

Wholly Underwater Mortgages in Chapter 13: The Possible Treatment

1. Non-modification?

a. § 1322(b); *Nobelman v. American Sav. Bank*, 508 U.S. 324 (1993).

b. **Rejection of non-modification for liens unsupported by any equity.** *First Mariner Bank v. Johnson*, 411 B.R. 221, 224 (D. Md. 2009):

[B]ecause the first lien on the Property exceeds the equity remaining in the home, Appellant's secondary lien is wholly unsecured, and its interests may be modified by the Chapter 13 plan, pursuant to § 1322(b)(2). This conclusion is consistent with all six Courts of Appeals to have directly considered the issue, as well as two Bankruptcy Appellate Panels. See *Zimmer v. PSB Lending Corp.*, 313 F.3d 1220 (9th Cir. 2002); *Lane [v. W. Interstate Bancorp]*, 280 F.3d 663, 665 (6th Cir. 2002); *Pond v. Farm Specialist Realty*, 252 F.3d 122 (2d Cir. 2001); *Tanner [v. FirstPlus Fin., Inc.]*, 217 F.3d 1357, 1360 (11th Cir. 2000), 217 F.3d 1357; *Bartee [v. Tara Colony Homeowners Ass'n]*, 212 F.3d 277, 290 (5th Cir. 2000); *McDonald v. Master Fin., Inc.*, 205 F.3d 606 (3d Cir. 2000); *Domestic Bank v. Mann*, 249 B.R. 831 (1st Cir. BAP 2000); *Lam v. Investors Thrift*, 211 B.R. 36 (9th Cir. BAP 1997).

2. Avoidance of the lien or satisfaction of the lien?

a. **Avoidance.** *In re Lavelle*, No. 09-72389-478, 2009 WL 4043089 (Bankr. E.D.N.Y. Nov. 19, 2009): “[The] second mortgage cannot be considered a secured claim under § 506(a), because the junior claim is wholly unsecured. Accordingly, the plain meaning of § 506(d) requires the lien to be voided.”

b. **Satisfaction.** *Pees v. D.A.N. Joint Venture II (In re Claar)*, 368 B.R. 670, 678 (Bankr. S.D. Ohio 2007) (quoting *In re Hernandez*, 175 B.R. 962, 967 (N.D. Ill. 1994) for the rule that “Bankruptcy Code section 1327 [binding effect of plans] . . . provides the mechanism by which Chapter 13 Debtors can strip down creditor's liens without resorting to § 506(d).”)

3. Adversary, motion, or plan?

a. **Fed. R. Bankr. P. 7001.** Adversary proceedings, governed by Part VII of the Bankruptcy Rules, include proceedings “to determine the validity, priority, or extent of a lien or other interest in property, other than a proceeding under Rule 4003(d) [avoidance of liens impairing exemptions].”

b. Fed. R. Bankr. P. 3012. “The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest”

c. Fed. R. Bankr. P. 2002(b), 3015(b). “[T]he clerk, or some other person as the court may direct, shall give . . . all creditors . . . not less than 28 days’ notice by mail of the time fixed . . . for filing objections and the hearing to consider confirmation of a . . . chapter 13 plan.” “The plan or a summary of the plan shall be included with each notice of the hearing on confirmation mailed pursuant to Rule 2002.”

d. Adversary proceeding required for lien removal. *In re Forrest*, 424 B.R. 831, 833 (Bankr. N.D. Ill. 2009): “[W]hen the existence of the lien itself is at issue, then the ‘validity’ and ‘extent’ of the lien are certainly at issue, so an adversary proceeding is necessary.” [Citing Fed. R. Bankr. P. 7001.] *Forrest* also holds that where the Bankruptcy Rules provide for a specific form of notice, “due process entitles a party to receive such notice before an order binding the party will be afforded preclusive effect.” 424 B.R. at 834, quoting *In re Hanson*, 397 F.3d 482, 486 (2005).

e. Rule 3012 provides an appropriate alternative. *Stewart v. JP Morgan Chase Bank (In re Stewart)*, 408 B.R. 215, 219 (Bankr. N.D. Ind. 2009): “[A] Chapter 13 plan which proposes to ‘strip’ allegedly totally unsecured residential mortgages will not be effective to ‘strip’ those mortgages absent the utilization of a separate proceeding, either a contested matter under Rule 3012 or an adversary proceeding under Rule 7001(2).”

f. Plan confirmation is sufficient. *In re Jarvis*, 390 B.R. 600 (Bankr. C.D. Ill. 2008): “The proposed strip off may be raised as a contested matter and presented as a provision in a Chapter 13 plan. A separate adversary proceeding is not necessary.”

g. *Espinosa*. The Supreme Court expounded on the requirements of procedural due process for Chapter 13 creditors in *Espinosa v. United Student Aid Funds, Inc.*, 130 S.Ct. 1367 (2010), which found that a Chapter 13 plan providing for discharge of a student loan did not deny due process even though the adversary proceeding required by the Bankruptcy Rules for such a discharge was not employed. The Court reasoned as follows:

Espinosa’s failure to serve United [the student loan creditor] with a summons and complaint deprived United of a right granted by a procedural rule. See Fed. Rule Bkrcty. Proc. 7004(b)(3). United could have timely objected to this deprivation and appealed from an adverse ruling on its objection. But this deprivation did not amount to a violation of United’s constitutional right to due process. Due process requires notice “reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.” *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314, 70 S.Ct. 652, 94 L.Ed. 865 (1950); see also *Jones v. Flowers*, 547 U.S. 220, 225, 126 S.Ct. 1708, 164 L.Ed. 2d 415 (2006) (“[D]ue process does not require actual notice . . .”). Here, United received *actual* notice of

the filing and contents of Espinosa's plan. This more than satisfied United's due process rights.

130 S.Ct. at 1378.

4. Lien termination on plan completion without discharge (because debtor not entitled to discharge)?

a. § 1325(a)(5)(b), allowing modification of a secured claim if:

(5) with respect to each allowed secured claim provided for by the plan—

...
(B) (i) 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

b. No lien termination in the absence of discharge. *In re Lilly*, 378 B.R. 232, 236-37 (Bankr. C.D. Ill. 2007):

A debtor who files a Chapter 13 case despite not being eligible for a discharge, nevertheless has the power to modify a secured creditor's rights under Section 1322(b)(2), and the power to pay the creditor's claim with interest at the *Till* rate under Section 1325(a)(5)(B)(ii). Without a discharge, however, these modifications are effective only for the term of the plan. The DEBTOR remains liable for the full amount of the underlying debt determined under nonbankruptcy law, including her liability for interest calculated at the contract rate. If the interest rate reduction achieved under a confirmed plan was determined to be permanent and binding on the creditor, that would result in a de facto discharge of a portion of the underlying debt, a benefit to which the DEBTOR is not entitled. Once the plan is completed, the DEBTOR remains liable for the balance of the "underlying debt determined under nonbankruptcy law," which remains secured by the lien under Section 1325(a)(5)(B)(ii)(I)(aa).

c. Another possible view. Because the lien retention provision of § 1325(a)(5)(B)(i)(I) only applies "with respect to each allowed secured claim," and because, under § 506(a), a claim is only a secured "to the extent of the value of [the] creditor's interest" in the collateral, it could be determined that a wholly underwater mortgage is not an "allowed secured claim" subject to the lien retention provision.