

LIEN STRIPPING OF PRIMARY RESIDENCE MORTGAGES  
IN CHAPTER 13 BANKRUPTCY UPDATE

Brett Pfeifer and Arnie Lueders  
Credit Solutions S.C.  
February 8, 2011

Lien Stripping (aka lien avoidance, aka cramdown)

A. Definition/Issue.

1. Generally speaking junior liens can be stripped off of debtor's asset(s) in a Chapter 13 when there is limited equity in the asset; ie. after deducting senior liens from the property's current market value. The claim is only secured to the available equity. (Cramdown)
2. There is a special exception to this concept that limits lien stripping when the lien is a voluntary lien, like a mortgage, on property that is the debtor's principal residence. Under this exception, voluntary liens on a home can be stripped off only if there is no equity in the property at all, after totaling the senior liens, to which the lien in question could attach. *Nobelman v American Savings Bank*, 508 U.S. 324, 113 S.Ct. 2106 (1993).
3. The promises by the current administration have failed to change the bankruptcy law to allow the modification of home mortgages by reducing the amount of the lien to the current value of the property.
4. However, § 506 of the Bankruptcy Code acknowledges that a lien is only a secured claim to the extent there is value in the asset to which it attaches. To the extent that the claim exceeds the value of the collateral, that portion of the claim is unsecured.

B. Code Sections.

1. 11 U.S.C. §506(a) and 11 U.S.C. §506(d) are used to bifurcate the lien into secured and unsecured.
2. The secured claim is allowed in the amount up to the fair market value of the property at the time of the stripping.
3. The balance of the claim that exceeds the fair market value of the property is now deemed unsecured and thereby affecting the rights of the lien holder. § 1322(b)(2).
4. However, the "anti-modification" provision of § 1322(b)(2) prohibits the lien stripping of a junior lien of a homeowner's principle residence if there is even \$1 worth of equity above that of the senior lien.
5. The lien stripping renders such junior liens as totally unsecured, as there is no equity to attach to and thus is not an allowed secured claim.

C. Procedure

1. The issue as to whether lien stripping can be accomplished by Motion, Adversary or merely by the Confirmed Plan has largely been settled

with an Adversary winning. *In re Forrest*, 410 B.R. 816 (Bankr. N.D.IL 2009).

- i. Bankruptcy Code, Bankruptcy Rules, and the US Constitution require debtor to file an adversary proceeding to lien strip.
  1. Rule 7001 requires an adversary proceeding to determine validity, priority, or extent of lien or other interest in property.
  2. Failure to comply with the heightened notice provisions violates the US Constitution by depriving the junior mortgage of life, liberty, or property, without due process of law.
2. Nuts and Bolts.
  - i. Identify the Parties. FRCP 19 requires joinder of any person wherever nonjoinder would prevent complete relief or the nonjoined person claims an interest relating to the subject matter and that parties absence may impair or impede that person's ability to protect the interest or leave an existing party subject to inconsistent obligations. Look at:
    1. Bank Statements
    2. Deed of Trust
    3. Promissory Note
    4. Notice of Default
    5. Notice of Trustee Sale
    6. Proof of Claim
    7. Motion for Relief of Stay
    8. Special notices
    9. Title Report
  - ii. Complaint: Should identify the parties, the property, the existing liens (senior mortgages, real estate taxes) and the fair market value.
  - iii. Exhibits: Property valuation substantiation, affidavits.
  - iv. Filing: ECF...Adversary...Open Adversary Proceeding.
    1. File complaint and attach adversary coversheet and any exhibits.
    2. Filing fee is "Waived" for the Debtor.
    3. Court will prepare the summons and docket. You have 10 days to serve the summons and complaint on the Defendant(s).
  - v. Service of Process- Notice, Notice, Notice
    1. F.R.B.P. 7004(h) – Service on insured depository institution in a contested or adversary proceeding shall be made by certified mail addressed to an officer of the institution unless-the institution has appeared by its attorney, in which case the attorney shall be served by first-class mail; if the service by certified mail is unsuccessful the court may permit service by first-class

mail to an officer; the institution has waived in writing its entitlement to service by certified mail by designating an officer to receive service.

2. F.R.B.P. 7004(b)(3) – if not insured depository institution, serve according to a domestic or foreign corporation by mailing a copy to the attention of an officer, a managing or general agent, or to any other agent authorized to receive service of process, and if the agent is authorized by statute to receive service and if the statute so requires, by also mailing a copy to the defendant.
3. Does and Don'ts.
  - a. Don't send to a P.O. Box.
    - i. Doesn't meet 7004(b)(3) requirement.
    - ii. Doesn't trigger presumption of actual knowledge thus raising a due process issue.
  - b. Service of an attorney who appeared for the party in a prior action does NOT create an implied agency to receive service in a new action.
  - c. Filing an appearance and requesting notice under Rule 2002 does not necessarily appoint an attorney as agent to receive service of process.
  - d. Does an officer have to be named "John Doe, President, ABC Corp." or is it sufficient to serve "President, ABC Corp." in F.R.B.P. 7004? Courts are split or not decided. Best to specifically name the person to be served.
  - e. Certificate of Service- carefully prepare COS showing proper service on any and all parties per Rule 7004, indicating title of person served (e.g. "attorney for ABC, corp.) or ("Agent for Service of Process") or ("President of ABC, corp.").
  - vi. Send offer of stipulation...you would be surprised.
  - vii. Pretrial always via phone with all Judges.
  - viii. Motions for Default
    1. Attach evidence including affidavits, appraisals, and service issues.
    2. Judges Kelley and Shapiro in person default hearings...bring your client.
    3. Judges Pepper and McGarity are by negative notice.

#### D. Effective Date.

1. Confirmation of plan?

2. Discharge?
3. What if case is converted or discharged? §§ 348, 349 and 1325(a)(5)(B)(i)(II)?
4. What if NO discharge or conversion?
5. Need to record order in Recorder of Deeds office. Who? When?

E. Danger, Danger.

1. Debtor should be fully informed of the dangers involved if case is converted or dismissed.
2. Defenses.
  - i. FMV battle.
  - ii. Ineligibility Defense under § 109(e) –unsecureds too much.
  - iii. Adversary Proceeding defense if not brought by AP.
  - iv. Inadequate notice defense.
  - v. Getting the underlying bankruptcy dismissed.