Business Monday

JULY 19, 2015

U.S. Supreme Court ruling preserving second mortgages in Chap. 7 bankruptcies exposes flaw in bankruptcy code for community associations

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Special to the Miami Herald

The recent decision by the U.S. Supreme Court in the case of *Bank of America v. Caulkett* represents an important win for mortgage lenders as well as community associations. The court ruled that homeowners who are underwater on their first mortgage cannot void second mortgages by filing for Chapter 7 bankruptcy, and

the ruling also appears to apply to other secured lienholders including community associations.

The case involved two Florida homeowners who asked the bankruptcy court to wipe away their second mortgages from Bank of America given that their properties maintained no equity after their respective first mortgages. All nine Supreme Court justices agreed that filing for Chapter 7 bankruptcy protection does not give homeowners the power to wipe away second mortgages simply because their properties are worth less than they owe under their first mortgage. According to a report by CoreLogic, approximately 2.1 million underwater homeowners had second mortgages in the second quarter of 2014. In Florida, 23 percent of the state's roughly 1.3 million homes that are currently underwater on their first mortgage have multiple mortgages, according to RealtyTrac.

More than 700,000 individuals and couples filed for Chapter 7 bankruptcy last year, making it the most popular type of bankruptcy filing. Chapter 7 bankruptcies enable court-appointed trustees to sell a debtor's non-exempt assets in order to repay creditors in accordance with the priorities established in the bankruptcy code.

The Supreme Court ruling does not completely prevent homeowners from canceling second mortgages or other junior lienholders in bankruptcy. Debtors can continue to strip off second mortgages by filing for bankruptcy under either Chapter 11 or 13, which are financial reorganization forms of bankruptcy in which they must pay back creditors over a period of time.

For community associations, the ruling will direct the bankruptcy courts to conclude that the secured liens that associations file against units whose owners have not paid their association dues also cannot be wiped away by underwater homeowners in Chapter 7 bankruptcies. Homeowners and condominium associations in Florida have had to contend with record numbers of foreclosures during the meltdown in the housing market, and many owners of units in foreclosure have been filing for bankruptcy protection and using the same "lien stripping" provisions that were extinguished for Chapter 7 bankruptcies by this Supreme Court ruling to wipe away their association liens. This has resulted in significant shortfalls in associations' finances that have had to be made up by all of the paying unit owners, who are essentially being forced by the delinquent owners to pay more than their fair share.

While the new ruling will benefit community associations by eliminating lien stripping for Chapter 7 bankruptcies, the ruling does not apply to the financial reorganization forms of bankruptcy under Chapter 11 and Chapter 13, in which lien stripping has been particularly abundant for Florida associations. This means that many associations might continue to see their right to collect from delinquent unit owners voided by the bankruptcy courts.

This Supreme Court ruling has shined a spotlight on the lien stripping provisions of the federal bankruptcy code like never before, and the time has come for our country's lawmakers to take note of the fact that legislative changes are required in order to address the inequities that are caused by these provisions as they now stand. Lien stripping represents a huge windfall for homeowners who fall into foreclosure, fail to pay their association dues and are then able to eliminate 100 percent of their association debt by filing for bankruptcy. The associations maintain the property values of the residences for the benefit of the delinquent homeowners, who end up retaining their home free of their maintenance assessment arrears through their repayment plan approved by the bankruptcy court, and they preserve the collateral of the homeowners' first-mortgage lenders. The fellow neighbors of the delinquent unit owner end up footing the bill, which in some cases reach six figures after years of nonpayment, while the debtor and their mortgage lender reap the rewards of a properly maintained property at no expense to either of them.

While the U.S. bankruptcy code is a federal law and the laws governing condominium associations and HOAs are state laws, the lawmakers from states such as Florida, which is the state with the most associations at approximately 46,000, should now consider changes to the federal bankruptcy code that would enable community association liens to take a higher priority. Due to the special role that the associations play in preserving the underlying collateral for home mortgages, their liens should either be exempt from lien stripping altogether or there should be some form of a surcharge against the first mortgage lender to force it to pay the association that is maintaining its collateral.

The high court's decision in *Caulkett* appears to invite a challenge to other decisional precedent that might ultimately revisit and/or approve lien stripping in Chapter 7 cases. As such, it should serve as a clarion call for the U.S. Congress

to reassess the particularly onerous lien stripping provisions of the country's bankruptcy code.

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