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Lien Stripping in Consumer Bankruptcy

Bringing or Defending Actions to Avoid Junior Mortgage Liens

THURSDAY, NOVEMBER 8, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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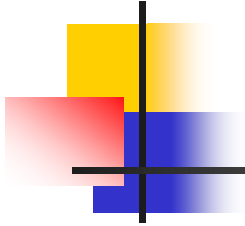
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STRIPPING WHOLLY UNSECURED JUNIOR MORTGAGE LIENS

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What is stripping?

- Bankruptcy procedure to avoid wholly unsecured junior liens that encumber real property.
- Chapter 7. Supreme Court held prohibited lien stripping of residential mortgages in Chapter 7 cases. *Dewsnup v. Timm*, 502 US 410 (1992).
- Chapter 13. Supreme Court bifurcated the issue between lien “strip-off” and lien “strip-down.” Prohibited strip-downs of partially secured liens to the value of the collateral. *Nobleman v. American Savings Bank*, 508 US 324 (1993). No Supreme Court guidance on Chapter 13 lien strip-offs.



Sections 506 and 1322

Section 506(a) determines the secured status of a junior lienholder's claim (fully secured, partially secured, wholly unsecured). Section 506(d) provides for a lien avoidance to the extent that a lien secures a claim against the debtor that is not an allowed secured claim.

Section 1322(b)(2) prohibits a chapter 13 debtor from relying on §506(a) to strip-off a wholly unsecured homestead mortgage.



Courts Authorizing Lien Stripping

- Lien strip-offs allowed by Courts of Appeals in the 1st, 2nd, 3rd, 5th, 9th, and 11th circuits.
- Majority view in most all other circuits.
- No Circuit Court of Appeal has prohibited lien strip-off.



Valuation Becomes the Issue

Is Lien WHOLLY or PARTIALLY unsecured?

- Determine debt amount of senior lender ... Obtain payoff statement from lender.
- Determine value of collateral real estate ... Zillow.com; Realtor's broker opinion (aka Certified Market Appraisal).
- Certified Appraiser Valuation.
- Cost vs. Opposition.



Motion vs. adversary vs. operation of plan

- Adversary is best.
- Rule 7001(2) requires adversary proceeding to determine the validity, priority or extent of a lien in property.
- Local Model Plan language: “The following claims are secured by collateral that either has no value or that is fully encumbered by liens with higher priority. No payment will be made on these claims on account of their secured status, but to the extent that the claims are allowed, they will be paid as unsecured claims.”
- Sample copy of complaint is attached to course materials.



Determine appropriate defendant

- Difficult with all the loan transfers and assignments.
- Review debtor's correspondence.
- Title search.



Service of process

- Non-bank v. bank aka “Insured Depository Institution”
- Service upon non-bank provided in Rule 7004(b)(3):
 - via US Mail addressed to the attention of an officer, managing agent, or any other agent authorized by appointment or by law to receive service of process.
- Secretary of State records for registered agent.
- Service upon Insured Depository Institution is much harder and is provided by Rule 7004(h):
 - via Certified Mail addressed to an officer of the institution
 - Who is an officer? Eg. JP Morgan Chase v. JP Morgan Home Finance v. JP Morgan.
 - Call General Counsel’s office, search the internet, Office of the Comptroller of the Currency, and Federal Reserve Bank, etc.



Jurisdiction

- Rule 7008 requires jurisdictional statement in complaint.
- 28 USC §151 (Designation of bankruptcy courts by district court).
- §157 (core proceeding).
- §1334 (jurisdiction).



Collateral Description

Be specific in your description of the collateral

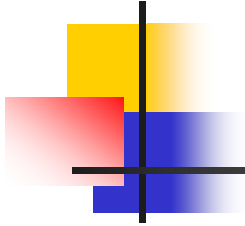
- Street address
- PIN (parcel identification number)
- Legal description.



Chapter 20 cases

- Strip-offs not allowed in some jurisdictions
- Discharge required

The foregoing slide deck was created by Robert V. Schaller of Schaller Law Firm in Oak Brook, IL for a Strafford program on this topic on January 24, 2012.



DEFENSES TO MORTGAGE LIEN STRIPPING IN CONSUMER BANKRUPTCY

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ULTIMATE DEFENSE: YOU HAVE AN "ALLOWED SECURED CLAIM"

- THE CLAIM SECURED BY YOUR LIEN IS CONSIDERED TO BE AN **"ALLOWED SECURED CLAIM"** UNDER ONE OR MORE OF THESE BANKRUPTCY CODE SECTIONS:
 - 11 U.S.C. § 506(a)
 - 11 U.S.C. § 502
 - 11 U.S.C. § 1322(b)(2)
 - 11 U.S.C. § 1325(a)(5)
- These sections protect liens on "ALLOWED SECURED CLAIMS"



STATUTORY BASIS TO VALUE SECURED CLAIM

11 U.S.C. § 506 Determination of secured status

(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, ..., **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. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

§ 506(a) (Emphasis added)

- Secured claims are valued under 506(a).
- The value of a secured claim is the value of the property which secures the claim.
- 506(a) allows secured claims to be bifurcated into secured and unsecured portions.
- How is a wholly unsecured mortgage lien valued under 506(a)?
 - The secured value is \$0.



"ALLOWED" CLAIM AS DEFINED BY § 502

11 U.S.C. § 502 Allowance of claims or interests

- (a) A claim or interest, proof of which is filed under section 501 ... is ***deemed allowed***, unless a party in interest... objects.
- (b) ***Except as provided*** in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and ***shall allow such claim*** in such amount, except to the extent that--...

§ 502 (Emphasis added)

- A claim is valid unless objected to.
- §502 states all grounds under which a filed claim may be disallowed.
- A court may not disallow a claim if the value of an underlying lien is determined to be \$0 because that is not one of the grounds for disallowing claims.
- A filed secured claim is an "allowed" claim.
- Because it has recourse to a lien, it is secured, no matter the value of the lien.



CLAIMS THAT ARE "NOT ALLOWED SECURED CLAIMS" ARE VOID

11 U.S.C. § 506 Determination of secured status

(d) To the extent that a lien secures a claim against the debtor that *is not an allowed secured claim, such lien is void*, unless--
.....

§506(d) (Emphasis added)

- If a lien is valued at \$0 under § 506(a), is it "not an allowed secured claim?"
- Can this section be used to void a wholly unsecured mortgage lien?
 - As an unsecured claim, it could be considered to be "not an allowed secured claim", and so, void.
- Does this section operate to void wholly unsecured liens on its own or in conjunction with 506(a)?



§ 506(d) MAY NOT BE USED TO VOID LIENS ALLOWED UNDER § 502

***Dewsnup v. Timm*, 502 U.S. 410, 417 (U.S. 1992)**

Chapter 7 debtor may not "strip down" a mortgage lien to the value of the real estate and declare void the remaining balance of the claim under 506(d).

- Liens survive bankruptcy.
- 506(d) voids claims that are disallowed under § 502.
- 506(d) does not void claims that are not secured under a 506(a) valuation.
- A Chapter 7 debtor may not "strip down" a mortgage lien to the value of the property.
- The unsecured portion of a mortgage lien may not be voided under 506(d).
- "Allowed Secured Claim" does not have identical meaning in § 506(a) and § 506(d).
- "Allowed Secured Claim" may have a different meaning in another Code sections.



VALUATION OF LIENS UNDER 506(a) IN CHAPTER 13 BANKRUPTCY

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

Chapter 13 debtor may not strip down the mortgage lien to the secured value of his residence

- The interplay between § 506(a) and §1322(b)(2).
- § 506(a) is used to value a claim secured by a mortgage lien.
- §1322(b)(2) prohibits modification of a creditor's rights when its lien is "secured only by a security interest in the debtor's principal residence".
- If a lien is partially secured by a debtor's principal residence, then the creditor's rights may not be modified in a Chapter 13 plan.
- May not Strip Down (Bifurcate) a mortgage under § 506(a) that is "secured only by a security interest in the debtor's principal residence".



Lane v. W. Interstate Bancorp (in Re Lane), 280 F.3d 663, 669 (6th Cir. Tenn. 2002)

Chapter 13 debtor permitted to strip off wholly unsecured mortgage lien from residence

- A lien secured only by a debtor's principal residence is subject to valuation under § 506(a).
- If the lien has any value (even \$1) it is a secured claim and is subject to anti-modification provision of §1322(b)(2).
- If the lien has \$0 value, the claim is unsecured.
- §1322(b)(2) only prohibits modification of claims that are secured.
- If the lien on a debtor's principal residence is wholly unsecured, it is not a secured claim under §1322(b)(2) and so the lien may be "stripped off" in a Chapter 13 bankruptcy

DEFENSES TO LIEN STRIPPING

1. Chapter 20

A. If Debtor is Not Eligible for a Discharge, the Debtor May Not Strip Lien

Conflicting Case Law is Emerging.

Pro-Creditor Law: Chapter 20 Debtors may not strip wholly unsecured liens on principal residence if they are not eligible for a Chapter 13 discharge

- If Debtor obtains a Chapter 7 discharge within 4 years of filing a Chapter 13, they are not eligible for a Chapter 13 discharge- 11 U.S.C. § 1328(f)(1).

- 2005 BAPCPA amendments included lien retention rights for secured creditors:

If a claimant has an "**Allowed Secured Claim**", the claimant is entitled to retain the lien until the earlier of " the payment of the underlying debt determined under nonbankruptcy law; or ...discharge under section 1328". 11 U.S.C. § 1325(a)(5)(B)(i)

- If your claim is an "Allowed Secured Claim", this section applies.
- Ergo, If the debtor is not eligible for a Chapter 13 discharge, the creditor is entitled to retain its lien until the full debt is paid, and it may not be stripped off.



PRO-CREDITOR REASONING

- Decisions adopt *Dewsnup's* definition of "**Allowed Secured Claim**".
- § 506(a) merely values a claim; it alone does not affect liens.
- If there is recourse to an underlying lien, and the claim has not been disallowed under § 502, then it is an "**Allowed Secured Claim**", and the creditor is entitled to retain its lien until discharge or full payment.
- Under § 1325(a)(5) a creditor with an "**Allowed Secured Claim**" retains its lien until the earlier of discharge or payment in full under non-bankruptcy law.

Creditor has an 'Allowed Secured Claim' even if its lien has no value



Cases in accord: (Not intended to be exhaustive)

Orkwis v. MERS (In re Orkwis), 457 B.R. 243 (Bankr. E.D.N.Y. 2011)

In re Rosa, 2011 Bankr. LEXIS 4865 (Bankr. M.D. Fla. Dec. 15, 2011)

In re Quiros-Amy, 456 B.R. 140 (Bankr. S.D. Fla. 2011)

In re Gerardin, 447 B.R. 342 (Bankr. S.D. Fla. 2011)

Erdmann v. Charter One Bank (In re Erdmann), 446 B.R. 861 (Bankr. N.D. Ill. 2011)

In re Victorio, 454 B.R. 759 (Bankr. S.D. Cal. 2011)

In re Fenn, 428 B.R. 494 (Bankr. N.D. Ill. 2010)

Lindskog v. M&I Bank FSB (In re Lindskog), 451 B.R. 863 (Bankr. E.D. Wis. 2011)

In re Mendoza, 2010 Bankr. LEXIS 664 (Bankr. D. Colo. Jan. 21, 2010)

Blosser v. KLC Fin., Inc. (In re Blosser), 2009 Bankr. LEXIS 1049 (Bankr. E.D. Wis. Apr. 15, 2009)

In re Jarvis, 390 B.R. 600 (Bankr. C.D. Ill. 2008)



PRO-DEBTOR REASONING:

- Decisions adopt *Nobelman* 's definition of "**Allowed Secured Claim**".
- § 506(a) determines whether a claim is secured or unsecured.
- If there is no equity to attach to a lien, it is not an "**Allowed Secured Claim**" because it is an unsecured claim.
- Debtors may strip wholly unsecured liens in Chapter 13.
- Because the creditor does not have an "**Allowed Secured Claim**" it is not entitled to the lien retention provisions of 11 U.S.C. § 1325(A)(5)(B)(i).

Creditor does NOT have an "Allowed Secured Claim" because its claim is unsecured.



Cases in accord: (Not intended to be exhaustive)

Fisette v. Keller (In re Fisette), 455 B.R. 177 (B.A.P. 8th Cir. 2011)

In re Fair, 450 B.R. 853 (E.D. Wis. 2011)

In re Miller, 2011 Bankr. LEXIS 4798 (Bankr. E.D.N.Y. Dec. 15, 2011)

Davis v. TD Bank, N.A. (In re Davis), 447 B.R. 738 (Bankr. D. Md. 2011)

In re Jennings, 454 B.R. 252 (Bankr. N.D. Ga. 2011)

In re Okosisi, 451 B.R. 90 (Bankr. D. Nev. 2011)

In re Waterman, 447 B.R. 324 (Bankr. D. Colo. 2011)

In re Tran, 431 B.R. 230 (Bankr. N.D. Cal. 2010)

In re Hill, 440 B.R. 176 (Bankr. S.D. Cal. 2010)



B. Chapter 20 - GOOD FAITH

- If lien strip is permitted in your jurisdiction in Chapter 20, you may still prevail on a good faith objection.
- While some courts did find that debtors can strip wholly unsecured mortgage liens without a Chapter 13 discharge, they denied confirmation because the lien strip plan was not proposed in good faith.
- Consider this defense if you are in a jurisdiction where lien stripping is allowed when debtor is not eligible for discharge.
- A good faith analysis in lien strip cases:
 - 1) the proximity in time of the chapter 13 filing to the chapter 7 filing;
 - 2) whether the debtor has incurred some change in circumstances between the filings that suggests a second filing was appropriate and that the debtor will be able to comply with the terms of the chapter 13 plan;
 - 3) whether the two filings accomplish a result that is not permitted in either chapter standing alone; and
 - 4) whether the two filings treat creditors in a fundamentally fair and equitable manner or whether they are rather an attempt to manipulate the bankruptcy system or are an abuse of the purpose and spirit of the Bankruptcy Code.

Davis v. TD Bank, N.A. (In re Davis), 447 B.R. 738, 750 (Bankr. D. Md. 2011)

Tip: Include a good faith objection to a Chapter 20 plan with your objection to lien stripping without discharge.



More Good Faith considerations

- Review for a classic good faith objection - totality of the circumstances.
- Review for good faith as if Debtor is asking the court to extend or impose the automatic stay after successive Chapter 13 filings.
- Was the Petition filed in Good Faith?
- Has the plan been proposed in Good Faith?
 - Compare debts in Chapter 7 and Chapter 13 cases. Is the mortgage the only debt?
 - Compare income and expenses.
 - Why is this Chapter 13 justified - is there an independent reason for the filing other than a lien strip?
 - Compare values of property - Did debtor schedule different value in Chapter 7 than Chapter 13?



2. VALUATION – THE ULTIMATE WEAPON

- Creditor has an "**Allowed Secured Claim**" because there is equity in the property that attaches to the claim.
- 506(a) valuation
- Get an inside and outside appraisal from a reputable appraiser.
- Verify the balances of any senior lienholders.
- Scrutinize the debtor's appraisal.
 - Suggested Listing Price Evaluations are not appraisals and may be inflated.
 - Date of appraisal.
 - Compare considered factors and assigned values in both appraisals.
 - Are comparables truly comparables?
- If real estate is primary residence, and there is even \$1 in equity, debtors may not strip lien.
- If real estate is non-residential, debtor may "cram down" the lien to the value of the property.

Beware: You may win the battle, but lose the war. Debtor may chose to convert to Chapter 7 and give up the home if the lien must be paid in a Chapter 13 plan.



3. LOAN MODIFICATION OR CONSENSUAL STRIP DOWN

Consensual Strip Down:

- Parties agree to bifurcate the loan.
- Debtor typically pays secured amount in full through the plan, and the remaining balance is paid as an unsecured claim.
- Business decision
- Debtor entitled to lien release after completing all payments under the plan and discharge.

Loan Modification:

- HAMP
- Debtor would have to be eligible under federal program.
- Debtor would have to perform on the modified loan for three consecutive months to make modification permanent.
- Long-term solution - outlives bankruptcy case.



4. COLLATERAL ATTACKS

A. Due Process

- Creditor may vacate a lien strip order if Creditor did not get notice of lien strip in time to object.
- Only puts Creditor in position to defend the proposed lien strip.
- Caveat: If confirmed plan orders lien strip and Creditor was given proper notice, the Creditor may not later contest the lien strip.

United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367 (2010)

B. Res Judicata

- If a prior order was entered regarding the value of the real estate and which shows equity for junior lien, it may not be contested later.
 - Chapter 13 Debtor obtained confirmation of plan which showed a small amount of equity for the junior lienholder, but later brought adversary proceeding to strip junior lien using an appraisal showing a lower value than the confirmed value. Confirmation order set the value of the real estate as scheduled.

Charlick v. Cmty. Choice Credit Union (In re Charlick), 444 B.R. 762 (Bankr. E.D. Mich. 2011)



C. Object to Plan

Is there an independent reason to object to the plan?

- Review plan for compliance with § 1322 and § 1325.
 - If Claim is wholly unsecured, has debtor devoted all disposable income to the plan?
 - Lien retention: If lien is to be stripped, does plan provide creditor retains lien if case is converted or dismissed?
 - Liens are revived upon dismissal or conversion.
§ 349 (b)(1)(C) & § 348(f)(1)(C)(i).
If Jurisdiction allows, § 1325(a)(5)(B)(i).
- Object to lien strip by plan if not permitted in jurisdiction or by court.



D. Move to Dismiss Case

- Before and after confirmation.
- Review § 1307 for possible grounds.
 - Default in plan payments.
 - Unreasonable delay.
 - "Material Default" - Failure to pay 1st mortgage holder.
- § 109(g) - Eligibility for Chapter 13.



E. Procedural Road Blocks

- If jurisdiction or court requires lien strip be brought by motion or adversary, but application is not in proper form, object.
 - May not be best practice as court will usually require the proper format.
 - The real issue is whether the lien is an "allowed secured claim", not the format of the pleading.

- Does Debtor propose to strip lien by operation of § 506(a) in conjunction with § 506(d)?
 - These two sections alone may not void a lien.
Dewsnup v. Timm, 502 U.S. 410, 417 (U.S. 1992)
Orkwis v. MERS (In re Orkwis), 457 B.R. 243 (Bankr. E.D.N.Y. 2011)



BEST PRACTICES

- Always file a secured proof of claim.
- Always review for a Chapter 20 filing.
- Do a good faith review.
- Always ensure lien survives dismissal or conversion.
- Always ensure lien strip occurs upon Chapter 13 discharge (or plan completion) and not at confirmation.
- And finally:
 - Know when to fold 'em.
 - Your client will not always have a secured claim.
 - Sometimes the best you can do is enter into an agreed order protecting the lien in case of discharge or conversion.



STRIP OFF IN CHAPTER 7

Supreme Court

- Strip Down Chapter 13: Nobleman

Chapter 13 debtors may strip down partially secured liens under 11 U.S.C. §1322(b)(2) except for liens secured solely by debtor's residence

- Strip Down Chapter 7: Dewsnup

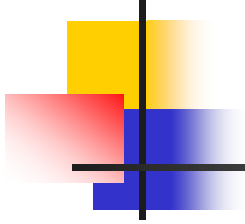
Chapter 7 debtors may not strip down partially secured liens. Liens survive bankruptcy



Circuit Courts

- Strip off Chapter 13: Nobleman and 11 U.S.C. §1322(b)(2) and 506(a).
Most Circuits allow strip off of wholly unsecured junior mortgage on debtor's residence.

- Strip off Chapter 7: Most Courts will not allow: Dewsnup
 - Wachovia Mortgage v. Smoot, 2012 U.S. Dist. LEXIS 135712 (E.D.N.Y. Sept. 20, 2012)
 - In re Talbert, 344 F.3d 555 (6th Cir.2003)
 - In re Ryan, 253 F.3d 778 (4th Cir. 2001)
 - Laskin v. First National Bank of Keystone (In re Laskin), 222 B.R. 872 (9th Cir. BAP 1998)
 - In re Richins, 469 B.R. 375 (Bankr. D. Utah 2012)
 - Cook v. IndyMac Bank (In re Cook), 449 B.R. 664 (D.N.J. 2011)
 - In re Immel, 436 B.R. 538 (Bankr. N.D. Ill. 2010)



- 11th Circuit Allows Strip Down in Chapter 7

- McNeal v. GMAC Mortg., LLC (In re McNeal), 2012 U.S. App. LEXIS 9589 (11th Cir. Ga. May 11, 2012)
 - a. Unpublished
 - b. An 11th Cir. pre-Dewsnup case allowed strip off in Chapter 7. “Settled Circuit Law” only permits 11th Cir. to ignore its precedent if an intervening Supreme Court decision is “clearly on point”. Dewsnup is not because it is limited it to its precise issue: strip down, not strip off.