Fourth Circuit Case on Modification of Residential Mortgage

The Fourth Circuit has held that in a case where the rate of interest on a residential mortgage loan had been increased upon default, a Chapter 13 Plan proposing to "cure" default under 11 U.S.C. §1322(b) is an impermissible modification barred by §1322(b)(2).

In the case of Anderson v. Hancock, No. 15-1505 (Bankr. EDNC April 27, 2016), the lenders, two individuals who had financed the purchase of a residence by the Debtors, had exercised their remedy under the Note to increase the interest rate from 5.00% to 7.00% and the monthly payment from $1,368.90 to $1,696.52 after a default by the Debtors.

The remedy was based upon a provision in the Note that provided:

In the event the borrower has not paid their monthly obligation within 30 days of the due date, then borrower shall be in default. Upon that occurrence, the borrower's interest rate shall increase to Seven percent (7%) for the remaining term of the loan until paid in full. The increase in interest rate shall result in a new payment of $1,696.52, which shall be due and payable monthly according to the terms stated herein, save and accept the increase in rate and payment.

As an alternative to an increase in interest rate upon default occurring 30 days after the payment due date, lender may, in the lender's sole discretion either 1) require borrower to pay immediately the full amount of principal which has not been paid and all the interest that I owe on that amount. The date for the full amount of principal must be at least 30 days after the date on which notice is mailed to the borrower or delivered by other means or 2) pursue any other rights available to lender under North Carolina Law.

The Debtors failed to make their monthly payments and the lenders notified them of the increase in interest and payment under the default rate provision. The Debtors continued to make no payments under the Note and the lenders proceeded with foreclosure. Debtors filed a petition under Chapter 13 and proposed a Plan curing the default by paying the prepetition arrears over 60 months, making regular monthly payments under the Note and reducing the interest rate to the pre-default rate for arrearage and regular payments. The lenders objected to the Plan and the Bankruptcy Court sustained the objection indicating that the proposed reduction of interest rate "ran afoul of 11 U.S.C. §1322(b)(2), which prevents plans from 'modify[ing]' the rights of creditors whose interests are secured by debtors' principal residences." The Bankruptcy Court rejected the argument that the

increased rate of interest was a result of default that could be cured consistent with §§1322(b)(3) and (b)(5). The District Court affirmed, but held that the rate of interest for both arrearage and post-petition payments would depend on whether the loan was in an accelerated status.

THE COURT OF APPEALS HELD §1322(B)(2) FORBIDS "MODIFICATION" OF THE LENDERS' RIGHTS INCLUDING A REMEDY INCLUDED IN A NOTE FOR A HIGHER RATE OF INTEREST AFTER DEFAULT REASONING THAT "TURNING AWAY FROM THE DEBTORS' CONTRACTUALLY AGREED UPON DEFAULT RATE OF INTEREST WOULD EFFECT AN IMPERMISSIBLE MODIFICATION OF THE TERMS OF THEIR PROMISSORY NOTE." The Fourth Circuit held all post-petition payments should reflect the default rate negotiated by the parties as evidenced in the Note.