's claim that is only secured by a debtor's principal residence.[9] As such, it is important to review the underlying loan documents and nonbankruptcy law to identify the creditor's pre-bankruptcy rights so that the creditor's claim in bankruptcy is not modified.

Many residential mortgage lenders require their borrowers to make monthly escrow payments in addition to regular principal and interest payments. These escrow payments fund an escrow account from which the lender later pays for items such as the borrower's insurance and tax obligations. Outside of bankruptcy, the Real Estate Settlement Procedures Act ("RESPA") and Regulation X, RESPA's implementing regulation, govern the procedures lenders must follow to collect and maintain the escrow account.[10]

Recently, courts have addressed the impact of a Chapter 13 bankruptcy on the governing provisions of RESPA and Regulation X. In *Countrywide Home Loans, Inc. v. Rodriguez*, a residential mortgage lender filed a petition for writ of certiorari with the United States Supreme Court presenting the following question:

> Does the Bankruptcy Code's automatic stay, 11 U.S.C. § 362, take precedence over a mortgage lender's right under the Real

6. 11 U.S.C. § 109(e) ("Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than $250,000 and noncontingent, liquidated, secured debts of less than $750,000, or an individual with regular income and such individual's spouse, except a stockbroker or a commodity broker, that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than $250,000 and noncontingent, liquidated, secured debts of less than $750,000 may be a debtor under chapter 13 of this title."). The dollar amounts have been adjusted in 2007 and 2010 pursuant to 11 U.S.C. § 104(a). According to the Historical and Revision Notes in § 109, the amounts are now at $360,475 for unsecured debts and $1,081,400 for secured debts. *Id.* § 109 (2006 & Supp. V 2011). Furthermore, a debtor with regular income includes an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title, other than a stockbroker or a commodity broker." *Id.* § 101(30) (2006).

7. RAO ET AL., *supra* note 1, § 9.3.1; *see also* 11 U.S.C. § 1322(b)(5) (2006).

8. RAO ET AL., *supra* note 1, § 9.2.2.

9. 11 U.S.C. § 1322(b)(2).

10. 12 U.S.C. §§ 2601–2617 (2006 & Supp. V 2011); 24 C.F.R. §§ 3500.1–.23 (2012).

> Estate Settlement Procedures Act, 12 U.S.C. § 2609(a)(2), to require a borrower to deposit additional funds into his escrow account after filing for Chapter 13 bankruptcy protection when those funds are needed to cover the borrower's anticipated post-petition taxes, insurance, and other escrow obligations?[11]

The parties in *Rodriguez*[12] each presented convincing arguments. For example, the lender argued that the borrower's position—which would force lenders to treat unpaid escrow payments as a claim and to subsequently pay third parties out of an escrow account with only hypothetical positive funds—required the lender to provide an interest-free loan.[13] On the other hand, the borrowers argued that unpaid escrow amounts are identical to unpaid principal and interest payments;[14] thus, the debtor should have the opportunity to cure all arrearages during the life of the Chapter 13 plan.

Determining the outcome to this question requires careful attention to the relevant statutes, the facts of the cases, and the effects on the parties involved. The courts that have addressed the parties' arguments have concluded that there are two possible outcomes: unpaid pre-petition escrow amounts either constitute part of a claim or they do not.[15] These dichotomous outcomes constitute all-or-nothing approaches, which could have major impacts on both parties. In general, the debtor attempts to cure as many defaults as possible with the funds available—there is a limited pool of funds for the debtor's multiple creditors to share. Many may think that a lender is in a better position to bear the burden; however, while one loan may have only a couple thousand dollars at stake, a lender may have fifty or more loans with debtors in bankruptcy. Thus, accumulated, this burden could involve several hundreds of thousands of dollars in a lender's portfolio. Accordingly, if there is another option that treats both parties better, why should the courts choose an all-or-nothing approach?

Part II of this Note provides a general overview of the respective parties involved and the treatment of taxes, insurance, and loan payments. It then introduces RESPA, the nonbankruptcy law governing the procedures lenders must follow to collect and maintain escrow accounts outside of bankruptcy. Part III explores the unpaid pre-petition escrow amount debate using the parties' and courts' arguments in *Rodriguez* and addresses the

11. Petition for a Writ of Certiorari at i, Countrywide Home Loans, Inc. v. Rodriguez, 132 S. Ct. 573 (2011) (No. 10-1285), 2011 WL 1523291, at *i.

12. *In re* Rodriguez (*Rodriguez I*), 391 B.R. 723 (Bankr. D.N.J. 2008), *aff'd*, No. 07-24687 (MBK), Civ. No. 08-5207 (AET), 2009 WL 8451888 (D.N.J. May 12, 2009), *vacated and remanded*, 629 F.3d 136 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

13. *Id.* at 729–30.

14. Reply Brief of Appellants at 14, *In re* Rodriguez, 629 F.3d 136 (3d Cir. 2010) (No. 09-2724), 2010 WL 3559304, at *14.

15. *See infra* Part III.

bankruptcy statutes involved. Part IV then confronts issues that the courts have failed to consider. Part V concludes by proposing an alternative approach to the all-or-nothing decisions the courts have made, which utilizes both RESPA and the Bankruptcy Code to find a middle-ground outcome that benefits all parties.

## II. TAXES, INSURANCE, AND LOAN PAYMENTS

Before considering the parties' and courts' arguments over the issue of pre-petition unpaid escrow amounts, it is important to look at the underlying rights in their basic form. This Part focuses on the individual parties involved,[16] their separate enforcement rights both inside and outside of bankruptcy, and how an escrow arrangement affects those rights. Additionally, this Part introduces RESPA, the nonbankruptcy law governing the procedures lenders must follow to collect and maintain escrow accounts.

### A. *LOANS WITHOUT ESCROW ARRANGEMENTS*

Outside of bankruptcy, a taxing authority assesses property taxes on an individual's residence. It then sends out tax bills, informing individuals of the amounts and due dates of their property taxes. If an individual does not pay his or her taxes when they are due, the taxing authority sends overdue tax notices. Upon nonpayment, the taxing authority proceeds to a tax sale.[17] At the tax sale, a third-party purchaser can pay the individual's taxes,[18] and after a period of time, the tax purchaser can become the owner of the property.[19]

A few procedures change for the taxing authority when dealing with an individual who becomes a Chapter 13 bankruptcy debtor. The filing of a bankruptcy petition focuses attention to when taxes attach to the property—the taxing authority has a claim in bankruptcy for any pre-petition attached taxes.[20] This amount could be the full year's taxes or it could be what remains unpaid for the applicable tax period. During a Chapter 13 bankruptcy, the pre-petition taxes are paid over the life of the debtor's plan.[21] The Bankruptcy Code allows the taxing authority to continue to take the steps necessary to effectuate its lien on the property if the lien arises

16. The parties include the debtor and lender, as well as the entities most involved with escrow items: tax authorities and insurance companies.

17. *See, e.g.*, 35 ILL. COMP. STAT. 200/21-190 (2010); IOWA CODE § 446.7 (2011); N.J. STAT. ANN. § 54:5-19 (West 2002 & Supp. 2012).

18. *In re* Cortner, 400 B.R. 608, 612 (Bankr. S.D. Ohio 2009) (finding that the creditor was the purchaser at the tax sale, the creditor had a tax claim in bankruptcy, and "the Creditor [was] entitled to the interest rate established by the tax certificate auction on the Debtor's delinquent real estate taxes"); *see also supra* note 17.

19. *See, e.g.*, 35 ILL. COMP. STAT. 200/22-30; IOWA CODE § 448.1; N.J. STAT. ANN. § 54:5-46.

20. *See* 11 U.S.C. § 101(5) (2006); *Id.* § 362(a) (2006 & Supp. IV 2010).

21. *Id.* § 1322(a)(2) (2006 & Supp. V 2011).

post-petition; however, it may not attempt to collect the pre-petition taxes from the debtor or sell the outstanding taxes at a tax sale.[22] Any post-petition taxes, however, are considered administrative expenses.[23] This means that the debtor must pay the post-petition taxes when they become due.[24] If the debtor cannot pay the post-petition taxes, this shows the court that the debtor's plan is unsuccessful, and upon motion, the court can lift the bankruptcy stay, allowing the creditors to sell the property to collect on their debts.[25]

Unlike taxes, which are imposed on an individual, property insurance contracts are entered into voluntarily to protect an individual from financial loss stemming from fire or other damage to the property. If such damage occurs, the insurer will then issue a check to the individual for his or her loss. Given the nature of insurance, the individual pays in advance for coverage. Upon renewal, if the individual does not pay the insurance premium, then the insurance company cancels the policy and the property is uninsured. Thus, if an individual does not have insurance and a fire or other disaster destroys or damages the property, the value of the property will be diminished—possibly to nothing. Additionally, if an individual files for bankruptcy, the insurance company will not have a pre-petition claim for an insurance premium because premiums are prepaid and thus the individual does not owe the insurer anything.[26] If a debtor does not pay the insurance premium when it comes due post-petition, the property becomes uninsured. Creditors may force-place insurance[27] on the property, but this requires an application to the bankruptcy court per Rule 2016(a).[28] Alternatively, if a debtor does not have insurance on the property, his creditors may raise an adequate protection issue.[29] The court may lift the bankruptcy stay, in which case the creditors could then foreclose on the property to collect on their debts.

When an individual obtains financing from a lender to purchase a residence, he will execute several loan documents. The loan documents contain provisions that specify when a default occurs. Generally, the documents indicate that a default occurs as a result of a failure to make the required monthly payments, a failure to pay taxes, or a lack of insurance.

22. *Id.* § 362(a)(3), (b)(18) (2006).

23. *Id.* § 503(b)(1)(B); *cf. id.* § 1305(a)(1).

24. *See id.* § 503(b)(1)(B).

25. *Id.* § 1307(c)(1).

26. *See supra* notes 1–4 and accompanying text (discussing how bankruptcy triggers a break between pre-petition and post-petition claims).

27. Force-placed insurance is insurance the lender obtains on the property when the borrower fails to maintain the necessary insurance coverage, which allows the lender to protect its collateral.

28. *In re* Evans, 421 B.R. 217, 220 (Bankr. N.D. Miss. 2009).

29. *See infra* Part IV.C.

Upon default, the lender will send a notice of default, accelerate the loan if the default remains uncured, and foreclose on the property to recover as much of the debt as possible. If a deficiency exists after sale of the property, the lender can obtain a deficiency judgment against the individual borrower. This is an in personam obligation and the lender can then go after the individual's other property to collect the remaining amount of the debt.[30] If the lender paid the individual's taxes or insurance in order to protect the property, the lender will be reimbursed for those items.[31] In a Chapter 13 bankruptcy, like the situation involving the taxing authority, any pre-petition arrearage amounts due under the loan documents are paid over the life of the debtor's plan. Post-petition, the bankruptcy anti-modification provision applies; thus, the Chapter 13 debtor must make the regular maintenance payments in addition to the payments curing the default.[32]

In sum, under a successful bankruptcy plan, the debtor will maintain property insurance and pay the lender and taxing authority any pre-petition arrearages over the life of the plan. If the debtor fails to make post-petition payments when due, creditors can get the property released from the stay and foreclose.

### B. *LOANS WITH ESCROW ARRANGEMENTS*

Upon lending money to a residential borrower, a lender usually requests an escrow account to protect the collateral—the property.[33] This ensures the lender that the property taxes and property insurance premiums are promptly paid. As discussed above, if a borrower fails to pay a tax bill, the taxing authority may place a lien on the property, and upon continued nonpayment, the taxing authority may force a tax sale of the property. When tax liens attach to the property, they become senior to all other liens, including the lender's lien.[34] Thus, if a taxing authority conducts a tax sale, the lender may lose its ability to collect on its loan debt. Additionally, if a borrower fails to pay insurance premiums, the property may become worthless in the case of a fire or other disaster. The lender would be limited to seeking an in personam judgment against the borrower; if the debtor has few other assets, the lender will not be able to collect on the debt.

When the terms of the loan documents create an escrow account, those terms require the debtor to make monthly escrow payments in addition to principal and interest. RESPA authorizes the lender to collect and distribute funds from the escrow account, and it also restricts the methods the lender

30. BLACK'S LAW DICTIONARY 862 (9th ed. 2009) (defining "in personam" as an action "brought against a person rather than property").

31. This is governed by the terms of the underlying loan agreement.

32. 11 U.S.C. § 1322(b)(5) (2006).

33. *See* RAO ET AL., *supra* note 1, § 8.1.

34. *See, e.g.*, 35 ILL. COMP. STAT. 200/21-75 (2010); IOWA CODE § 445.28 (2011); N.J. STAT. ANN. §§ 54:5-6, -10 (West 2002).

can employ.[35] If the debtor is current on escrow payments, the lender then makes the tax and insurance payments as they become due.[36] If the borrower is delinquent on payments, the lender can choose not to pay the escrow items, or the lender can pay and ask the debtor to reimburse the costs.[37] In the event the borrower continually fails to make the escrow payments, the lender may send a notice of default, accelerate the loan, and foreclose on the property. The lender can then bring a deficiency claim against the borrower for any costs the sale proceeds did not cover.

The taxing authority is not involved in the escrow arrangement. Thus, as noted above, if pre-petition taxes are due and still owing (i.e., neither lender nor borrower has paid), the taxing authority has a claim in bankruptcy. If the lender has already paid, then the taxing authority does not have a claim, and the lender has a claim for this advance. Like the taxing authority, the insurance company is not involved in the escrow arrangement. Thus, if the insurance premium is not paid, the insurer will cancel the insurance. Because insurance is paid in advance, however, the insurance company does not have a claim in bankruptcy.

### C. *REAL ESTATE SETTLEMENT PROCEDURES ACT*

Congress enacted RESPA[38] in 1974 to, in part, regulate escrow accounts "established in connection with [a federally related mortgage] loan for the purpose of assuring payment of taxes, insurance premiums, or other charges with respect to the property."[39] Congress has since enacted several provisions imposing new requirements on lenders and loan servicers.[40] The Department of Housing and Urban Development ("HUD") regulates and enforces RESPA, and RESPA's implementing regulation is contained in Regulation X.[41] RESPA applies to most home mortgages.[42]

RESPA and Regulation X limit escrow accounts in several ways in order to protect against potential lender abuses and servicing problems. First, RESPA limits the amount a lender may collect to "a sum that will be sufficient to pay such taxes, insurance premiums and other charges" for the

35. *See infra* Part II.C.

36. *See infra* Part II.C.

37. *See infra* Part II.C.

38. Real Estate Settlement Procedures Act of 1974, Pub. L. No. 93-533, 88 Stat. 1724 (codified as amended at 12 U.S.C. §§ 1831b, 2601–2617 (2006 & Supp. V 2011)).

39. 12 U.S.C. § 2609(a)(1) (2006); *see also id.* § 2602(1) (defining "federally related mortgage loan"); 24 C.F.R. § 3500.5(b) (2012) (providing RESPA exemptions). In *Rodriguez*, Countrywide Home Loans, Inc. focused on "for the purpose of assuring payment." Brief of Appellee Countrywide Home Loans, Inc. at 2, *In re* Rodriguez, 629 F.3d 136 (3d Cir. 2010) (No. 09-2724), 2010 WL 3559303, at *2 (quoting 12 U.S.C. § 2605(g) (2006)).

40. RAO ET AL., *supra* note 1, § 8.2.1.

41. 24 C.F.R. §§ 3500.1–.23.

42. RAO ET AL., *supra* note 1, § 8.1.

applicable twelve-month period.[43] RESPA also allows the lender to collect an additional amount—a cushion[44]—of up to "one-sixth of the estimated total amount of such taxes, insurance premiums and other charges . . . during the ensuing twelve-month period."[45] The borrower pays the aggregate sum in twelve monthly installments.[46] "As a result, a lender must estimate future property taxes and assessments, as well as insurance premiums, and allocate the estimated sum over a period sufficient to provide adequate funds to pay the escrow charges when due."[47]

The lender may request additional amounts if the lender determines that there is an escrow deficiency or an escrow shortage.[48] While the terms deficiency and shortage appear similar, RESPA defines them differently. Before defining the terms, however, it is first important to understand that a lender determines if there is a deficiency or shortage by conducting an escrow account analysis.[49] Regulation X requires the lender to "conduct an escrow account analysis upon establishing an escrow account and at completion of the escrow account computation year."[50] Additionally, the

43. 12 U.S.C. § 2609(a)(1). The "[*e*]*scrow account computation year* is a 12-month period that a servicer establishes for the escrow account beginning with the borrower's initial payment date. The term includes each 12-month period thereafter, unless a servicer chooses to issue a short year statement under the conditions stated in § 3500.17(i)(4)." 24 C.F.R. § 3500.17(b).

44. 24 C.F.R. § 3500.17(b) ("*Cushion or reserve* . . . means funds that a servicer may require a borrower to pay into an escrow account to cover unanticipated disbursements or disbursements made before the borrower's payments are available in the account, as limited by § 3500.17(c)."). For a description of these funds, see *id.* § 3500.17(c)(1)(ii). The cushion portion of Countrywide's post-petition recalculation, $87.02, was uncontested. *Rodriguez I*, 391 B.R. 723, 728 n.6 (Bankr. D.N.J. 2008), *aff'd*, No. 07-24687 (MBK), Civ. No. 08-5207 (AET), 2009 WL 8451888 (D.N.J. May 12, 2009), *vacated and remanded*, 629 F.3d 136 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

45. 12 U.S.C. § 2609(a)(1).

46. *Id.* § 2609(a)(2).

47. *Rodriguez I*, 391 B.R. at 727.

48. 24 C.F.R. § 3500.17(c)(1)(ii). There is also the possibility that an escrow surplus will result, requiring the lender to refund the borrower. *Id.* § 3500.17(f)(2)(i) ("If an escrow account analysis discloses a surplus, the servicer shall, within 30 days from the date of the analysis, refund the surplus to the borrower if the surplus is greater than or equal to 50 dollars . . . .").

49. *Id.* § 3500.17(b).

50. *Id.* § 3500.17(f)(1)(i). According to 24 C.F.R. § 3500.17(b):

> *Escrow account analysis* means the accounting that a servicer conducts in the form of a trial running balance for an escrow account to:
>
> (1) Determine the appropriate target balances;
>
> (2) Compute the borrower's monthly payments for the next escrow account computation year and any deposits needed to establish or maintain the account; and
>
> (3) Determine whether shortages, surpluses or deficiencies exist.

*Id.* § 3500.17(b).

lender "may conduct an escrow account analysis at other times during the escrow computation year."[51]

An escrow deficiency is "the amount of a negative balance in an escrow account."[52] The only way a deficiency occurs is if the lender advances funds to pay an escrow item, creating the negative balance.[53] An escrow shortage is "an amount by which a current escrow account balance falls short of the target balance at the time of escrow analysis."[54] As a result, there are not enough funds to pay upcoming escrow items.[55]

The lender's collection options depend on: (1) whether there is an escrow deficiency or escrow shortage; and (2) if the amount of the deficiency or shortage is (a) less than or (b) equal to or greater than one month's escrow payment. If there is an escrow deficiency that is equal to or greater than one month's escrow payment, the lender: (1) "may allow the deficiency to exist and do nothing to change it";[56] or (2) "may require the borrower to repay the deficiency in two or more equal monthly payments."[57] If there is an escrow shortage that is equal to or greater than one month's escrow payment, the lender: (1) "may allow a shortage to exist and do nothing to change it";[58] or (2) "may require the borrower to repay the shortage in equal monthly payments over at least a 12-month period."[59]

Regulation X provides an additional rule if the borrower is not current with escrow payments at the time the lender conducts an escrow analysis: "If the servicer does not receive the borrower's payment within 30 days of the payment due date, then the servicer may recover the deficiency pursuant to the terms of the mortgage loan documents."[60] Regulation X does not provide a similar provision for escrow shortages. Thus, the lender should collect the escrow shortage with the procedures outlined above.[61] With this general overview, the next Part focuses on the particular facts and arguments of *Rodriguez* to explore the unpaid pre-petition escrow amount debate.

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51. *Id.* § 3500.17(f)(1)(ii).

52. *Id.* § 3500.17(b).

53. *See id.*

54. *Id.* "*Target balance* means the estimated month end balance in an escrow account that is just sufficient to cover the remaining disbursements from the escrow account in the escrow account computation year, taking into account the remaining scheduled periodic payments, and a cushion, if any." *Id.*

55. There can be both an escrow shortage and an escrow deficiency.

56. 24 C.F.R. § 3500.17(f)(4)(ii).

57. *Id.*

58. *Id.* § 3500.17(f)(3)(ii)(A).

59. *Id.* § 3500.17(f)(3)(ii)(B).

60. *Id.* § 3500.17(f)(4)(iii).

61. *See* RAO ET AL., *supra* note 1, § 8.3.4.3 (outlining the requirements for shortages).

## III. *RODRIGUEZ*: AN ILLUSTRATION OF THE ARGUMENTS MADE REGARDING UNPAID PRE-PETITION ESCROW AMOUNTS

This Part summarizes the *Rodriguez* facts and decisions to show the analysis of the parties' and courts' positions regarding unpaid pre-petition escrow amounts. This analysis demonstrates the narrow focus of the arguments made and ultimately why this Note's alternate solution provides a better approach to solving this debate.

In 2005, Francisco Rodriguez and Anna Rodriguez (the "Rodriguezes") obtained a mortgage from First Mutual Corp. to purchase a home in Monmouth County, New Jersey.[62] Later, Countrywide Home Loans, Inc. ("Countrywide") acquired the mortgage.[63] The mortgage's terms provided that "the Rodriguezes' monthly payments consisted of (1) an amount to cover principal, interest, and any late fees, and (2) an amount to cover taxes, insurance, and other charges."[64] Countrywide placed the Rodriguezes' payments of taxes, insurance, and other charges in an escrow account.[65] The mortgage allowed Countrywide to use the escrow funds to pay the taxes, insurance, and other charges as those payments became due.[66] The principal and interest monthly payment was $1898.35,[67] and the monthly escrow payment was $707.20.[68] Accordingly, the Rodriguezes' total monthly payment was $2605.55.

On October 10, 2007, the Rodriguezes filed a voluntary Chapter 13 bankruptcy petition.[69] At the time of filing, the Rodriguezes were eight months of principal and interest and escrow payments in arrears.[70] Omitting late fees and costs, the Rodriguezes' outstanding payments totaled $20,844.40: $15,186.80 for principal and interest, and $5657.60 for escrow.[71] During this eight-month period, Countrywide advanced funds to

62. *In re* Rodriguez (*Rodriguez II*), 629 F.3d 136, 136–37 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

63. *Id.* at 137.

64. *Id.* (internal quotation marks omitted); *see also Rodriguez I*, 391 B.R. 723, 727 (Bankr. D.N.J. 2008) ("Contractually, the Debtors' mortgage provides that the Debtors shall pay all property taxes. However, the mortgage further requires that the Debtors pay amounts due for property taxes to the lender as future escrow items throughout the 12-month period preceding the month in which the property taxes are due. Such payments must be made concurrently with the principal and interest payments due to the lender each month." (footnote omitted)), *aff'd*, No. 07-24687 (MBK), Civ. No. 08-5207 (AET), 2009 WL 8451888 (D.N.J. May 12, 2009), *vacated and remanded*, 629 F.3d 136 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

65. *Rodriguez II*, 629 F.3d at 137.

66. *Id.*

67. *Rodriguez I*, 391 B.R. at 726.

68. *Rodriguez II*, 629 F.3d at 137.

69. *Id.*

70. *Id.*

71. *Id.* (calculating principal and interest as $1898.35 times eight months and escrow as $707.20 times eight months).

cover the Rodriguezes' real estate taxes and insurance obligations, creating a $3869.91 escrow deficiency.[72]

Countrywide's pre-petition claim on January 15, 2008 included[73]:

| | |
|---|---|
| Monthly Payments (8 months at $1,898.35) | $15,186.80 |
| Foreclosure Fees | $700.00 |
| Foreclosure Costs | $1,527.00 |
| Escrow Deficiency | $3,869.91 |
| Total Pre-Petition Arrears | $21,283.71 |

The parties did not dispute that Countrywide advanced $3869.91 and that this advanced escrow deficiency was a valid "claim" under the Bankruptcy Code.[74] Rather, the dispute arose because Countrywide's claim did not include the remaining escrow that the Rodriguezes owed.[75] This additional, unclaimed amount was $1787.69, calculated by taking the total amount the Rodriguezes owed Countrywide for escrow, $5657.60, less the advanced $3869.91.[76]

As part of Countrywide's claim, Countrywide included its post-petition escrow recalculation, resulting in an increased escrow monthly payment.[77] The new escrow monthly payment was $947.77, as opposed to the prior $707.20.[78] In Countrywide's escrow payment breakdown, the post-petition figure included three things: "(1) $650.10 'base' escrow payment, (2) $210.62 shortage contribution, and (3) $87.02 required reserve."[79]

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72. *Rodriguez I*, 391 B.R. at 726. The court used the term "escrow shortage"; however, as defined in Part II.C, the correct term is "escrow deficiency."

73. *Id.* (format altered).

74. *Id.*

75. *Rodriguez II*, 629 F.3d at 138.

76. *Id.* at 137. In its brief as amicus curiae, the United States wrote:

> There is some disagreement in the briefs and decisions in this case about the exact amount of the pre-petition escrow arrearage and the corresponding hypothetical non-delinquent escrow-account balance. Because the legal issues in this case do not turn on the precise amount of the escrow arrearage and associated hypothetical escrow-account balance, this brief follows the court of appeals in assuming that the escrow arrearage was $5657.60 and that the relevant hypothetical non-delinquent escrow balance would have been $1787.69.

Brief for the United States as Amicus Curiae at 5 n.1, Countrywide Home Loans, Inc. v. Rodriguez, 132 S. Ct. 573 (2011) (No. 10-1285), 2011 WL 4874084, at *5 n.1 (citation omitted). The bankruptcy court added a ninth month into their arrearage calculation. *Rodriguez II*, 629 F.3d at 137 n.1. As such, the bankruptcy court indicated that the Rodriguezes were $6364.80 in arrears ($707.20 monthly escrow payment times nine months), making the unclaimed escrow amount $2494.89 ($6364.80 minus the $3869.91 advanced escrow deficiency). *See id.* at 137 & n.1.

77. *Rodriguez II*, 629 F.3d at 137.

78. *Id.*

79. *Rodriguez I*, 391 B.R. at 726. "[U]pon the filing of Debtor's petition, Countrywide increased Debtor's post-petition payments in the amount of $210.65 per month, alleging the collection of an escrow shortage of $2,527.81." *Id.* The parties only disputed the $210.65

The Rodriguezes argued that Countrywide's post-petition escrow analysis constituted an unlawful collection of a pre-petition obligation, violating the automatic stay provisions of the Bankruptcy Code.[80] The Rodriguezes insisted that Countrywide should have claimed the entire escrow shortfall, $5657.60, in its bankruptcy claim because that was a monetary "default" under their loan documents.[81] Specifically, they argued that the Bankruptcy Code also required Countrywide to claim the $1787.69 unpaid escrow, which the Rodriguezes would then pay over the life of their Chapter 13 bankruptcy plan—in this case, sixty months.[82]

In response, Countrywide argued that it did not have a "claim" for the $1787.69 unpaid—and not advanced—escrow shortfall; therefore, it could not claim this unpaid escrow in the bankruptcy.[83] Countrywide did not dispute that the escrow obligations arose before the Rodriguezes filed bankruptcy.[84] "Instead, Countrywide assert[ed] that as between itself and the Debtors, no claim arose in its favor until it paid the taxes and an escrow shortage accrued."[85] Additionally, Countrywide argued that RESPA governed Countrywide's collection of escrow funds, which would allow Countrywide to collect escrow shortages within twelve months rather than over the sixty months of the life of the Rodriguezes' Chapter 13 plan.[86] The next Subparts explain the parties' focus on the terms "claim" and "default," and modifying the loan documents.

### A. *BANKRUPTCY "CLAIM"*

In *Rodriguez*, the parties disputed whether Countrywide had a "claim" against the Rodriguezes for unpaid pre-petition escrow amounts. The parties each highlighted certain terms from the definition of "claim" in the Bankruptcy Code. Accordingly, it is important to examine the definition of "claim" in its entirety:

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increased escrow shortage amount; the parties did not dispute the $650.10 per month base amount or the $87.02 per month reserve amount. *See id.* at 726–27.

80. *Id.* at 725.

81. *Id.*

82. *Id.* at 727–29; *cf.* Scott F. Norberg & Nadja Schreiber Compo, *Report on an Empirical Study of District Variations, and the Roles of Judges, Trustees and Debtors' Attorneys in Chapter 13 Bankruptcy Cases*, 81 AM. BANKR. L.J. 431, 453 (2007) ("With respect to plan length, the Bankruptcy Code provides that a Chapter 13 plan generally may not exceed three years except for 'cause,' and that a plan must run for no less than three years unless unsecured creditors are to be paid in full under a shorter plan. The maximum length of a Chapter 13 plan is five years." (footnotes omitted)).

83. *Rodriguez II*, 629 F.3d at 140.

84. *Rodriguez I*, 391 B.R. at 730.

85. *Id.* As previously mentioned, the court technically should have used the term "escrow deficiency" rather than "escrow shortage." *See supra* note 72.

86. *Id.*; 24 C.F.R. § 3500.17(f)(3)(c) (2012).

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.[87]

First, the *Rodriguez* parties and courts disputed the meaning of the phrase "right to payment." The *Rodriguez* bankruptcy court found that "[a] 'right to payment,' as incorporated in the statutory definition of 'claim' . . . implicitly encompasses a right of retention, which is not subsumed in Countrywide's 'right to collect' escrow items."[88] The Third Circuit, however, refused to focus on this phrase alone. Rather, the Third Circuit "explained that . . . focus on the 'right to payment' failed 'to give sufficient weight' to the other words in the statutory definition . . . of 'claim.'"[89]

Looking beyond the initial language of the definition, Congress also included modifying terms, such as "contingent," "unmatured," and "unliquidated" payments.[90] The Third Circuit acknowledged that Countrywide's right to collect payment from the Rodriguezes may have been *contingent* on Countrywide actually advancing its own funds to satisfy the borrower's escrow items,[91] such as tax and insurance payments.[92] Following this concession, however, the Third Circuit held that "the *contingent* nature of the right to payment does not change the fact that the right to payment exists, even if it is remote, and thereby constitutes a 'claim.'"[93]

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87. 11 U.S.C. § 101(5) (2006).

88. *Rodriguez I*, 391 B.R. at 730.

89. *Rodriguez II*, 629 F.3d 136, 139 (3d Cir. 2010) (quoting Jeld–Wen, Inc. v. Van Brunt (*In re* Grossman), 607 F.3d 114, 121 (3d Cir. 2010)), *cert. denied*, 132 S. Ct. 573 (2011).

90. 11 U.S.C. § 101(5)(A). Congress intended the definition of "claim" to be very broad. Congress stated: "By this broadest possible definition . . . all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court." S. REP. NO. 95-989, at 22 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5808. The Supreme Court also reached this conclusion, noting that "Congress intended in § 101(5) to incorporate the broadest available definition of 'claim.'" Johnson v. Home State Bank, 501 U.S. 78, 83 (1991).

91. *Rodriguez II*, 629 F.3d at 142.

92. *See id.* at 140.

93. *Id.* at 142 (emphasis added). In a strong dissent, however, Judge Sloviter indicated that he did not believe that the loan document language concerning the escrow payments created a "claim" under the Bankruptcy Code. *Id.* at 145 (Sloviter, J., dissenting). Rather, Sloviter concluded that while Countrywide could accelerate the loan based on the Rodriguezes' nonpayment of the escrow funds, the acceleration was only applicable to payment of the actual sums secured by the mortgage—the principal and interest payments. *Id.* Like the bankruptcy court, Sloviter found that Countrywide acted in accordance with RESPA and noted the

Finally, the Bankruptcy Code defines "debt" as a "liability on a claim."[94] Congress indicated that "a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor."[95] Countrywide argued that "any missed pre-petition escrow deposits . . . [were] not part of the 'debt' that [was] owed to Countrywide."[96] Rather, only amounts Countrywide advanced became a "debt" as stated in the loan documents.[97] Additionally, Countrywide argued, and the bankruptcy court agreed, that "[a]n escrow account is not a debt or a liability. It is an asset held by the servicer for the borrower that is used to pay the borrower's tax and insurance obligations and to protect the lender's collateral."[98] The unpaid escrow amounts were not a "debt" that Countrywide could add to the note; therefore,

majority's inattention to RESPA. *Id.* at 144 ("The majority never even tries to explain why RESPA is inapplicable."). Finally, Sloviter quoted the bankruptcy court and indicated that Countrywide did not have a claim for the additional $1787.69 unpaid escrow because "Countrywide merely collects and holds such funds for payment to third parties." *Id.* at 145 (quoting *Rodriguez I*, 391 B.R. at 730). In fact, Sloviter argued that the additional $1787.69 had no relationship to Countrywide's post-petition calculation of the monthly escrow shortage payments:

> [A]s calculated by the Bankruptcy Court, the Rodriguezes' monthly post-petition shortage payments should be $94.53 a month. Over the course of a year, this amounts to approximately $1,134.30. Perversely, under the majority's opinion, Countrywide is required, and indeed allowed, to claim $1,787.69 in Bankruptcy for the missed escrow payments, when it would have been entitled to increase the shortage payments by only $1,134.30 over the course of a year.

*Id.* at 145 n.4 (citation omitted).

94. 11 U.S.C. § 101(12).

95. S. REP. NO. 95-989, at 23 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5809. It is important to note, however, that

> [t]his definition of "debt" and the definition of "claim" on which it is based, proposed 11 U.S.C. 101(4), does not include a transaction such as a policy loan on an insurance policy. Under that kind of transaction, the debtor is not liable to the insurance company for repayment; the amount owed is merely available to the company for setoff against any benefits that become payable under the policy. As such, the loan is not a claim (it is not a right to payment) that the company can assert against the estate; nor is the debtor's obligation a debt (a liability on a claim) that will be discharged under proposed 11 U.S.C. 523 or 524.

*Id.*

96. Petition for a Writ of Certiorari, *supra* note 11, at 10.

97. Mortgage from Francisco and Anna Rodriguez to First Mutual Corp. 4 (Mar. 25, 2005) (filed with the Monmouth County, N.J. Recorder on Apr. 16, 2005, at bk. OR-8452, pg. 8194, Instrument No. 2005058517) ("Any amounts disbursed by Lender under this paragraph shall become an additional debt of Borrower and be secured by this Security Instrument.").

98. Brief of Appellee Countrywide Home Loans, Inc., *supra* note 39, at 16. The bankruptcy court found that "[i]n collecting escrow amounts as part of the mortgagors' monthly mortgage payments, Countrywide serves merely as a conduit for such payments and should only recover in bankruptcy for such items actually disbursed on behalf of mortgagors." *Rodriguez I*, 391 B.R. at 730. Judge Sloviter also agreed in his Third Circuit dissent. *Rodriguez II*, 629 F.3d at 145 (Sloviter, J., dissenting).

Countrywide could not sue the Rodriguezes for those missed payments.[99] Rather, the escrow account was additional security, and only advanced escrow payments were added to the debt.[100]

The Rodriguezes responded that the escrow account was pledged as "additional security for all sums due under the mortgage. Therefore, irrespective of intent of distribution, past, present or future, these pre-petition escrow deposit[s] can and often are utilized as payments for other fees, costs and expenses associated with the loan and/or default."[101] As the Rodriguezes' final argument suggests, the parties' arguments commingled with a related issue: Whether a "default" under the mortgage created a "claim." The term "default" appears in the anti-modification provision of the Bankruptcy Code, discussed in the next Subpart.

### B. *ANTI-MODIFICATION PROVISION*

In general, a Chapter 13 plan may "modify the rights of holders of secured claims."[102] Under § 1322(b)(2), however, a Chapter 13 plan may not modify "a claim secured only by a security interest in real property that is the debtor's principal residence."[103] Congress provided an exception to this anti-modification provision. Section 1322(b)(5) provides that notwithstanding Section 1322(b)(2), a plan may "provide for the *curing of any default within a reasonable time and maintenance of payments* while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due."[104] In effect, Congress stated that "a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred."[105]

The Bankruptcy Code, however, does not define "default."[106] Courts look to additional external sources to determine what constitutes a "default"[107]: "[T]he amount necessary to cure the default[] shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law."[108] Like "default," the Bankruptcy Code does not define what period of time is "reasonable." A Chapter 13 plan may not last for a

99. Brief of Appellee Countrywide Home Loans, Inc., *supra* note 39, at 19.

100. *Id.* at 19 n.10.

101. Reply Brief of Appellants, *supra* note 14, at 9 (citation omitted).

102. 11 U.S.C. § 1322(b)(2) (2006).

103. *Id.*

104. *Id.* § 1322(b)(5) (emphasis added).

105. H.R. REP. NO. 103-835, at 55 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3364.

106. Black's Law Dictionary defines "default" as "[t]he omission or failure to perform a legal or contractual duty; esp., the failure to pay a debt when due." BLACK'S LAW DICTIONARY 480 (9th ed. 2009).

107. *See In re* F.B.F. Indus., Inc., 165 B.R. 544, 548–50 (Bankr. E.D. Pa. 1994).

108. 11 U.S.C. § 1322(e).

period longer than five years.[109] However, "[i]t is not safe to assume that a cure over the entire length of the plan will be found to be reasonable."[110]

The parties' arguments, considered in light of the relevant statutes, appear to yield only two possible outcomes: unpaid pre-petition escrow amounts either constitute part of a claim or they do not. First, a court could determine, as did the *Rodriguez* bankruptcy court, that the unpaid pre-petition escrow amounts are not a "claim," and therefore the lender can collect the unpaid pre-petition escrow amounts in accordance with the underlying loan documents—starting the post-petition escrow analysis with a zero escrow balance.[111] The debtor pays back the advanced funds over the life of his Chapter 13 bankruptcy plan, and the lender collects any other deficiency or shortage using RESPA and Regulation X guidelines.[112] Generally, this means that the lender will be able to assess payments sufficient to bring the escrow account current over the next twelve months, regardless of the effect on the debtor's bankruptcy plan. This prevents lenders from having to provide debtors with interest-free loans.[113] If a lender could not recalculate escrow accounts post-petition, the lender would have to make additional out-of-pocket advances on behalf of the borrower,[114] which is the protection RESPA sought to provide lenders.[115]

Second, as the Third Circuit decided in *Rodriguez II*, a court could determine that unpaid pre-petition escrow amounts are part of a creditor's "claim" and that allowing the debtor to bring these payments current over the life of a Chapter 13 plan does not modify the mortgage.[116] This position requires lenders to treat the escrow account as if it has a positive balance in post-petition calculations, accounting for the escrow payments that should have existed in the escrow account if debtors would have made their pre-petition escrow payments.[117] In other words, the lender treats the escrow account as current, even though it will not actually be current until the end of the plan. In effect, the lender's post-petition recalculations are conducted in accordance with RESPA, with the exception that the unpaid pre-petition payments cannot be collected using RESPA and Regulation X procedures.[118]

109. *Id.* § 1322(d).

110. RAO ET AL., *supra* note 1, § 9.3.1.

111. *Rodriguez I*, 391 B.R. 723, 731 (Bankr. D.N.J. 2008), *aff'd*, No. 07-24687 (MBK), Civ. No. 08-5207 (AET), 2009 WL 8451888 (D.N.J. May 12, 2009), *vacated and remanded*, 629 F.3d 136 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

112. *Id.*; *see also* 11 U.S.C. § 1322(a)(2) (2006 & Supp. V 2011).

113. *See Rodriguez I*, 391 B.R. at 729–30. Had the court required Countrywide to claim the $1787.69 unpaid escrow, Countrywide would have needed to calculate the Rodriguezes' post-petition escrow obligations based on a positive escrow balance. *Id.*

114. *Id.*

115. *Id.*

116. *Rodriguez II*, 629 F.3d 136, 141–42 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

117. *Id.*

118. *Id.*

Rather, the unpaid pre-petition amounts are collected during the life of the Chapter 13 plan.[119] This position focuses on the term "default" in the underlying contract—here, the underlying loan documents.[120] In most cases, a borrower's nonpayment of an escrow amount creates a default under the loan documents.[121] Accordingly, because Congress intended to allow a debtor in bankruptcy the right to cure a default "within a reasonable time,"[122] the debtor can cure his pre-petition defaults while also making post-petition payments during the life of the Chapter 13 plan.[123]

In sum, courts look to the loan documents to determine whether missed escrow payments create a default. If so, then courts reason that Congress intended for a Chapter 13 debtor to cure those defaults—the missed escrow payments—over the life of the debtor's Chapter 13 plan. This analysis, however, ignores the second portion of Section 1322(e), which states that the amount necessary to cure relies on applicable nonbankruptcy law.[124] RESPA is an applicable nonbankruptcy law here, which governs the collection of escrow amounts. Thus, while a missed escrow payment is a "default" under the loan documents, relying solely on the loan documents ignores Congress's express provisions in RESPA.

These diametrically opposed outcomes unnecessarily constitute all-or-nothing approaches. The next Part calls attention to several important issues the courts failed to consider, and accordingly, Part V then provides an alternative approach that evaluates the tax and insurance escrow obligations separately to produce a middle-ground outcome that better balances the parties' interests and gives greater fidelity to the statutory regime governing bankruptcy and home mortgages.

## IV. THE *RODRIGUEZ* GAPS: UNADDRESSED ARGUMENTS

The parties in the cases addressing pre-petition unpaid escrow amounts have focused on the terms "claim" and "default," and modifying the loan documents, but the analysis should not be this narrowly focused. Adopting a narrow focus forces courts to take an all-or-nothing approach. This Part highlights several issues the *Rodriguez* courts did not consider that parties

119. *Id.*

120. While the parties blend the words "claim" and "default" in their arguments, the starting point is whether the debtor is attempting to cure a "default" in his or her Chapter 13 plan. *See supra* notes 103–08 and accompanying text.

121. *See, e.g.*, *Rodriguez II*, 629 F.3d at 141. The parties did not dispute that the Rodriguezes' failure to make escrow payments created a default under the mortgage. *See id.* at 138–40.

122. 11 U.S.C. § 1322(b)(5) (2006).

123. *See id.*

124. *Id.* § 1322(e) ("[I]f it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.").

may raise in future litigation and emphasizes why courts should adopt the alternative approach in Part V.

The *Rodriguez* bankruptcy court indicated that requiring lenders to claim unpaid pre-petition escrow amounts modifies the loan, which violates the anti-modification provision of the Bankruptcy Code. Does the lender's security interest in escrow funds, however, make the anti-modification provision inapplicable? Did the courts ignore the importance of RESPA's separate definitions of "escrow shortage" and "escrow deficiency"? As discussed above, when a debtor fails to maintain insurance on the property or pay taxes, does the property become inadequately protected? When a court requires a lender to claim the unpaid pre-petition escrow amounts, the lender must treat the escrow account as current: does this practice force lenders to make involuntary loans to the debtor borrowers? Based on the answers to these questions and the parties' separate enforcement rights discussed above, courts should treat pre-petition tax and insurance obligations separately, taking an alternative approach to the all-or-nothing decisions courts have made.

### A. *IS THE ANTI-MODIFICATION PROVISION INAPPLICABLE?*

Under the anti-modification provision, a bankruptcy court cannot modify "a claim secured only by a security interest in real property that is the debtor's principal residence."[125] In 2005, Congress added two definitions to the Bankruptcy Code: "debtor's principal residence" and "incidental property."[126] A debtor's principal residence is now defined as "a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to real property."[127] Additionally, incidental property may include items such as rent, escrow funds, and insurance proceeds.[128] Courts have split on whether a security interest in escrow funds, which applies here, allows for modification of the loan.

Some courts hold that when a debtor also grants a lender a security interest in the escrow funds, the debtor retains no interest in the funds after they are placed in the escrow account.[129] Accordingly, the escrow funds do not create additional collateral, and the Bankruptcy Code's anti-modification provision still applies.[130] In contrast, other courts hold that

125. *Id.* § 1322(b)(2).

126. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 306(c), 119 Stat. 23, 80–81 (codified as amended at 11 U.S.C. § 101(13A), (27B) (2006 & Supp. V 2011)).

127. 11 U.S.C. § 101(13A) (2006 & Supp. V 2011).

128. *Id.* § 101(27B) (2006).

129. *See, e.g.*, 1st 2nd Mortg. Co. v. Ferandos (*In re* Ferandos), 402 F.3d 147, 155–56 (3d Cir. 2005).

130. *Id.*

because debtors are entitled to the surplus, if any, under RESPA guidelines, the debtors retain an interest in the escrow funds.[131] As such, the lender has a separate security interest in the escrow funds, which makes the anti-modification provision inapplicable as to the entire mortgage.[132]

As discussed in Part III, which evaluated *Rodriguez*, a lender cannot claim unpaid escrow amounts as a debt under the loan documents. If the lender foreclosed on the property, it would not receive additional funds for the unpaid escrow amounts, only for any advanced funds. The Third Circuit, however, took the position that unpaid escrow amounts constitute a right to payment and the lender should claim them in the bankruptcy proceedings. This may implicitly create a new right to collateral—a personal property interest in the escrow payments. If this is the case, the mortgage may be subject to modification. This could negatively affect either party. For example, one modification option could make the full loan payable over the life of the bankruptcy plan. Another option might discharge any part of the lender's debt that is unsecured.

### *B. TREATMENT OF RESPA ESCROW SHORTAGE VERSUS ESCROW DEFICIENCY*

As discussed in Part II.C, courts and commentators often use "escrow deficiency" and "escrow shortage" interchangeably, but they represent different escrow conditions.[133] In *Rodriguez*, the parties did not dispute that the lender should claim lender advances—creating an "escrow deficiency"—in the bankruptcy. In addition to the *Rodriguez* bankruptcy court, however, at least one other court concluded that lenders may include "escrow shortages" in a debtor's post-petition escrow payments.[134] In *Hosley*, the lender filed a motion to lift the stay based on the debtor's refusal to pay escrow shortages post-petition.[135] Not only did the court find that RESPA authorized the collection, but it also held that the lender had a valid right to seek a lift of the stay to enforce collection of the escrow shortage.[136] Although a relief from the stay was not issued in this case, if the court would have granted the relief, the lender could then have foreclosed on the property to collect its debt.

131. *See In re* Bradsher, 427 B.R. 386, 391–92 (Bankr. M.D.N.C. 2010); Thomas v. Countrywide Home Loans, Inc. (*In re* Thomas), 344 B.R. 386, 391–92 (Bankr. W.D. Pa. 2006).

132. *Bradsher*, 427 B.R. at 392; *Thomas*, 344 B.R. at 392.

133. An escrow deficiency is "the amount of a negative balance in an escrow account." 24 C.F.R. § 3500.17(b) (2012). The only way a deficiency occurs is if the lender advances funds to pay an escrow item, creating the negative balance. An escrow shortage is "an amount by which a current escrow account balance falls short of the target balance at the time of escrow analysis." *Id.* As a result, there will not be enough funds to pay upcoming escrow items.

134. Hosley v. Wells Fargo Bank Minn. (*In re* Hosley), No. 1:08-CV-752 (LEK), Bankr. Case No. 05-15888, 2008 WL 5169553, at *2 (N.D.N.Y. Dec. 9, 2008).

135. *Id.* at *1.

136. *Id.* at *2–3.

### C. ADEQUATE PROTECTION ISSUES

Section 362(d) of the Bankruptcy Code applies in Chapter 13 cases and states that "the court shall grant relief from the stay . . . for cause, including the lack of adequate protection of an interest in property."[137] A debtor's failure to pay real estate taxes or his failure to pay insurance are reasons "for cause."[138] Thus, a Chapter 13 debtor's failure to pay post-petition taxes and insurance premiums when due creates a lack of adequate protection and gives the lender cause for relief from the stay. If escrow funds are not available, a lender may choose to not pay the taxes and insurance when due.[139] If the debtor does not have funds available either, the court may lift the stay and let the lender foreclose.

### D. FORCED LOANS

The Third Circuit rejected the idea that its decision requires lenders to make involuntary loans.[140] Its requirement that lenders treat the escrow accounts as current, however, makes this assertion incorrect. RESPA requires a lender to "advance funds to make disbursements in a timely manner as long as the borrower's payment is not more than 30 days overdue."[141] Because the court tells the lender that the debtor is current, the lender must advance payment for escrow items, forcing the lender to advance additional funds to the debtor. Alternatively, if courts did not intend for debtors to be considered current for RESPA purposes, then the lender is not required to make any advances. In this case, as discussed above, the lender would be better off to let the taxes and insurance go unpaid.[142] Under either event, the property is no longer adequately protected. As a result, the property will be released from the bankruptcy stay and the property may be foreclosed.

## V. ALTERNATIVE, MIDDLE-GROUND APPROACH TO THE RESPA VERSUS BANKRUPTCY CODE DEBATE

Allowing debtors to make unpaid pre-petition escrow amounts over the life of the plan may seem beneficial, but subsequent courts reviewing the concerns presented above may realize that the result of doing so affects other parts of the Bankruptcy Code. There is an alternative, middle-ground

137. 11 U.S.C. § 362(d)(1) (2006).

138. *See In re* Rosen, 208 B.R. 345, 356 (D.N.J. 1997) ("The failure to provide for real estate taxes may be a basis for finding a lack of adequate protection."); *In re* Jones, 189 B.R. 13, 15 (Bankr. E.D. Okla. 1995) (holding that despite having minimal equity in the property, the debtor's lapse of insurance created a lack of adequate protection, and thus cause existed for relief from stay).

139. This alternative exists if the court does not intend Chapter 13 debtors to be considered current for RESPA purposes. *See supra* Part II.A–B.

140. *See supra* notes 91–92 and accompanying text.

141. 24 C.F.R. § 3500.17(k)(2) (2012).

142. This does not include the inherent risk of nonpayment. *See supra* Part II.A–B.

approach, however, that balances the parties' interests and creates an outcome that should avoid the additional concerns: courts should treat pre-petition taxes and insurance escrow items separately.

As analyzed in Part II.A–B, a taxing authority keeps its same enforcement rights whether an individual has an escrow arrangement with a lender or not. The only thing that changes when the individual files a Chapter 13 bankruptcy is that the taxing authority can no longer enforce its pre-petition tax lien, if any, against the property; any pre-petition taxes are paid over the life of the plan. The lender does not have a claim for the same amount as a taxing authority unless it paid the taxes pre-petition, or if the unpaid pre-petition escrow amounts coincidentally cover the same amount.[143]

Under this alternative approach, the pre-petition tax claim amount should be paid over the life of the plan. The lender should not be able to claim any greater right than the taxing authority has.[144] Courts should not

143. *See In re* Hight, 393 B.R. 484, 497 (Bank. S.D. Tex. 2008).

144. *See Campbell I*, 361 B.R. 831, 844 (Bankr. S.D. Tex. 2007), *aff'd in part, rev'd in part*, 545 F.3d 348 (5th Cir. 2008). There could be an additional issue with the collection of taxes, but the alternative approach this Note recommends would avoid this conflict because it would focus on what rights the taxing authority had pre-petition or post-petition. The *Campbell* bankruptcy court was the only court pre-*Rodriguez* that directly addressed the issue of whether unpaid pre-petition escrow amounts—specifically taxes—are part of a creditor's "claim." *See Campbell II*, 545 F.3d 348, 354 (5th Cir. 2008); *see also Rodriguez II*, 629 F.3d 136, 141–42 (3d Cir. 2010), *cert. denied*, 132 S. Ct. 573 (2011).

The bankruptcy court conducted both a subrogation claim and contractual rights analysis, concluding that the lender should have claimed the unpaid pre-petition escrow amounts under either. *Campbell I*, 361 B.R. at 848. The court extended the *Rodriguez* issue, however, by indicating that the lender could have included both pre-petition escrow shortages and deficiencies—not limited to unpaid escrow amounts. *Id.* The court would require a lender to determine, when it files its claim, whether it will pay taxes due post-petition, and if so, then claim those amounts in the bankruptcy—not limiting the claim to the contractual unpaid pre-petition escrow amounts:

> The lender's proof of claim may properly include any pre-petition contractual *shortfall* in the escrow account. If the lender includes this amount in its proof of claim, (i) it may be cured under a chapter 13 plan; and (ii) the amount set forth in the proof of claim must be credited to the debtor's escrow account. If the *lender* does not include the amount in its proof of claim, then the *debtor* may pay the property taxes over the period allowed by § 1322(a)(2), with the lender making appropriate partial payments via disbursements out of the escrow account for payments collected by the lender prior to the date on which the post-petition tax payment was due.

*Id.* (emphases added).

The same court, however, determined in a later case that the lender had "the right, but not the obligation" to pay the real estate taxes; thus, the lender could not include escrow shortfalls. *In re* Hight, 393 B.R. at 497. In *Hight*, the lender anticipated what the taxes would be and claimed an additional escrow amount to account for the shortage that would occur when the lender paid the pre-petition attached taxes. *Id.* The bankruptcy court held that the lender only had a "claim" for funds actually advanced. *Id.* This case, however, provides limited

allow lenders to use RESPA in post-petition calculations to account for any unpaid pre-petition escrow amounts that would have been used for paying any portion of the pre-petition tax amounts. In the event a lender pays the taxes to protect its collateral, the court should modify the plan to make the pre-petition tax payments payable to the lender rather than the taxing authority.[145]

In contrast, an insurance company does not have a claim in a Chapter 13 bankruptcy because insurance is paid in advance. Thus, there is no doubling effect as with the taxing authority and the lender. Courts should allow lenders to use RESPA in the post-petition calculations to account for any unpaid escrow amounts that would have been used for paying insurance.

In addition, courts should allow lenders to use RESPA to collect for all future, post-petition taxes and insurance escrow obligations. This will lower the post-petition recalculation amounts, give the debtor relief, and reduce any out-of-pocket expenses the lender would be required to make. Additionally, the property will remain adequately protected, and this approach will allow courts to avoid the modification issue because this approach limits lenders' rights to those which the individual tax and insurance entities could claim. Allowing lenders to conduct post-petition calculations using this alternative approach highlights the advantages of RESPA and the Bankruptcy Code for all parties involved.

## VI. CONCLUSION

The courts that have addressed how unpaid pre-petition escrow amounts should be treated have concluded that there are two possible outcomes: unpaid pre-petition escrow amounts either constitute part of a claim or they do not. These opposed outcomes constitute all-or-nothing approaches, which could have major impacts on both parties. If courts focused more on the underlying rights and parties involved in tax and insurance payments, they would realize that the analysis to date has focused too narrowly on "claim" and "default." By stepping out of the all-or-nothing mentality, and treating insurance and tax escrow items separately, a middle-ground approach would better balance the parties' interests and create an outcome that highlights the benefits of both RESPA and the Bankruptcy Code, while avoiding additional arguments that the *Rodriguez* courts did not address.

language from the underlying loan agreement; thus, this may merely be an issue of poor drafting.

145. This subrogation is authorized under 11 U.S.C. § 509(a) (2006).