

Bankruptcy column

Lien stripping, not as sexy as it sounds

Column #4

An important benefit of a bankruptcy filing is the ability to nullify certain liens. For this column, the focus will be on liens attaching to homestead real estate. Liens attached to non-homestead real estate may be susceptible to removal or modification in a chapter 13 bankruptcy.

The most common situation is a typical judicial lien for a monetary judgment acquired by a creditor and filed in the county within which the bankruptcy debtor owns his or her home. For judicial liens, the applicable statute is 11 USC §522(f)(1)(A). The fundamental basis to be able to remove a judicial lien is demonstrating that the debtor's equity in their homestead is less than the permissible bankruptcy homestead exemption. The debtor's equity is determined simply by calculating the sum of the market value of the homestead, less the current balance on any mortgages and outstanding property taxes. If the amount of the equity is less than the applicable exemption, then any judicial lien is almost universally susceptible to being removed ("stripped off") by motion in the bankruptcy proceeding. The applicable homestead exemption in New York ranges from a low of approximately \$80,000 in certain counties, to over \$130,000 in Saratoga County per debtor. The amounts are periodically adjusted. In most instances the debtor's equity is within the exemption level, and removal of the liens will be successful. Note that judicial liens fall within the type of lien that can be removed, but nonjudicial liens, such as IRS liens and those filed by DSS, are not susceptible to be removed. Also, judicial liens for child support and maintenance cannot be removed (11 USC §522(f)(1)(A) excludes debts under §523(a)(5) that are Domestic Support Obligations). While I have read one bankruptcy court decision outside New York that removed a nonjudicial lien, to my knowledge the practice is not currently being allowed in the Northern District of New York.

The removal of judicial liens can be done in either a chapter 7 or a chapter 13 bankruptcy. Ideally, the application to remove the lien is made while the bankruptcy case is still open. Nonetheless, if someone had filed bankruptcy, but had not made the specific motion to remove liens that were against their homestead at the time of the bankruptcy filing, the bankruptcy case usually can be reopened even years after discharge, to have the liens stripped. Removal of

judgment liens is only relevant to homestead property that is owned by the debtor as of the date of the bankruptcy filing. As most attorneys know, judgment liens that were filed prior to the bankruptcy do not attach to real estate that is acquired subsequent to the bankruptcy filing.

The other aspect of lien stripping pertains to second and subsequent mortgages. The applicable statutes are 11 USC §506(a) and 11 USC§1322(b)(2). The primary issue is whether the balance owed on the first mortgage at the time of the bankruptcy filing exceeds the market value of the real estate. If so, the theory is that there is no equity to which a subsequent mortgage can attach, and therefore the second mortgage can be deemed an unsecured debt. In this situation, unlike that described with judgments above, the homestead exemption is irrelevant. If the home value exceeds the balance on the first mortgage by merely a dollar, the subsequent mortgages cannot be removed. Also, removal of a second or third mortgage can only be done within a chapter 13 bankruptcy, not within a chapter 7 case.

Procedurally, in a chapter 13, the application to remove the second mortgage is done early in the case. However, if the motion is successful, the order striking the second mortgage requires that the debtor successfully complete their bankruptcy plan. Therefore, the debtor will have to complete a three to five-year plan to obtain the benefit of the removal of the subsequent mortgage. Being able to come out of bankruptcy without a second mortgage is quite an incentive to finish the bankruptcy plan.

The amount of applications to strip off second mortgages is notably less in the last couple of years. In the "free-for-all lending" days before the crash, when lenders were giving out second mortgages with what appeared to be little if any processing, and real estate values were seemingly based on fantasy, second mortgages were routinely being thrown out, including six figure equity loans.

To remove second mortgages and judgments, proof of home value is needed. Depending on the nature of the debt, the particular creditor involved, and the amount of apparent equity, proof may be as simple as using a service such as Zillo, a comparative market analysis, or an estimate by a realtor. In certain situations a more formal appraisal may be necessary.

The application to remove judgment liens is rarely if ever challenged. For second mortgages, the applications also are rarely challenged, with the exception being where the

creditor is a locally based lender, and there may be a real dispute on the current market value of the property.

For nonjudicial liens, and liens against non-homestead property, in a chapter 13 plan you may be able to strip the lien, or pay less than the full lien amount, and have the amount paid as part of the plan payment. Such provision would to allow the lien to be deemed fully satisfied at the end of the plan and allow the debtor to emerge with clear title on his or her assets. Whether or not such lien adjustment is feasible in a chapter 13 context depends on many factors including the amount of the lien, the value of equity in property sought to be protected, the nature of the lien, the treatment of other creditors within the plan, and the amount of income available to the debtor to make such payments on top of what else will be required by the bankruptcy plan.

Stripping liens may not be sexy, but it is a powerful remedy.

Debtors' Prison

I am often asked by clients, "Can I go to jail?" The reassuring answer is, "Absolutely not. There are no more debtor's prisons." But, for someone who is dishonest in their petition, jail is an option. Here is this column's teaching moment showing what not to do when seeking relief under the bankruptcy laws.

Mr. East had his company file bankruptcy the day before a scheduled foreclosure auction on company property. The property had a value exceeding one million dollars. The bankruptcy court ordered him to sell the property and remit \$1.2 million to the mortgage holder. Instead of complying, Mr. East retained \$800,000.00. That act led to an indictment, which led to a guilty plea to embezzling from a bankruptcy estate. Thou shall not steal.