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# From the Bankruptcy Courts

Benjamin Weintraub\* and Alan N. Resnick\*\*

## A LESSON IN DRAFTING HOME MORTGAGES AFTER NOBELMAN: WHEN TAKING MORE RESULTS IN LESS

In a period of declining real estate values, it is not surprising to find that the principal balance of a home mortgage loan exceeds the current value of the property. It is also not surprising that home owners unable to pay high monthly payments have looked to Chapter 13 of the Bankruptcy Code as a possible avenue to reduce their mortgage obligations. Turning to Chapter 13, instead of Chapter 7, has become more important for individual debtors since the Supreme Court held in its 1992 decision in *Dewsnup v. Timm*<sup>1</sup> that a Chapter 7 debtor may not avoid, or "strip down," a lien to current market value merely because the value of the property was less than the amount of the debt at the time of bankruptcy. The Supreme Court left open the question of whether

its decision in *Dewsnup* has any application in a Chapter 13 case.<sup>2</sup>

Chapter 13 contains a special protection, found in no other chapter, that is designed to protect the sanctity of the home mortgage. Section 1322(b)(2) of the Code provides that a Chapter 13 plan may:

(2) modify 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; [emphasis added]<sup>3</sup>

Until recently, courts were not in agreement on whether a Chapter 13 debtor could bifurcate an undersecured mortgage on the debtor's principal residence into secured and unsecured claims, and to modify or

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<sup>1</sup> 112 S. Ct. 773 (1992).

<sup>2</sup> The Supreme Court based its decision in *Dewsnup* on the meaning of the words "allowed secured claim" in Section 506(d) of the Code. The Court, however, specifically stated in a footnote that "we express no opinion as to whether the words 'allowed secured claim' have different meaning in other provisions of the Bankruptcy Code." 112 S. Ct. at 778 n.3. Therefore, the Supreme Court left unanswered the question of whether *Dewsnup* governs the interpretation of "allowed secured claim" in Section 1325(a)(5).

<sup>3</sup> 11 U.S.C. § 1322(b)(2).

eliminate the unsecured claim only.<sup>4</sup> By doing so, the debtor would be able to effectively reduce the mortgage to the value of the home, and, through a Chapter 13 plan, continue to pay monthly mortgage payments until the stripped-down secured claim has been paid in full. That is, the Chapter 13 plan would provide for payment of the monthly installments under the loan agreement without reduction, but that the payments would stop after the principal paid equalled the stripped-down lien amount. Courts were divided on whether this strategy violated the Code's prohibition found in Section 1322(b)(2) with respect to the modification of the rights of the holder of the home mortgage.

The Supreme Court finally resolved this issue in *Nobelman v. American Savings Bank*,<sup>5</sup> a case in which the Chapter 13 debtor attempted to strip down the home mortgagee's lien, which secured its \$71,335 claim, to the \$23,500 value of the collateral, and to treat the \$47,835 deficiency as an unsecured claim to be paid nothing under the plan. The Supreme Court held that the bifurcation of a home mortgage into secured and unsecured portions, and modification of the unse-

cured deficiency claim, is not permitted in a chapter 13 case.

[T]o give effect to § 506(a)'s valuation and bifurcation of secured claims through a Chapter 13 plan in the manner petitioners propose would require a modification of the rights of the holder of the security interest. Section 1322(b)(2) prohibits such modification where, as here, the lender's claim is secured only by a lien on the debtor's principal residence.<sup>6</sup>

Accordingly, claim bifurcation and lien stripping in Chapter 13 cases with respect to a mortgage on only the debtor's principal residence is not permitted under the Code.

#### **Chapter 13 Lien Stripping on Property Other Than the Debtor's Principal Residence**

Although the Supreme Court in *Nobelman* made it clear that, because of Section 1322(b)(2), claim bifurcation and lien stripping may not be accomplished in Chapter 13 when the collateral is only the debtor's principal residence, that decision did not address the application of the Supreme Court's prohibition of Chapter 7 lien stripping announced in *Dewsnup* to a Chapter 13 case in which the collateral is not the debtor's principal residence.

#### *In re Hirsch*

An interesting decision that came from the Bankruptcy Court for the Eastern District of Pennsylvania

<sup>4</sup> See, e.g., *In re Bellamy*, 962 F.2d 176 (2d Cir. 1992) (Chapter 13 stripdown of home mortgage to value of collateral was permitted and did not violate Section 1322(b)(2)); *In re Houghland*, 886 F.2d 1182 (9th Cir. 1989) (same). Contra, *In re Nobelman*, 968 F.2d 483 (5th Cir. 1992); *In re Etchin*, 128 BR 662 (Bankr. W.D. Wis. 1991).

<sup>5</sup> 113 S. Ct. 2106 (1993).

<sup>6</sup> 113 S. Ct. 2111.

after the Supreme Court's decisions in *Dewsnup* and *Nobelman* is *In re Hirsch*.<sup>7</sup> The opinion in *Hirsch* demonstrates how at least some lower courts may narrowly construe the Supreme Court's prohibitions on lien stripping.

In 1989, the debtor and his wife financed the purchase of their home in Philadelphia with a \$92,000 loan from Citicorp. The debtor and his wife executed a mortgage document that gave Citicorp a mortgage on the real property and "all easements, rights, appurtenances, rents, royalties, mineral, oil and gas rights and profits, water rights and stock and all fixtures now or hereafter a part of the property." A judgment of mortgage foreclosure was entered in April 1992 in the sum of \$107,779, later reassessed to \$122,898.

In March 1993, the debtor filed an individual Chapter 13 petition at a time when, according to the debtor, the value of the home was only \$85,000. He filed a plan that contemplated \$2,300 monthly payments for sixty months which would be sufficient to pay off the alleged allowed secured claim of \$85,000. The debtor commenced adversary proceedings to strip down the amount of Citicorp's mortgage to the \$85,000 value of the home, and to avoid entirely the lien of an alleged second mortgagee. The proceeding against the second mortgagee was settled, and Citicorp and

the debtor submitted a stipulation agreeing that the value of the home was \$88,000.

In its decision, the Bankruptcy Court permitted the strip down of Citicorp's mortgage despite the Supreme Court's holding in *Nobelman*. The Bankruptcy Court regained by holding that the prohibition on lien stripping found in *Dewsnup* does not apply in any cases other than Chapter 7 cases:

[I]t is important to emphasize what *Nobelman* did not decide. Firstly, the Court did not rely on the reasoning employed in the context of a Chapter 7 case in *Dewsnup v. Timm* [citation omitted]. It did not hold that a 'strip down' of a mortgagee's lien was not permissible in a Chapter 13 case . . . [T]he Court did not hold that the reasoning of *Dewsnup* applied to a Chapter 13 (or a Chapter 11) case. If the Court had so reasoned, it would have been unnecessary for it to reach the issue of the impact of § 1322(b)(2) upon 'lien stripping.' However, *Dewsnup* is not even cited in the brief *Nobelman* opinion.<sup>8</sup>

The most surprising aspect of the decision in *Hirsch* was the court's scrutiny of the mortgage documents to find that it was not a security interest in only the debtor's residence.

[T]he Court [in *Nobelman*] did not comment on the issue of whether 11 U.S.C. § 1322(b)(2) was applicable to the mortgage at issue, given the particular security interests taken therein, because the *Nobelman* debt-

<sup>7</sup> 1993 WL 225742 (Bankr. E.D. Pa. June 25, 1993).

<sup>8</sup> 1993 WL 225742, at \*2.

or apparently assumed or conceded that the mortgage in issue was within the scope of § 1322(b)(2).<sup>9</sup>

The Bankruptcy Court then examined the language of Section 1322(b)(2) ("other than a claim secured only by a security interest in real property that is the debtor's principal residence") and held that the mortgage executed by the debtor and his wife did not fit within that narrow category.

There is ample authority for the principle that the parties' instant mortgage, in which a security interest in "rents," "profits," present and future "fixtures," and all "replacements and additions" to the Home is taken, is not a claim secured "only by . . . real property," and hence is not within the scope of § 1322(b)(2).<sup>10</sup>

Based on this reasoning, the court held that the debtor may bifurcate Citicorp's claim and strip down Citicorp's lien to the value of the home. Other courts also have used this same reasoning to permit strip

downs in Chapter 13 cases when the scope of the mortgage goes beyond the real estate.<sup>11</sup>

### Conclusion

Needless to say, mortgagees will have to be careful in the drafting of mortgage documents if they want the protection afforded by the Supreme Court's decision in *Nobelman*. Lien stripping may still be available to the Chapter 13 debtor if the mortgage includes any personal property or other assets that is not the debtor's principal residence. Clearly, the overzealous mortgagee who attempts to obtain as much collateral as possible may find—in a subsequent Chapter 13 case in which the debtor seeks to strip down the mortgage to the current collateral value—that by taking more, it received less.

<sup>11</sup> See, e.g., *In re Hammond*, 62 USLW 2035, 1993 WL 258789 (E.D. Pa. July 2, 1993) (*Nobelman* and section 1322(b)(2) were inapplicable where the home mortgage provided that it also covered "any and all applicances, machinery, furniture and equipment (whether fixtures or not) of any nature whatsoever now or hereafter installed in or upon said premises."). See also, *Wilson v. Commonwealth Mortgage Corp.*, 895 F.2d 123 (3d Cir. 1990).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*