Bankruptcy Bar Association for the District of Maryland, Baltimore Chapter
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David Sommer and Anatoly Smolkin
Gallagher Evelius& Jones LLP

Lien Stripping and *Bank of Amer. v. Toledo-Cardona*, No. 14-163 and *Bank of Amer. v. Caulkett*, No. 13-1421 (petition granted Nov. 17, 2014) (consolidated for argument) in the Supreme Court of the United States.

I. Lien stripping generally.

   a. General rule in bankruptcy: Liens pass through bankruptcy unaffected.

   b. What is lien stripping? Using bankruptcy to void or limit the effect of a lien on property whose value is less than the debt the lien secures.

      i. Affects the rights of a creditor to recover against property to satisfy the creditor's claim.

      ii. Modifies or eliminates the *in rem* remedies (against the property) of a creditor rather than its *in personam* remedies (against the person).

   c. 2 kinds of lien stripping:

      i. Strip down: reduces undersecuredlien to the current value of the property to which the lien attaches. Lien is bifurcated and only unsecured portion of the lien is removed. *Johnson v. Asset Mgt. Group*, 22 B.R. 364, 365 n.3 (D. Md. 1998).

      ii. Strip off: removes a wholly unsecured lien in its entirety (i.e., voids a lien that is entirely "underwater"). Entire lien is removed. *Johnson*, 22 B.R. at 365 n.3.

II. Relevant statutory provisions: A claim's status as secured or unsecured depends on the value of the collateral.

   a. 11 U.S.C. §506(a):

      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 claim.

   b. 11 U.S.C. §506(d):

(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--

(1)such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

(2)such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

c. 11 U.S.C. §1322(b)(2):

(b) Subject to subsections (a) and (c) of this section, the plan may-- … (2) 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, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

d. 11 U.S.C. §1325(a)(5)(B)(i)(I) & (II):

Except as provided in subsection (b), the court shall confirm a plan if [it meets certain conditions, including] with respect to an allowed secured claim provided for by the plan … the plan provides that – (I) the holder of such claim retain the lien securing such claim until the earlier of – (aa) the payment of the underlying debt determined under nonbankruptcy law; or (bb) discharge under section 1328; and (II) if the case under this chapter is dismissed or converted without completion of the plan, such lien shall also be retained by such holder to the extent recognized by applicable nonbankruptcy law ….

III. Lien stripping in Chapters 7, 13, and 20.

a. Chapter 7.

i. No "strip-down" in Chapter 7. *Dewsnup v. Timm*, 502 U.S. 410 (1992).

ii. Fourth Circuit held that reasoning of *Dewsnup* applied to "strip-off" attempts by debtors as well. *Ryan v. Homecomings Fin. Network*, 253 F.3d 778 (4th Cir. 2001). Other circuits have reached the same conclusion. *See, e.g., Talbert v. City Mortg. Serv.*, 344 F.3d 555 (6th Cir. 2003); *Laskin v. First Nat'l Bank of Keystone*, 222 B.R. 872 (9th Cir. BAP 1998).

iii. Eleventh Circuit has held that "strip off" is permitted by §506(d) and that *Dewsnup* holding does not control because it is not "clearly on point."

b. Chapter 13.

i. All courts, including the Fourth Circuit, that have considered whether lien "strip-off" is available in Chapter 13 have concluded that it is permitted. A valueless lien is deemed an unsecured claim under Section 506(a). This operates with Section 1322(b)(2) to permit the wholly underwater lien to be eliminated.*Branigan v. TD Bank, N.A.*, 716 F.3d 331 (2013); *Suntrust Bank v. Millard*, 414 B.R. 73 (D. Md. 2009); *First Mariner Bank v. Johnson*, 411 B.R. 211 (D. Md. 2009).

ii. Under Section 1322(b)(2), lien "strip-down"on principal residence is not permitted in Chapter 13. *Nobleman v. America Savings Bank*, 508 U.S. 324 (1993).

iii. Debtors may "strip-down" lien on property that is not the debtor's principal residence. *Scarborough v. Chase Manhattan Mtg. Co.*, 461 F.3d 406 (3d Cir. 2006).

c. Chapter 20.

i. Chapter 20 is a colloquial reference to a Chapter 13 bankruptcy filed within four years of a Chapter 7 bankruptcy that concluded with a discharge. Debtor is not eligible to obtain a discharge in the Chapter 13 bankruptcy. 11 U.S.C. §1328(f)(1).

ii. No strip-down permitted on homestead property. *SeeNobleman v. America Savings Bank*,508 U.S. 324 (1993). In some districts, a plan may strip down a lien on non-homestead property. *See In re Wimmer*, 512 B.R. 498 (Bankr. S.D.N.Y. 2014).

iii. Circuits are split on question of whether a debtor may "strip off" a lien in Chapter 20.

iv. Fourth Circuit has held that "strip-off" is permitted in Chapter 20, both as to the debtors' principal residence and their non-homestead property. *Branigan v. TD Bank, N.A.*, 716 F.3d 331 (4th Cir. 2013). The Court explained that "the analysis permitting lien stripping in Chapter 20 cases is no different than that in any other Chapter 13 case." *Id*. at 338.

	STRIP DOWN	STRIP OFF
CHAPTER 7	Not permitted. *Dewsnup*	Circuit split; not possible in most circuits, including the Fourth Circuit, but permitted in Eleventh Circuit. Subject to Supreme Court review.
CHAPTER 13	Not permitted for principal residences. *Nobleman*. But it is permitted for non-homestead property.	Possible in all circuits that have considered the issue, including the Fourth Circuit, as to homestead and non-homestead property if the case is filed in good faith.
CHAPTER 20	Not permitted for principal residences. *Nobleman*. Some districts have permitted strip down onnon-homestead property.	Circuit split. In Fourth Circuit, lien strip-off is permittedboth as to homestead and non-homestead property if the case is filed in good faith.

IV. *Bank of Amer. v. Toledo-Cardona*, No. 14-163 and *Bank of Amer. v. Caulkett*, No. 13-1421 (petition granted Nov. 17, 2014) (consolidated for argument)

a. Facts

i. Debtor in *Toledo-Cardona* filed for Chapter 7 bankruptcy in the U.S. Bankruptcy Court for the Middle District of Florida.

ii. At the time he filed for bankruptcy, Debtor's home was subject to two mortgage liens.
1. The debt owed on the first mortgage exceeded the fair market value of the property, leaving the first mortgage "undersecured."
2. The second mortgage, which was held by Bank of America, had a value of over $100,000.

iii. But because the debt secured by the first lien exceeded the value of the property, Bank of America's junior lien was considered completely underwater.

b. Procedural History& Relevant Precedent

i. Motion to Strip Off/Void in the Bankruptcy Court

1. Because Bank of America's lien was underwater, Debtor filed a motion in the bankruptcy court to "strip off"—or void—Bank of America's junior lien in its entirety.
2. Bank of America conceded that under binding 11th Circuit precedent, Debtor's motion to strip off the junior lien should be granted.

ii. Relevant Precedent
   1. *Folendore v. U.S. Small Business Admin.*, 862 F.2d 1537 (11th Cir. 1989)
      a. Chapter 7 case.
      b. Creditor held a junior mortgage on debtor's property. But creditor's lien was completely underwater—the property's value was less than the outstanding debt on two senior mortgage loans.
      c. The 11th Circuit held that Section 506(d) permitted the debtor was to strip off a wholly underwater junior lien.
      d. The court reasoned that because Section 506(a) treats the portion of a secured claim that is in excess of the value of the security as "unsecured," the junior lienholder had no "allowed <u>secured</u> claim" under 506(d), thus permitting the lien to be stripped off.
   2. *Dewsnup v. Timm*, 502 U.S. 410 (1992)
      a. Chapter 7 case.
      b. Creditor issued a loan to debtor, which was secured by debtor's real property. When debtor filed for bankruptcy, the lien was partially underwater—that is, the outstanding balance on the loan exceed the current fair market value of the property.
      c. Pursuant to Section 506(d), debtor moved to void the portion of the lien that was underwater. In other words, the debtor sought a "strip down" because his lien was only partially, not completely, underwater.
      d. The Supreme Court rejected the debtor's arguments in favor of the strip down, holding that Section 506 does not permit a debtor to "strip <u>down</u>" a creditor's lien simply because it is undersecured in light of the current value of the collateral.
   3. *Dewsnup*'s application to "Strip Offs"
      a. The 4th, 6th, and 7th circuits have held that the reasoning in *Dewsnup* applies equally to strip offs.
         i. *Ryan v. Homecomings Fin. Network*, 253 F.3d 778 (4th Cir. 2001).
         ii. *In re Talbert*, 344 F.3d 555 (6th Cir. 2003).
         iii. *Palmor v. First Am. Bank*, 722 F.3d 992 (7th Cir. 2013).

b. But the 11th Circuit has not followed the trend, holding instead that its prior panel decision in *Folendore* (and not the Supreme Court's decision in *Dewsnup*) controls in the "strip off" context.
    i. In *McNeal v. GMAC Mortg., LLC*, 735 F.3d 1263 (11th Cir. 2012), the 11th Circuit explained that it may depart from an earlier 11th Circuit panel decision only when an intervening Supreme Court decision is "clearly on point."
    ii. The 11th Circuit reasoned that *Dewsnup* was not "clearly on point" because it "disallowed only a 'strip down' of a partially secured mortgage lien and did not address a 'strip off' of a wholly unsecured lien."
    iii. The lienholder in *McNeal* petitioned for a rehearing en banc. The petition was pending for almost two years, but it was finally denied by the 11th Circuit in May 2014.

iii. Back to *Toledo-Cardona*
    1. After the bankruptcy court granted Debtor's motion to strip off Bank of America's junior lien, Bank of America appealed to the district court, but moved for summary affirmance subject to its right to seek appellate review.
    2. Bank of America appealed to the 11th Circuit, and requested that the Court hear its appeal en banc, recognizing that an 11th Circuit panel was bound by its prior precedent in *McNeal*.
        a. The 11th Circuit declined, and instead issued a short unpublished, *per curiam* opinion, in which it affirmed the strip off of Bank of America's junior lien in light of its prior precedent.

c. Appeal to the Supreme Court

i. The Supreme Court granted Bank of America's petition for certiorari.

ii. Question presented: When a first mortgage on a Chapter 7 debtor's home is undersecured, such that a second mortgage is completely "underwater," can a Chapter 7 debtor "strip off" the junior mortgage-holder's lien in its entirety?

V. Arguments of the parties

a. Bank of America's arguments

i. "Under the logic" of the Court's decision in *Dewsnup*, a lien cannot be stripped off pursuant to§506(d)
    1. The words "allowed secured claim" in §506(d) need not be read as indivisible term of art defined by reference to §506(a).Rather, they should be read term-by-term to refer to any claim that is, first, allowed, and, second, secured.
    2. If a claim is "allowed" and "secured" by a lien with recourse to the underlying collateral, it does not come within the scope of §506(d).
    3. The only difference between *Toledo-Cardona* and *Dewsnup* is that the debtor wants to reduce the value of the lien to zero.*Dewsnup*already held that §506(d) does not allow the bankruptcy court to squeeze down a valid lien to the current value of the property to which it is attached.

ii. Section 506(a) matters only to the treatment of the creditor's claim for distribution purposes.
    1. The portion of the claim exceeding the value of the collateral is treated as unsecured for distribution of non-exempt estate assets. Section 506(a) has no effect on the treatment of the creditor's lien under Section 506(d).
    2. This reading promotes well-established pre-Code practice in which liens pass through bankruptcy unaffected unless the underlying claim is disallowed. Section 506(d) strips only liens securing <u>disallowed</u> claims.

iii. Eleventh Circuit is the only circuit that disagrees with BOA position. Fourth, Sixth, and Seventh Circuits apply *Dewsnup* to prohibit strip off in Chapter 7 cases. Need for uniformity in the administration of chapter 7 cases across the country.

iv. Permitting lien strip-off in chapter 7 could result in costlier mortgages as creditors charge higher interest rates to compensate for increased risk of loss.

v. The appreciation in value of the collateral should accrue to the benefit of the creditor rather than provide a "windfall" to the debtor; this is consistent with the bargained-for rights between the mortgagor and mortgagee.

vi. The more specific lien stripping provisions of the Code (e.g., §§722 and 1325(a)(5)(B)) would be superfluous if Section 506(d), which is applicable to all Code chapters, automatically stripped the lien.

vii. Congress has had numerous opportunities to revise Section 506(d) since *Dewsnup* and has opted against doing so. Congress has acquiesced in *Dewsnup*'s reading of Section 506(d).

b. Debtor's arguments

i. Plain reading of Section 506(d) expressly voids junior liens that are entirely underwater. Two step statutory argument:
    1. An entirely underwater junior lien is an "unsecured claim" under 506(a), which provides that "[a]n allowed claim of a creditor secured by a lien on property … is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of the secured claim."
    2. As an unsecured claim under Section 506(a), it is "not an allowed secured claim," which makesand such lien void under Section 506(d).

ii. *Dewsnup*is consistent with the "clear statutory text" of 506(a) and (d), and its holding was carefully limited to the strip down context.
    1. In *Dewsnup*, the mortgage was only partially underwater. In other words, it was "undersecured," not entirely unsecured. Therefore, under Section 506(a), the lien included secured components and unsecured components.
    2. Because it included secured components, the undersecured mortgage in *Dewsnup* still qualified as an "allowed secured claim" and was therefore ineligible to be voided under 506(d).
    3. Here, on the other hand, an entirely underwater second mortgage retains no secured components. It is not an "allowed secured claim," and it is void under 506(d).

iii. Policy considerations weigh in favor of permitting lien strip off in Chapter 7
    1. *Dewsnup* rationale of preventing a windfall todebtors if the property later appreciates doesnot apply as strongly in the strip off context. If a court voids an entirely underwater junior lien, any future appreciation goes first and foremost to the partially underwater senior creditor, not the debtor.
    2. Voiding junior liens helps to stop junior lien creditors from obstructing mutually beneficial bargains between senior creditors and debtors.
        a. For example, to avoid bankruptcy or foreclosure, debtors can negotiate consensual resolutions with their mortgagees, including short sales.
        b. But a junior lienholder could create a "hostage situation" by vetoing short sales and forcing foreclosure instead.
        c. Because the junior lienholder would receive nothing from a short sale, they have nothing to lose by holding up sales solely to extract a settlement from senior lienholders.

3. Unlike first mortgages, which have a long history of passing through bankruptcy unaffected, there is no history of secondary mortgages passing through bankruptcy in the years before the 1978 Bankruptcy Code.