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# BANKRUPTCY COURT DECISIONS LIMIT DEBTOR'S LIEN STRIPPING OPTIONS UNDER CHAPTER 13

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### INTRODUCTION

A series of recent cases from the United States Bankruptcy Court for the Central District of California have limited a debtor's lien stripping options under Chapter 13 of the United States Bankruptcy Code.

Specifically:

(1) A debtor who files a Chapter 13 case with the intent to strip a junior lien from his or her primary residence must count the amount of that wholly unsecured lien as an unsecured debt for eligibility purposes under 11 U.S.C. §109(e). If the unsecured real estate debt when added to debtor's other unsecured debts exceeds \$336,900.00, such debtor is no longer eligible to file a Chapter 13 case. *In re: Smith* 435 B.R. 637 (9<sup>th</sup> Cir. BAP, 2010),

and

(2) A debtor who has filed a Chapter 20 bankruptcy case (a Chapter 7 bankruptcy case followed by a Chapter 13 case) may not use the lien stripping provisions of 11 U.S.C. §506 to strip a wholly unsecured junior lien on debtor's principal residence. (*In re Winitzky* – Memorandum of Decision in Case 08-19337MT).

### 1. Lien Stripping in Chapter 13

Until recently, many debtors were able to use a Chapter 13 bankruptcy case to entirely disregard a junior lien against their principal residence and pay that creditor pennies on the dollar as an unsecured debt and be relieved of the debt.

The lien stripping procedure is and was available to Chapter 13 debtors where the debtors could establish that there was no equity whatsoever for a junior lienholder.

Several decisions from the 9<sup>th</sup> Circuit and the United States Bankruptcy Court for the Central District of California have limited a debtor's ability to utilize the lien stripping provisions of the Bankruptcy Code to avoid such liens and have made Chapter 13 bankruptcy eligibility far more difficult.

“  
... new tools to avoid having a junior  
lien stripped in bankruptcy.”

### 2. Treatment Of Wholly Unsecured Junior Lien Debt For Chapter 13 Eligibility

#### *IN RE: SMITH*

Before the housing bubble burst, many homeowners used the ever-growing equity in their homes, combined with the ability to deduct mortgage interest on their taxes, to refinance higher interest credit cards, to buy luxury goods, to pay for college and for many other reasons. As a result of the mortgage meltdown, those property owners now find themselves upside down on their homes with debt they can no longer afford to pay.

Upon proof to the satisfaction of the Court, Chapter 13 debtors may strip the lien of a wholly unsecured junior trust deed holder in a Chapter 13 plan and upon discharge be relieved of any further obligation on that debt. See *Lam v. Investors Thrift* (*In: re Lam*) 211 B.R. 36, 41 (9<sup>th</sup> Cir. BAP 1997).

11 U.S.C. §109(e) provides, in part, that only individuals with non-contingent liquidated unsecured debts less than \$336,900.00 may be a debtor under Chapter 13.<sup>1</sup>

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### Chapter 13 — Continued from Page 6

In two consolidated appeals, the 9<sup>th</sup> Circuit Bankruptcy Appellate Panel (“BAP”) has held that, for purposes of determining Chapter 13 eligibility, the amount of the wholly unsecured voluntary lien obligation (formerly secured by the debtor’s principal residence) was to be treated as unsecured debt rather than as secured debt making many debtors ineligible for Chapter 13 under 11 U.S.C. §109(e). *In re: Smith* 435 B.R. 637 (9<sup>th</sup> Cir. BAP 2010).

#### THE SMITHS

The Smiths acquired their home in 2006 for \$570,000.00 financing the initial purchase through Countrywide Home Loans (“Countrywide”). A year later, the Smiths borrowed an additional \$250,000.00 from Washington Mutual Bank (“WAMU”) secured by a home equity loan and deed of trust. In 2008, following the mortgage meltdown, the Smiths filed a Chapter 13 bankruptcy petition. In their bankruptcy schedules, the Smiths assert that their home was valued at \$370,000.00, while the outstanding obligation to Countrywide was \$547,782.00. The Smiths stated their intention to seek a determination from the Court that (a) they could stop making payments to WAMU; (b) treat WAMU’s claim as wholly unsecured; and (c) that their obligation to WAMU be treated as an unsecured debt paid pro rata with other unsecured creditors. *In re: Smith, supra*, 435 B.R. 637 at 639-640.

Although WAMU did not object to the Smith’s Chapter 13 plan, the Chapter 13 Trustee moved to dismiss the Smiths’ case because, when added to their other unsecured debt on Schedule F, the Smiths’ total unsecured debt was \$470,035.36, an amount which exceeded the \$336,900.00 statutory maximum for Chapter 13 eligibility. *In re: Smith, supra*, 435 B.R. 637 at 640.

The Smiths argued that since the lien could only be stripped upon successful completion of their Chapter 13 plan and entry of a discharge in their case, the lien should be treated as a secured debt for purposes of determining Chapter 13 eligibility. The Bankruptcy Court disagreed and granted the Trustee’s Motion to Dismiss, finding that the Smiths were ineligible to be debtors under 11 U.S.C. §109(e). *In re: Smith, supra*, 435 B.R. 637 at 640.

#### THE HAMBURGS

The Hamburgs purchased their home in August 2003. Flagstar Bank was the holder of the first trust deed loan, and BAC Home Loan Services LP fka Countrywide Home Loans Servicing (“BAC”) was the holder of the second. *In re: Smith, supra*, 435 B.R. 637 at 640.

On April 3, 2009, the Hamburgs filed a Chapter 13 case. In their schedules, they asserted that the value of their home was \$480,000.00 and that their obligation to Flagstar was \$483,988.00. The BAC lien was wholly unsecured, and the Hamburgs sought to extinguish the BAC lien upon discharge from Chapter 13. On July 10, 2009, the Court entered an Order voiding BAC’s lien and ordering it to be treated as an unsecured debt. The Court’s Order excused the Hamburgs from making monthly payments during the pendency of the case and would have permanently relieved the Hamburgs of the obligation to BAC upon discharge. *In re: Smith, supra*, 435 B.R. 637 at 640.

In this case, the Court, apparently *sua sponte*, determined that the Hamburgs were ineligible for Chapter 13 because the other unsecured debt combined with the BAC claim exceeded \$336,900.00. The Court dismissed the case, confirmed a Chapter 13 plan and stayed the effectiveness of the dismissal pending resolution of the appeal. *In re: Smith*.

Both the Smiths and the Hamburgs filed timely appeals. Judge Tighe in her Memorandum of Law (“Eligibility Memorandum”) held that:

“There have been a number of other cases presenting the same issue, but they have been dismissed or converted to Chapter 7 for failure to make plan payments before any ruling on the debt limits could be issued. Debtors making decisions about how to save their home need to know clearly before a case is filed whether Chapter 13 is a viable option or whether they must find a way to file a more expensive Chapter 11 case. This is a matter of significant public importance in an area where foreclosure rates are at a historic high and the debt limit set by Congress do not adequately address a large number of average home owners in financial distress.”



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*In re: Smith, supra*, 435 B.R. 637 at 642 (citing Eligibility Memorandum 10: 6-13).

Based on the appeals presented, the BAP was asked to determine whether a debt secured by a wholly unsecured consensual lien under 11 U.S.C. §506 should be counted as unsecured debt for purposes of determining eligibility under 11 U.S.C. §109(e).

The Court acknowledged that a great number of homeowners, particularly in regions such as the Central District of California, have been hard hit by the “Great Recession” and the collapse of the housing bubble. Many homes have lost half of their value. While many simply walk away, others have tried to save their homes in Chapter 13.

While sympathetic to the problem, the BAP reluctantly affirmed the Bankruptcy Court’s decisions suggesting that this was a matter within the purview of Congress to provide for relief for homeowners impacted by the current economic climate.

### THE BAP’S ANALYSIS

#### LIEN STRIPPING AUTHORITY AND CHAPTER 13 PLAN

The Court cited 11 U.S.C. §1322(b)(2) for the proposition that a Chapter 13 plan may modify a secured creditor’s rights other than a claim secured only by a security interest in the debtor’s principal residence. While a partially secured lien may on debtor’s principal residence may not be stripped, a wholly unsecured lien may be stripped under 11 U.S.C. §1322(b)(2).

The BAP acknowledged that such lien stripping has become important to Chapter 13 debtors in these housing bubble cases.

11 U.S.C. §1325 sets forth the requirements for confirmation of a Chapter 13 plan. Specifically, 11 U.S.C. §1325(a)(5) requires that with respect to secured creditors, a plan must provide for one of these alternative treatments to which the secured creditor contends:

- (a) Treatment to which the secured creditor consents;
- (b) Retention of the collateral by debtor with a stream of

payments to the secured creditor; or

- (c) Surrender of the collateral to the secured creditor.

[Citing *Trejos v. VW Credit Inc. (In re Trejos)* 374 B.R. 210, 214 (9<sup>th</sup> Cir. BAP 2007)]

Therefore, unless the secured creditor consents to receiving no payments, they must receive a stream of payments. The BAP points out that §1325(a)(5) applies only to an “allowed secured claim”. Therefore, if the Court determines that a creditor is wholly unsecured, then the debtors are excused from treating the claim as secured under a Chapter 13 plan.

Lien stripping occurs under 11 U.S.C. §506(a) and Federal Rule of Bankruptcy Procedure Rule 3012. The Bankruptcy Court is given authority to ensure that collateral or its proceeds are returned to the proper creditor. *In re: Smith, supra*, 435 B.R. 637 at 644 (citing H.R. Rep. No. 95-595, at 382.)

Under non bankruptcy law, a secured claim need only be secured by some collateral and only when a creditor seeks to enforce a claim against the collateral is the collateral’s value determined.

11 U.S.C. §506(a) operates as the substitute for enforcement.

Rule 3012 authorizes the Bankruptcy Court to make a determination of value of a claim and the extent to which the collateral is allowed as secured and the extent to which it is unsecured. *In re: Smith, supra*, 435 B.R. 637 at 645.

Both the Smiths and the Hamburgs sought and obtained determinations under 11 U.S.C. §506(a). Neither WAMU (the Smiths) nor BAC (the Hamburgs) challenged the debtors’ valuations. The result was that while both the Smiths and the Hamburgs were allowed to treat their second trust deed loans as unsecured, the Court determined that the second lienholders’ claims must be counted as unsecured debt for purposes of Chapter 13 eligibility.

### DETERMINING WHETHER THE DEBT IS SECURED OR UNSECURED

In 2001, the 9<sup>th</sup> Circuit determined that claims of a judgment



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lienholder were to be counted as an unsecured debt **as of the petition date for purposes of determining Chapter 13 eligibility.** *Scovis v. Henrichsen (In re: Scovis)*, 249 F.3d 975, 981 (9<sup>th</sup> Cir. 2001).

The appellants in this case, citing *Scovis* suggest that eligibility should be determined by debtor's originally filed schedules. *In Re: Scovis, supra*, 249 F.3d at 982. The Smiths and the Hamburgs suggest that the second trust deed obligations are properly scheduled on Schedule D (secured claims), not on Schedule F (unsecured claims).

The Court here held that *Scovis* was intended to ensure a straightforward and realistic application of a debtor's status as a "readily ascertainable amount." In *Scovis*, the judgment lien was listed on Schedule D, but the Court, using the schedules which also listed a California Homestead exemption, determined that the bankruptcy court had been provided to a "sufficient degree of certainty" that the entire judgment lien should be classified as "unsecured" for eligibility purposes.

Similarly in these cases, the Court found that because the Smiths' and Hamburgs' first liens exceed the value of the residences, the Court had a "sufficient degree of certainty" to determine that the liens were wholly unsecured under 11 U.S.C. §506(a).

The Smiths and the Hamburgs also argued that the Court should not look to post-petition events to determine the amount of the debt citing *Slack v. Wilshire Ins. Co.*, 187 F.3d 1070, 1073 (9<sup>th</sup> Cir. 1999). The Court disagreed, holding that the issue in *Slack* was whether a debt was non-contingent and liquidated and whether it should be counted at all for eligibility purposes. In these cases, there is no dispute that the amount of the debt is fixed.

Referring to the decision in *Scovis*, the Court here held that issue is the principle of certainty:

"Although [in *Slack*] we were defining the term 'liquidated' and not 'secured' we included in the eligibility determination readily ascertainable amounts, even though liability on the debt had not been finally decided . . . This principal of certainty causes equal force in the present context, where the homestead

exemption's effect on the status of the Debtor's debt as secured or unsecured is readily ascertainable." *Scovis*, 249 F.3d at 984.

The Court in *Smith* held that the principle of certainty applies where the effect of the value of the property on the status of appellants' debts as secured or unsecured is readily ascertainable. The only issue here as the Court saw it was whether *Scovis* could be applied to consensual liens (as opposed to a judgment lien).

The Smiths and the Hamburgs then argued that 11 U.S.C. §1322(b)(2) prohibits a change in the status of secured lienholder's claims because it precludes modification of the rights of claims secured only by debtor's principal residence to render the claims unsecured.

The Court held that the debtors actually wanted those junior liens to be unsecured and that it was disingenuous of the debtors to now assert that all §1322(b)(2) allows is for cessation of payments (not a modification of the second lienholder's rights). The lien stripping motions in fact resulted in their second lienholder's claims becoming unsecured.

### DETERMINING WHEN DEBT IS TREATED AS UNSECURED

Turning to the timing issue (i.e. whether it is secured or unsecured at the time of filing), the Court looked at whether the *Scovis* analysis is altered because the second liens may not have been avoided. In a footnote, the Court held that for the purposes of this case:

"We need only decide whether the application of §506(a) can operate to change the status of a claim from secured to unsecured in a bankruptcy case and whether such change impacts the §109(e) eligibility determination. We observe that §506(a) provides, 'to the extent that a lien secured a claim against the debtor that is not an allowed secured claim, such lien is void. . . .' Further, §1327(c) provides 'Except as otherwise provided in the plan or order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.'" *In re: Smith, supra*, 435 B.R. 637 at 647 (FN7).

Since *Scovis* held (and many other circuits agree) that the



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unsecured portion of the under-secured debt is counted as unsecured for §109(e) eligibility purposes and since §506(d) implements §506(a) by providing that the lien is void as to any unsecured portion of the claim, such claim must be counted as unsecured for eligibility analysis.

### 3. Viability of Lien Stripping in a Chapter 20 Case After the BAPCPA

#### *IN RE: WINITZKY*

Many debtors file what is referred to as a Chapter 20 where the debtors first file a Chapter 7 to discharge certain (but not all) of their obligations followed by a Chapter 13 where debtors pay a fraction of their otherwise non-dischargeable debt and obtain a second discharge.

In 2005, Congress amended the Bankruptcy Code. 11 U.S.C. §1328(f)(1) provides that a debtor may not obtain a discharge under Chapter 13 when that debtor received a Chapter 7 discharge within the preceding four years.

In May 2009, the case of *In re Winitzky* was before Judge Maureen Tighe in the Central District of California (USBC Case No. 1:08-bk-19337-MT). Judge Tighe issued a Memorandum of Decision (in which Judges Mund and Thompson concurred) concluding that Chapter 13 debtors who received a Chapter 7 discharge within the past four years may not strip a completely unsecured consensual lien off their primary residence.

In May 2008, the Winitzkys filed a Chapter 7 petition. A trustee administered their case and issued a no asset report. On

July 2, 2008, the second trust deed holder, J.P. Morgan Chase (“Chase”) obtained an order for relief from stay. Five days later, the senior lienholder, Greenpoint Mortgage, also received an order for relief from stay. On August 20, 2008, debtors received a discharge including over \$100,000.00 in unsecured credit card debt.

On November 4, 2008, Greenpoint recorded a Notice of Trustee’s Sale. The Winitzkys filed a Chapter 13 bankruptcy case. The debtors scheduled the Greenpoint deed of trust at \$634,494.00 and the Chase deed of trust at \$155,000.00. Debtors filed a declaration of a realtor and sought to avoid the Chase lien, and strip several other unrelated liens.

No objections were filed with regard to the motion to avoid the Chase lien or to the Chapter 13 plan.

In reviewing the case, the Court, *sua sponte*, ruled that “Because valuable property rights are at issue, and a number of cases are being filed presenting the same questions, it is necessary to address the debtor’s right to strip a wholly unsecured lien through a Chapter 20 regardless of whether the motion is challenged.” Memorandum of Decision 2:22-25.

The Court ruled that because the amended Bankruptcy Code does not allow the Court to grant a discharge in a Chapter 13 filed less than four years after the issuance of a discharge under Chapter 7, the Bankruptcy Code cannot permit a lien to be stripped under 11 U.S.C. §506 on the Debtor’s principal residence even if it is fully unsecured.

#### CONCLUSION

Based on these cases, a lender or loan servicer in a Chapter 13 case may have some new tools to avoid having a junior lien stripped in bankruptcy.

<sup>1</sup> This amount is adjusted by Congress every three years.



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