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Additional concerns for residential lenders in Chapter 11 and 13

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In last month's edition, I discussed potential loan modifications facing residential lenders in Chapter 11 and 13 cases in bankruptcy. In addition to those concerns, however, residential lenders also need to be aware of the risks involved in providing borrowers second or third mortgages on their homes. As mentioned last month, with many high leveraged borrowers and declining property values, this has clearly become more of a concern for mortgagees holding a second or third mortgage.

In those instances, the lender potentially could have its entire debt cramdowned and treated as unsecured, notwithstanding it is secured by the debtor's primary residence. Consider the following example:

* The mortgagor's residence is worth $300,000.
* Bank A has a first mortgage of $200,000
* Bank B holds a second mortgage in the amount of $100,000
* Bank C holds a third mortgage in the amount of $75,000.

Under this scenario, the first mortgage is secured as is the second mortgage. The anti-modification provision of the Bankruptcy Code would apply to those mortgages since they are fully secured. However, the debtor/mortgagor would undoubtedly argue that Bank C's mortgage of $75,000 should be treated as wholly unsecured and, as a result, treated as any other unsecured debt. Should that occur, Bank C's loan would be paid a pro rata share under the plan of reorganization equal to that provided to the other unsecured creditors. This is the unfortunate result for Bank C because for a mortgagee to receive the protection of the anti-modification provision it must first show it has a secured claim. Pursuant to the Bankruptcy Code, a secured claim is not secured merely due to the existence of a mortgage on the land records but only when the value of the collateral is proven to be more than the amount due on the loan.

However, all is not lost for Bank C provided it can demonstrate that the residence is worth more than $300,000. Moreover, Bank C is not required to prove that its entire loan is secured, only that a portion of it is secured. So, for example, even if Bank C can show that the property is worth only $310,000, its claim cannot be treated as unsecured. The Bankruptcy Code and the related case law are clear that so long as some portion of the lien (even if that is only $1) is secured by the residence, Bank C would be considered the holder of a claim secured by the debtor's principal residence and its rights in the entire lien would be protected under the antimodification provision. The courts' stated rationale for this conclusion is the secured portion of a mortgagee's claim would necessarily be effected by the modification of the unsecured portion. And, since the modification of the secured portion is impermissible under the Code, the entire lien must be treated as secured.

For a while, some circuits held to the minority position that the rights of all mortgagees are entitled to the protection of the Bankruptcy Code's antimodification provision, even if they held completely unsecured claims. That minority view however, appears to have been completely swept away for the more well-reasoned majority view outlined here.

This is another example of another area of concern for the residential lender. Second and third mortgage holders could find themselves in a "battle of appraisers" attempting to prove that a portion - any portion - of their debt is secured so as to avoid being treated as any other unsecured creditors. As a result, secured lenders need to be acutely aware of the value of the collateral when providing loans when the resulting mortgage will not be the first mortgage on the residence.

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