CREDITORS' RIGHTS IN UNDER-SECURED MORTGAGES

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Many experts attribute today's unstable economic climate to the housing bubble and the resulting record number of foreclosures. As of March 2009, Nevada had the highest percentage of homes with negative equity. Approximately 55 percent of homeowners are upside-down. In Las Vegas, 58 percent of homeowners have negative equity. In light of these numbers, the question often arises as to what extent bankruptcy law can be used to modify a mortgage.

Up to this point in time, bankruptcy has played a limited role. Two U.S. Supreme Court decisions interpreted the Bankruptcy Code in a way that limited the ability of the court to modify or reduce the value of residential mortgage liens. Specifically, the Supreme Court has held that bankruptcy courts cannot strip down an under-secured lien to the fair market value of the property under either Chapter 7 or Chapter 13. However, legislation is currently pending that would give the bankruptcy court the power to strip down a mortgage to its fair market value in a Chapter 13 case.

The Current State of the Law

Individuals generally have two options when declaring bankruptcy: Chapter 7 or Chapter 13 of the Bankruptcy Code. A Chapter 7 bankruptcy is liquidation. The purpose of Chapter 7 is to achieve a fair distribution of the debtor's nonexempt property and to give the debtor a fresh start through the discharge of debt. Chapter 13 of the Bankruptcy Code, on the other hand, permits an individual debtor to retain assets and adjust his or her debt through a repayment plan approved by a bankruptcy court, thereby repaying creditors in whole or in part.

Under bankruptcy law, a lien is a secured claim only to the extent of the value of the asset.[1] A lien is an unsecured claim to the extent the value of the asset is worth less than the claim.[2] Pursuant to § 506(d), a lien can normally be "stripped" when the lien exceeds the value of the asset.

Thus, in a Chapter 7 bankruptcy, many debtors argued that § 506(d) allows a debtor to strip down a lien on real property to the fair market value of the property when the market value is less than the amount secured by the lien. However, the Supreme Court rejected this interpretation in *Dewsnup v. Timm*.[3] The court held that § 506(d) does not allow a debtor to strip down the lien when the claim is secured by a lien and has been fully allowed pursuant to § 502 (Section 502 of the Bankruptcy Code defines when a claim is allowed). Instead, the creditor's lien remains on the real property until the foreclosure or sale as that is what was bargained for by the mortgagor and the mortgagee.

The *Dewsnup* court was concerned about freezing the creditor's secured interest at a judicially determined valuation. Under such an approach, the creditor would lose the benefit of any increase in the value of the property that occurred between the judicially determined valuation and a sale. After *Dewsnup*, in addition to prohibiting a debtor from stripping down a lien to the fair market value of the property, most courts have held that a debtor cannot use § 506 to "strip off" an allowed junior lien where the senior lien exceeds the fair market value of the real property.[4] However, once the real property is sold, the unsecured amounts still owed against the liens are converted to unsecured debt, subject to pro rata payment and discharged.

In the Chapter 13 context, § 1322(b)(2) of the Bankruptcy Code provides that the plan may "[m]odify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims." In *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), the Supreme Court found that § 1322(b)(2) prohibits a Chapter 13 debtor from reducing an under-secured mortgage to the fair market value of the residence.

The court in *Nobelman* relied on the fact that the creditor was the holder of a secured claim because the home retained a certain value as collateral. Following *Nobelman*, the Ninth Circuit and other courts have held that a wholly unsecured lien, such as junior lien where the senior lien exceeds the fair market value of the real property, is not protected by the anti-modification clause of § 1322(b)(2).[5] In other words, a Chapter 13 debtor may be able to avoid a wholly unsecured lien on his or her residence.

Proposed Legislation

As of the writing of this article, bankruptcy law does not permit loan modifications on a Chapter 13 debtor's principal residence. That may be about to change. On March 5, 2009, the U.S. House of Representatives passed the Helping Families Save Their Homes in Bankruptcy Act of 2009, which would remove the anti-modification provision of § 1322(b)(2) and allow bankruptcy judges to modify the terms of mortgages on principal residences of Chapter 13 debtors. Under this legislation, bankruptcy judges would have four options for modifying the terms of a mortgage:

1) reduce the principal due on a mortgage,
2) freeze the interest rate on a mortgage; for example, the variable interest rate on an adjustable rate mortgage,
3) lower the interest rate on the mortgage, or
4) extend the term for repayment of the loan up to 40 years.

The proposed legislation would require a debtor to contact the creditor and attempt to come to an agreement regarding the modification of the mortgage before such a debtor proposed a mortgage modification to the bankruptcy court.

It is believed that the legislation, which creates the prospect that a federal judge could ultimately strip down a mortgage to its fair market value, will motivate lenders to modify the terms of distressed loans. The proposed law has generally been opposed by the banking industry and Republicans. However, this has not universally been the case, as Citigroup has said that it supports the reform.

The bill is currently stalled in the U.S. Senate as opponents work to narrow the scope of the bill, for example, by having it only apply to current, and not future, loans. President Barack Obama supports the legislation. On a related note, Obama has announced that he plans to use $75 billion to provide subsidies to banks as incentives to lower interest rates on distressed mortgages.

Proponents of the adoption of the anti-modification provision of § 1322(b)(2) say that it will allow up to 1.8 million people to stay in their homes. Opponents of the bill say that it is unfair to mortgagors, will ultimately increase the borrowing costs to future mortgagees, and possibly further depress the value of mortgage-backed securities. In his concurrence in *Nobelman*, Justice Stevens took note of the reason that § 1322(b)(2) prohibits a Chapter 13 debtor from stripping down a secured mortgage to the fair market value of the residence. The legislative history "indicat[es] that favorable treatment of residential mortgagees was intended

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to encourage the flow of capital into the home lending market." It remains to be seen whether the bankruptcy courts will be allowed to modify a secured mortgage on a principal residence. If so, Stevens' reasoning suggests that the law should be narrowly tailored to avoid a long-term chilling effect on the willingness of lenders to provide mortgages.

If the Helping Families Save Their Homes in Bankruptcy Act of 2009 is passed, creditors will still have options to protect their liens. Creditors can contest the valuation of the property, oppose a Chapter 13 bankruptcy on other grounds, seek conversion to a Chapter 7 bankruptcy, or call their favorite creditor's counsel.

Conclusion

National and local lawmakers are struggling to find solutions in these troubling economic times. In light of the record number of foreclosures, the United States Congress is looking into what role bankruptcy law can play in the economic recovery. As the law stands, at the time this article was written, homeowners cannot use bankruptcy to modify an under-secured mortgage. However, proposed changes to bankruptcy law would allow loan modification in a Chapter 13 bankruptcy, which will significantly impact creditor's rights. NL

1. 11 U.S.C. § 506(a)(1).
2. Id.
3. 502 U.S. 410 (1992).
4. See, e.g., *In re Talbert*, 344 F.3d 555 (6th Cir. 2003).
5. See, e.g., *In re Zimmer*, 313 F.3d 1220 (9th Cir. 2002).

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