

# Stripping it Down – Real Estate Issues in Bankruptcy

by Sarah Beckett Boehm



Bankruptcy law encompasses many areas of practice, including real estate. Addressing real property issues and assisting debtors in keeping their home is often the driving force behind a Chapter 13 case. This article summarizes real estate issues that frequently arise in individual reorganization cases under Chapter 13 of the Bankruptcy Code and suggests practice pointers for handling them.

## Lien Stripping

There are fundamental differences between Chapters 7 and 13 of the Bankruptcy Code. Chapter 7 contemplates liquidation of the estate, while Chapter 13 enables individuals<sup>1</sup> to develop a plan to repay all or part of their debts over three to five years and save their homes from foreclosure. The United States

Supreme Court also has drawn an important distinction — a Chapter 7 debtor cannot “strip down” a partially underwater mortgage<sup>2</sup> or “strip off” a wholly underwater mortgage,<sup>3</sup> while a Chapter 13 debtor may strip off a wholly unsecured mortgage.

One significant benefit of Chapter 13, then, is that a wholly unsecured mortgage lien can be “stripped off” to render the debt unsecured.<sup>4</sup> Lien stripping is available against junior mortgages on the debtor’s principal residence if the senior mortgage equals or exceeds the value of the property. In order to strip off a junior mortgage lien, the debtor must file a separate adversary proceeding.<sup>5</sup> If the debtor is successful, the order stripping off the junior lien may be filed in the appropriate state court land records.

While a Chapter 13 plan may modify the rights of holders of certain secured claims, it may not modify a security interest in real property that is the debtor’s principal residence, subject to limited exceptions.<sup>6</sup> One exception is that if the last payment on the

original mortgage payment schedule is due before the final payment on the Chapter 13 plan is due, it may be subject to modification by the Chapter 13 plan.<sup>7</sup> For example, if a final mortgage balloon payment matures before the end of the Chapter 13 plan, the full amount could be stretched out over the life of the plan rather than being paid in a lump sum.

Additionally, if the debtor owns investment or other property that is not his or her principal place of residence, the mortgage can be “crammed down” through the Chapter 13 plan. This process allows the debtor to reduce the principal balance of the mortgage to the value of the real estate, and then to pay that amount with interest. It also may allow the debtor to reduce the mortgage interest rate.

### Exemptions

Know them. Use them. 11 U.S.C. § 522(f) enables a debtor to eliminate, in whole or in part, liens<sup>8</sup> that impair an exemption to which the debtor is entitled. Virginia provides minimal homestead protection, so debtors should take advantage of what little is available, including: \$5,000 per person (\$10,000 per person for anyone 65 or older), plus \$500 for each dependent;<sup>9</sup> an additional \$10,000 for any veteran with a service-connected disability of 40 percent or more;<sup>10</sup> \$2,000 per month up to \$24,000 during a one-year period of administration of the decedent’s estate for a surviving spouse and minor children;<sup>11</sup> and \$20,000 from the decedent’s estate in lieu of any share passing to the spouse from the estate.<sup>12</sup> Generally, property held by tenants by the entireties is protected from the claims of all judgment lien creditors of only one of the tenants, unless the service was emergency medical care.<sup>13</sup>

### Title Searches

Running a title search can be beneficial. The results will reflect who owns the property, how it is being held (e.g., individually, tenants by the entireties), if there are any deeds of trust or other liens against the property, and if there are any restrictions or easements that could affect title. If the property is allegedly held as tenants by the entireties, ensure the deed contains the “five unities” — interest, title, time, possession, and marriage.<sup>14</sup> Not only is some of this information required for the debtor’s Schedules of Assets and Liabilities filed in the bankruptcy court, but it also

may provide a roadmap for real estate issues that may arise during the bankruptcy case. For example, if any judgment liens were filed less than ninety days before the case was filed, they may be subject to avoidance.<sup>15</sup> As noted above, if there are junior mortgages that exceed the fair market value of the property, they may be stripped off by filing an adversary proceeding complaint. Moreover, the search could turn up a title defect. If a deed of trust was not properly recorded in the appropriate city or county, the lien may be subject to avoidance during the bankruptcy case, rendering the lender unsecured and subject to a pro rata distribution with other unsecured creditors.<sup>16</sup>

### Liquidation Analysis

A Chapter 13 debtor is not required to pay general unsecured claims in full. Rather, the percentage to be paid is determined by the “best interest of creditors” test and the amount of the debtor’s disposable income. The best interest of creditors test requires that in order to confirm a Chapter 13 plan, the value of property to be distributed under the plan to unsecured creditors must not be less than the amount that would be paid to such creditors in a hypothetical Chapter 7 liquidation.<sup>17</sup> Because the best interest of creditors

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test considers how much unsecured creditors actually would receive if the assets were liquidated in a Chapter 7 proceeding, calculating the fair market value of the real property is critical when performing a liquidation analysis. To calculate the fair market value of the property for a liquidation analysis, a debtor may deduct all valid liens on the property as a whole, and then from the debtor’s share of the equity remaining after deducting all valid liens, the debtor may be able to deduct the cost of liquidation (e.g., 6 percent realtor’s commission for improved land, 10 percent for unimproved land), exemptions, other closing and administrative costs, and the Chapter 7 trustee’s commission.<sup>18</sup> Always check local practice to determine how the trustee and judges calculate these amounts and what deductions they allow.

### Valuation

Valuing real property can be vital to a Chapter 13 case. If the senior lien exceeds the fair market value of the property, junior liens may be stripped. The fair market value of a property also will be factored in to the best interest of creditors test. Because of the important role it plays, valuation may come down to a

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battle of the experts. The key to valuation is to know the local custom and practice. A debtor should consider: (i) whether the county or city in question tends to value real estate above or below true market value, and, if so, to what extent; (ii) what other forms of evidence (broker's price opinions, "comps," etc.) are acceptable to counter a current tax-assessed value; and (iii) any recent changes to the house or land, or any needed repairs, that would affect its current value, but might be unknown to the tax assessor.

### Mobile Homes

A mobile home may be converted to real property or it may remain a vehicle and, therefore, personal property.<sup>19</sup> If the mobile home remains personal property,<sup>20</sup> it may be crammed down to the fair market value in the debtor's Chapter 13 plan. If the debtor wishes to have it deemed real property, the owner must submit to the Department of Motor Vehicles an Affidavit for Manufactured Home Conversion to Real Property Form. Once the DMV cancels the title, the owner must file an Affidavit Regarding Manufactured Home in the circuit court land records where the property is located. A search of DMV records and land records may be necessary to determine if a lender has a lien on the mobile home, the land, or both.<sup>21</sup>

### Recording the Release of Non-consensual Liens

If a judgment or tax lien is being paid through the Chapter 13 plan, it is important to ensure that the release of that lien is recorded in the state court land records. This may be done by including language in the Chapter 13 plan that upon entry of the debtor's discharge,

the debtor may obtain an order from the bankruptcy court releasing the lien as having been paid in full. This can also be accomplished by the more cumbersome route of recording in the state court the Chapter 13 plan, confirmation order, and discharge order. Both of these options, however, eliminate the need for the debtor to locate the lien creditor to obtain the release.

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### Endnotes:

- 1 To be eligible for Chapter 13, an individual (not a corporation or partnership) must have unsecured debts of less than \$383,175 and secured debts of less than \$1,149,525. 11 U.S.C. § 109(e). These figures are subject to readjustment. *Id.* at § 104.
- 2 *Dewsnup v. Timm*, 502 U.S. 410, 416-20 (1992).
- 3 *Bank of Am., N.A. v. Caulkett*, 135 S. Ct. 1995, 1999-2000, 2001 (2015).
- 4 The Fourth Circuit, among others, allows debtors to strip off liens that are wholly unsecured under section 506(a), reasoning that they do not represent "secured claims" subject to the anti-modification provision of section 1322(b)(2). *In re Davis*, 716 F.3d 331, 334-36 (4th Cir. 2013) ("We too have affirmed, albeit in unpublished opinions, the stripping off of valueless liens against principal residences in Chapter 13 cases.") (collecting cases and describing the rationale for stripping off wholly underwater liens).
- 5 Fed. R. Bankr. P. 7001(2).
- 6 11 U.S.C. § 1322(b)(2).
- 7 *Id.* at § 1322(c)(2).
- 8 Statutory liens are not avoidable under section 522. They may, however, be crammed down in a Chapter 13 plan, with a portion treated as priority or unsecured. Judicial liens and non-possessory, non-purchase money liens on household goods, tools of the trade, or professional prescribed health aids are avoidable.
- 9 Va. Code Ann. § 34-4.
- 10 *Id.* at § 34-4.1.
- 11 *Id.* at § 64.2-309.
- 12 *Id.* at § 64.2-311.
- 13 *Id.* at § 55-37 and 8.01-220.2, 55-37; see also 11 U.S.C. § 522(b)(3)(B). *But see United States v. Craft*, 535 U.S. 274, 283-89 (2002) (holding that a federal tax lien can attach to

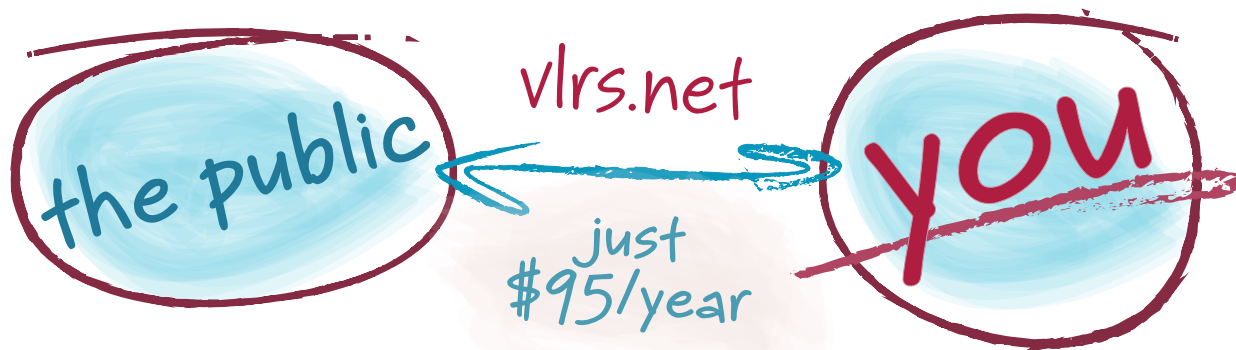
one spouse’s interest in tenants by the entirety property even though the other spouse does not owe debt).

- 14 *In re Sampath*, 314 B.R. 73, 84, 98 (Bankr. E.D. Va. 2004); see also Va. Code Ann. §§ 55-20, -21 (abolishing survivorship between joint tenants and discussing joint ownership in real and personal property).
- 15 11 U.S.C. § 547(b)(4)(A).
- 16 This may be a double-edged sword for a debtor who still has to satisfy the best interest of creditors test.
- 17 11 U.S.C. § 1325(a)(4).
- 18 See, e.g., *In re Todd*, Case No. 02-04451 (Bankr. W.D. Va. Mar. 17, 2003) (Stone, J.); *In re Neal*, No. 01-80851, 2001 WL 36268654, \*2-4 (Bankr. E.D. Va. Oct. 24, 2001) (conducting a liquidation analysis); *In re Leedy*, 230 B.R. 678, 683 (Bankr. E.D. Va. 1999) (discussing the inclusion of sale costs with respect to the best interests of creditors test).
- 19 Va. Code Ann. § 46.2-653.1; see also *In re Banks*, 259 B.R. 848, 850-51 (Bankr. E.D. Va. 2001).
- 20 If a mobile home is taxed as personal property, then a debtor can use the tax records as evidence that it remains personal property.

- 21 See *Ennis v. Green Tree Servicing (In re Ennis)*, 558 F.3d 343 (4th Cir. 2009) (holding that a mobile home titled by the DMV, taxed as personal property, and secured so that it “would ‘not become a fixture or part of [] real property’” without the lender’s consent did not satisfy the real property requirement of § 1322(b)).



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