

BANKING LAW ALERT

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A NEW LOOK AT HOME MORTGAGES IN BANKRUPTCY

Traditionally, home mortgage creditors have been provided special protections in consumer bankruptcy proceedings. Section 1322(b) of the Bankruptcy Code prohibits a debtor from modifying the rights of creditors secured only by a security interest in real property that is the debtor's principal residence. The courts have extended this protection to junior mortgages such as home equity lines of credit in situations where there is as little as \$1.00 of equity over and above the first mortgage. Similarly, in Chapter 7 cases, junior home mortgage creditors enjoyed protection of their liens against discharge even where there is little or no value in the residential real property after considering first mortgage.

However, in light of the recent national trend toward depreciation of residential real property following the bursting of the "real estate bubble" and the increase in foreclosures which followed, some courts now are re-evaluating the protections afforded to home loan creditors in bankruptcy. Recently, the U.S. Court of Appeals for the Eleventh Circuit ruled that a Chapter 13 debtor who was not otherwise eligible for discharge due to prior filings could "strip" a completely unsecured junior mortgage, the effect of which would be to completely eliminate the mortgage and relieve the debtor of the responsibility of repaying the same. The court held that the Bankruptcy Code operated to classify wholly unsecured junior mortgages as mere unsecured claims to be "stripped" from the property where the junior mortgage was not secured by any value of the home. Wells Fargo Bank vs. Scantling

Furthermore, the Supreme Court has recently announced that it will review and decide whether homeowners in Chapter 7 Bankruptcy can avoid a second mortgage where the home's market value has dropped below the amount the debtor owes on the first mortgage. Should the Supreme Court determine that the Chapter 7 debtor is able to "strip off a second lien" where the debtor is "under water" on the primary lien, the landscape for home mortgage lenders, particularly home equity lenders, in bankruptcy could change.

While this trend toward re-evaluating home mortgage claims in bankruptcy has been confined largely to a couple of judicial circuits, the recently

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announced review of these issues by the Supreme Court could have a nationwide impact. A ruling in the favor of the consumer bankruptcy debtor could require lenders to re-evaluate their practices and standards for second mortgage home equity loans and/or other loans secured by junior liens against residential properties. The determination of sufficient equity over and above the first mortgage would become paramount.

We will continue to monitor the Supreme Court's action in this matter and update you on the court's ruling and the potential impact of the same on lending practices.



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