Courts Divided Over Using Chapter 20 Bankruptcy Filings to "Strip Off" Wholly Unsecured Mortgages

By Camille J. Iurillo and Sabrina C. Beavens

Scenario: Mr. and Mrs. Smith received a Chapter 7 bankruptcy discharge in October 2010. They were enjoying their "fresh start" free of the credit card debt which had been burdening them for years. The Smiths were both employed and able pay the first and second mortgages on their homestead. Unfortunately, last month Mr. Smith ran a stop sign and collided with a tractor trailer causing him to sustain extensive bodily injury. He is unable to work and the family must cover their monthly expenses on Mrs. Smith's wages alone. The Smiths can no longer afford to pay both mortgages on their homestead, but they can afford to pay the first. Does the Bankruptcy Code provide relief to this family?

Maybe. The issue presented is whether a debtor(s) who is not eligible for a Chapter 13 discharge because the debtor received a discharge in a chapter 7 case within four years of the new filing may "strip off" a wholly unsecured junior mortgage in a Chapter 20 case. (A Chapter 20 case is a Chapter 13 case following a Chapter 7 case where the debtor received a discharge.) This issue has not been decided by the Eleventh Circuit and as two recent opinions demonstrate, Florida bankruptcy courts are divided.

In *In re Scantling*, 465 B.R. 671 (Bankr. M.D. Fla. 2012) the debtor filed a motion to determine secured status of the second and third mortgages on her homestead. The debtor valued the home at $118,000.00 and the balance on the first mortgage was approximately $122,000.00. Accordingly, the junior mortgages held by Wells Fargo were wholly unsecured. Wells Fargo objected to the motion arguing that because the debtor had received a discharge in her prior Chapter 7 case within four years of the filing of the Chapter 13 case, she was not eligible for a discharge under 11 U.S.C. § 1328(f) and therefore could not "strip off" the junior mortgages.

The court divided its analysis into three parts: (1) analysis of the established guiding principles from the Supreme Court and circuit courts on Chapter 20 cases; (2) consideration of the applicable Bankruptcy Code provisions in light of those principles; and (3) consideration of the opinions ruling that strip offs in Chapter 20 cases were not permissible.

The guiding principles distilled from the Supreme Court and circuit courts were: (1) The Bankruptcy Code does not prohibit Chapter 20 cases. If a debtor meets the eligibility requirements of a Chapter 13 filing, the debtor may propose a plan that strips off junior liens even after the personal liability of the debtor was discharged in the prior Chapter 7 case; (2) The rights of secured creditors cannot be modified in a Chapter 7 case; (3) A secured creditor's rights cannot be modified in a Chapter 13 case if the value of collateral value, even $1.00, secures the junior lien; and (4) 11 U.S.C. § 1322(b)(2) permits a debtor to strip off a wholly unsecured lien on the debtor's principle residence.

The court then focused on the interplay between § 506(a) and § 1322(b)(2). Section 1322(b)(2) permits a debtor to modify the rights of a secured creditor provided the lien is not on the debtor's principle residence. The key is that under § 506(a) a wholly unsecured junior mortgage is not a

claim secured by the debtor’s principle residence. Accordingly, the debtor may exercise the right to strip off the mortgage because it is not secured.

The *Scantling* court also considered the reasoning of courts granting the objections of junior mortgage holders. These courts hold that 11 U.S.C. § 1325(a)(5) prohibits Chapter 20 lien stripping. This section states, in pertinent part, that a plan may be confirmed if the holder of an allowed secured claim has accepted the plan and the holder of such claim retains its lien until the earlier of “(aa) the payment of the underlying debt determined under nonbankruptcy law; or (bb) discharge under section 1328”. However, the court pointed out that this section only applied to “allowed secured claims” and a wholly unsecured junior mortgage is not an allowed secured claim.

The court ultimately held that eligibility for a discharge is not a requirement for relief under Chapter 13 of the Bankruptcy Code. Section 1328(f)(1) only precludes a debtor from receiving a discharge in the Chapter 13 case, “but that in no way limits any other rights available to the debtor under the Bankruptcy Code, such as the right to strip off unsecured junior liens under § 506(a) and § 1322.” It is important to note that the court stated that the right to strip off unsecured mortgages in no discharge cases is not absolute and the Chapter 13 plan must be filed in good faith.

In contrast, the court in *In re Pierre*, 2012 WL 928192 (Bankr. M.D. Fla. March 16, 2012), held that “[a]ttempts to strip off….[junior liens] in a Chapter 20 no-discharge situation not only violate[s] the plain language of the Bankruptcy Code” but also violates “Congress’ clear intent in enacting” the 2005 amendments to the Bankruptcy Code. The facts of *Pierre* are unique in that the debtor had been granted a discharge in a prior bankruptcy case with her husband. She subsequently moved to revoke her discharge (her husband did not) which was granted by the court. In the Chapter 13 case, the debtor sought to strip off certain liens on investment property and bifurcate (or strip down) liens on other property into secured and unsecured claims. The properties were owned as tenants by the entirety with the debtor’s spouse.

Citing to *Scantling* as a minority holding contradicting Congress’ intent in creating Chapter 13, the court held that “a lien valued at zero pursuant to § 506(d) is not void again unless and until the debtor receives a discharge.” Whereas the *Scantling* viewed the central purpose of Chapter 13 as saving homes, the court in *Pierre* described Chapter 13 as being “created to protect overextended individual wage earners desiring to voluntarily repay their debts through the automatic stay and provide financial relief through a fresh start. To view Chapter 13 as an instrument for protecting real property, or as a panacea for the real estate recession, misconstrues Congress’ intended purpose of Chapter 13. Although debtors indeed may use Chapter 13 to save their homes, the legislative purpose of Chapter 13 is to maximize recovery to creditors by allowing debtors to cure arrears and make payments over a period of up to 60 months.”

The debtor, who was eligible for a discharge, was precluded from stripping off the lien for two reasons. First, the court held that a debtor may not strip off a lien encumbering real property owed as TBE unless the spouse is a debtor in the case. Second, both owners of the TBE property must be eligible to receive a Chapter 13 discharge. The debtor’s motion failed both prongs. The

Court established a "black and white rule" that "co-TBE owners must file a joint Chapter 13 case and both must receive Chapter 13 discharges before *either* can strip down/off a secured lien."

In sum, currently, a Chapter 13 debtor who is not eligible for a discharge may be able to strip off a wholly unsecured junior lien, depending on the judge assignment. Further, the differing legal analysis of the various provisions of the Bankruptcy Code by the respective courts is ripe for appeal and therefore the law may change after a case is filed.

Iurillo & Associates, P.A., located in downtown St. Petersburg, is comprised of **Camille J. Iurillo**, Shareholder, **Gina M. Pellegrino**, Associate, and **Sabrina C. Beavens**, Associate. The primary areas of practice of **Iurillo & Associates, P.A.** are Commercial and Bankruptcy Litigation, Debtors' and Creditors' Rights, and Foreclosures/Workouts.