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# Lien Stripping in Consumer Bankruptcy

Bringing or Defending Actions to Avoid Junior Mortgage Liens in Chapter 13 Filings

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TUESDAY, JANUARY 24, 2012

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

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Today's faculty features:

Robert V. Schaller, Owner, Schaller Law Firm, Oak Brook, Ill.

Monette W. Cope, Junior Partner, Weltman Weinberg & Reis, Chicago

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## **Chapter 13 Lien Strip-Offs of Wholly Unsecured Junior Mortgages**

By: Robert V. Schaller ©2011. All rights reserved.

Lien stripping is not permitted in Chapter 7 bankruptcy cases. That door was closed by the U.S. Supreme court in Dewsnup v. Timm, 502 U.S. 410 (1992). There, the Dewsnup court expressly prohibited lien stripping via §506(a) in Chapter 7 cases.

Prior to the Dewsnup decision, the Supreme Court had not addressed the issue of lien stripping in Chapter 13 bankruptcy cases, leaving unresolved the issues of (a) stripping an undersecured mortgage lien and (b) stripping a wholly unsecured junior mortgage lien.

One of those issues was resolved in 1993. The Supreme Court address the issue of lien stripping of undersecured mortgage liens in its seminal decision of Nobelman v. American Savings Bank, 508 U.S. 324 (1993). In Nobelman, the Supreme Court addressed the issue of whether a debtor's attempt to "strip-down" an undersecured residential mortgage lien held by the senior lienholder was prohibited. More specifically, the court framed the issue as whether §1322(b)(2) prohibited a chapter 13 debtor from relying on §506(a) to reduce an undersecured homestead mortgage to the fair market value of the mortgaged residence. The Nobleman court then held that §1322(b)(2) does prohibit a debtor from stripping-down the undersecured home mortgage to its fair market value.

Left unanswered was the issue regarding "stripping-off" wholly unsecured second mortgage liens. Therefore, the issue remained unanswered whether §1322(b)(2) prohibited a chapter 13 debtor from relying on §506(a) to strip-off a wholly unsecured homestead mortgage. Without Supreme Court direction, the issue of lien stripping wholly unsecured homestead mortgage liens has been hotly debated and frequently litigated. The majority of courts that have addressed this issue are in favor of allowing Chapter 13 debtors to strip-off wholly unsecured

homestead mortgage liens, including Judge Squires of the US Bankruptcy Court for the Northern District of Illinois. See Waters v. The Money Store (In re Waters), 276 B.R. 879 (Bankr. N.D.IL 2002)(J. Squires). But, there is some authority rejecting the ability to strip-off these liens, including Judge Schmetterer in the US Bankruptcy Court for the Northern District of Illinois. See Barnes v. American General Finance (In re Barnes), 207 B.R. 588 (Bankr. N.D.IL 1997)(J. Schmetterer).

Regrettably, the Seventh Circuit Court of Appeals has not directly ruled on this issue. But all of the other Circuit Courts that have addressed this issue have been in unanimous support of the majority position of allowing lien stripping of wholly unsecured junior mortgage liens. The Second Circuit, Third Circuit, Fifth Circuit, Sixth Circuit, and Eleventh Circuit all agree that a lien strip-off of wholly unsecured junior mortgage is permissible after Nobelman. See Pond v. Farm Specialist Realty (In re Pond), 252 F.3d 122 (2nd Cir. 2001); McDonald v. Master Fin., Inc. (In re McDonald), 205 F.3d 606 (3rd Cir. 2000); In re Bartee, 212 F.3d 277 (5th Cir. 2000); In re Lane, 280 F.3d 663 (6th Cir. 2002); Zimmer v. PSB Lending Corp., 313 F.3d 1220 (9th Cir. 2002); and In re Tanner, 217 F.3d 1357 (11th Cir. 2000). See also two Bankruptcy Appellate Panels supporting lien strip-offs, Domestic Bank v. Mann, 249 B.R. 831 (1st Cir. BAP 2000); and Lam v. Investor Thrift, 211 B.R. 36 (9th Cir. BAP 1997).

Judge Squires' Waters case illustrates the majority position. In re Waters, 276 B.R. 879 (Bankr. N.D.IL 2002). There the Waters court framed the issue as whether a Chapter 13 debtor can strip off a wholly unsecured junior mortgage pursuant to 11 U.S.C. §506(d), notwithstanding the anti-modification protection afforded holders of home mortgages in 11 U.S.C. §1322(b)(2). The court began its analysis by distinguishing between (a) attempts to “strip-down” undersecured mortgage liens and (b) attempts to “strip-off” wholly unsecured mortgage liens. The court immediately rejected any attempts to strip-down a mortgage lien because of the Supreme Court's Nobelman decision. But the facts in Waters demonstrated that the uncontroverted fair market

value of the debtor's home was less than the amount of debt subject to the senior mortgage lien. Therefore, the court found that the second mortgage was wholly unsecured. The Waters court spent the remainder of the opinion resolving the "strip-off" issue. In the end, the Waters court stripped the wholly unsecured junior mortgage and avoided the lien.

A similar approach was taken in First Mariner Bank v. Johnson, 411 B.R. 221 (D. Md. 2009). There, the Johnson court began its discussion by examining Section 506 and Section 1322(b)(2). Section 506(a) generally permits a debtor to bifurcate a secured creditor's claim into secured and unsecured portions if the amount of the claim exceeds the value of the collateral. Section 506(a) applies to bankruptcies under all chapter and sorts creditors' allowed claims against the debtor into secured and unsecured claims:

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, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim...

11 U.S.C. Section 506(a)(1).

Whereas, 11 U.S.C. Section 1322(b)(2) applies only to Chapter 13 bankruptcies. It states that a debtor's Chapter 13 plan may:

"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." 11 U.S.C. Section 1322(b)(2).

The Johnson court rejected creditor's argument that the Supreme Court's Nobleman decision interpreted Section 1322(b)(2) as prohibiting the modification of any claim secured

by a lien on real property that is the debtor's principal residence. The court rejected creditor's attempt to equate the phrases 'secured by a lien on real property' and "secured claim."

11 U.S.C. Section 1322(b)(2).

The Johnson court found that the anti-modification provision in Section 1322(b)(2) did not apply because junior lienholder's lien was not a "secured claim" within the meaning of the Bankruptcy Code. The court believed that the proper starting point in its analysis is the valuation in Section 506(a), not the anti-modification exception contained in Section 132(b)(2). Therefore, the court found that a creditor cannot invoke the anti-modification protection in Section 1322(b)(2) without first demonstrating that it has an allowed secured claim.

The Johnson court also noted that lawyers and layperson often think of any claim for repayment of a mortgage loan as a "secured claim" whether or not the mortgagee could actually realize anything at a foreclosure sale. However, that is incorrect as a matter of bankruptcy law. Whether a lienholder has a "secured claim" or an "unsecured claim," in the sense in which those terms are used in the Bankruptcy Code, depends on whether the lienholder's interest in the collateral has economic value. Therefore, a junior mortgagee whose lien on a Chapter 13 debtor's property is "completely under water" holds an unsecured claim regardless of the fact that the junior mortgage was secured by a lien on the debtor's principal residence.

Therefore, the Johnson court stripped the junior lien after concluding that because the first lien on debtor's property exceeded the fair market value in the home, the junior lien was wholly unsecured, and its interest could be modified by the Chapter 13 plan pursuant to Section 1322(b)(2).

#### ABOUT THE AUTHOR

Robert Schaller has been practicing law in the Chicagoland area for more than 25 years and concentrates his practice on consumer bankruptcy law. He has filed thousands of

bankruptcy cases and offices in Oak Brook, IL. He attended the University of Illinois and received a B.S. in Accountancy. He received his J.D. from the DePaul University. Mr. Schaller is also a Certified Public Accountant. His website is [www.SchallerLawFirm.com](http://www.SchallerLawFirm.com).

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF ILLINOIS

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In Re: :  
 : Chapter 13  
**George & Martha Washington** :  
 : Case No. 11-12X45  
 Debtor(s) : Judge: A. Lincoln  
 : Trustee: Smith

-----X  
In Re: :  
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**George & Martha Washington** : Adversary  
 Plaintiff(s) : Case No. 12 A 0X133

-vs- :  
 :  
**National Junior Bank, N.A.** :  
 Defendant :

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**ADVERSARY COMPLAINT TO DETERMINE NATURE AND EXTENT OF LIEN AND  
AVOID JUNIOR MORTGAGE OF NATIONAL JUNIOR BANK, N.A.**

NOW COMES, the Plaintiffs George & Martha Washington, by and through attorney Robert V. Schaller, and file this adversary complaint to determine the nature and extent of a junior mortgage lien and to avoid said junior mortgage lien held by defendant National Junior Bank, N.A. In support thereof, plaintiffs state as follows:

1. Plaintiffs, George & Martha Washington are individuals residing at 123 Main Street, Mount Vernon, IL 60601.
2. National Junior Bank, N.A. is the lender and/or servicer of a junior mortgage.
3. On 12/4/09, George & Martha Washington filed a Petition for Relief under Chapter 13 of Title 11 of the United States Code in the Northern District of Illinois. The case was assigned Case Number 11-12X45.

4. This Adversary Proceeding arises under Sections 502 and 506 of the United States Bankruptcy Code.

5. This Honorable Court has jurisdiction over this Adversary Proceeding pursuant to 28 USC Sections 151, 157 and 1334 and Local Rule 2.33 of the United States District Court for the Northern District of Illinois, in that this action relates to the Bankruptcy Case 11-12X45, In Re George & Martha Washington, which is presently pending before this Honorable Court.

6. This proceeding is a core proceeding under 28 USC Section 157(b)(2)(K).

7. George & Martha Washington is/are the owner(s) of real estate commonly known as 123 Main Street, Mount Vernon, IL 60601 (hereinafter called "the real estate") bearing PIN and legally described as follows:

PIN: 15-05-XX-288-507-0180

Legal Description: Lot 40, in River Side Estates Unit 1, a subdivision of part of the East Half of Section 6, and part of the East Half of Section 12, in Township 27 North Range 10, East of the Third Principal Meridian, according to the plat thereof recorded December 27, 1988, as Document No. 88-12575 in Cook County, Illinois.

8. The fair market value of the real estate is no more than \$279,250.00. Attached hereto and made a part hereof is a Realtor market analysis prepared by Realtor Gloria Knoweverything and Schedule A.

9. Incorporated herein by reference is Schedule A and D of Plaintiffs' bankruptcy schedules, and any amendments thereto, in the underlying Chapter 13 bankruptcy case 11-12X45.

- 10.** Upon information and belief, a first mortgage lien is currently held by National Senior Bank, N.A. in the amount no less than \$316,520.00.
- 11.** The defendant(s) hold a junior mortgage originally granted in the amount of \$121,126.00. This junior mortgage is believed to have been recorded in the Office of the Cook County Recorder of Deeds as Document Number 88-12575 (hereinafter, the “Junior Mortgage Lien”).
- 12.** Plaintiffs seek to determine the nature and extent of Defendant’s Junior Mortgage Lien, and seek to avoid the Junior Mortgage lien.
- 13.** Under Sections 506(a) and 506(d), defendant’s junior mortgage would be an allowed secured claim to the extent of the value of the estate’s interest in the property securing the claim, and defendant’s lien is void to the extent it is not an allowed secured claim.
- 14.** The junior mortgage lien is wholly unsecured because the amount owned on the first mortgage, believed to be no less than \$316,520.00, exceeds the fair market value of the underlying property.
- 15.** Because the junior mortgage lien held by defendant is wholly unsecured, it should not be allowed as a secured claim and the mortgage lien may be stripped off. In Re Mann, 249 B.R. 831, 840 (1<sup>st</sup> Cir BAP 2000); In Re Pond, 2001 U.S.App.Lexis 11287 (2<sup>nd</sup> Cir. 2001); In re McDonald, 205 F.2d 606 (3<sup>rd</sup> Cir 2000); Bartee vs. Tara Colony Homeowners Assoc, 212 F.3d 277 (5<sup>th</sup> Cir. 2000); In re Lam, 211 B.R. 36 (9<sup>th</sup> Cir BAP 1357); In Re Tanner, 217 F.3d 1357 (11<sup>th</sup> Cir)

**16.** This Complaint is also an objection to whatever claim might be filed or allowed regarding the junior mortgage.

WHEREFORE, **George & Martha Washington** pray that this Honorable Court enter judgment against National Junior Bank, N.A. and find that the alleged lien of defendant is completely unsecured, avoid defendant's junior mortgage lien, find that the junior mortgage is of no further legal effect and for any further relief that this court deems just and proper.

January 23, 2012

Respectfully Submitted,  
**George & Martha Washington**

s/s Robert V. Schaller  
By: Plaintiffs' Counsel

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