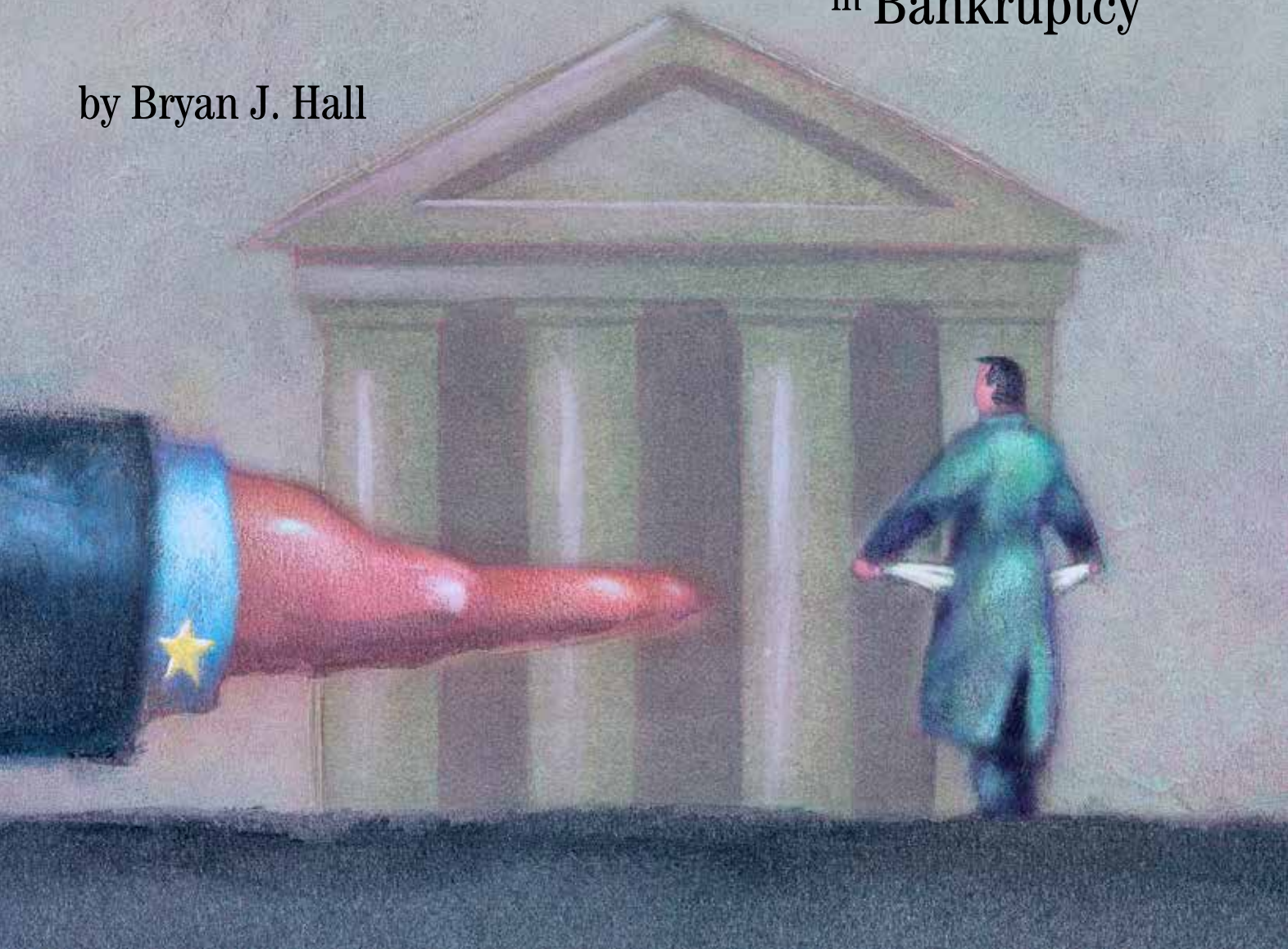


Stripping Liens to Save Their Homes: Debtors' Options to Reduce Mortgage Debt in Bankruptcy

by Bryan J. Hall



More than 20 percent of American homeowners with mortgages were underwater in 2012, meaning they owed more than their homes were worth.¹ Homeowners with second or third mortgages are twice as likely to be underwater.² For homeowners like these, one of the principal benefits of filing bankruptcy is the ability, in certain circumstances, to reduce their mortgage debt by stripping off unsecured mortgage liens. However, the ability to reduce or eliminate unsecured mortgage debt can depend on where and how the debtor files for bankruptcy.

Secured or Unsecured

When a consumer debtor files for bankruptcy, she has several options including Chapter 7 liquidation, where the debtor keeps all exempt property and the remainder is sold off to satisfy creditors, or Chapter 13 individual reorganization, where the debtor keeps all her pre-filing property but must repay her creditors over a three- or five-year period.³ When a homeowner files bankruptcy, her creditors are entitled to file claims seeking recovery of the full unpaid amount, and secured creditors are entitled to recover the value of their collateral.⁴ Section 502 of the Bankruptcy Code provides that a claim, once filed, is deemed allowed unless a party in interest objects.⁵ However, if a creditor's secured claim exceeds the value of its collateral, that creditor is undersecured.

Bankruptcy Code § 506 provides the mechanism for determining whether a claim is a secured claim or an unsecured claim. Section 506(a) provides that “[a]n allowed claim of a creditor secured by a lien on property ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim.”⁶ Section 506(a) adds that a valuation of the collateral must be made “in light of the purpose of the valuation and of the proposed disposition or use of the property.”⁷ Following on this, § 506(d) provides that “[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void”⁸

This power to void liens is not without limits. For example, a Chapter 13 debtor is prohibited from modifying the rights of a secured creditor whose claim is “secured only by a security interest in ... the debtor's principal residence.”⁹ This so-called anti-modification provision in § 1322(b)(2) allows a mortgage lien on the debtor's home to ride through bankruptcy intact.

Lien Stripping

A secured claim is one that by definition, is secured by a lien on specified collateral. If there is not enough value in the collateral to secure the claim, the debtor may be able to “strip off” the lien entirely or “strip down” the lien to the value of the collateral. Stripping off refers to the process of entirely removing a mortgage lien from the home because there is no value in the home beyond what is encumbered by more senior liens. Stripping down refers to bifurcating the claim into secured and unsecured portions—the secured claim equals the unencumbered fair market value of the home, and the unsecured claim reflects the balance. The effect of either stripping off or stripping down the lien is to render a previously secured claim either wholly unsecured or partially unsecured, with the debtor now able to treat the unsecured portion like other unsecured claims, thus reducing the mortgage debt.¹⁰ Of these two processes, stripping down is the more controversial.

In a pair of decisions, the U.S. Supreme Court has taken a dim view of stripping down partially secured liens. In *Dewsnup v. Timm*, the Court held that a Chapter 7 debtor could not use § 506(d) to strip down a partially secured junior mortgage lien to the fair market value of the property.¹¹ Analyzing the language of §§ 502, 506(a) and 506(d), the Court found that “§ 506(d) does not allow petitioner to ‘strip down’ respondents' lien, because respondents' claim is secured by a lien and has been fully allowed pursuant to § 502.”¹² In other words, in Chapter 7 “the creditor's lien stays with the real property until the foreclosure,” regardless of whether

it is fully or partially secured.¹³ The Court reasoned that this result is consistent with what the borrower and lender had bargained for and that any increase in value in the home during the bankruptcy should accrue to the lender and not the borrower.¹⁴

The following year, in *Nobelman v. American Savings Bank*, the Supreme Court held that a Chapter 13 debtor could not strip down a partially secured junior mortgage lien to the fair market value of the home, because the anti-modification provision in § 1322(b)(2) protected both the secured and unsecured portions of the claim.¹⁵ Therefore, so long as a mortgage lien in a Chapter 13 case is secured by some value, even \$1, the anti-modification provision prohibits the debtor from treating any portion of the claim as unsecured.

The question not answered by *Dewsnup* or *Nobelman* is whether a Chapter 7 debtor and/or a Chapter 13 debtor can strip off a lien on her home when there is no value securing the lien.

Chapter 7

Most courts that have considered the issue have concluded that *Dewsnup's* holding that a Chapter 7 debtor cannot use § 506(a) and (d) to strip down a partially secured lien also prohibits stripping off a wholly unsecured lien. These courts reason that a § 506(a) valuation must be made in light of a purpose, and a valuation for a Chapter 13 repayment plan is a valid purpose, but that a valuation in a Chapter 7 liquidation solely to strip off a junior mortgage lien is not.¹⁶

A few decisions have interpreted *Dewsnup* narrowly to only prohibit strip downs, and have permitted Chapter 7 debtors to strip off unsecured mortgage liens, even in cases where the debtor has no nonexempt assets and creditors will receive nothing.¹⁷ Recently, the U.S. Court of Appeals for the Eleventh Circuit joined this latter group, holding in *In re McNeil* that a Chapter 7 debtor could use § 506 to strip off a wholly unsecured junior mortgage lien.¹⁸ The Eleventh Circuit first found that “because *Dewsnup* disallowed only a ‘strip down’ of a partially secured mortgage lien and did not address a ‘strip off’ of a wholly unsecured lien,” it was inapplicable to a strip off in a Chapter 7.¹⁹ The court then looked to pre-*Dewsnup* Eleventh Circuit precedent which determined that an allowed claim that is wholly unsecured is voidable under the plain language of § 506(d).²⁰ Despite the different purposes for Chapter 7 (liquidation) and Chapter 13 (repayment), the Eleventh Circuit found nothing in *Dewsnup* or the Bankruptcy Code that conflicted with its holding, and thus became the first circuit court to permit strip offs in Chapter 7.²¹

Even more recently, in *Wachovia Mortgage v. Smoot*, the U.S. District Court for the Eastern District of New York reversed a bankruptcy court decision that had permitted a Chapter 7 debtor to strip off a wholly unsecured junior mortgage lien, holding that *Dewsnup* precludes a debtor from stripping off unsecured mortgage liens in Chapter 7.²² This ruling effectively overturned the only decisions other than *McNeil* to permit strip offs in Chapter 7.

Chapter 13

An altogether different state of the law exists in Chapter 13 where courts are generally in agreement that Chapter 13 debtors may strip off wholly unsecured mortgage liens. These courts have found that the anti-modification provision in § 1322(b)(2) does not apply to a wholly unsecured mortgage lien because the claim is not

secured by a lien on the debtor's principal residence, due to the lack of any value in the home to which the lien may attach. The U.S. Court of Appeals for the Second Circuit reasoned in *In re Pond* that

the anti-modification exception of Section 1322(b)(2) protects a creditor's right in a mortgage lien only where the debtor's residence retains enough value—after accounting for other encumbrances that have priority over the lien—so that the lien is at least partially secured under Section 506(a)... Because th[is] lien is wholly unsecured, defendants are not “holders of ... a claim secured only by a security interest in ... the debtor's principal residence,” 11 U.S.C. § 1322(b)(2), and their rights in the lien are not protected under the anti-modification exception of Section 1322(b)(2).²³

The Third, Fourth, Fifth, Sixth, Ninth, and Eleventh Circuits have all concurred with this conclusion.²⁴

Recently, however, the U.S. Court of Appeals for the Tenth Circuit held in *In re Woolsey* that Chapter 13 debtors could not strip off a wholly unsecured mortgage lien.²⁵ *Woolsey* presented a peculiar issue; the debtors argued that the unsecured lien could be avoided solely under § 506(d) and that § 1322(b)(2) was inapplicable to their case.²⁶ Relying on the arguments before it, the Tenth Circuit held that *Dewsnup* unambiguously precluded the use of § 506(d), standing alone, to avoid unsecured mortgage liens.²⁷ The court recognized, as noted above, that every other circuit court that has considered the issue has permitted strip offs in Chapter 13 when analyzing § 506(d) in conjunction with § 1322(b)(2), but the Tenth Circuit did not join the other circuits because the debtors refused to invoke § 1322(b)(2).²⁸

7 + 13 Equals a Chapter 20 Split

With limited exceptions, Chapter 7 debtors cannot strip off wholly unsecured mortgage liens in bankruptcy, while Chapter 13 debtors can. The picture becomes more complex in a so-called Chapter 20 case. Chapter 20 refers to a debtor who files for Chapter 7 and receives a discharge of his personal obligations and then later files a Chapter 13 to reorganize his mortgage debt. In Chapter 7, the debtor can eliminate his personal liability on the mortgage debt but, generally, cannot modify a mortgage or strip off unsecured mortgage liens, so the debtor must file a subsequent Chapter 13 if he seeks to modify the mortgage holder's *in rem* rights against the property.²⁹ If the debtor files for Chapter 13 within four years of receiving the Chapter 7 discharge, he cannot receive a discharge in the Chapter 13 case. As a result, the Chapter 13 case allows the debtor to repay his debts over three or five years, but he cannot discharge those debts.³⁰ The question that has created a split among courts is whether a Chapter 20 debtor can strip off a wholly unsecured junior mortgage lien in his Chapter 13 case, even though that debtor cannot receive a discharge of his debts. This dispute turns on when the lien is avoided.

About half of the courts to consider the issue have concluded that a Chapter 20 debtor cannot strip off an unsecured lien because the lien is not avoided until the debtor receives his discharge or the debt is paid in full.³¹ These courts point to § 1325(a)(5)(B), which requires that for “each allowed secured claim,” the debtor's plan must provide that the lien remains “until the debt is discharged or paid in full”; this section further provides that the lien “remains

intact if the case is dismissed or converted.”³² Thus, these courts conclude that until and unless the debtor receives a discharge (which he cannot in Chapter 20), an unsecured lien is not avoided and cannot be stripped off.

The other half of courts faced with this issue have allowed the Chapter 20 debtor to strip off an unsecured junior lien. These courts reason that § 1325(a)(5) simply does not apply to a wholly unsecured claim because—as noted in the discussion of Chapter 13 above—if there is no value to secure the junior lien, the claim is not an “allowed secured claim,” it is an unsecured claim.³³ These courts find further support in the language of § 1325(a)(5)(B)(i)(II), which provides that a lien is retained if the case is dismissed or converted; however, this provision does not address the scenario where a Chapter 20 debtor completes his plan payments, his case is fully administered, and the case is closed without dismissal or conversion and without the debtor receiving a discharge.³⁴ As the Eighth Circuit Bankruptcy Appellate Panel (BAP) noted in *In re Fisette*, “nothing in the Bankruptcy Code conditions a Chapter 13 debtor's ability to modify a wholly unsecured creditor's lien under § 1322(b)(2) on his eligibility for a discharge,” nor does the Bankruptcy Code include eligibility for a discharge as a requirement for confirmation of a Chapter 13 plan.³⁵ Accordingly, the BAP concluded that a Chapter 20 debtor may strip off an unsecured junior mortgage lien on the debtor's principal residence, and that the lien is avoided upon completion of the debtor's Chapter 13 plan payments, not upon discharge.³⁶

The BAP's decision in *Fisette* was appealed to the U.S. Court of Appeals for the Eighth Circuit, which recently dismissed the appeal for lack of jurisdiction; because the BAP had ordered the case remanded to the bankruptcy court for further consideration of the debtor's plan, the Eighth Circuit found that the BAP decision was not a final order for appeal purposes.³⁷ However, in rejecting the appeal, the Eighth Circuit noted, but did not decide, several issues that can arise when a Chapter 20 debtor seeks to avoid wholly unsecured mortgage liens, including whether the plan was proposed in good faith and whether the plan is otherwise confirmable.³⁸

Conclusion

The state of the law on lien stripping in bankruptcy remains in flux. While most courts do not permit a debtor to strip off a wholly unsecured junior mortgage lien in Chapter 7, but do allow it in Chapter 13, there is some contrary authority. In addition, the law on lien stripping in Chapter 20 cases remains nearly evenly split, with the Eighth Circuit's decision in *Fisette* having raised, but not reached, several important issues. For now, bankruptcy practitioners and other attorneys who are counseling clients in financial distress need to be aware of a debtor's options for avoiding junior mortgage liens in bankruptcy, as well as the current law of their circuit, their district, or even their judge. ☉

Bryan J. Hall is the term law clerk for the Hon. Alan S. Trust, U.S. Bankruptcy Court, Eastern District of New York. None of the statements contained in this article constitutes official policy of any judge, court, agency, government official, or quasi-governmental agency.



Endnotes

¹See Manuel S. Santos, *How Home Loan Modification Through the 60/40 Plan Can Save the Housing Sector*, FED. RES. BANK OF ST. LOUIS REV. 103 (Mar./Apr. 2012) (research.stlouisfed.org/publications/review/12/03/103-116Santos.pdf); Ben S. Bernanke, Speech to the 2012 National Association of Home Builders International Builders' Show (Feb. 10, 2012) (www.federalreserve.gov/newsevents/speech/bernanke20120210a.pdf).

²See Robbie Whelan, *Second-Mortgage Misery*, WALL ST. J. (June 7, 2011) (online.wsj.com/article/SB10001424052702304906004576369844062260756.html).

³A consumer debtor may also file Chapter 11 if, for example, her debts exceed the cap for Chapter 13, or she may file Chapter 12 if the debtor is a family farmer or a family fisherman. See 11 U.S.C. § 109(b), (d), (e) and (f).

⁴FED. R. BANKR. P. 3001; see *Dewsnup v. Timm*, 502 U.S. 410 (1992); *Long v. Bullard*, 117 U.S. 617 (1886).

⁵11 U.S.C. § 502(a) (2011); see § 502(b) for the bases for objecting to claims.

⁶§ 506(a).

⁷*Id.*

⁸§ 506(d).

⁹§ 1322(b)(2); see also § 1325(a)(5) for the requirements for treatment of a secured lien in the Chapter 13 plan. The anti-modification provision in § 1322(b)(2) does not apply to a Chapter 13 debtor's real property that is not the debtor's principal residence, such as a vacation home or investment property. See *In re Russell*, 458 B.R. 731, 737 (Bankr. E.D. Va. 2010); *In re Santiago*, 404 B.R. 564, 569 (Bankr. S.D. Fla. 2009). However, if a debtor seeks to use the Chapter 13 plan process to strip down a partially secured claim on property other than her principal residence, the secured portion of the claim must be satisfied during the three- to five-year term of the plan. See *In re Enewally*, 368 F.3d 1165, 1172 (9th Cir. 2004); *In re Collins*, 2010 WL 5173840, at *3 (Bankr. D. Or. Dec. 15, 2010).

¹⁰See *In re Miller*, 462 B.R. 421, 425 (Bankr. E.D.N.Y. 2011).

¹¹*Dewsnup v. Timm*, 502 U.S. 410, 416–17 (1992).

¹²*Id.* at 417.

¹³*Id.*

¹⁴*Id.*

¹⁵*Nobelman v. American Sav. Bank*, 508 U.S. 324 (1993).

¹⁶See *In re Pomilio*, 45 B.R. 11, 16–17 (Bankr. E.D.N.Y. 2010) (citing cases); see also *In re Miller*, 462 B.R. 421, 434 (Bankr. E.D.N.Y. 2011) (citing *Nobelman*, 508 U.S. at 328–29). (“It was permissible for petitioners to seek a valuation in proposing their Chapter 13 plan, since § 506(a) states that ‘[s]uch value shall be determined ... in conjunction with any hearing ... on a plan affecting such creditor's interest.’”)

¹⁷See *In re Lavelle*, 2009 WL 4043089, at *4–5 (Bankr. E.D.N.Y. Nov. 19, 2009); see also *In re Smoot*, 465 B.R. 730, 734 (Bankr. E.D.N.Y. 2011), *rev'd*, *Wachovia Mortg. v. Smoot*, 478 B.R. 555 (E.D.N.Y. 2012).

¹⁸*In re McNeil*, 477 F. App'x 562 (11th Cir. 2012) (unpublished).

¹⁹*Id.* at 564.

²⁰*Id.* (citing *Folendore v. U.S. Small Bus. Admin.*, 862 F.2d 778 (11th Cir. 1989)).

²¹Other circuit courts have held that Chapter 7 debtors cannot strip off unsecured junior mortgage liens. See *Talbert v. City Mortgage Servs.*, 344 F.3d 555 (6th Cir. 2003); *Ryan v. Homecomings*

Fin. Network, 253 F.3d 778 (4th Cir. 2001); see also *In re Laskin*, 222 B.R. 872 (B.A.P. 9th Cir. 1998).

²²*Wachovia Mortg. v. Smoot*, 478 B.R. 555, 568 (E.D.N.Y. 2012).

²³*In re Pond*, 252 F.3d 122, 126–27 (2d Cir. 2001).

²⁴See *Zimmer v. PSB Lending Corp.* (*In re Zimmer*), 313 F.3d 1220 (9th Cir. 2002); *Lane v. W. Interstate Bancorp* (*In re Lane*), 280 F.3d 663 (6th Cir. 2002); *In re Pond*, 252 F.3d 122, 127 (2d Cir. 2001); *Am. Gen. Fin., Inc. v. Dickerson* (*In re Dickerson*), 222 F.3d 924 (11th Cir. 2000); *Tanner v. First Plus Fin., Inc.* (*In re Tanner*), 217 F.3d 1357 (11th Cir. 2000); *In re Bartee*, 212 F.3d 277 (5th Cir. 2000); *McDonald v. Master Fin., Inc.* (*In re McDonald*), 205 F.3d 606 (3d Cir. 2000); *First Mariner Bank v. Johnson*, 411 B.R. 221 (D. Md. 2009), *aff'd*, 407 F. App'x 713 (4th Cir. 2011) (per curiam) (unpublished); *Suntrust Bank v. Millard* (*In re Millard*), 414 B.R. 73 (D. Md. 2009), *aff'd*, 404 F. App'x 804 (4th Cir. 2010) (per curiam) (unpublished); *Lam v. Investors Thrift* (*In re Lam*), 211 B.R. 36 (B.A.P. 9th Cir. 1997).

²⁵*In re Woolsey*, 696 F.3d 1266, 1272–74 (10th Cir. 2012).

²⁶*Id.* at 1272, 1278.

²⁷*Id.* at 1278; see also *In re Christo*, 2012 WL 3839238, at *5–6 (Bankr. N.D. Ohio Sept. 4, 2012) (reiterating that § 506 does not provide an independent basis to avoid an unsecured mortgage lien and refusing to apply § 1322(b)(2) in a Chapter 7 case).

²⁸*Woolsey.*, 696 F.3d at 1278.

²⁹See *In re Miller*, 462 B.R. 421, 425 (Bankr. E.D.N.Y. 2011); see also *Dewsnup v. Timm*, 502 U.S. 410 (1992).

³⁰See *Miller*, 462 B.R. at 425; 11 U.S.C. § 1328(f)(1).

³¹See, e.g., *In re Orkwis*, 457 B.R. 243, 250 (Bankr. E.D.N.Y. 2011).

³²*Id.*, quoting *In re Geradin*, 447 B.R. 342, 351 (Bankr. S.D. Fla. 2011); see 11 U.S.C. § 1325(a)(5)(B)(i)(I) and (II).

³³See *Miller*, 462 B.R. at 430–31.

³⁴See *id.*

³⁵*In re Fisette*, 455 B.R. 177, 185–86 (B.A.P. 8th Cir. 2011).

³⁶*Id.* at 186.

³⁷See *In re Fisette*, 695 F.3d 803, 804 (8th Cir. 2012), citing 28 U.S.C. § 158(d)(1).

³⁸See *id.* at 805–06, citing 11 U.S.C. § 1325(a)(3), (a)(4), and (b)(1)(B).