Case Law Update: The Northern District's New Judges Talk about Split Consumer Issues

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REAFFIRMATION AGREEMENTS
The Court's Role & Duties
ABI Chicago Consumer Bankruptcy Conference
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I. Reaffirmation Standards

A. For enforceable reaffirmation agreement *when debtor is represented by counsel*:

- agreement must be made prior to entry of discharge;
- debtor must receive disclosures in section 524(k)
- agreement must be filed with bankruptcy court, accompanied by declaration or affidavit of debtor's attorney stating that:
  - agreement is informed and voluntary,
  - reaffirmed debt does not impose undue hardship, and
  - attorney has fully advised debtor of legal effect of agreement and any default thereunder; and
- debtor must not have rescinded agreement prior to discharge or within 60 days after agreement has been filed, whichever occurs later.

11 U.S.C. § 524(c).

B. If all requirements are satisfied, agreement becomes effective immediately upon being filed with court *as long as there is no presumption of undue hardship*. 11 U.S.C. § 524(k)(3)(J)(i).

II. Undue Hardship

A. Presumption of undue hardship:

- will arise based on what is shown on debtor's completed and signed statement in support of agreement required under subsection (k)(6)(A) (the "Debtor's Statement in Support"). 11 U.S.C. § 524(m)(1);
- no requirement that information on Debtor's Statement in Support be accurate or, if information is not accurate, that court look to other documents or statements;
- Debtor's Statement in Support must be accompanied by statement of total income and expenses on schedules I and J. If there is a difference between income and expenses on those schedules and Debtor's Statement in Support, the latter must include explanation of the difference. Fed. R. Bank. P. 4008(b).

- Presumption of undue hardship exists if debtor's monthly income less debtor's monthly expenses is less than scheduled payments on reaffirmed debt.

B. Credit Union Exception:

- If creditor is credit union and debtor was represented by attorney during negotiation of reaffirmation agreement, agreement becomes effective upon filing.

- When agreement is with credit union, no presumption of undue hardship exists. 11 U.S.C. § 524(m)(2).

- Code does not provide for independent court review of reaffirmation agreement between represented debtor and credit union.

C. Because of requirements and inaccuracies inherent on Debtor's Statement in Support, two views have developed as to how to determine whether presumption of undue hardship will arise:

- **Broad Scope Determination**—Bankruptcy court has power to evaluate accuracy of financial disclosures made by debtor as part of reaffirmation package. *In re Laynas*, 345 B.R. 505 (Bankr. E.D. Pa. 2006).

- **Narrow Scope Determination—**Determination as to whether presumption of undue hardship will arise is determined solely from figures required by Debtor's Statement in Support. *In re Wilson*, 363 B.R. 220 (Bankr. D.N.M. 2007).

D. If presumption of undue hardship exists, **court must review the application for approval**:

- Debtor can rebut the presumption in writing by identifying "additional sources of funds to make the payments."

- If presumption is not rebutted **to court's satisfaction**, court may disapprove agreement after notice and hearing, which must be concluded before entry of debtor's discharge.

11 U.S.C. § 524(m)(1).

E. Court Review of Undue Hardship

- Very little authority on what constitutes rebutting the presumption "to the court's satisfaction."

- Reaffirmation agreements are strictly construed to protect debtor from "overreaching creditors." *In re Petersen*, 110 B.R. 946, 949-50 (Bankr. D. Colo. 1990) (internal quotation omitted).

- Section 524 is meant to protect a debtor who unwittingly executes, or has been coerced into executing, a reaffirmation agreement; the provisions of section 524(c) are a shield to protect the debtor. *Id.* at 950.

- Code does not provide for independent court review of reaffirmation agreements entered into by represented debtor when there is no presumption of undue hardship or presumption period has passed.

- Court's review of attorney-certified reaffirmation agreements should focus on presumption of undue hardship and whether attorney's certification complies with Rule 9011.

- If debtor seeking approval of reaffirmation agreement is not represented by counsel, bankruptcy court must:

  - inform debtor that reaffirmation is not required,
  - describe legal consequences of reaffirming debt, and
  - decide whether reaffirmation is in debtor's best interest or poses undue hardship.

III. Issues in Connection with Attorney Certification Requirement

A. Two Attorney Certification Requirements Under Section 524 and Official Bankruptcy Form:

- Debtor's attorney must certify that:

  - agreement is "fully informed and voluntary,"
  - it does not impose an "undue hardship on the debtor," and
  - attorney has "fully advised the debtor of the legal effect and consequences" of the agreement.

- If presumption of undue hardship arises, section 524(k)(5)(B) requires debtor's attorney to certify that, in attorney's opinion, debtor will be able to pay debt notwithstanding presumption of undue hardship.

B. Common Ethical Problem Resulting from Requirements

- Debtor wants to reaffirm debt but attorney believes reaffirmation not in debtor's best interests.

- If attorney certifies, runs the risk of violating the rules of professional responsibility and/or Rule 9011 or even committing fraud.

- Code should not be read to *require* attorneys to sign certification.

C. Ways That Attorneys Have Responded to the Potential Ethical Conflicts

- Limiting the scope of representation by excluding reaffirmations
- Partial withdrawal

Some courts have held that limiting the scope of representation and partial withdrawal are not allowed.

IV. The "Made" Requirement Under Section 524(c)(1)

A. Reaffirmation agreement is enforceable only if, *inter alia*, "such agreement was made before the granting of the discharge[.]" 11 U.S.C. § 524(c)(1).

B. Issue: When is a reaffirmation agreement "made" for purposes of section 524(c)(1)?

- ***In re Davis***, 273 B.R. 152, 153 (Bankr. S.D. Ohio 2001): "[W]here it can be shown that a reaffirmation was 'made,' i.e., signed, *before* the granting of the discharge, then the reaffirmation agreement may be 'filed' *after* the granting of the discharge."
- ***In re LeBeau***, 247 B.R. 537, 540-41 (Bankr. M.D. Fla. 2000): Reaffirmation agreement was enforceable as having been "made" prior to entry of debtors' discharge, where parties had reached agreement on terms of agreement and debtors had commenced performance thereunder, even though debtors' signed writing embodying terms of agreement was filed after entry of discharge.

V. The "Ride-Through" (or "Pass-Through") Option

A. "Ride–through" (or "pass-through") allows debtor current on payments to retain property and continue to make payments without reaffirming or redeeming.

- Prior to BAPCPA, five circuits held that ride-through was available to debtors (Second, Third, Fourth, Ninth, Tenth).
- Other circuits rejected ride-through (First, Fifth, Seventh, Eleventh).
- Since BAPCPA, debtor's ability to state ride-through intention when filing chapter 7 has been restricted. Debtor seeking to retain property after filing must now state intention to either reaffirm or redeem. 11 U.S.C. §§ 521(a), 362(h). "Ride-through" still appears to be available, however, under a narrow set of circumstances.

B. Where the Seventh Circuit Stands

- No Seventh Circuit case on issue since passage of BAPCA

- Pre-BAPCA—***In re Edwards*, 901 F.2d 1383 (7th Cir. 1990)**: Court found ride-through not permitted, holding that debtor must, as condition of retaining, either redeem or reaffirm, even though debtor had performed and was continuing to perform all obligations of loan agreement.

- Post-BAPCA Case in Bankruptcy Court for Northern District of Illinois—***In re Alvarez,* No. 10-B-28565, 2012 WL 441257 (Bankr. N.D. Ill. Feb. 10, 2012).** Court stated its belief that section 521(a)(6) is intended to emphasize that there is no "ride-through option."

C. Ride-Through in Practice:

- Court has discretion to examine situations where there is undue hardship and to suggest to debtor who is current that debtor retain collateral and continue to make payments.

- Court cannot, however, order "ride-through."

- Court needs to know if creditor requires reaffirmation agreement in order for debtor to retain collateral in deciding whether to permit reaffirmation.

D. Circumstances Under Which Ride-Through May Be Available

- **Via a Reaffirmation Agreement That Is Not Approved—*In re Blakeley,* 363 B.R. 225 (Bankr. D. Utah 2007)**: Court found that debtor may still be able to obtain the benefits of "ride-through" if: (1) debtor timely filed statement of intent; (2) debtor timely entered into reaffirmation agreement with creditor; (3) debtor was *pro se* or, despite being represented by counsel, court chose to review the agreement; (4) court denies approval of agreement; and (4) court would have allowed "ride-through" prior to BAPCPA.

- **Via a Default—*In re Rowe,* 347 B.R. 341 (Bankr. D. Kan. 2006)**: Court noted that, although Congress eliminated a debtor's ability to select "ride-through," in Kansas "the practical result in many cases will be no significant change from the pre-BAPCPA Code as construed by the Tenth Circuit, except the stay will be automatically lifted."

- **Based on Section 521(a)(2)(A) Which Was Unchanged by BAPCPA—*Ford Motor Credit Co. v. Baker (In re Baker)*, 400 B.R. 135 (D. Del. 2009):** Relying on Third Circuit's decision in *In re Price*, 370 F.3d 362 (3d Cir. 2004), which in turn relied on section 521(a)(2)(A) which was unchanged by BAPCPA, court held that debtors had option of retaining their vehicles while continuing to make their regular monthly payments.

VI. Interesting Reaffirmation Statistics

Source: Government Accountability Report: GAO-08-94—Bankruptcy: Implementation of Reform Act's Debt Reaffirmation Provisions*, available at* http://www.gao.gov/htext/d0894.html, December 2007 (based on a representative sample of bankruptcy filed with reaffirmation agreements between October 17, 2005 and October 17, 2006 in five bankruptcy courts—in Alabama, California, Illinois, Texas, West Virginia)

Attorney Signatures and Certifications

- 95% to 100% of attorneys signed certification agreements for their clients
- In 1% to 11% of certifications, attorneys added language that attorney was not guaranteeing debtor's repayment or ability to repay debt

Collateral & Debt Burden

- Secured debts for cars and homes were most frequent type of reaffirmed debt
- 90% or more of all reaffirmation agreements were for debts secured by assets
- 54% to 87% of reaffirmation agreements were for automobiles
- 15% to 24% of reaffirmation agreements were for homes
- Credit card debt was most frequently reaffirmed unsecured debt
- 2% to 10% of all reaffirmation agreements were for unsecured debts
- Reaffirmed debt burden was less than 25% of total debt (in 2/3 of the cases reviewed)

Interest Rates

- For 56% to 84% of reaffirmed debts, interest rates were equal to original rate
- For 10% to 44% of reaffirmed debts, interest rates were less than original rate
- For 0% to 8% of reaffirmed debts, interest rates were more than original rate

Undue Hardship

- 67% to 88% of agreements included statement that agreement did not impose an undue hardship

Amount of Reaffirmed Debt

- Average amount reaffirmed per reaffirmation agreement was $12,000 to $31,000

CASES AND RECENT DEVELOPMENTS AFFECTING THE ATTORNEY AS CREDITOR IN BANKRUPTCY PROCEEDINGS

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United States Bankruptcy Court, Northern District of Illinois

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I. INTRODUCTION

A. In re Eriksen: The recent case of *Petti Murphy & Assocs. v. Eriksen (In re Eriksen)*, 2012 WL 3150325 (Bankr. N.D. Ill. Aug. 2, 2012), presented the issue of whether a debt owed by a Chapter 7 individual debtor to an attorney who had represented the individual's corporation prior to his bankruptcy should be excepted from discharge on grounds of fraud, the debt having arisen in connection with issuance of an insufficient funds retainer check.

Prior to the debtor/shareholder's bankruptcy, his corporation had been involuntarily placed into Chapter 11, and he sought to obtain counsel for his company just prior to a court hearing in the corporation's case. He met with proposed counsel and obtained the firm's agreement to represent the company, but only on the condition that the firm receive a retainer and that the shareholder guarantee payment of the firm's fees. The shareholder signed and delivered to the firm a check for the first half of the retainer, but the check never cleared. The firm then filed suit and obtained a judgment against the shareholder in state court under the Illinois Deceptive Practices Statute relating to the issuance of the insufficient funds check. When the shareholder filed his Chapter 7 petition, the law firm filed a complaint for a declaration that the judgment debt was nondischargeable, *inter alia*, under §523(a)(2)(A), which excepts from discharge debts for money, services, or extensions of credit obtained through fraud.

In ruling on the shareholder/debtor's motion for summary judgment, Judge Cassling noted that "[t]he heart of the [law firm's] claim under § 523(a)(2)(A) is whether the Debtor actually

represented that the Check would be honored," and he found that genuine issues of material fact existed on that element of the claim, precluding summary judgment. Judge Cassling also rejected the debtor's argument that summary judgment was warranted because the firm would be unable to prove that, in agreeing to continue to represent the debtor's corporation, it had justifiably relied on the debtor's representations that the check would clear. The question, however, was "a close one," and Judge Cassling noted that the firm, experienced in bankruptcy matters, should have been skeptical of the assertions of financial solvency. He further noted that the firm was actually aware that the debtor's company was a credit risk and had insisted on a guarantee of its legal bills.

B. *Eriksen* Considered in Larger Terms: The *Eriksen* matter is of interest for a number of reasons, including the specific holding regarding justifiable reliance. More than this narrow holding is at play, however. While *Eriksen* highlights the particular challenge faced by former bankruptcy attorneys who appear as creditors in subsequent bankruptcy matters, it also stands in a broader sense as an example of a very common challenge faced in recent bankruptcies -- the appearance of the debtor's former attorneys as creditors. The broader and more common issues in such appearances, though not squarely addressed in *Eriksen*, are the focus of this outline. In particular, this outline focuses on the ethical challenges relating to confidential information faced by attorneys as creditors. Both the attorneys acting as creditors and counsel to the bankruptcy estate must be mindful of these challenges, as through design or inadvertence, it appears to be commonplace for those ethical constraints to be ignored. This outline also discusses briefly some other challenges faced by attorneys as creditors, including whether service on a committee of creditors is appropriate, and how an attorney's lien might have an effect.

II. THE MODEL RULES OF PROFESSIONAL CONDUCT

A. Several of the Model Rules of Professional Conduct are implicated in the various scenarios where an attorney appears as creditor in a bankruptcy case. Among them are:

1. Model Rule 1.9. Model Rule of Professional Conduct 1.9, titled "Duties to Former Clients," provides in subparagraph (c) as follows:

> (c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:
>
> (1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or
>
> (2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.[1]

2. Model Rule 1.6. To determine whether the Rules would permit the use of information relating to the representation of a former client, as required by Model Rule 1.9 quoted above, the attorney must consult Model Rule of Professional Conduct 1.6, which provides in relevant part:

> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
>
> (b) A lawyer may reveal information relating to the representation of a client

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[1] MODEL RULES OF PROF'L CONDUCT R. 1.9 (7th ed. 2011).

to the extent the lawyer reasonably believes necessary: ...

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client. ...[2]

3. The Illinois Rules. Every state has enacted a standard for nondisclosure of client confidences substantially similar to Rule 1.6 in their respective rules of professional conduct. Illinois is no different, and the Illinois rule is substantially identical to the Model Rule.[3] Attorneys should be mindful, however, that the current version of Rule 1.6 in Illinois just recently became effective - - as of January 1, 2010. The rule prior to that amendment provided:

(a) Except when required under Rule 1.6(b) or permitted under Rule 1.6(c), a lawyer shall not, during or after termination of the professional relationship with

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[2] ANN. MODEL RULES OF PROF'L CONDUCT R. 1.6 (7th ed. 2011).

[3] Rule 1.6 of the Illinois Rules of Professional Conduct currently provides in relevant part as follows:

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation, or the disclosure is permitted by paragraph (b) or required by paragraph (c).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
...

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client ... ILL. RULES OF PROF'L CONDUCT R. 1.6 (2010).

> the client, use or reveal a confidence or secret of the client known to the lawyer unless the client consents after disclosure. ...
>
> (c) A lawyer may use or reveal:
>
> (1) confidences or secrets when permitted under these Rules or required by law or court order, ... or
>
> (3) confidences or secrets necessary to establish or collect the lawyer's fee or to defend the lawyer or the lawyer's employees or associates against an accusation of wrongful conduct.[4]

"Confidences" were defined as "information protected by the lawyer-client privilege under applicable law."[5] "Secrets" were defined as "information gained in the professional relationship, that the client has requested be held inviolate or the revelation of which would be embarrassing to or would likely be detrimental to the client."[6]

One of the significant changes is that the new rule, instead of protecting confidences and secrets, now protects "information relating to the representation of a client." This broader description of confidential information represents an expansion of the client's protection, inasmuch as "information relating to the representation of a client" covers *all* information an attorney gleans from representing a client, even when the client has not requested confidentiality or when the information would not necessarily hurt or embarrass him.[7]

Comment 4 to the Illinois Rule provides that "information relating to the representation of

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[4] ILL. RULES OF PROF'L CONDUCT R. 1.6 (repealed 2009).

[5] ILL. RULES OF PROF'L CONDUCT Terminology (repealed 2009).

[6] *Id*.

[7] *See* Dorothy Anderson, *When Your Client Sues You, Are Your Lips Still Sealed?* (Sep. 2003), available at http://www.mass.gov/obcbbo/lips.htm.

a client" also includes information that "could reasonably lead to the discovery of such information by a third person."

4. The Defense Exception. Another significant change was made in that portion of the Illinois rule commonly referred to as the Defense Exception, now contained in subparagraph (b)(5). As quoted above, the Illinois rule prior to 2010 provided that a lawyer could use or reveal protected information "necessary to establish or collect the lawyer's fee or to defend the lawyer or the lawyer's employees or associates against an accusation of wrongful conduct." In other words, the attorney could reveal protected information either in a proceeding to collect his fees or in defense of a claim or action brought against him by the client.

The amended version provides that the lawyer may reveal information relating to the representation of a client to the extent the lawyer *reasonably* believes it is necessary to establish a claim or defense on his behalf in a controversy between himself and the client.

It should first be noted that although this amended version of the Defense Exception no longer specifically refers to fee collection efforts, Comment 11 to the Rule makes clear that fee collection is subsumed within the language of the new rule, i.e., establishing a claim on the lawyer's behalf in a controversy with the client. The Comment states that an attorney "entitled to a fee is permitted by paragraph (b)(5) to prove the services rendered in an action to collect it."

Significantly, the new rule changes the "*necessary* to establish or collect lawyer's fees" to "*reasonably believes necessary*." This change establishes a more objective standard by which to measure the attorney's conduct; even if he sincerely believes disclosure is necessary to establish his claim or defense, he will be in violation of the rules if that belief is not "reasonable."[8]

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[8] *Id.*

a. Preventing a Violation. The Defense Exception to nondisclosure is thus rather narrow. And since it is unclear how much discretion a lawyer has in revealing protected information under the "reasonably believes necessary" standard, the cautious lawyer will heed the guidance offered in Comment 14 to the Rule, concerning measures that can be taken to prevent a violation. The Comment states that the lawyer "should first seek to persuade the client to take suitable action to obviate the need for disclosure." As a practical matter, this step may be unavailing where counsel is pursuing fee collection in a bankruptcy case, because "persuad[ing] the client to take suitable action to obviate the need for disclosure" would be tantamount to asking for payment, an act prohibited by the automatic stay.[9]

Comment 14 goes on, however, to suggest that if disclosure is to be made in a judicial proceeding, the lawyer should obtain appropriate protective orders or seek other arrangements that will limit access to the information to the court or to other persons having a need to know it. Such arrangements may include the sealing of documents and *in camera* review of disclosed information.[10] Again, counsel would be well-advised to take one or more of these steps, to the extent possible, because violative disclosures may result in disciplinary action or court sanctions.[11]

(1.) Protective orders can be obtained in bankruptcy cases just as in district court proceedings. For example, Federal Rule of Civil Procedure 26 applies in adversary proceedings and contested matters in bankruptcy court. (*See* Fed. R. Bankr. P. 7026, 9014.) Federal Rule of Civil Procedure 26(c) provides that the court may issue a protective order for good cause shown, in order

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[9] *See* 11 U.S.C. § 362(a).

[10] *See also* ME. RULES PROF'L CONDUCT R. 1.6; Spratley v. State Farm Mut. Auto. Ins. Co., 2003 UT 39, 78 P.3d 603, 610; N.Y. City Ethics Op. 1986-8 (1986).

[11] *See*, *e.g.*, Styles v. Mumbert, 164 Cal.App. 4th 1163, 1169 (2008).

to protect a party or person from, *inter alia*, annoyance, embarrassment, or oppression. This rule has been applied to protect confidential and privileged information.

(2.) With regard to the sealing of documents, the Bankruptcy Court for the Northern District of Illinois has adopted Local Rule 5005-4, which provides that all documents filed with the Clerk are accessible to the public unless covered by a "Restricting Order." Accordingly, counsel must file a motion seeking an order allowing the document to be filed under seal. The rule contains detailed provisions concerning the necessary contents of the order, the method for submitting the document under seal, the required docket entries, and procedures for access to the document as well as its ultimate disposition.

(3.) As a final precautionary measure, counsel seeking to ensure compliance with Rule 1.6 should obtain legal advice from attorneys well-versed in the ethical rules. Indeed, Rule 1.6 itself contains, in subparagraph (b)(4), a specific exception allowing disclosure of protected information to another attorney for this very purpose.

III. SPECIFIC CHALLENGES

A. Can an attorney/creditor file a complaint seeking to deny the debtor a discharge?

1. The Ethics Committee of the Los Angeles County Bar Association issued Opinion No. 452 on November 21, 1988,[12] advising that while an attorney/creditor's filing of a claim in a bankruptcy case falls within the exception to the rule of nondisclosure (and even the use of confidences and secrets to litigate the claim, if contested), the Committee went on to opine that "collective actions to collect debts generally from a former client do not fall within the scope" of

[12] L.A. County Op. No. 452 (1988), (available at http://www.lacba.org/Files/Main%20Folder/Documents/%20Ethics% 20%20%20Opinions/Files/Opinion452.pdf).

the Defense Exception. The attorney must be more of a "bystander in the collective effort" and therefore may not use protected information to object to the debtor's discharge.

2. This position was taken by the Ninth Circuit Bankruptcy Appellate Panel in *In re Rindlisbacher*.[13] In *Rindlisbacher*, an attorney had represented the debtor prepetition in a divorce action in state court. In that action, the debtor had testified that he had no rental income from a home that he owned, but he later confided to his attorney that the testimony was false. The debtor thereafter filed a bankruptcy petition, still owing divorce counsel substantial fees. In the bankruptcy case, the debtor failed to report the rental income in his schedules, and his divorce attorney filed a complaint objecting to the debtor's discharge. The debtor moved for summary judgment, contending that his former attorney's actions violated the prohibition against disclosure of protected information. The court agreed, holding that the attorney's disclosure in the discharge objection proceeding of the confidence concerning the debtor's rental income did not come within the Defense Exception.

In *In re Klober*,[14] the court denied the debtor's motion to dismiss his former counsel's complaint objecting to discharge (as well as to the dischargeability of counsel's debt), noting that no authority had been cited in support of the debtor's contention that an attorney may not file such a complaint without first seeking permission from the former client. The court observed, however, that the allegations of the complaint did not, in any event, appear to disclose any confidential communications.

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[13] In re Rindlisbacher, 225 B.R. 180 (B.A.P. 9th Cir. 1998).

[14] In re Klober, 143 B.R. 702 (Bankr. E.D. Ark. 1992).

B. Can an attorney/creditor file a complaint seeking to except his debt for fees from the debtor's discharge?

The simple answer to this question is yes. There is a distinction between objections to discharge and objections to the dischargeability of a debt. The former seek to deny the discharge in toto, which benefits all creditors, whereas the latter seek only to except a particular debt from discharge - - benefitting only the creditor involved. Thus, when an attorney/creditor files a complaint to except his debt from discharge, he is not engaging in a "collective" effort on behalf of all creditors; he is acting only on his own behalf. The Ethics Committee of the Los Angeles County Bar Association, in keeping with its view that only collective action falls without the scope of the Defense Exception, advised in Opinion No. 452 that an adversary complaint seeking to except from the client's discharge the particular debt owed to the attorney for unpaid fees may be prosecuted under § 523 of the Bankruptcy Code (provided the attorney holds such a cause of action), as long as counsel avoids the disclosure of confidences and secrets (to the extent feasible) and obtains appropriate confidentiality orders for that purpose.[15]

C. Can an attorney/creditor serve on a creditors' committee?

1. The Alaska Bar Association Ethics Committee issued Ethics Opinion No. 86-2 on March 11, 1986, advising that a law firm with knowledge of or access to a former client's financial affairs may not serve on a creditor's committee without informed and effective consent from the client. The ethics committee reasoned that members of a creditors' committee have a fiduciary duty towards the class of creditors the committee represents, which is an obligation the law firm would

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[15] *See also* In re Klober, 143 B.R. 702 (Bankr. E.D. Ark. 1992).

not be able to fulfill without violating its ethical obligations to its former client through disclosure of client confidences.[16]

2. The issue of counsel's participation on the creditors' committee in his former client's bankruptcy case was addressed in *In re Featherworks Corp*.[17] There, the court at first did not appoint the debtor's former counsel to the committee because it believed "that to include a debtor's former attorneys [o]n the creditors' committee might result in a conflict of loyalties: on the one hand, the debtor's creditors would depend on the committee and its members for guidance in such matters as whether to 'investigate the acts, conduct, assets, liabilities and financial condition of the debtor ... '; on the other hand, the attorney might be inhibited from giving such guidance by his obligation to preserve" client confidences. Also, the court did not believe that it was necessary for the attorney to be on the committee in order to establish or collect his fee.[18] Upon a subsequent request by the attorney to be added to the committee (brought under then §1102(c) of the Bankruptcy Code), the court decided to grant the attorney's request. However, the court's decision was based in large part on the fact that the debtor's opposition to the request was not based on privilege issues or anything related to the former attorney-client relationship and also on the fact that membership would have had little practical significance, since the committee was not actually functioning.

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16 Ak. Ethics Op. No. 86-2 (1986) (available at https://www.alaskabar.org/servlet/content/86_2.html)

17 In re Featherworks Corp., 25 B.R. 634 (Bankr. E.D.N.Y. 1982).

18 *Id*. at 644.

D. Can an attorney/creditor draft a creditors' plan of reorganization?

In *In re Burton Securities, S.A.*,[19] the attorney had previously represented the debtor corporation in connection with the bankruptcies of other entities. When the debtor filed its own chapter 11 petition, it still owed fees to its former counsel. In the debtor's bankruptcy, the attorney drafted a creditors' plan of reorganization and accompanying disclosure statement, which was approved by all classes except equity holders. The debtor objected to confirmation of the plan on the grounds that it was not proposed in good faith as required by 11 U.S.C. § 1129(a)(3), because the attorney had violated the rules of professional conduct, including the rule prohibiting disclosure of protected information. The court phrased the issue before it as "whether a law firm may propose a creditor plan of reorganization in the bankruptcy of its former client to attempt to recover" its fees. The court ultimately found that the attorney had not used client confidences in drafting the plan and disclosure statement but added that even if he had, the ethical rules would not necessarily have been violated. "To hold otherwise," said the court, "would prevent a law firm from ever collecting its fee in a former client's bankruptcy."[20]

It should be noted that the latter statement by the court constituted dictum. In light of the proscription against taking collective action in a bankruptcy case, it is doubtful whether an attorney/creditor can prepare and file a plan of reorganization without violating his ethical obligations to the former client. Although such action may benefit the attorney, it primarily benefits all creditors and will in most circumstances fall beyond what is reasonably necessary to collect the attorney's fee.

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19 In re Burton Securities, S.A., 148 B.R. 478 (Bankr. S.D. Tex. 1992).

20 *Id*.

E. Can former counsel enforce his attorney's lien on work product after his former client files bankruptcy?

There are two types of attorney's liens - - the retaining lien and the charging lien - - each of which is recognized under the common and/or statutory law of most states. In Illinois, the retaining lien is a creature of the common law. In *Johnson v. Cherry*,[21] the Seventh Circuit, in vacating the trial court's directive that counsel turn over all documents and papers to the client, discussed the differences between the two liens.

Where counsel's fees remain unpaid, the retaining lien attaches to documents or other property coming into counsel's possession during the course of the attorney-client relationship, if that relationship terminates for reasons other than professional misconduct. Counsel can assert the lien and retain possession of the file until the client either remits the unpaid fees or provides adequate security to protect counsel's interest.[22]

The charging lien, on the other hand, attaches only to proceeds recovered by the client (e.g., through judgment or settlement) in pursuit of the claim for which counsel was engaged. In Illinois, the charging lien may be asserted under section 1 of the Illinois Attorneys' Lien Act, 770 ILCS 5/1.

If the client files bankruptcy, however, the lien may be avoidable under §545 of the Bankruptcy Code, which provides in relevant part that the trustee "may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien ... is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists ..."

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[21] Johnson v. Cherry, 422 F.3d 540 (7th Cir. 2005).

[22] *Id*. at 554.

In order to perfect the charging lien in Illinois, the attorney must serve written notice on the party against whom the client is asserting the underlying claim.[23] It is not always clear, however, under the laws of many states, exactly what is required for perfection in this regard. Under New Jersey law, for example, courts have disagreed as to whether the charging lien is perfected or enforceable where counsel fails to serve a "pre-action notice" to the client or to file a petition for determination of the lien in the underlying proceeding.[24]

The retaining lien, on the other hand, is perfected simply by possession, and "[a]s a general matter, a lawyer's ethical duties to her client do not preclude an attorney from invoking her retaining lien in furtherance of her right to compensation."[25] As further noted in *Johnson*, however, the possessory right is not unbounded, and unpaid counsel's right to hold on to the file may in certain circumstances yield when the client or a third party establishes a need for the documents.

Indeed, if the former client files a bankruptcy petition, the client's documents are subject to turnover under § 542(e) of the Bankruptcy Code, which provides that subject to any applicable privilege, the court may order an attorney, accountant, or other person that holds recorded information relating to the debtor's property or financial affairs to turn over such information to the trustee. While voluntary relinquishment of a client's file ordinarily will vitiate the retaining lien,

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[23] Johnson, 422 F.3d at 554.

[24] *Compare* In re Rapid Freight Systems, Inc., 2011 WL 1300441, *4-8 (Bankr. D.N.J. Mar. 31, 2011); Hoffman & Schreiber v. Medina, 224 B.R. 556 (D. N.J. 1998); *with* In re Gallagher, 283 B.R. 608 (Bankr. M.D. Fla. 2002) (citing In re Smith, 263 B.R. 71, 78 (Bankr. D. N.J. 2001) (*but see* opinion after remand, In re Smith, 2002 WL 342082 (Bankr. D. N.J. March 5, 2002))).

[25] Johnson, 422 F.3d at 555 (citing Ill. Rule of Prof'l Conduct 1.8(i)(1)).

counsel turning over the client's file to a bankruptcy trustee will retain his lien as long as turnover is effected pursuant to an order of the court.[26]

In re Highland Park Assocs. Ltd. Partnership I[27] involved an attorney's lien held by former bankruptcy counsel in the same case, and the court ordered the firm to turn over the documents in their possession under § 542(e). The court went on to explain, however, that the firm was entitled to adequate protection of the value of its interest in the file - - though "determining that value is difficult."[28] A retaining lien is a "passive" lien, which cannot be actively enforced, as through the sale of collateral. Ordinarily, the real value of the lien is that the client has to pay the attorney's fee if he wants the documents subject to the lien.[29] As noted in *Highland Park*, however, "section 542(e) 'was designed to prevent attorneys and accountants from coercing debtors to pay claims in full ahead of other creditors.'" Accordingly, the 'coercive' value of the lien should not be the measure of adequate protection.[30]

As recently observed in *Rapid Freight*, the majority of courts considering the issue "conclude that an attorney who turns over the documents to a trustee, as required under ... §542(e), 'may be entitled to a replacement lien or administrative expense measured by the value the documents provide, if any, in revealing assets or assisting in the administration of the estate.'"[31]

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26 *See* Rapid Freight, 2011 WL 1300441 at *10.

27 In re Highland Park Assocs. Ltd. Partnership I, 132 B.R. 358 (Bankr. N.D. Ill. 1991).

28 *Id*.

29 *Id*.; *see also* Johnson, 422 F.3d at 555.

30 *Id*. at 358.

31 Rapid Freight, 2011 WL 1300441 at *10 (quoting from In re Herrera, 390 B.R. 746, 748-49 (Bankr. S.D. Fla. 2008)).

Needless to say, debtor's former counsel should never refuse turnover when so ordered under § 542(e) - - whether or not he believes that the proposed protection is inadequate - - as refusal will likely result in sanctions.

Lien Strip-Offs and Lien Strip-Downs in Chapters 7, 13 and "20"

By: The Honorable Donald R. Cassling
United States Bankruptcy Court for the Northern District of Illinois

I. Definitions

A. Lien Strip-Offs – The avoiding of a wholly undersecured junior lien under 11 U.S.C. § 1322(b)(2) in a Chapter 13 proceeding or under 11 U.S.C. § 506(d) in a Chapter 11 proceeding.

B. Lien Strip-Downs – The bifurcation of a partially undersecured junior lien into a secured claim and an unsecured claim under 11 U.S.C. § 506(a).

C. "Chapter 20" – A Chapter 7 case followed quickly by a Chapter 13 case. In the typical situation, the Debtor's residence is encumbered by multiple mortgages and the Debtor has no equity in the property. The Chapter 7 Trustee under these circumstances will normally make no claim against the residence and will often issue a no-asset report, and the Debtor will receive a discharge of all her debts. If one of the mortgagees has not yet completed foreclosure proceedings, the Debtor will, within a short period of time after the Chapter 7 case is closed, file a Chapter 13 proceeding. Even though she is not entitled to a Chapter 13 discharge under 11 U.S.C. § 1328(f)(1), the Chapter 13 filing will stay foreclosure proceedings while the Debtor attempts to strip off the junior mortgage on the residence. If she is successful in doing so, it will improve her chances of striking a deal with the senior mortgagee and avoiding foreclosure.

II. Summary of Conclusions

A. Lien strip-offs are available in the "reorganization" chapters of the Code (Chapters 11, 12 and 13), but are generally not available in the liquidation chapter of the Code (Chapter 7).

1. The courts are split on the appropriate procedure for obtaining a lien strip-off in Chapter 13. The three choices are (a) by adversary proceeding under Fed. R. Bankr. P. 7001(2); (b) by motion under Fed. R. Bankr. P. 3012; or (c) by plan under 11 U.S.C. § 1322(b)(2).
2. There are practical advantages and disadvantages to each procedure. My view is that attorneys should be free to choose the procedure that best fits their goals for their clients, as long as the notice they provide to the junior lienholder satisfies the requirements of due process.
3. Regardless of the procedure used, the better-reasoned opinions place great weight upon the sufficiency of the notice provided to the junior lienholder.

B. Lien strip-downs are available in Chapter 11 but are not available under Chapter 13 or Chapter 7 with respect to the Debtor's principal residence. Lien strip-downs are available in a Chapter 13 proceeding with respect to collateral other than the Debtor's principal residence.

C. Authorities are split as to whether Chapter 20s are permissible. Similarly, authorities are split as to whether a Chapter 13 debtor who is ineligible for a discharge is entitled to strip off a wholly undersecured lien on her principal residence. Even where Chapter 20s are permissible, the odds are great that the Chapter 13 will be dismissed for having been filed in bad faith.

III. The Governing Statutes and Rules

A. 11 U.S.C. § 506(a)(1) – "An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property. . . ."

B. 11 U.S.C. § 506(d) - "To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void . . . ."

C. 11 U.S.C. § 1322(b)(2) – The Chapter 13 plan may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence . . . ."

D. 11 U.S.C. § 1325(a)(5)(B)(i) – "[T]he court shall confirm a [Chapter 13] plan if . . . the plan provides that . . . the holder of [a] claim retain[s] the lien securing such claim until the earlier of . . . the payment of the underlying debt . . . ; or . . . discharge under section 1328; and . . . if the case . . . is dismissed or converted without completion of the plan, such lien shall also be retained by such holder . . . ."

E. 11 U.S.C. § 1328(f)(1) – "[T]he court shall not grant a discharge . . . if the debtor has received a discharge . . . in a case filed under chapter 7 . . . during the 4-year period preceding the date of the order for relief under this chapter . . . ."

F. Bankruptcy Rule 3012 – "The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct."

G. Bankruptcy Rule 7001(2) – "An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings: . . . (2) a proceeding to determine the validity, priority, or extent of a lien or other interest in property . . . ."

H. Bankruptcy Rule 7004(h) – "Service on an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act) in a contested matter or adversary proceeding shall be made by certified mail addressed to an officer of the institution unless -- (1) the institution has appeared by its attorney, in which case the attorney shall be served by first-class mail; (2) the court orders otherwise after service upon the institution by certified mail of notice of an application to permit service on the institution by first class mail sent to an officer of the institution designated by the institution; or (3) the institution has waived in writing its entitlement to service by certified mail by designating an officer to receive service."

IV. *Dewsnup, Nobelman* and *Lam*

A. *Dewsnup v. Timm*, 502 U.S. 410 (1992) – Section 506(d) does not allow a Chapter 7 debtor to "strip down" a secured creditor's lien to the judicially determined value of the collateral. Because the secured creditor's claim is secured by a lien and has been fully allowed pursuant to § 502, it cannot be classified as "not an allowed secured claim" for purposes of the lien-voiding provision of § 506(d). In reaching its result, the Court rejected the argument that an "allowed secured claim" must be given the same meaning in § 506(d) as it is given in § 506(a), despite the canon of statutory construction that ordinarily requires the same term

within a single statute to be given a single meaning. Instead, the Court emphasized that the pre-Code rule was that liens on real property pass through bankruptcy unaffected. That rule was such a fundamental principle of pre-Code bankruptcy law that the Court refused to conclude that Congress intended to abrogate it, absent clear evidence of such abrogation in either the legislative history or the language of the Code itself.

B. *Nobelman v. Am. Sav. Bank*, 508 U.S. 324 (1993) – Section 1322(b)(2) prohibits a Chapter 13 debtor from relying on § 506(a) to reduce the amount of a junior lender's partially secured residential mortgage claim by reference to the fair market value of the mortgaged residence at the time of the bankruptcy filing. So long as the § 506(a) valuation determined that the junior lender was at least partially secured, the lender was entitled under § 1322(b)(2) to all of a secured claimant's "rights [as a claim] holde[r]." Those rights include the junior lender's contractual rights to the agreed upon interest rates, monthly payment amounts, and repayment terms. At least where the junior lienholder's claim is partially secured, any modification of those rights proposed in a Chapter 13 plan is impermissible under § 1322(b)(2).

C. *Lam v. Investors Thrift (In re Lam)*, 211 B.R. 36 (B.A.P. 9th Cir. 1997) – The ruling in *Nobelman* that § 1322(b)(2) bars a Chapter 13 plan from modifying the rights of partially secured holders of residential mortgages does not apply to holders of totally unsecured claims, because those creditors hold no "secured claims" within the meaning of § 1322(b)(2).

V. May a lien strip-off (as opposed to a lien strip-down) be accomplished in a Chapter 7 proceeding, notwithstanding *Dewsnup*?

A. Yes

McNeal v. GMAC Mortg., LLC (In re McNeal), No. 11-11352, 2012 WL 1649853 (11th Cir. May 11, 2012). Under the Eleventh Circuit's "prior panel precedent" rule, a later panel may depart from an earlier panel's decision only when the intervening Supreme Court decision is "clearly on point." The Supreme Court's decision in *Dewsnup* only addressed lien strip-downs in Chapter 7s, not lien strip-offs. Because the prior Eleventh Circuit decision in *Folendore v. U.S. Small Bus. Admin.*, 862 F.2d 1537 (11th Cir. 1989) permitted lien strip-offs in Chapter 7s, the "prior panel precedent" rule of the Eleventh Circuit means that the *Folendore* ruling will continue to apply in that Circuit.

B. No

1. *Laskin v. First Nat'l Bank of Keystone (In re Laskin)*, 222 B.R. 872 (B.A.P. 9th Cir. 1998). In concluding that lien strip-offs are not permissible in Chapter 7 proceedings, the Court emphasized that the lien strip-off which was permitted in *Lam* was based on § 1322(b)(2) and not on the distinction drawn between §§ 506(a) and 506(d) in *Dewsnup*. The Court also noted that there is no provision in Chapter 7 equivalent to § 1325(a)(5)(B)(ii), a section which requires the determination of secured claims in the confirmation of Chapter 13 plans. The Court further noted that it does not even make sense to deal with claim allowance in a no-asset Chapter 7 case: "In contrast to Chapter 13, where claims must be allowed or disallowed to determine what gets paid

through the plan, and the would-be secured creditor whose claim is allowed only as unsecured gets paid as an unsecured creditor, the allowance of a secured claim, or determination of secured status is meaningless in a Chapter 7 where the trustee is not disposing of the putative collateral." *Id*. at 876. This was crucial to the Court's reasoning because "*Dewsnup* teaches that, unless and until there is a claims allowance process, there is no predicate for voiding a lien under § 506(d). Absent either a disposition of the putative collateral or valuation of the secured claim for plan confirmation in Chapter 11, 12 or 13, there is simply no basis on which to avoid a lien under § 506(d)." *Id*. Finally, "Section 506 was intended to facilitate valuation and disposition of property in the reorganization chapters of the Code, not to confer an additional avoiding power on a Chapter 7 debtor. In contrast to Chapter 13 debtors, who may use § 506 to determine the amount to be paid to a creditor as a secured claim in return for at least a chance of being paid as an unsecured creditor, Laskin seeks to use § 506(d) to expand the rights afforded Chapter 7 debtors by removing an encumbrance from his real property, which he intends to retain. This result is not authorized by the Bankruptcy Code, and is clearly prohibited by *Dewsnup*." *Id*. (citation omitted).

2. *Ryan v. Homecomings Fin. Network*, 253 F.3d 778 (4th Cir. 2001). The Court held that the reasoning of *Dewsnup* applied equally to Chapter 7 lien strip-offs and to Chapter 7 lien strip-downs. The Court rejected the argument that *Nobelman* changed this result, pointing out that *Nobelman* barely discussed either *Dewsnup* or § 506(d).

3. *Talbert v. City Mortg. Servs. (In re Talbert)*, 344 F.3d 555 (6th Cir. 2003). The Court reached the same result, with the same analysis, as *Ryan*.

VI. Proper method to accomplish lien strip-off in Chapter 13

A. Adversary proceeding required

1. *In re Ginther*, 427 B.R. 450 (Bankr. N.D. Ill. 2010). Because the Debtor seeking a lien strip-off is not seeking to "value" the junior lien under Fed. R. Bankr. P. 3012 (in which case a motion would suffice), but instead is seeking to avoid it entirely under Fed. R. Bankr. P. 7001(2), an adversary proceeding is required. However a creditor may waive his right to an adversary proceeding by failing to object to lien strip-off through an alternative procedure.
2. *In re Forrest*, 424 B.R. 831 (Bankr. N.D. Ill. 2009). The Court applied the same rationale as the *Ginther* case, but also emphasized the necessity to protect the due process rights of the lien holder through the heightened notice requirements imposed in adversary proceedings.

B. Adversary proceeding not required; can strip lien by way of motion or adversary proceeding

1. *In re King*, 290 B.R. 641 (Bankr. C.D. Ill. 2003). The Debtor may not strip a lien under a Chapter 13 plan. She must proceed either by adversary proceeding or motion.
2. *Stewart v. JP Morgan Chase Bank (In re Stewart)*, 408 B.R. 215 (Bankr. N.D. Ind. 2009). Under the Seventh Circuit's decision in *In re Hanson*, 397 F.3d 482 (7th Cir. 2005), a Chapter 13 plan cannot, in and of itself, modify

creditors' interests under circumstances in which those interests are more properly dealt with under a different procedural mechanism under the Bankruptcy Code. Lien-stripping in Chapter 13 proceedings is contemplated either by Fed. R. Bankr. P. 3012 (i.e., by contested motion) or by Fed. R. Bankr. P. 7001(2) (i.e., by adversary proceeding) and not by plan. The Court further opined that Debtors can proceed by motion only where there is a single junior mortgage to be stripped. Where there is more than one, the Debtor must file an adversary proceeding.

C. Can strip lien under plan, by motion or by way of an adversary proceeding, so long as the creditor's due process rights are observed

In re Stassi, No. 09-71563, 2009 WL 3785570 (Bankr. C.D. Ill. Nov. 12, 2009). The Court followed what it described as the majority of cases in permitting lien-stripping to be accomplished through motion or plan, recognizing that some courts require adversary proceedings. The Court's primary emphasis was on the quality of notice provided to the creditor, stressing that Fed. R. Bankr. P. 9014 requires the same type of heightened notice that would be provided in an adversary proceeding.

D. My Rule

I follow a modified version of *Stassi*. I will let attorneys select which procedure they want to use - adversary proceedings, motions or plans. However, the heightened notice requirements applicable to adversary proceeding must be observed. In the case of lien-stripping through a plan, I require not only service by certified mail on an officer of the lender if it is an

insured depository institution, but also explicit and conspicuous language in the notice of service itself emphasizing that the plan seeks to strip the lien of the junior lienholder.

VII. Is discharge eligibility necessary for lien strip? The "Chapter 20" Issue

A. Yes

1. *In re Jarvis*, 390 B.R. 600 (Bankr. C.D. Ill. 2008). In this case, the Debtor received a Chapter 7 discharge and then quickly filed Chapter 13 in an attempt to strip-off the junior lien. The Court held, consistently with *Dewsnup*, that liens generally pass through bankruptcy and that eligibility for Chapter 13 discharge was therefore necessary to obtain junior lien strip-off. Here, the Debtor's recent Chapter 7 discharge made the Debtor ineligible for a Chapter 13 discharge, so the lien strip-off was unavailable.
2. *Lindskog v. M & I Bank FSB (In re Lindskog)*, 451 B.R. 863 (Bankr. E.D. Wis. 2011). Same result and rationale as *Jarvis*.
3. *Erdmann v. Charter One Bank (In re Erdmann)*, 446 B.R. 861 (Bankr. N.D. Ill. 2011). The Court agreed with the majority of courts that discharge eligibility is a prerequisite to lien stripping. The Court also held that giving notice of lien stripping only under a plan denies due process to the junior lienholder.
4. *In re Fenn*, 428 B.R. 494 (Bankr. N.D. Ill. 2010). Same analysis and result as *Jarvis*.

B. No

1. *In re Fair*, 450 B.R. 853 (E.D. Wis. 2011). In concluding that a Chapter 13 discharge is not a prerequisite to lien-stripping, the Court uncoupled § 506(a) from the discharge issue in Chapter 13 proceedings. Section 506(a) provides the statutory authority for a court to declare that a lien that is completely under water is not a secured claim. Once that determination has been made, §§ 1322 and 1325 do not apply, because those provisions apply only to secured claims. However, the Court noted that it still retains power to disapprove the lien strip-off if it determines that the Chapter 13 proceeding was filed in bad faith and proof that it was filed solely for the purpose of stripping off the junior lien is strong evidence of bad faith.
2. *In re Okosisi*, 451 B.R. 90 (Bankr. D. Nev. 2011). Like the Court in *Fair*, the Court in *Okosisi* held that § 1325(a)(5) only applies to "allowed secured claims." Moreover, under *Nobelman*, "when a creditor is wholly unsecured after application of Section 506(a), the creditor has only an unsecured claim for purposes of Section 1322(b)(2)." *Id*. at 98. Unsecured creditors' rights "are subject to modification through the chapter 13 plan . . . and do not qualify to be treated as secured creditors for purposes of Section 1325(a)(5)." *Id*. Where, upon completion of a Chapter 13 plan, the Debtor is not eligible for a discharge, the case will be closed without discharge rather than dismissed. As a result, "the code sections that reverse any lien avoidance actions contained within a chapter 13 plan upon conversion or dismissal are not implicated, and, thus, do not act to prevent the permanence of the lien avoidance." *Id*. at 100.

"Once a debtor successfully completes all plan payments required by a chapter 13 plan, the provisions of the plan become permanent, and the lien avoidance is, similarly, permanent." *Id*. "Section 1328(f) only prohibits discharge. . . . If Congress's goal was to limit the operation of Sections 1322(b)(2) and 1327 as well as discharge, it could have explicitly drafted the statute [BAPCPA] to achieve this goal." *Id*. at 101. Finally, the Court concluded that the Chapter 13 had been filed in good faith, because the Debtor had other valid reasons for filing a Chapter 13 petition, it acted equitably in proposing the plan, it was devoting all of its income to the plan, and it did not use serial filings to avoid payment to creditors.

3. *Anderson v. Harris Bank, N.A. (In re Anderson)*, Ch. 13 Case No. 10 B 45294, Adv. No. 10 A 02467, oral ruling (Bankr. N.D. Ill. June 24, 2011) (Goldgar, J.). Citing *Fair* and *Okosisi* with approval, the Court concluded that § 1328(f)(1) does not itself bar a Debtor otherwise ineligible for a discharge from stripping off an unsecured junior lien. That section is instead concerned solely with the availability of discharge. Nor does the Code condition a Debtor's right to confirm a Chapter 13 plan on the Debtor's eligibility for discharge, because § 1325(a)(5) only applies to allowed secured claims. A wholly undersecured junior lien is an unsecured claim under § 506(a).

Elizabeth Anderson v. Harris N.A. (In re Elizabeth Anderson)
Nos. 10 B 45294, 10 A 2467

Ruling on Motion to Dismiss Adversary Complaint
June 24, 2011, at 10:30 a.m.

This adversary proceeding is before the court on the motion of defendant Harris N.A. to dismiss the complaint of plaintiff Elizabeth Anderson. In her complaint, Anderson seeks to strip off Harris's second mortgage lien on Anderson's residence. Harris contends that its lien can't be stripped, even if its claim is wholly unsecured, because Anderson is ineligible for a discharge.

Because Anderson proposes to strip the lien only on the completion of her plan payments, and because Harris hasn't taken issue with her use of an adversary proceeding as a vehicle for lien-stripping, the motion presents no opportunity to address other sticky questions such as when precisely lien-stripping occurs and whether an adversary proceeding is the proper vehicle to accomplish it. The only question on the current motion is whether Anderson's ineligibility for a discharge means she can't strip Harris's lien.

Although, as Harris notes, the vast majority of decisions in this circuit favor Harris's position on this question, the minority view is the correct one. The motion to dismiss will therefore be denied.

1. Facts

On a motion to dismiss under Rule 12(b)(6), all well-pleaded allegations in the complaint are taken as true, and all reasonable inferences are drawn in favor of the non-movant. *Rujawitz v. Martin*, 561 F.3d 685, 688 (7th Cir. 2009).

The complaint alleges the following facts. Debtor Elizabeth Anderson owns real estate located at 1533 Old Barn Road in Libertyville, Illinois. Although Anderson doesn't allege so

specifically, the property appears to be her residence. The property has a fair market value of $424,000. ING Direct holds a first mortgage lien on the property securing a loan with a principal balance of $468,000. Harris has a second mortgage on the property securing a loan. The current balance of that loan is unknown, but the original loan amount was $117,000.

In 2010, Anderson filed a chapter 7 bankruptcy case. She received her discharge on May 26, 2010. On October 9, 2010, five and a half months later, Anderson filed this chapter 13 bankruptcy case. Anderson acknowledges that because she received a chapter 7 discharge within four years of her chapter 13 filing, she is ineligible for a discharge here. *See* 11 U.S.C. § 1328(f)(1).

In her adversary complaint, Anderson seeks to "strip off" Harris's second mortgage and to treat Harris's claim as wholly unsecured. Anderson's proposed plan calls for the same treatment of the Harris claim.

Harris now moves to dismiss Anderson's complaint for failure to state a claim on the ground that a debtor ineligible for a discharge under section 1328(f) can't strip off a wholly unsecured lien.

2. Discussion

Harris's motion to dismiss will be denied. It is well-established that a chapter 13 debtor can strip off a wholly unsecured junior lien on the debtor's residence. Nothing in the Bankruptcy Code suggests that a debtor not eligible for a chapter 13 discharge is barred from employing that restructuring tool.

The starting point of the analysis is section 506(a)(1), which defines when a claim has secured status. Under that section, the term "secured claim" doesn't have the same meaning that it has under state law. Even when a creditor has a security interest under state law, section

506(a) provides that the creditor's claim in bankruptcy is secured only to the extent of the value of the collateral supporting the claim. If the value is less than claim, the claim is undersecured. And if there is no value at all supporting the claim, the claim is unsecured – the security interest under state law notwithstanding.

In a chapter 13 case, a lien that is wholly unsecured under section 506(a) can be removed as an encumbrance on the collateral – "stripped off" is the bankruptcy colloquialism – and the creditor's claim treated as unsecured. The question is how that can be done.

• Some courts say that section 506(d) provides the lien-stripping vehicle. That section voids a lien that secures a claim against the debtor "that is not an allowed secured claim." The problem is that in *Dewsnup v. Timm*, 502 U.S. 410 (1992), the Supreme Court held that section 506(d) doesn't permit lien-stripping in a chapter 7 case, and under section 103(a) of the Code the provisions of chapter 5 (of which section 506(d) is one) apply equally to cases under chapter 13. So what's true for chapter 7 under *Dewsnup* must also be true for chapter 13. (In addition, section 506(d) only permits the voiding of a lien that isn't an "allowed" claim. Since section 502(a) says a claim is "allowed" if filed, section 506(d) can only void a claim that is disallowed or not filed.)

• Rather than section 506(d), the provisions of chapter 13 itself provide the means for stripping off a lien when the creditor is wholly unsecured. *See In re Jarvis*, 390 B.R. 600, 603 (Bankr. C.D. Ill. 2008). Section 1322(b)(2) allows a plan to "modify the rights . . . of holders of unsecured claims." That modification can include stripping of the lien. True, section 1322(b)(2) protects the rights of a holder of "a claim secured only by a security interest in real property that is the debtor's principal residence." But that protection doesn't help a creditor such as a junior lienholder whose claim is unsupported by any value in collateral because under section 506(a) that creditor isn't the holder of a secured claim.

So far, nothing I've said is particularly controversial. Six courts of appeals and two bankruptcy appellate panels have all reached the same conclusion. *See In re Okosisi*, No. BK-S-09-27113-BAM, 2011 WL 2292148, at *2 (Bankr. D. Nev. May 16, 2011) (citing cases). All other things being equal, then, and assuming (as we must) the truth of the complaint's allegations, Anderson could strip off Harris's lien. Harris concedes as much.

What makes the difference here, Harris contends, is that Anderson is ineligible for a discharge in her chapter 13 case. In 2005, the Bankruptcy Code was amended to add section 1328(f), which provides in part that "the court shall not grant a discharge of all debts provided for in the plan or disallowed under section 502, if the debtor has received a discharge (1) in a case filed under chapter 7 . . . during the 4-year period preceding the date of the order for relief under this chapter."

Although courts are deeply split on the issue, the majority of courts agree with Harris, holding that a debtor who won't receive a discharge under this section can't strip off a wholly unsecured junior lien. At least five decisions in this circuit have reached this conclusion. *See Lindskog v. M & I Bank FSB (In re Lindskog)*, Nos. 10-27037-jes, 10-2278, 2011 WL 1576561 (Bankr. E.D. Wis. April 13, 2011); *Erdmann v. Charter One Bank (In re Erdmann)*, 446 B.R. 861 (Bankr. N.D. Ill. 2011); *In re Fenn*, 428 B.R. 494 (Bankr. N.D. Ill. 2010); *In re Blosser*, Nos. 07-28223-svk, 08-2353, 2009 WL 106445 (Bankr. E.D. Wis. April 15, 2009); *Jarvis*, 390 B.R. 600.

The better view, however, is the minority – well-represented by two recent decisions, *In re Fair*, No. 10-C-1128, 2011 WL 14866021 (E.D. Wis. April 19, 2011), and *Okosisi*, 2011 WL 2292148. As these decisions explain, the reasons underlying the majority view are not convincing.

First, section 1328(f)(1) itself doesn't bar a debtor ineligible for a discharge from stripping off an unsecured junior lien. Nothing in section 1328(f), or any other part of section 1328 for that matter, addresses a debtor's treatment of secured or unsecured claims in a plan or otherwise. Section 1328(f) is concerned solely with the availability of discharge. *See Fair*, 2011 WL 14866021, at *3; *Okosisi*, 2011 WL 2292148, at *8; *In re Tran*, 431 B.R. 230, 235 (Bankr. N.D. Cal. 2010).

Second, nothing elsewhere in the Code conditions a debtor's right to confirm a chapter 13 plan on the debtor's eligibility for a discharge. Courts taking the majority approach often rely on section 1325(a), which discusses requirements for chapter 13 plans. Specifically, these courts cite section 1325(a)(5)(B)(i)(I)(bb), which says that "with respect to each secured claim provided for by the plan," the plan must provide that "the holder of such claim retain the lien securing the claim until the earlier of the payment of the underlying debt determined under non-bankruptcy law; or discharge under section 1328." Courts in the majority reason that if a debtor is stripping off a lien, he isn't letting the creditor retain its lien until the debt is paid in full or until discharge.

The problem with this analysis is it assumes the claim in question is secured. That assumption is critical because section 1325(a)(5) only applies to an "allowed secured claim provided for by the plan." It doesn't apply to unsecured claims. But if no value supports a junior lien, section 506(a) makes the creditor's claim *un*secured rather than secured. And if the claim is unsecured, the limits in section 1325(a)(5) on how that claim can be treated are irrelevant. Decisions like *Fenn* that depend on section 1325(a)(5) for their outcome fail to acknowledge that section 506(a) is always the starting point in sorting out which claims can be given which treatment in a plan. *See Fair*, 2011 WL 14866021, at *3; *Okosisi*, 2011 WL 2292148, at *6.

Third, the policy views of courts in the majority supply no basis for barring a debtor ineligible for a discharge from stripping off a lien. These courts find distasteful the prospect of what they call a "de facto discharge." In *Blosser*, for example, the court said that "allowing a debtor to file chapter 7, discharge all dischargeable debts[,] and then immediately file Chapter 13 to strip off a second mortgage lien would not be much different than simply avoiding the mortgage lien in the chapter 7 itself," something *Dewsnup* doesn't permit. *Blosser*, 2009 WL 1064455, at *1. In *Jarvis*, the court noted that it could "find no evidence that, by adding new § 1328(f), Congress intended to expand debtors' remedies" in this way. *Jarvis*, 390 B.R. at 606.

But section 1328(f) neither expands nor contracts "debtors' remedies." It says nothing about them at all – except, of course, the remedy of discharge. Nor is stripping off an unsecured junior mortgagee's lien a "de facto discharge." *See Fair*, 2011 WL 14866021, at *3 (calling this characterization "inaccurate"). The language of the Code is clear. With no express prohibition, debtors who won't be discharged because of section 1328(f) are just as able to strip liens under section 1322(b)(2) as debtors who will be discharged. Had Congress wanted to limit the operation of section 1322(b)(2), it could have. It didn't. *See Okosisi*, 2011 WL 2292148, at *6. In the absence of some prohibition in the Code itself, it is not the place of courts "to rewrite the statute, turning it into something they consider more logical, sensible, or conducive to human progress or enlightenment." *In re Farrar-Johnson*, 353 B.R. 224, 229 (Bankr. N.D. Ill. 2006).

3. Conclusion

For these reasons, the motion of Harris, N.A. to dismiss the adversary complaint of debtor Elizabeth Anderson is denied. Harris has 28 days to answer the complaint. A separate scheduling order will be entered.