CONSUMER BANKRUPTCY

Chapter 7 Cram-Down of Second Mortgages

New LI case permits lien-stripping previously impossible

By Craig D. Robins

One of the biggest problems that homeowners face in today's recessionary economy is the loss in the value to their homes. It is not uncommon to see houses that have dropped 50 percent in value over the past few years, leaving many to wonder if it is even worthwhile to keep their home.

As such, many homes are "under water" or "upside down" meaning that the homes are worth less than the balance due on the mortgage. In many cases, there are two mortgages and the home is worth less than the first mortgage, making the second mortgage totally unsecured.

Up until recently, there was little recourse available to consumer bankruptcy filers to eliminate mortgages that were underwater. However, a new decision released last month has now changed all that, permitting cram-down of second mortgages in Chapter 7 bankruptcy cases.

What is a Cram-down?

Also known as a "strip-off," a cram-down is when a debtor modifies the rights of a mortgagee, who is a secured creditor, by having the bankruptcy court strip off the secured status of the mortgage because there is insufficient value in the property to secure any part of it.

A cram-down removes the mortgage as a lien on the premises.

Chapter 13 Bankruptcy cases Cram-downs

The existing state of the law has been that only Chapter 13 debtors had the unique ability to cram-down mortgages, and then, only the second mortgage. Chapter 7 debtors did not have any ability to cram down any mortgage.

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The reason for this is that the provision for cram-down is § 1322(b)(2), located in Chapter 13 of the Bankruptcy Code, which limits debtors from cramming down first mortgages.

The Lavelle case changes the law

On November 25, 2009, Central Islip Bankruptcy Judge Dorothy T. Eisenberg issued a decision permitting Chapter 7 debtors to cram-down second mortgages. *In re: Mark T. Lavelle, et. al.* (09-72389-478, Eastern District of New York).

An unusual aspect of this case is that the debtors did not even file an application seeking to cram-down their mortgage – it fell in their lap. The debtors are typical consumers residing in Levittown who sought Chapter 7 relief in April 2009. They were represented by Long Island bankruptcy attorney Norman M. Mendelson, Esq.

The home was in the name of the husband and it was worth $400,000. The balance owed on the first mortgage was $411,000 and the balance on the second mortgage was $9,900. Both mortgages were held by Bank of America.

In May 2009, the mortgagee, represented by Steven J. Baum, P.C. filed a motion seeking relief from the stay on the second mortgage based on the fact that the debtor had no equity in the property.

However, the debtor defended that motion by filing opposition in the form of a cross-motion seeking to avoid the mortgagee's lien on the second mortgage under Bankruptcy Code § 506(a), arguing that the creditor only had a secured claim to the extent of the value of its collateral, and an unsecured claim for the balance.

The debtor argued that even though this was a Chapter 7 case, the ability of the court to modify wholly unsecured liens against a debtor's residence in a Chapter 13 case under § 1322(b)(2) should be extended to Chapter 7 cases.

Judge Eisenberg, in a very complicated and complex, technically-worded decision which discussed two Supreme Court cases, first noted that the debtor's motion should have been brought by adversary proceeding, but nevertheless permitted the debtor to proceed by motion, which she pointed out was "technically incorrect."

The distinction between 'Strip-Down" and "Strip-Off"

The court addressed the 1992 *Dewsnup* Supreme Court decision which held that a Chapter 7 debtor may not "strip down" a first mortgage to the fair market value of the property. However, there is a difference between "stripping down" a mortgage and "stripping off" a mortgage.

Stripping-down refers to removing that portion of a mortgage that is unsecured, which is done pursuant to § 506. On the other hand, "stripping off" is essentially cramming down a mortgage, which means removing its lien status altogether.

The judge observed that since *Dewsnup*, the issue of whether wholly unsecured liens may be "stripped off," as opposed to "stripped down," has been a contentious issue between various bankruptcy and district courts and their respective Courts of Appeals.

Judge Eisenberg then discussed the 1993 Supreme Court case of *Nobelman* which barred Chapter 13 debtors from relying on § 506 to bifurcate an undersecured mortgage to secured and unsecured components.

However, the *Nobelman* case only applies to situations where a portion of the

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