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Residential mortgage lenders face significant perils when their borrowers file for bankruptcy

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In the present residential market, with many highly leveraged borrowers and generally declining property values, mortgage lenders face significant perils when their borrowers file for bankruptcy protection. While these risks are generally well-understood in the commercial real estate world, residential lenders may also find themselves with court-sanctioned "cramdown" debt modifications that drastically alter the original mortgage loan terms. How bankruptcy courts address residential mortgage loan restructuring is generally a function of the nature and use of the property. .

A cramdown allows a debtor to bifurcate the debt into a secured portion (based on the current value of the property) and an unsecured portion with the unsecured portion only receiving a pro-rata distribution similar to the debtor's other unsecured creditors. In areas where real estate prices have depreciated, cramdowns can result in significant mortgage reductions.

A modification of the mortgage would then allow the borrower to reduce the monthly mortgage payment. In some cases, the court may order the remaining secured debt amortized over the remaining life of the loan term, thus lowering monthly payments. In other cases, monthly payments remain the same as before the cramdown, and the secured mortgage is simply paid off faster.

While the Bankruptcy Code does not typically allow debtors to "cramdown" a debt owed to a secured lender which is secured by a mortgage on the debtor's primary residence (often referred to as the antimodification provision), there are exceptions. Those exceptions occur when the loan documents provide additional collateral or the debtor's use of the property provides the lender additional security.

Some examples are where the real estate at issue is a multifamily dwelling, used as a bed and breakfast, or the loan documents provide the lender a security interest pursuant to Article 9 of the UCC. In those instances, courts are much more likely to hold that since the property is income producing, the secured lender will not be afforded the protection of the antimodification provision, regardless of the borrower's use of the property as his residence.

Unfortunately, this has led some debtors to argue that the debtor's use of the property for his business (typically because the residence contains a home office) means the property is income producing. That argument, without more, is unavailing. The primary reason is because the use of the home for one's business does not provide the lender any additional collateral and typically does not add any value to the real estate.

Also, if the debtor has demonstrated an intent to use his property as farmland, subdivide it, or harvest it for timber, the real estate may also be subject to modification and a cramdown. It should be noted, however, that the debtor's "intent", must be more than just a future desire to use the land for one of those purposes. The debtor typically must demonstrate what affirmative acts have been taken to use the property for that purpose

Lastly, some bankruptcy courts have employed factors to determine whether a mortgage should be subject to modification and/or cramdown. These include whether the mortgage was handled through the commercial loan department or the residential loan department, whether the interest rates applied to the mortgage were home loan rates or commercial loan rates, and the extent to which potential business uses of the land were considered by the lender.

By considering the totality of such factors, the court will decide whether the mortgage is secured by something more than just the debtor's residence and, as a result, whether the lender bargained to be within the scope of the antimodification provision.

In short, the courts have determined that when the collateral securing the loan includes something in addition to the debtor's primary residence, the antimodification provision will not apply. As a result, lenders need to be aware whether the loan documents secure more than just a residence and what is the debtor's use, or intended use, of the property. The outcome to that analysis can have a dramatic impact on whether a lender is paid in full or something far less.

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