Consumer Track

Lien-Stripping in Consumer Bankruptcy: Bringing or Defending Actions to Avoid Junior Mortgages

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DISCHARGE ELIGIBILITY AND LIEN STRIPPING: CAN A DEBTOR NOT ELIGIBLE FOR DISCHARGE STRIP OFF A LIEN?

BY: MOHAMMED O. BADWAN, ESQ.

1) The Bankruptcy Code does not contain a section that directly addresses lien stripping. It is the interplay of a combination of sections that permits a debtor to strip off wholly unsecured liens. It is widely accepted that a debtor may strip off wholly unsecured liens in a Chapter 13 if the debtor is eligible for discharge. However, the issue of whether a debtor not eligible for discharge may strip off a lien has divided the courts.

    a) Common scenario in which the issue arises:

        i) Debtor files a Chapter 7 case and receives a discharge of all dischargeable debts. Debtor is not eligible for a Chapter 13 discharge for 4 years. All unavoided liens on debtor's property pass through the discharge unaffected. Debtor then files a Chapter 13 on the heels of the Chapter 7 discharge (commonly known as a Chapter 20) to reinstate a mortgage. Can the debtor strip off any fully unsecured liens notwithstanding the fact the Debtor is not eligible for discharge? (1) As explained below the courts are divided on this issue.

2) Relevant statutes:
    a) 11 U.S.C. §1328(f)(1):
        i) A debtor is prohibited from receiving a Chapter 13 discharge if the debtor received a discharge in a Chapter 7, 11, or 12 case in the four (4) years preceding the date of the order for relief in the Chapter 13 case.

    b) 11 U.S.C. §1322(b)(2):
        i) A 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.

    c) 11 U.S.C. §1325(a)(5):
        i) One of the requirements for a confirmable Chapter 13 Plan, absent creditor acceptance, is that the plan provide that the holder of an allowed *secured claim* retain its lien until the earlier of a) the payment of the underlying debt or b) discharge.

    d) 11 U.S.C. §506:
        i) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under 552 of this

title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property.

3) Anti-Chapter 20 lien stripping: Debtor must be discharge eligible.
   a) Applicable law:
      i) State law dictates the validity of a lien. §1322(b) allows a debtor to modify the rights of a secured creditor unless the secured claim arises from a security interest on the debtor's principal residence. §506 dictates whether a claim is secured for bankruptcy purposes. Pursuant to §1325(a)(5), the secured creditor will retain its lien until the earlier of a) the payment of the underlying debt or b) discharge.
   b) Argument:
      i) Considering the debtor in a Chapter 20 context is not eligible for discharge then the only way to extinguish the lien is for payment of the underlying debt.

4) Pro-Chapter 20 lien stripping: Debtor need not be eligible for discharge.
   a) Applicable law:
      i) State law dictates the validity of a lien. §1322(b) allows a debtor to modify the rights of a secured creditor unless the secured claim arises from a security interest on the debtor's principal residence. §506 dictates whether a claim is secured for bankruptcy purposes. Pursuant to §1325(a)(5), the secured creditor will retain its lien until the earlier of a) the payment of the underlying debt or b) discharge.
   b) Argument:
      i) Whether a debtor is eligible for discharge is irrelevant. If the claim is unsecured pursuant to §506 then the debtor may modify the rights of the secured creditor pursuant to §1322(b)(2) and §1325(a)(5) is inapplicable as it only applies to *secured claims*. The wholly unsecured lien is not a secured claim pursuant to §506 and thus §1325(a)(5) does not apply.

5) Major rulings:
      i) Anti-Chapter 20 lien stripping:
         (1) The 10th Circuit concluded that a debtor's Chapter 13 Plan must conform to 11 U.S.C. §1325(a)(5)(B), and that a proposal to strip off a wholly unsecured junior mortgage without being eligible for a discharge would violate the lien retention provision of §1325(a)(5)(B)(i), which requires a plan to provide that a secured

creditor retain its lien *until discharge*. (*Emphasis added*.) *Prairie v. Picht (In re Picht),* 428 B.R. 885 (10th Cir. BAP 2010).

(a) The 10th Circuit followed the rulings in (non-exhaustive list):
  (i) *In re Fenn,* 428 B.R. 494 (Bankr.N.D.Ill. 2010)
  (ii) *In re Jarvis,* 390 B.R. 600 (Bankr.C.D.Ill. 2008)
  (iii) *In re Mendoza,* 2010 WL 736834 (D.Colo. 2010)
  (iv) *In re Blosser,* 2009 WL 1064455 (Bankr.E.D.Wis. 2009)

ii) Pro-Chapter 20 lien stripping:

(1) Unlike the 10th Circuit, the 8th Circuit held that §1325(a)(5) does not apply in the case of a wholly unsecured lien as §1325(a)(5) only applies to allowed secured claims as governed by §506. *In re Fisette,* 455 B.R. 177, 185 (8th Cir. BAP 2011).

(a) Consequently, the 10th Circuit held, "a debtor's ability to strip off a lien is effective upon completion of his obligations under his plan, rather than on his receipt of a discharge." *Fisette* at 185.

(2) The 6th Circuit adopted the holding of the 10th Circuit:

(a) "We conclude that the Bankruptcy Code permits the result advanced by the debtors. The starting point for our analysis is *Bateman,* where we held that a Chapter 13 debtor need not be eligible for a discharge in order to take advantage of the protections afforded by Chapter 13. Therefore, if the Bankruptcy Code provides a mechanism for stripping off worthless liens absent a discharge, a debtor may avail himself of that relief." *In re Davis*, 716 F.3d 331, 338 (4th Cir. 2013).

(3) The 10th and 6th Circuits followed the rulings in (non-exhaustive list):
  (i) *In re Frazier*, 469 B.R. 889, 900 (Bankr.E.D.Cal. 2012)
  (ii) *In re Gloster,* 459 B.R. 2005, (Bankr.D.N.J. 2011)
  (iii) *In re Okosisi,* 451 B.R. 90, 103 (Bankr.D.Nev. 2011)
  (iv) *In re Tran,* 431 B.R. 230, 237 (Bankr.N.D.Cal. 2010)
  (v) *In re Grignon,* 2010 WL 5067440 (Bankr.D.Or. 2010)
  (vi) *In re Hill,* 440 B.R. 176, 182 (Bankr.S.D.Cal. 2010)

WHAT IS THE MEANING OF "PRINCIPAL RESIDENCE" IN THE CONTEXT OF §1322(b)(2) AND §1123(b)(5)?

BY: MOHAMMED O. BADWAN, ESQ.

1) The Bankruptcy Code generally allows for debtors to modify the rights of holders of secured claims. However, the exception to the modification rights is if the secured creditor has a secured claim against the debtor's principal residence. Naturally, creditors and debtors take opposite views on how the courts should interpret "principal residence" for bankruptcy purposes as the ramifications of which view the courts adopt are rather significant.

   a) Common scenario in which the issue arises:

      i) Debtor owns and resides in a 4-unit building. Debtor occupies one of the units. The fair market value of the building is $200,000. The building is encumbered by a mortgage lien in the amount of $400,000. The debtor proposes to cramdown the mortgagee's claim to its fair market value of $200,000 (secured claim of $200,000 and unsecured claim of $200,000). The mortgagee objects to the cramdown because it is the debtor's "principal residence" and thus its rights may not be modified.

2) Relevant statutes:

   a) 11 U.S.C. §101(13):
      i) The term "debtor's principal residence"
         (1) (A) means a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to real property; and
         (2) (B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer if used as the principal residence by the debtor.

   b) 11 U.S.C. §1322(b)(2):
      i) A 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.
      ii) This section is commonly referred to as the "anti-modification clause".

   c) 11 U.S.C. §1325(a)(5):
      i) The Court shall confirm a plan if with respect to each allowed secured claim provided for by the plan if the plan provides the value, as of the effective date of the plan, of property to be distributed under the plan

on account of such claim is not less than the allowed amount of such claim.

d) 11 U.S.C. §506:
   i) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under 552 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property.

e) 11 U.S.C. §1123(b)(5):
   i) A Chapter 11 plan my modify the rights of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence.

3) 11 U.S.C. §1322(b)(2) and 11 U.S.C. §1123(b)(5) are identical, accomplishing the same goal in Chapter 11 as in Chapter 13. See *In re Abrego,* 506 B.R. 514 (N.D.Ill. 2014), *In re Benafel,* 461 B.R. 581 (9th Cir. BAP 2011), *Granite Bank v. Cohen*, 267 B.R. 39, 42 (Bankr.D.N.H. 2001), and *Lomas Mortgage, Inc. v. Louis*¸ 82 F.3d 1 (1st Cir. 1996).

4) The distinction on whether a property is a debtor's principal residence is significant. Specifically, a debtor may *not* modify the rights of a secured creditor holding a security interest in the debtor's principal residence.

5) Question of law:
   a) Does the anti-modification clause apply to mixed-use dwellings in which the debtor resides in one of the units?

6) Major Rulings:
   a) Anti-modification clause inapplicable:
      i) *In re Scarborough*, 461 F.3d 406 (3rd Cir. 2006):
         (1) The anti-modification clause does *not* apply to multi-unit buildings in which the debtor resides in one of the units.
            (a) "However, Congress did not, thus the absence of any express terms is indicative of Congress' intent to exclude multi-unit dwellings in which a debtor resides in a unit outside the purview of the anti-modification clause. By using the word "is" in the phrase "real property that *is* the debtor's principal residence," Congress equated the terms "real property" and

"principal residence." Put differently, this use of "is" means that the real property that secures the mortgage must *be only* the debtor's principal residence in order for the anti-modification provision to apply. We thus agree with the reasoning of the Bankruptcy Court for the District of Connecticut when it noted that § 1322(b)(2) "protects claims secured only by a security interest in real property that *is* the debtor's principal residence, not real property that *includes* or *contains* the debtor's principal residence, and not real property *on which the debtor resides." In re Adebanjo,* 165 B.R. 98, 104 (Bankr.D.Conn.1994). A claim secured by real property that is, even in part, *not* the debtor's principal residence does not fall under the terms of § 1322(b)(2). Consequently, "real property which is designed to serve as the principal residence not only for the debtor's family but for other families is not encompassed by the clause." *Id.; see also In re Maddaloni,* 225 B.R. 277, 280 (D.Conn.1998) ("[T]he use of 'is' without any modifier (*e.g.,* 'in whole' or 'in part') does not evince an intent by Congress to apply the antimodification provision to real property that includes, but is more than, a debtor's residence."); *In re McGregor,* 172 B.R. 718, 720 (Bankr.D.Mass.1994) (relying on plain language of § 1322(b)(2) to permit modification of claim secured by "the debtor's residence and property which has 'inherently income producing' power"); *In re Legowski,* 167 B.R. 711, 714 (Bankr.D.Mass.1994) . *In re Scarborough*, 461 F.3d 406, 411 (3rd Cir. 2006).

ii) *Lomas Mortgage Inc. v. Louis*, 82 F.3d 1 (1st Cir. 1996):
   (1) The anti-modification clause does *not* apply to multi-unit buildings in which the debtor resides in one of the units.
      (a) "Additionally, extending the antimodification provision to multi-family houses would also create a difficult line-drawing problem. It is unlikely Congress intended the antimodification provision to reach a 100-unit apartment complex simply because the debtor lives in one of the units. Limiting the antimodification provision to single-family dwellings creates a more easily administered test. We are left then without clear guidance on the question here from either the language or contemporaneous legislative history of § 1322(b)(2). But there is guidance

from another source: the amendments to Chapter 11 contained in the Bankruptcy Reform Act of 1994, Pub.L. No. 103-394, 108 Stat. 4106 (1994) (codified in scattered sections of 11 U.S.C.). In those amendments Congress referred favorably to case law under Chapter 13 holding that the antimodification provision did not apply to multi-family housing, and established that it wished petitions under Chapter 11 and Chapter 13 to treat the matter in the same way." *Lomas Mortgage Inc.* at 6.

iii) Holdings consistent with *Scarborough* and *Lomas Mortgage Inc. v. Louis:*
(1) *Bullard v. Hyde Park Savings Bank*, 494 B.R. 92, 97 (1st Cir. BAP 2013)
(2) *In re Abrego*, 506 B.R. 509 (Bankr.N.D.Ill. 2014)
(3) *In re Johnson-Hines*, 2012 WL 1820881 (Banr.N.D.Ga. 2012)
(4) *In re Adenbanjo*, 165 B.R. 98, 104 (Bankr.D.Conn. 1994)
(5) *In re Maddaloni*, 225 B.R. 277, 280 (D.Conn. 1998)
(6) *In re McGregor*, 172 B.R. 718, 720 (Bankr.D.Mass. 1994)
(7) *In re Legowski*, 167 B.R. 711, 714 (Bankr.D.Mass. 1994)
(8) *In re Del Valle*, 186 B.R. 347 (Bankr.D.Conn. 1995)
(9) *In re McVay.*, 150 B.R. 254 (Bankr.D.Or. 1993)

b) Anti-modification clause does apply:
i) *In re Wages*, 2014 WL 1133924 (9th Cir. BAP 2014):
(1) "Finally, there is the bright-line approach taken by the bankruptcy court in *In re Macaluso*, 254 B.R. 799, 800 (Bankr.W.D. N.Y. 2000). The Court held that the anti-modification exception in §1322(b)(2) applies to any property that is used as the debtor's principal residence, notwithstanding the fact that the debtor's property in that case included a second residential unit an a store. We conclude that the bright-line approach is most consistent with the plain language of §1123 (b)(5). As noted by the bankruptcy court, the plain language of §1123(b)(5) does not protect from modification 'claim[s] secured only by a security interest in real property that is *exclusively* the debtor's principal residence,' or 'claim[s] secured only by a security interest in real property that is the debtor's principal residence *unless the debtor also uses the property for significant commercial purposes.' Wages,* 479 B.R. at 581. We agree with the bankruptcy court's assessment that is

nothing in the bankruptcy code indicating that once, a commercial use of a property becomes sufficiently 'significant,' that property ceases being the debtor's principal residence--either a property is a debtor's principal residence or it is not. The adoption of an objective rule eliminates line drawing and promotes certainty in the home mortgage lending market. However, the downside is that a bright line rule may sometimes lead to harsh results. Nonetheless, 'the potential harsh results can not be used as an excuse by the Court to torture the Code's language to reach a different rule in this case. Even if the Court does not agree with all of the possible outcomes produced by the statutory language, it is Congress, not this Court, that must repair any problems with the Code.....Finally in support of their argument, debtors contend that the bankruptcy court's bright line construction of §1123(b)(5) seems to eliminate the use of the word 'only'. This textual argument is unpersuasive. Essentially debtors add a second 'only' into the statutory language to further the limit the application of §1123(b)(5). Although the statute uses 'only' to require the secured creditor have no other security for the debt, the Debtors construe the statute also to require that the residential structure serve on one function, that being their principal residence...The Debtor's argument finds no support in the plain language of the Code. There simply is no second 'only' in the statutory language of §1123(b)(5), nor any way to read the one usage of that term to limit the use of the property rather than limiting the extent of the collateral for the secured debt."

ii) Holdings consistent with *Wages*:
(1) *In re Macaluso*, 254 B.R. 799 (Banr.W.D.N.Y. 2000)

7) The strong majority of courts ignore the parties' intention on the loan transaction date for determining whether a property is a debtor's principal residence. *See In re Wages,* 2014 WL 1133924 (9th Cir. BAP 2014).

CHAPTER 13 LIEN STRIP - PROCEDURAL HIGHLIGHTS, BURDENS OF PROOF, AND RECOMMENDATIONS

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I. PROCEDURE

A debtor must utilize the interaction of 11 U.S.C. §§ 506(a) and 1322(b)(2) to strip a wholly unsecured lien that encumbers the debtor's principal residence in a Chapter 13 case. *See, e.g., SunTrust Bank v. Millard (In re Millard)*, 414 B.R. 73 (D. Md. 2009). 11 U.S.C. § 506(a) is utilized to establish that the lien is wholly unsecured; then, 11 U.S.C. § 1322(b)(2) provides an opportunity through which a debtor can modify the lien. The Bankruptcy Code and Federal Rules of Bankruptcy Procedure, however, do not provide a specific procedure for moving forward with such action. Additionally, the courts are split as to the appropriate procedure that debtors must utilize for this endeavor.

The majority of courts allow a debtor to value collateral either through motion practice pursuant to Fed. R. Bankr. P. 3012, through the plan confirmation process without the need of a separate motion, or through either process. *See, e.g., In re Bennett*, 312 B.R. 843 (Bankr. W.D. Ky. 2004) (motion); *In re Hudson*, 260 B.R. 421 (Bankr. W.D. Mich. 2001) (plan confirmation); *In re Millspaugh*, 302 B.R. 90 (Bankr. D. Idaho 2003) (both).

A minority of courts, however, have held that Fed. R. Bankr. P. 7001(2) requires a debtor to initiate an adversary proceeding to strip a lien because it is a request to determine the "validity, priority, or extent of a lien or other interest in property." Additionally, these courts believe that an adversary proceeding guarantees that the defendant will receive due process through the issuance and service of a summons and complaint as well as "all the trappings of traditional civil litigation." Further, these courts believe that adversary proceedings provide a greater degree of notice to a defendant that is clear, specific, and to the point. *See, e.g., In re Forrest,* 424 B.R. 831 (Bankr. N.D. Ill. 2009)*; SLW Capital, LLC v. Mansaray-Ruffin (In*

Mansary-Ruffin), 530 F.3d 230 (3d Cir. 2008); *but see, Thomas v. City of Philadelphia (In re Thomas)*, 497 B.R. 188 (Bankr. E.D. Penn. 2013) (suggesting *Mansaray-Ruffin* may have been overruled in part by *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 130 S.Ct. 1367, 176 L. Ed. 2d 158 (2010), insofar as it "suggested that the failure to employ the adversary proceeding procedures, when applicable, constitute a per se due process violation.")

Regardless of the procedure, the lien strip should be initiated prior to the confirmation of the Chapter 13 plan as courts have held that the binding effect of a confirmed plan prevents a debtor from later modifying the confirmed plan in order to strip off a mortgage. *See, e.g., In re Nolan*, 232 F.3d 528 (6th. Cir. 2000); *In re Shook*, 278 B.R. 815 (B.A.P. 9th. Cir. 2002).

II. BURDENS OF PROOF

Generally, to strip off a mortgage encumbering the debtor's principal residence, the debtor must establish that the lien is wholly unsecured. *See, e.g., Lane v. Western Interstate Bank Corp.*, 280 F.3d 663 (6th. Cir. 2002) (Chapter 13 debtor may strip off wholly unsecured second mortgage).

The Bankruptcy Code and Federal Rules of Bankruptcy Procedure, however, do not define which party has the ultimate burden of proof in the context of a motion under 11 U.S.C. § 506(a) to determine the value of collateral. Nevertheless, there are three approaches courts consider when determining the issue. They are: (1) the secured creditor bears the burden of proof by a preponderance of the evidence (*See, e.g., In re Sneijder*, 407 B.R. 46 (Bankr. S.D.N.Y. 2009)); (2) the debtor bears the burden of proof by a preponderance of the evidence (S*ee, e.g., In re Weichey*, 405 B.R. 158 (Bankr. W.D. Pa. 2009)); and (3) a burden shifting analysis in that the debtor bears the initial burden of proof to overcome the presumed validity and amount of the creditor's secured claim, but the ultimate burden of persuasion is upon the creditor to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim (S*ee, e.g., In re Robertson*, 135 B.R. 350 (Bankr. E.D.

Ark. 1992)). *See also, In re Heritage Highgate, Inc*., 679 F.3d 132, 139-140 (3d Cir. 2012) (court reviewed the three approaches).

III. RECOMMENDATIONS

A. Senior Liens

The pleading initiating the lien strip should state the amount of all liens that are in priority to the subject mortgage. This amount should include all senior mortgages, priority tax liens, and other liens or encumbrances that are in priority to the subject mortgage. The practitioner can obtain this information from the proof of claim for each lien holder, which is prima facie evidence of the validity and amount of the claim. Even if a proof of claim has not been filed with the court, recent statements from the lien holder may be sufficient to provide the information necessary to proceed with the action. In absence of a proof of claim, however, the debtor should be prepared to present testimony from the lien holder as to the amount owed on the petition date.

B. Property Value

The pleading should also state the value of the property. Many practitioners utilize the value of the property that the debtor provided in Schedule A of the Petition; however, because debtors generally do not have any expertise in valuing residential properties, many courts give little weight to such value, even when the subject mortgagee has not responded to the Complaint, Motion, or Plan. Courts give far more weight to values provided by appraisers. Courts also give weight to individuals with the experience and expertise in providing Broker Price Opinions. The best option, however, is to simply obtain an appraisal of the property. Additionally, while the utilization of a "State Equalized Value" may be sufficient to initiate the action, solely relying upon that value to meet the burden of proof is not recommended because many courts do not consider it as a reliable indicator of the value of the property.

C. Mortgage and Property Information

The pleading should also provide sufficient information regarding the mortgage that is subject to avoidance and the subject property. Such information includes, but is not limited to, the recording information and legal description of the property. This information not only aides the court and mortgagee when determining which mortgage is subject to the action, but will also become a necessary component of any order or document that is submitted for recordation with the register of deeds.

D. Due Process

To ensure that the mortgagee receives due process, it is recommended that all pleadings are served in accordance with Fed. R. Bankr. P. 7004. Rule 7004(b)(3) and (h) is applicable to corporations and insured depository institutions.

Rule 7004(b)(3) states that service may be made upon a corporation by first class postage prepaid by mailing a copy of the summons and complaint to the attention of an officer, a managing or general agent, or to any other agent authorized by appoint, or by law, to receive service of process and, if the agent is one authorized by statute to receive service and the statute so requires, by also mailing a copy to the defendant.

Rule 7004(h) states that service upon 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.

Fed. R. Bankr. P. 7004.