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Introduction to Cramdown and Lien Stripping

In addition to being able to stop a repossession or foreclosure and cure the arrears on secured debts over a period of 36-60 months, another feature that makes Chapter 13 attractive is the manner in which the U.S. Bankruptcy Code (hereinafter, "Code"), 11 U.S.C. §§ 101, *et seq.*, provides for the treatment of secured claims.

In Chapter 13, a debtor devotes his or her disposable income to a repayment plan for 36-60 months. Disposable income is the difference between net income and living expenses. Unsecured creditors do not receive any interest on their claims, and unless a debtor's disposable income is high enough, unsecured creditors do not get paid in full on their claims. In short, the extent to which unsecured creditors are paid in Chapter 13 depends on a debtor's ability to pay.

Secured creditors, on the other hand, do receive interest on their claims, but not on the entire balance (unless the value exceeds the balance). Secured creditors only receive interest to the extent of the value of the collateral. For instance, if a debtor owes ABC Finance Co. $10,000 on a car worth $6,000, the debtor pays $6,000 plus interest. The balance is treated as part of the debtor's unsecured debt. In essence, ABC Finance Co. has two claims: a secured claim for $6,000 plus interest, and an unsecured claim for $6,000. This process is known as cramdown (or bifurcation) and is governed by Section 506 of the Code.

An important exception to this process of cramdown is contained in Section 1322(b)(2) of the Code. This provision is otherwise known as the anti-modification provision, and it provides that a debtor under Chapter 13 cannot modify the rights of a secured claim when the claim is secured only by the debtor's principal residence. Prior to 1993, there was a split among circuits regarding what it meant to modify the rights of a secured creditor. Some circuits said that a Chapter 13 debtor could bifurcate and that only the secured portion was shielded from modification, while other circuits said the entire claim (usually a mortgage) was shield from modification. In 1993, the Supreme Court decided the case of *Nobelman v. American Savings Bank*, 508 U.S. 324, 113 S. Ct. 2106 (1993), deciding that the entire claim was shielded from modification. In other words, a claim, for example a mortgage, secured only by the debtor's principal residence, could not be bifurcated or crammed down.

Unfortunately, *Nobelman* did not end the discussion, because in its opinion, the Supreme Court also said that the staring point for the analysis is Section 506, which, again, is the section of the Code that states how secured claims are to be treated in Chapter 13 (i.e., paid value plus interest to the extent of the value of the collateral). What happens if there is a second mortgage and there is no equity? For example, how should the claims be treated when the debtor's house is worth $75,000, but the balance on the first mortgage is $80,000, and there is a second mortgage with a balance of $10,000? Looking at the language of Section 506, there is no value for the second mortgage, and thus the second mortgage is treated as an unsecured claim. Applying the language of 1322(b)(2) literally, the debtor is prohibited from modifying the rights of a secured claim against his home only if the claim is "secured." Right now, at least five (5) circuits agree that if the Chapter

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13 debtor has a wholly unsecured mortgage, the junior creditor (e.g., the second mortgagee) cannot invoke the anti-modification provision.[1] However, if there is any equity, even one dollar, after deducting prior encumbrances,[2] the junior mortgagee can also invoke Section 1322(b)(2) and protect its claim from modification. So in the above example, if the debtor's house was worth $80,001 instead of $75,000, there would be at least one dollar of value for the second mortgagee, preventing the debtor from stripping off the second mortgage.[3]

Although a few bankruptcy courts have allowed debtors under Chapter 7 to strip liens, in general, this lien stripping tool can only be used by debtors under Chapter 13.

To protect from modification, where there is a question of value, and hence the possibility of lien stripping, mortgage servicers should obtain a full appraisal of the subject property upon the filing of a Chapter 13 case. Of course, obtaining the highest estimated value possible from a qualified appraiser is the best weapon against strip-off. Recognize, however, that the debtor will also be procuring appraisals of the property, with a goal of obtaining the lowest value possible. Furthermore, in a situation where a court is faced with determining the proper value and it is presented with evidence by two (2) appraisers (assuming they are equally qualified), a court will often split the difference and find a fair market value between the two values.

1. *See, e.g., In re Pond*, 252 F.3d 122 (2d Cir. 2001); *McDonald v. Master Fin. Inc. (In re McDonald)*, 205 F.3d 606 (3d Cir.2000); *In re Bartee*, 212 F.3d 277 (5th Cir. 2000); *In re Tanner*, 217 F.3d 1357 (11th Cir. 2000).

2. *See, e.g., In re Calender*, 262 B.R. 777, 780 (8th Cir. 2001)(To determine amount of junior mortgagee's secured claim, bankruptcy court had to subtract, from value of real property securing it, amount of any prior encumbrances).

3. *See also In re Calender*, 262 B.R. 777, 780 (8th Cir. 2001)(To determine amount of junior mortgagee's secured claim, bankruptcy court had to subtract, from value of real property securing it, amount of any prior encumbrances).

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