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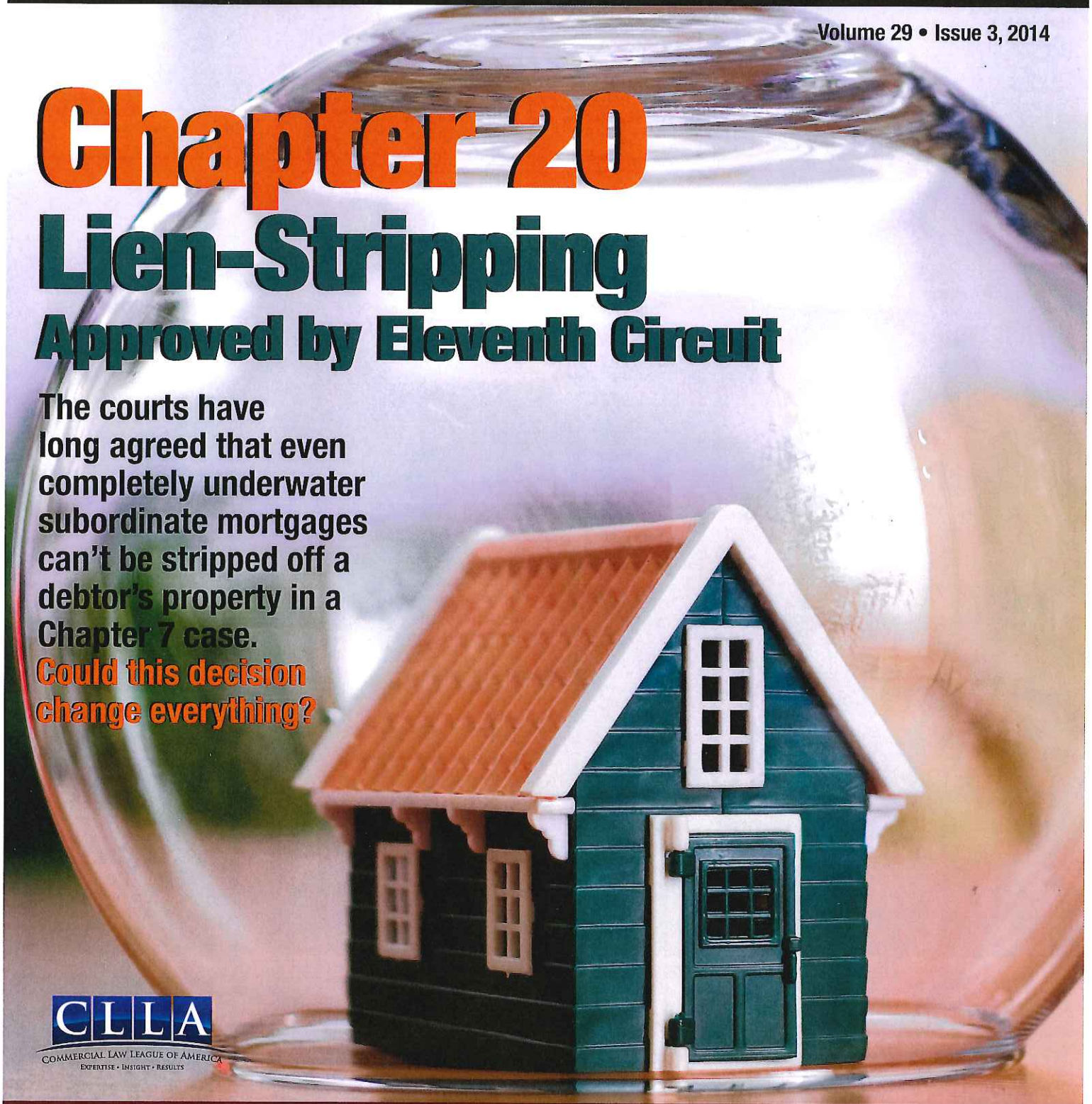

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Chapter 20 Lien-Stripping Approved by Eleventh Circuit

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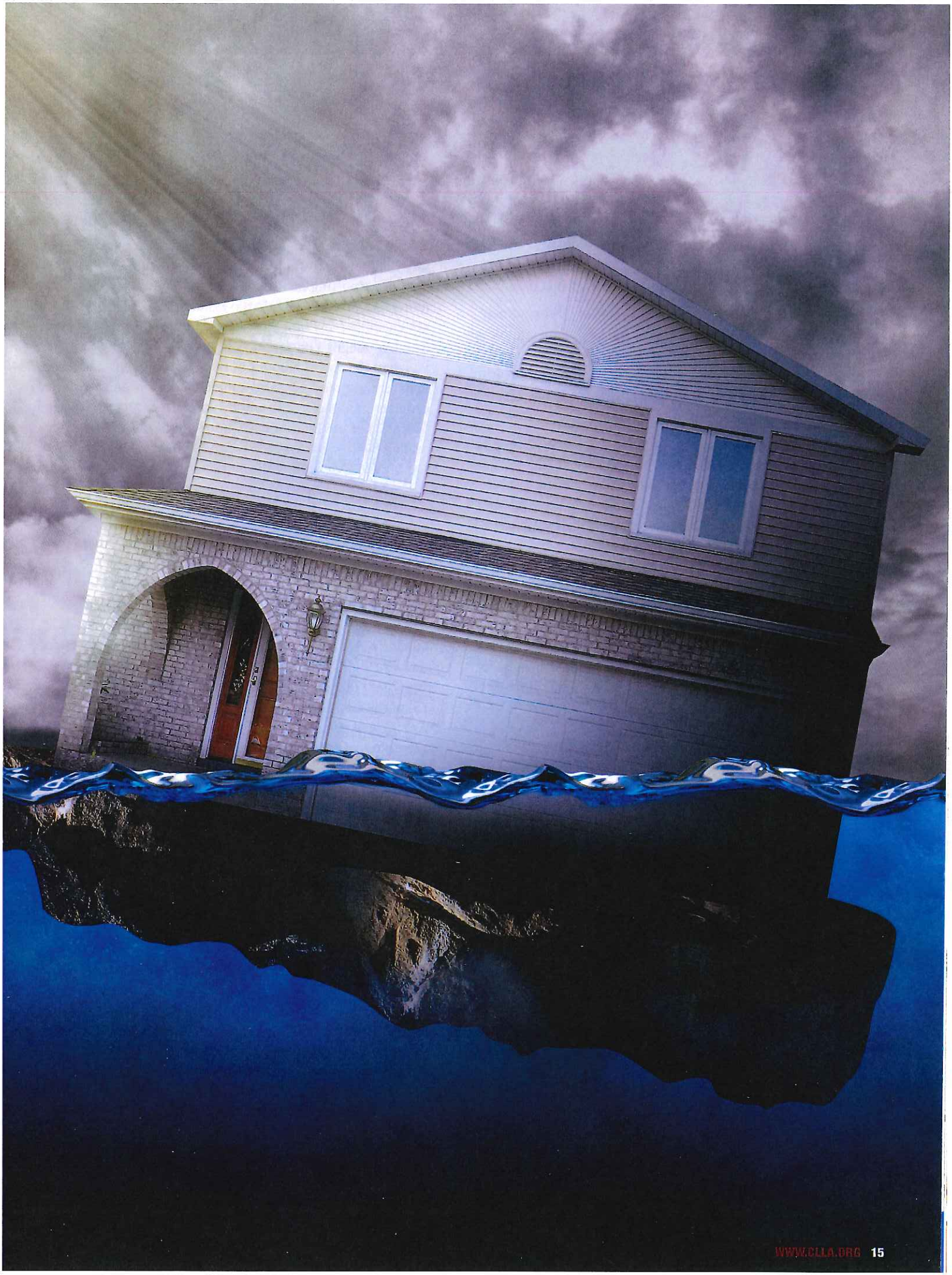
On June 18, 2014, the United States Court of Appeals for the Eleventh Circuit held that it is permissible for a debtor to strip-off subordinate liens in a Chapter 13 case that immediately followed the debtor's Chapter 7 discharge. *Scantling v. Wells Fargo Bank (In re Scantling)*, No. 13-10558, 2014 WL 2750349 (11th Cir. June 18, 2014).



It becomes the second court of appeals to so hold, following the lead of the Fourth Circuit. *Branigan v. Davis (In re Branigan)*, 716 F. 3d 331 (4th Cir. 2013). Two bankruptcy appellate panels concur. In re Fisette, 455 B.R. 177 (8th Cir. BAP 2011) (same holding), *app. dism'd In re Fisette*, 695 F.3d 803, 804 (8th Cir. 2012), and *In re Cain*, BAP No. 13-8045 (6th Cir. BAP July 14, 2014).

This new trend is significant because it has long been agreed by courts that even subordinate mortgages which are completely "underwater" cannot be stripped off a debtor's property in a Chapter 7 case. There is even some dispute among courts as to whether the practice is permissible in a Chapter 13 case.

The Importance of "Chapter 20"

To appreciate the significance of this ruling one must first consider how important the Chapter-7-followed-by-Chapter-13 scenario — the so-called Chapter 20 case — is to individual debtors. A Chapter 20 case typically results from a debtor's need to discharge unsecured debts in order to reduce total liabilities to a figure below the dollar limits for qualifying for Chapter 13 relief, and then to restructure secured debt pursuant to the authority of section 1322(b)(2), perhaps paying the secured creditor only the value of its collateral, retaining the collateral and paying the unsecured creditors only so much over time as they would have received from an immediate liquidation of the debtor's petition-date assets.

Individual debtors with regular income whose secured debts do not exceed $1,149,525 and whose unsecured debts do not exceed $383,175 are eligible to choose between Chapter 13 and Chapter 11 relief, see 11 U.S.C. §109(e). However, Chapter 13 is greatly preferable to the individual debtor in most circumstances. Chapter 11 is costly and presents major hurdles to plan confirmation not present in Chapter 13.

The greatest hurdle, perhaps, is the "absolute priority rule," preventing the confirmation of any Chapter 11 plan which offers a discounted payout to a non-accepting class of unsecured creditors while the debtor retains property, such as the debtor's business interests that often are essential to be retained in order to generate the profit to fund the plan. All four circuit courts that have considered the issue have found that the rule has continued vitality even as to individual Chapter 11 debtors. *In re Maharaj*, 681 F.3d 558, 569 (4th Cir. 2012); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013); *In re Lively*, 717 F.3d 406, 407 (5th Cir. 2013); *In re Cardin*, No. 13-5764, 2014 WL 1887583 (6th Cir. May 13, 2014). Chapter 20 cases present a permissible way for an individual debtor to restructure secured debts without having to meet the absolute priority rule.

The Scantling Case

Tahisia Scantling received a discharge of her debts in a voluntary Chapter 7 case. A few months later, she filed a Chapter 13 petition, reporting that she owned her home subject to three mortgages held by Wells Fargo Bank, N.A. The mortgages did not encumber any other collateral. In the Chapter 13 case, Scanling sought a determination that the value of the home was less than the payoff amount of the first mortgage, and the bank apparently agreed. She also sought a declaration that the subordinate mortgages were wholly unsecured pursuant to section 506(a)(1) of the Bankruptcy Code and therefore void under section 506(d). Bankruptcy Judge Michael G. Williamson of the Middle District of Florida found in favor of the debtor and declared the under-water mortgages void.

While another bankruptcy judge in Florida had ruled the same way, at least five other bankruptcy judges in Florida had published opinions to the contrary. Compare *In re Dang*, 467 B.R. 227 (Bankr. M.D. Fla. 2012) (Glenn, J.) with *In re Pierre*, 468 B.R. 419 (Bankr. M.D. Fla. 2012) (Jenneman, J.); *In re Gerardin*, 447 B.R. 342 (Bankr. S.D. Fla. 2011) (Mark, Isicoff, and Cristol, J.); *In re Quiros-Amy*, 456 B.R. 140 (Bankr. S.D. Fla. 2011) (Olson, J.). Those courts held that section 1325(a)(5) of the Code protected wholly underwater mortgage claims as "allowed secured claims" in a so-called "Chapter 20" case regardless of what would be considered "secured" under section 506(a), and the liens could not be voided. The United States Supreme Court had held in *Johnson*, a Chapter 20 case, in 1991 that a secured claim, the *in personam* liability of which was discharged in a Chapter 7 case, survived nonetheless as an *in rem* claim that can and must be treated in the Chapter 13 case that followed. *Johnson v. Home State Bank*, 501 U.S. 78, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991). And the following year the court held in a strip-down case that section 506(d) of the Code does not act to avoid a lien solely on the basis of a section 502(a) valuation of collateral but requires some other Code section to actuate the avoidance. *Dewsnup v. Timm*, 502 U.S. 410, 417, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992).

Those bankruptcy courts reasoned that: (a) section 502(b)(1) provides that claims are to be allowed except to the extent they are unenforceable against the debtor *and* the debtor's property; (b) the entire amount of the mortagee's claim survives the Chapter 7 discharge in the form of a lien on the home, even though the right to collect from the debtor as a personal liability

ended with the discharge; (c) the secured claim is not voided by section 506(d) because there is no provision in the Code that would meet the *Dewsnup* rule for actuating the avoidance; (d) section 1325(a)(5) requires Chapter 13 plans to provide that the lien of an allowed secured claim be retained until the underlying debt is paid in full or until a Chapter 13 discharge is granted; and (e) since 2005, section 1328(f) has barred debtors who received a discharge in a case commenced under Chapter 7 within four years prior to the Chapter 13 order for relief from receiving a Chapter 13 discharge. And they further noted that section 1322(b)(2) and (b)(5) combine to limit the restructuring of home mortgages to the cure of arrearages during the term of the plan.

These judges concluded that Congress no longer provides lien-stripping as a basis for Chapter 20 debtors to restructure debt secured solely by a home mortgage. They acknowledged, however, that numerous bankruptcy judges, especially in the Ninth Circuit, had permitted the practice. *In re Gerardin*, 447 B.R. 342, 349 (Bankr. S.D. Fla. 2011), citing cases.

The Eleventh Circuit Ruling

In a decision by Circuit Judge Gerald Bard Tjoflat and two senior district judges, the Eleventh Circuit panel affirmed Judge Williamson's decision, adopted his reasoning, and rejected the conclusions of the other Florida bankruptcy judges, which it described as a minority of courts. In *Tanner v. FirstPlus Financial, Inc. (In re Tanner)*, 217 F.3d 1357, 1360 (11th Cir. 2000) it had concluded that the Supreme Court's opinion in *Nobelman v. American Savings Bank*, 508 U.S. 324, 113 S. Ct. 2016, 124 L. Ed. 2d 228 (1993) — holding that a Chapter 13 debtor may not strip *down* a second mortgage lien on the debtor's residence — did not prevent a Chapter 13 debtor from stripping *off* a wholly unsecured home mortgage. Chapter 13 debtors have been permissibly stripping down wholly unsecured mortgages ever since. *Tanner's* holding has been followed in the Third and Fifth Circuits—the only other circuits to consider the issue in a Chapter 13 case prior to the Fourth Circuit's adoption of the same rule in a Chapter 20 case. 508 U.S. 324, 113 S. Ct. 2016, 124 L. Ed. 2d 228 (1993).

Citing *Tanner* as precedent, the appeals court concluded once again that *Dewsnup* protects only mortgagees for whom there is at least *some* collateral coverage for their mortgages, and held that wholly underwater subordinate mortgagees are not "secured creditors" entitled to the protection of the Chapter 13 antimodification clauses — section 1322(b) and 1325(a)(5) — in a "Chapter 20" case any more than they would have been in a Chapter 13 case.

A footnote states that the panel feels bound to follow prior published decisions of other Eleventh Circuit panels in deference to circuit precedent that panels should not diverge on the same issue; however, this panel's direction to publish the Scantling decision signals that the court is still supportive of the *Tanner* holding. *Scantling* at note 5. Another Eleventh Circuit panel noted its disagreement with *Tanner* but followed its holding. *In re Dickerson*, 222 F.3d 924, 926 (11th Cir.2000), *cert. denied*, 532 U.S. 972, 121 S.Ct. 1604, 149 L.Ed.2d 470 (2001).

It is noteworthy that, while the Eleventh Circuit has extended its *Tanner* holding to Chapter 20 cases, the panel did *not* cite the its recent approval of lien-stripping underwater mortgages in Chapter 7 cases in support of its holding. The Eleventh is the only circuit court which has approved chapter 7 strip-offs of home mortgages, in *McNeal v. GMAC Mortgage, LLC (In re McNeal)*, 735 F.3d 1263, 1266 (11th Cir.2012), *motion for rehearing en banc pending*; and a recent decision by a panel on which Judge Tjoflat sat seems to follow the *McNeal* holding only grudgingly. *Wilmington Trust, National Ass'n v. Malone (In re Malone)*, No. 13–13688, 2014 WL 1778982 (11th Cir. May 6, 2014). A motion for rehearing *en banc* remains pending in *McNeal*.

In summary, the Eleventh Circuit's new *Scantling* decision is a victory for individual debtors — at least those whose encumbered assets are worth no more than $1,149,525 in secured debt — looking for an alternative to Chapter 11 and its absolute priority rule. They may now discharge their unsecured debts in Chapter 7 and then cure their first mortgage arrears over as much as five years in Chapter 13 while stripping off any "underwater" second mortgage.

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