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Bankruptcy: Eleventh Circuit Review

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Abstract

In the last two years, the Eleventh Circuit decided several cases which have raised controversial questions about the treatment of liens¹ or secured claims² in consumer bankruptcy.

KEYWORDS: bankruptcy, review, circuit

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I. SECURED CLAIMS IN CONSUMER BANKRUPTCY

In the last two years, the Eleventh Circuit decided several cases which have raised controversial questions about the treatment of liens¹ or secured claims² in consumer bankruptcy. In *In re Folendore*,³ the court accepted an interpretation of the Bankruptcy Code unsupported in either pre-Code or legislative history: that a debtor in chapter 7⁴ may avoid wholly undersecured claims under section 506(d).⁵ Secured claims have received a chilly reception in bankruptcy throughout the years, and *Folendore* is frostier than most.

Related to *Folendore* is the development of home mortgage lien-stripping⁶ in chapter 13⁷: that a chapter 13 debtor may limit the mortgage lien during and after the chapter 13 case to the value of the home.⁸ Although the Eleventh Circuit has yet to rule on the controver-

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1. The Bankruptcy Code, Title 11 of the U.S.C. [hereinafter Code], states that a "lien" means charge against or interest in property to secure payment of a debt or performance of an obligation." 11 U.S.C. § 101(33) (1988).

2. The Code defines a secured claim broadly in section 506(a): "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 . . ." 11 U.S.C. § 506(a) (1988).

3. *In re Folendore*, 862 F.2d 1537 (11th Cir. 1989).

4. Chapter 7 of the Code provides for the liquidation of the debtor's nonexempt assets from which creditors will receive payment. The remaining chapters of the Code deal with reorganization of debtors.

5. 11 U.S.C. § 506(d). See *infra* note 27 and accompanying text.

6. Lien-stripping is the invalidation of a lien on property to the extent that the property has a value less than the debt secured by the lien.

7. Chapter 13 of the Code is a reorganization chapter. Debtor commits to a three (sometimes five) year payment plan. When, or if, the plan is completed, the debtor is discharged from any remaining debt other than domestic obligations and long-term debt. 11 U.S.C. § 1328 (1988).

8. Although this issue has not appeared in a reported Eleventh Circuit opinion, a discussion of the Third Circuit opinion in *Wilson v. Commonwealth Mortg. Co.*, 895 F.2d 123 (3rd Cir. 1990), is included because *Folendore* may foreordain that result.

sial question of home mortgage lien-stripping in chapter 13, the *Folendore* decision and the recent validation of serial bankruptcy filings in *Saylor*⁹ suggest that a "chapter 20"¹⁰ may permit a debtor to lien-strip a home mortgage.¹¹ In general under chapter 7, lien-stripping is controversial as is lien-stripping a home mortgage under chapter 13.

Bankruptcy is complex because the interpretation of the 1978 Code breeds three recurrent controversies. First, the functions of the several different chapters of the Code, as well as the different avenues of relief, are both alike, yet different. Second, a large number of key provisions of the Code, especially Chapter 5, apply to all chapters under which a debtor, and sometimes a creditor, may file for relief. Unless the Code drafters strove for controversy, it is a grave error to assume the usefulness, or appropriateness, of such a significant number of provisions for different forms of debtor relief. Surely, the drafters' expectation of how all the provisions would fit together exceeded their draftsmanship. Core conceptions in bankruptcy often fit a paradigm of liquidation and discharge; others fit a paradigm of reorganization. Rarely do the core conceptions fill the same function in both liquidation and reorganization. Because a number of core matters receive prescription in Chapter 5, the courts have had some difficulty finding how these fit both liquidation cases under Chapter 7 and reorganization cases under Chapters 11 and 13. The third essential creating more than technical controversy under the Code is public policy. Lien-stripping in bankruptcy generates controversy not only for its novelty, but because it significantly differs from lien avoidance under the classical,¹² strong-arm,¹³ preference¹⁴ and fraudulent transfer¹⁵ ideas. The classical theories of lien avoidance rest on a perceived inter-creditor unfairness. The strong-arm power invalidates pre-bankruptcy liens because failure to

See *infra* note 54 and accompanying text.

9. *In re Saylor*, 869 F.2d 1434 (11th Cir. 1989).

10. See *infra* note 92.

11. The use of a chapter 20 to lien-strip a home mortgage should be impermissible, and *Folendore* itself does not permit such a strategy. See *infra* notes 75-99.

12. The classical lien avoidance provisions of bankruptcy law antedate the Bankruptcy Code of 1978 and were firm fixtures of bankruptcy jurisprudence at that time. See Bankruptcy Act of 1898, *as amended* by the Chandler Act of June 22, 1938, ch. 575, 52 Stat. 840 (repealed 1979). These classical lien avoidance provisions continue in present law. See *infra* notes 13-15 and accompanying text.

13. 11 U.S.C. § 544 (a) (1988).

14. 11 U.S.C. § 547 (b).

15. 11 U.S.C. § 548.

notice the lien presumably misleads other creditors. Preferences upset traditional bankruptcy norms concerning what creditors should receive. Similarly, fraudulent transfers to creditors and donees, prior to bankruptcy, affect bankruptcy's distributional norms. For the most part, creditors and other third parties can engage in transactions with proper planning and immunize their interests from classical lien avoidance. That is, what one might regard as legitimate secured transactions entered into with a debtor prior to bankruptcy, properly executed and perfected, rarely result in avoidable liens under the classical lien avoidance powers.

However, the new phenomena of lien-stripping arises from either market value fluctuation or mistaken collateral valuation. Planning can generally control only the latter. Even if planning could control market value fluctuation, lien-stripping under the Code would remain controversial to the extent it exceeds the proper balance of debtor and creditor benefits. The ideal balance, if any, is controversial. Thus, lien-stripping as a debtor's tool will remain controversial.

A. *In re Folendore*

In *Folendore*, the Eleventh Circuit permitted the use of a controversial lien-stripping¹⁶ power by a chapter 7 debtor. Prior to *Folendore*, courts outside of this circuit disagreed about whether section 506(d) not only determines valid secured claims against the bankruptcy estate, but also invalidates liens outside of the bankruptcy case.¹⁷ The question

16. See *supra* note 6 (defining lien-stripping). *Folendore* approves a controversial interpretation of section 506(d) permitting the foregoing form of lien-stripping in a chapter 7 case, discussed *infra* notes 29-41. Other forms of lien-stripping are less controversial. See, e.g., 11 U.S.C. § 522(f) (1988).

17. Compare *In re Gaglia*, 889 F.2d 1304 (3rd Cir. 1989); *In re Lindsey*, 823 F.2d 189 (7th Cir. 1987); *In re Moses*, 110 Bankr. 962 (Bankr. N.D. Okla. 1990); *In re Brouse*, 110 Bankr. 539 (Bankr. D. Colo. 1990); *In re Zlogar*, 101 Bankr. 1 (Bankr. N.D. Ill. 1989); *In re Garnett*, 99 Bankr. 757 (D.W.D. Ky. 1989); *In re Hougland*, 83 Bankr. 648 (Bankr. D. Minn. 1988); *In re O'Leary*, 75 Bankr. 881 (Bankr. D. Or. 1987); *In re Worrell*, 67 Bankr. 16 (C.D. Ill. 1986); *In re Cleveringa*, 52 Bankr. 56 (Bankr. N.D. Iowa 1985); *In re Lyons*, 46 Bankr. 604 (Bankr. N.D. Ill. 1985); *In re Gibbs*, 44 Bankr. 475 (Bankr. D. Minn. 1984); *Brace v. State Farm Mut. Auto. Ins. Co.*, 33 Bankr. 91 (Bankr. S.D. Ohio 1983); *In re Tanner*, 14 Bankr. 933 (Bankr. W.D. Pa. 1981); *In re Walker*, 11 Bankr. 43 (Bankr. N.D. Ill. 1981); *with In re Dewsnup*, 908 F.2d 588 (10th Cir. 1990) *cert. granted*, 111 S.Ct. 949 (1991); *In re Israel*, 112 Bankr. 481 (D. Conn. 1990); *In re D'Angona*, 107 Bankr. 448 (Bankr. D. Conn. 1989); *In re Shrum*, 98 Bankr. 995 (Bankr. W.D. Okla. 1989); *In re McLaughlin*, 92 Bankr.

of extra-bankruptcy lien enforcement would not generally arise, but for a longstanding principle in bankruptcy: that discharge of debt does not per se invalidate a lien securing debt after bankruptcy.¹⁸ Congress undoubtedly reaffirmed the latter principle,¹⁹ and further provided debtors express provisions for avoiding certain liens in bankruptcy, so that after bankruptcy, debtors' fresh starts are unimpaired by lien survival.²⁰

Lien-stripping was part of the package of new rights individual debtors received under the 1978 Code. In chapter 7, individual²¹ debtors may strip particular liens which impair their enjoyment of exempt property.²² In chapter 13, individuals²³ may confirm a plan which limits payments on the secured claim to the value of the collateral.²⁴ Yet, the use of section 506(d) to strip-down a lien received no mention in the legislative history.²⁵ Other sections provide classical avoidance of what

913 (Bankr. S.D. Cal. 1988); *In re Verma*, 91 Bankr. 17 (Bankr. W.D. Pa. 1987); *In re Maitland*, 61 Bankr. 130 (Bankr. E.D. Va. 1986); *In re Wolf*, 58 Bankr. 354 (Bankr. N.D. Ohio 1986); *In re Cordes*, 37 Bankr. 582 (Bankr. C.D. Cal. 1984); *In re Mahaner*, 34 Bankr. 308 (Bankr. W.D. N.Y. 1983); *In re Nefferdorf*, 26 Bankr. 962 (Bankr. E.D. Pa. 1983); see also *In re Simmons*, 765 F.2d 547 (5th Cir. 1985); *In re Schneider*, 37 Bankr. 115 (Bankr. E.D. N.Y. 1984); *In re Spadel*, 28 Bankr. 537 (Bankr. E.D. Pa. 1983); *In re Harvey*, 3 Bankr. 608 (Bankr. M.D. Fla. 1980).

A decision in *Dewsnup*, now before the Supreme Court, should resolve this conflict.

18. *Long v. Bullard*, 117 U.S. 617, 620 (1886); *In re Tarnow*, 749 F.2d 464, 465 (7th Cir. 1984).

19. Section 524 (a)(2) as originally enacted included the phrase, "or property of the debtor," which some courts understandably assumed overruled *Long*, 117 U.S. at 617; e.g., *In re Willie Williams*, 9 Bankr. 228 (Bankr. D. Kan. 1981). Congress subsequently deleted the phrase.

20. 11 U.S.C. §§ 522(f), 722 (1988).

21. "Person" is defined in the Code as an "individual, partnership, and corporation . . ." 11 U.S.C. § 101(35) (1988). Only individuals receive exemptions under the Code. 11 U.S.C. § 522(b).

22. See 11 U.S.C. § 522 (f). Courts have disagreed about whether section 522(f) applies in Chapter 13 cases. Compare *In re Hall*, 752 F.2d 582 (11th Cir. 1985) (holding that it does apply) with *In re Berry*, 30 Bankr. 36 (Bankr. E.D. Mich. 1983).

23. Only individuals may file under chapter 13. 11 U.S.C. § 109(e) (1988).

24. 11 U.S.C. § 1325 (a)(5)(B)(ii).

25. The House concluded that:

Subsection [506](d) permits liens to pass through the bankruptcy case unaffected. However, if a party in interest requests the court to determine and allow or disallow the claim secured by the lien under section 502 and the claim is not allowed, then the lien is void to the extent that the claim is not allowed.

H.R. REP. 595, 95th Cong., 1st Sess., at 357 (1977), reprinted in 1973 U.S. CONG. &

section 506(d) recognizes as secured claims in appropriate cases.²⁶

What is striking about the balance Congress apparently made in the Code for chapter 7 cases is the specific limitation of the debtor's lien-stripping power to certain kinds of liens²⁷ on certain exempt or exemptible property under section 522.²⁸ In contrast, section 506 applies to all claims of liens, whether they are statutory, consensual, judicial or common law liens. Additionally, section 506 speaks about secured claims on any kind of property, real or personal, exempt, exemptible or non-exempt. In *Folendore*, a chapter 7 debtor sought to avoid a third mortgage²⁹ held by the Small Business Administration (SBA) on real

ADMIN. NEWS 5963, 6313.

It also noted that:

Subsection [506](d) provides that to the extent a secured claim is not allowed, its lien is void unless the holder had neither actual notice nor knowledge of the case, the lien was not listed by the debtor in a chapter 9 or 11 case or such claim was disallowed only under section 502(e).

S. REP. NO. 989, 95th Cong., 2d Sess., at 68 (1978), *reprinted in* 1978 U.S. CONG. & ADMIN. NEWS 5787, 5854.

Each of these reports on the Bankruptcy Code limits the voidability of a secured claim under section 506(d) to claims which are not allowable claims in bankruptcy. These reports show that section 506(a) determines whether an allowed claim is a secured claim. Further, they show that section 506(d) defines what is an allowed claim for purposes of section 506(a). With exceptions stated in section 506(d), claims which are not allowed under section 502(b), the general allowance of claims provision of the Code, cannot become secured claims in a bankruptcy proceeding. Liens secure claims; if a claim is invalid, the lien is also invalid in a bankruptcy proceeding. The legislative history thus shows that section 506(d) deals with the problem of liens securing claims which are not allowable in the bankruptcy. However, the recent cases such as *Folendore* have construed the function of section 506(d) as also regarding the problem of the undersecured lien.

26. *See supra* notes 13-15 and accompanying text. These other sections operate when section 506 recognizes a secured claim. For example, one, who prior to bankruptcy, had obtained a first mortgage on land owned by the debtor will have a secured claim in the debtor's bankruptcy. If the creditor obtained that mortgage as a gift from the debtor, the mortgage will first be identified by section 506 as a secured claim and in all likelihood, the secured claim will be avoided as a fraudulent transfer under section 548.

27. Debtor's lien-stripping power is limited to judicial liens on exempt property and nonpossessory, nonpurchase money security interests in particular personal property subject to exemption. 11 U.S.C. § 522 (f)(1)(2).

28. *See* § 522(f)(2).

29. The opinions in the case do not mention whether the realty in issue was exempt property. Even if it were, the lien-stripping rules for exempt property were inapplicable since only judicial liens may be stripped from exempt realty. § 522(f)(1). That the realty was not exemptible is implicit in the trustee's decision to abandon the prop-

property abandoned by the trustee.³⁰ The combined liens of these first two mortgages exceeded the value of the collateral.³¹ Section 506(d)³² provides: "(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void"³³

The issue in *Folendore* is whether a lien securing an allowable claim is voidable under section 506(d) in a chapter 7 case. The court stated the issue as the following: "[W]hether an unsecured lien supported by an allowable claim is voidable under 11 U.S.C.A. § 506(d)."³⁴ The court held that such a lien was voidable and reversed.

erty for lack of equity in the estate's interest. Abandonment under section 554 of property in which the estate's interest is merely nominal is routine and enables the trustee to avoid fruitless estate expenses, such as participating in a motion by secured claimants for relief from stay.

30. 862 F.2d at 1538.

31. The parties had stipulated in the bankruptcy court that the senior liens exceeded the value of the property subject to the mortgages. Both courts below denied the avoidance the debtors sought under section 506(d) because the debtors had not previously requested disallowance of the claim under section 502. *In re Folendore*, 85 Bankr. 180 (M.D. Ga. 1988).

However, it should be noted that the district court clearly stated that it did not consider the lack of a request for disallowance to have been a formal or procedural defect. The district court ruled on the basis of "cases holding that a debtor in a chapter 7 case may not use § 506(d) to void the consensual lien of a creditor because the lien is undersecured." *Id.* at 182.

32. Section 506(d) was amended in 1984 to eliminate the exception to its avoidance rule that stated, "unless a party in interest has not requested that the court determine and allow or disallow such claim under section 502 of this title." 11 U.S.C. § 506(d) (1978)(amended 1984). However, the revised exceptions to the avoidance rule expressly exempt certain disallowed claims from the operation of the rule: "(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title." 11 U.S.C. § 506(d) (1988).

Thus, one may well find unpersuasive the Eleventh Circuit's conclusion that the avoidance rule does not presume a disallowed claim. *See Folendore*, 862 F.2d at 1539. If the exceptions contemplate particularly grounded disallowances, the rule must contemplate disallowable claims. Otherwise, the rule would not need the exceptions originally or presently stated. The *Folendore* court describes the now repealed request exception, the 1979 version of section 506(d)(1), as serving a vital function. 862 F.2d at 1539 n.3.

33. 11 U.S.C. § 506(d). The exceptions which followed the quoted body of section 506(d) when the case arose stated: "(1) a party in interest has not requested that the court determine and allow or disallow such claim under section 502 of this title; or (2) such claim was disallowed only under section 502(e) of this title." 11 U.S.C. § 506(d) (1978)(amended 1984).

34. 862 F.2d at 1538.

“The plain language of the statute, supported by a majority of the bankruptcy courts, inferences drawn from the 1984 amendments, and common sense, [sic] requires the SBA’s lien be voidable whether or not its claim has been disallowed under section 502.”³⁵

Is the statute plain? The statute states that a lien is void to the extent it secures a claim against the debtor that is “not an allowed secured claim.”³⁶ In *Folendore* the parties agreed that the SBA did not have an “allowed secured claim.”³⁷ The SBA unsuccessfully pointed out that it held an allowed claim. Its position was that section 506(d) only voids liens securing disallowed claims. Since its claim was allowable, the lower courts properly rejected the debtors’ attempted avoidance.

Undoubtedly, the expression “not an allowed secured claim” is ambiguous. There are two reasons why a claim may not be allowed and secured. First, the claim may be wholly invalid and thus not allowed in bankruptcy. Second, though a claim may be valid and allowed, it may have nothing securing it, and thus not be a secured claim under section 506(a). The issue is whether the expression “not an allowed secured claim” in section 506(d) refers only to situations in which a secured claim (determined by section 506(a)) is not allowed under section 502. The legislative history speaks only to this function of section 506(d).³⁸ Or does the expression also embrace allowable claims which are not secured claims under section 506(a). The language is not plain.

The exceptions presume the text speaks to claims that are not allowable under other sections of the Code.³⁹ The inferences the court drew from the 1984 amendments may be countered by equally plausible inferences.⁴⁰

The court erred in relying on common sense in justification of its conclusion.

35. *Id.* at 1539.

36. 11 U.S.C. § 506(d).

37. What is an “allowed secured claim” is nowhere defined in the code. The court and the parties appear to have presumed that section 506(a) defines what is an allowed secured claim. But, section 506(a) only says that an allowed claim, in reference to section 502, secured by a lien on property is a “secured claim.” 11 U.S.C. § 506(a). The phrase “allowed secured claim” does not appear in section 506(a) at all but appears in sections 506(b)-(d).

38. *See supra* notes 25 & 32.

39. *See supra* note 32.

40. *See supra* note 32.

The whole point of bankruptcy is to provide a debtor with a fresh start. Section 506 allows the debtor the option to begin anew on its former property, Section 506 does not give a debtor its property back as some sort of windfall. It simply permits a debtor to eventually repurchase an equity interest in it, something the SBA admits it [the debtor] has the right to do on any other piece of land.⁴¹

Bankruptcy is intended to provide relief to both debtors and creditors. The court's function is to determine the meaning of an often difficult bankruptcy text. Reliance on plain meaning characterizations of undefined, ambiguous statutory language is unfair to both debtors and creditors.⁴²

The potential impact of *Folendore* may be addressed by considering why a debtor like *Folendore* would want to avoid a lien when property is worth no more than the debts secured by senior liens. Valuation of estate property is speculative. A debtor may think the collateral is worth more than the amount determined by the bankruptcy court. As well, property values may be temporarily distressed. At some future time, a debtor might be able to make a deal with senior lienors or borrow the money to buy them out. However, a trustee in a chapter 7 case is unlikely to await for these developments. Once the property is aban-

41. *Folendore*, 862 F.2d at 1540.

42. A further point against *Folendore* is that pre-Code law stated none of this. The Supreme Court has found pre-Code treatment of liens in bankruptcy critical when the Code is unclear. *See* *United Savings Assoc. v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365 (1989). Pre- and post-Code case law clearly state that such a lien, along with the senior liens, survive bankruptcy whether or not the debtor gets a discharge of the underlying debt. *See supra* note 18 and accompanying text.

Perhaps the majority of courts have confused the invalidation of a secured claim, per section 506(d) as a claim against property of the estate, with invalidity in general. The function of section 506 is merely administrative: to define what and who has a secured claim in bankruptcy for a bankruptcy case administration. One who has a fully secured claim could not participate, for example, in distribution from the unencumbered assets' liquidation. Nevertheless, one can appreciate the ease with which invalidity of a secured claim in a bankruptcy proceeding may be broadened to invalidity for all purposes — when a junior lien is not a secured claim in bankruptcy because the senior liens secure debt greater than the value of collateral. The Code seems to say this since by the term "void," one might understand the paramount federal law of the Code as superseding contrary state law. Unless one understands the characterization of an invalid secured claim under section 506(d) as implicitly limited to questions arising in the bankruptcy case, one may read the subsection universally.

done by the trustee,⁴³ the debtor's relatively inexpensive request⁴⁴ for avoidance under section 506(d) might encourage optimism on the debtor's part of eventually finding equity in the property.

In substance, lien cramdown⁴⁵ in reorganization cases proceeds under section 506 in the same initial manner as *Folendore*. The amount of a secured claim is obtained by determining the value of the collateral. When the collateral is worth less than the debt it secures, the amount of the secured claim is the value of the collateral. A debtor in reorganization must pay a secured claim at least the value of collateral under the plan, unless the claimant agrees to a lesser payment. This general structure of lien cramdown permeates the Code. Chapter 13 clearly limits all secured claims except for home mortgages to the value of the collateral.⁴⁶ Likewise, Chapter 12 states the same secured claim cramdown rule,⁴⁷ and chapter 11 differs only in the right of an under-secured creditor's opportunity to elect treatment of the claim as fully secured.⁴⁸ So, under the Code, the effect of lien-stripping as per section 506 will occur routinely in rehabilitation cases under the Code. Lien-stripping is a reorganization concept because it has traditionally been provided as a reorganization cramdown device.

What is strange about *Folendore* is not the substance but the locus of the lien-stripping in a chapter 7 liquidation case. An argument for lien-stripping under section 506(d) may point to other Code sections providing for lien-stripping within Chapter 7, such as sections 722⁴⁹ and 522(f).⁵⁰ However, the redemption opportunity of section 722 is narrow. This right of redemption applies only to exempt personal property intended for personal, family or household use, and only if such property secures a dischargeable consumer debt.⁵¹ Likewise, lien-stripping under section 522 extends only to exempt property.

43. The trustee may abandon property of the estate when the property has "inconsequential value or benefit to the estate." 11 U.S.C. § 554(a) (1988).

44. Or, is the request seemingly inexpensive? Potential appeals to the district or circuit courts of appeal surely bear on the utility of requesting and opposing avoidance under section 506(d).

45. The term cramdown describes the process in which a secured claim is reduced to the value of the collateral.

46. 11 U.S.C. § 1325 (a)(5)(B)(ii).

47. 11 U.S.C. § 1225(a)(5)(B) (1988).

48. 11 U.S.C. § 1111(b) (1988).

49. 11 U.S.C. § 722.

50. 11 U.S.C. § 522(f).

51. 11 U.S.C. § 722.

The implications of the *Folendore* treatment of section 506(d) in a distressed market are serious. Whether *Folendore* will lead to the results suggested in the following hypotheticals is speculative, since the courts may confine their analyses to only the most junior liens. For example, suppose I borrow money to add a pool or some other improvement to my house. Subsequently, I incur financial difficulty and file chapter 7 or 13.⁵² The current market value of my house is 50% below \$200,000, the amount I paid. I financed at 90% on my first mortgage and another 10% on a second mortgage for the pool. The house today at filing is worth \$100,000.

Having filed chapter 7, I use section 506(d) to avoid the junior lien per *Folendore*, because the junior lien is worthless: the senior mortgage exceeds the value of the collateral. Next, I also avoid so much of the first lien that exceeds \$100,000, the present value of the collateral, and I discharge both debts. Because I have kept the first mortgage debt current and continue to keep it current through bankruptcy, the first mortgagee cannot get relief from stay during the bankruptcy nor may it foreclose thereafter. Sometime after bankruptcy when the market rises, I refinance or sell the property. The payoff to the first mortgagee is \$100,000, the amount of its lien, less any principal paydowns made since its lien was reduced to that amount pursuant to the section 506(d) determination. Any contractual attempt to stop me from so doing falls under the supremacy clause. Any attempt to collect the debt on that mortgage is stayed.⁵³

52. Section 1111(b) of chapter 11 inhibits this form of lien-stripping. Under section 1111(b), an undersecured creditor may elect to have its secured claim allowed in the amount of the debt secured. That is, section 506 is displaced by section 1111(b). As a result of the election, a secured creditor must receive payments under the plan amounting to the debt. However, the secured claim may be paid over time and the time value of the payments must amount to no less than the value of the collateral. In terms of the present value of future payments, even an electing undersecured creditor receives in a chapter 11 plan only the value of its collateral. However, an electing undersecured creditor retains its lien on its collateral during the performance of a plan in the full amount of the debt. As a result, such a creditor may enforce that lien post-confirmation should the debtor default under the plan. The post-bankruptcy effectiveness of its lien differentiates chapter 11 lien-stripping from the chapter 7 lien-stripping accepted by *Folendore*. Should the collateral later appreciate in value due only to market forces, the electing undersecured creditor, who elected to have the entire claim treated as secured, may reap the appreciation if the debtor defaults. Under *Folendore*, the lien-stripped creditor in chapter 7 presumably cannot reinvigorate its lien after bankruptcy.

53. 11 U.S.C. § 524(a)(2).

B. Chapter 13 Home Mortgage Strip-down

In the same scenario, I may file chapter 13 rather than chapter 7, so long as I meet the jurisdictional limitations of chapter 13.⁵⁴ Whether I may use the section 506(d) strip-down in my scenario depends not only on the controversy about section 506(d), but also on a controversial passage which appears only in chapter 13. Under section 1322(b)(2), a 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”⁵⁵ Recently, the third⁵⁶ and the ninth⁵⁷ circuits have created a controversy by broadly interpreting a chapter 13 debtor’s right to modify a secured claim against the debtor’s principal residence.⁵⁸ These cases depend on section 506 and especially the *Folendore* interpretation. Cramdown in chapter 13 is precisely what section 506(d) accomplished in my previous example: all a chapter 13 debtor need pay a secured claim is the value of the collateral (any deficiency participates as an unsecured claim). Chapter 13 debtors have been cramming down secured claims on cars and nonresidential property for 12 years.⁵⁹ But, such debtors were thought unable to affect their home mortgage because of section 1322(b), which states a 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”⁶⁰

54. Code section 109(e) permits only individuals to use chapter 13. Individuals may have aggregate secured debts no greater than \$350,000 and aggregate unsecured debts no greater than \$100,000. Additionally, to file under chapter 13 one must have a regular source of income. 11 U.S.C. § 109(e).

55. 11 U.S.C. § 1322(b)(2) (1988).

56. *Wilson v. Commonwealth Mortg. Corp.*, 895 F.2d 123 (3d Cir. 1990).

57. *In re Hougland*, 886 F.2d 1182 (9th Cir. 1989).

58. 11 U.S.C. § 1322(b)(2).

59. Indeed, the courts have also permitted cramdown on the principal residence of a debtor when the debt is secured by more than only the principal residence of the debtor. This occurs because section 1322(b)(2) limits the chapter 13 debtor’s general right to modify secured claims to claims secured “only by a security interest in real property that is the debtor’s principal residence.” § 1322(b)(2); see *Wilson v. Commonwealth Mortg. Corp.*, 895 F.2d 123, 128 (3d Cir. 1990) (alternate holding); *In re Selman*, 120 Bankr. 576 (Bankr. D. N.M. (1990)); *In re Stiles*, 74 Bankr. 708 (Bankr. N.D. Ala. 1987); *In re Lapp*, 66 Bankr. 67 (Bankr. D. Colo. 1986); *In re Ramirez*, 62 Bankr. 668 (Bankr. S.D. Cal. 1986); *In re Baksa*, 5 Bankr. 184 (Bankr. N.D. Ohio 1980).

60. 11 U.S.C. § 1322(b).

The third and ninth circuits held that the "rights of holders of secured claims" means only their rights as a secured claimant determined by section 506(a).⁶¹ Because section 506(a) includes as a secured claim only that portion of a claim for which the value of the collateral provides security, an undersecured claim gives rise to a secured claim only in the amount of the value of the security or collateral. As to the excess of the debt above the value of the collateral, an unsecured claim is created. *Wilson* and *Houglund* interpret the non-modification rule of section 1322(b)(2) for principal residence mortgages to refer only to the secured claim as determined by section 506(a). However, the unsecured claim is modifiable. In effect, this appears to mean that the amount of the promised monthly mortgage installment cannot be modified, but the amount of the outstanding mortgage balance can be modified and stripped-down to the value of the collateral as determined under section 506(a). Thus, a debtor's monthly payment on the home mortgage, cannot be reduced, but a debtor may have the court adjudicate the outstanding balance of the mortgage lien as invalid to the extent the debt exceeds the property value.

Under this approach, the same result may be reached in my hypothetical through a chapter 13 case as well as in a chapter 7. As noted earlier, the ordinary cramdown of secured claims to the value of the collateral holds in chapter 13, but the specific limitation of section 1322(b)(2) bars home mortgage strip-down.⁶² Whether the decisions in *Wilson* and *Houglund* will prevail in the Eleventh Circuit remains to be seen. Much may be said against the cited rulings, however, I shall discuss only two points.

A secured claim in a chapter 13 bankruptcy proceeding cannot have a value larger than that of the collateral. Section 1322(b)(2) per-

61. *Wilson*, 895 F.2d at 128; *Houglund*, 886 F.2d at 1183.

62. Compare *In re Woodall*, 123 Bankr. 95 (W.D. Okla. 1990); *In re Moran*, 121 Bankr. 879 (Bankr. E.D. Okla. 1990); *In re Chavez*, 117 Bankr. 733 (Bankr. S.D. Fla. 1990); *In re Sauber*, 115 Bankr. 197 (Bankr. D. Minn. 1990); *In re Schum*, 112 Bankr. 159 (Bankr. N.D. Tex. 1990); *In re Diquinzio*, 110 Bankr. 628 (Bankr. D. R.I. 1990); *In re Russell*, 93 Bankr. 703 (D.N.D. 1988); *In re Brown*, 91 Bankr. 19 (Bankr. E.D. Va. 1988) with *In re Bellamy*, 122 Bankr. 856 (Bankr. D. Conn. 1991); *Goins v. Diamond Mortg. Corp.*, 119 Bankr. 156 (Bankr. N.D. Ill. 1990); *In re McNair*, 115 Bankr. 520 (Bankr. E.D. Va. 1990); *In re Gadson*, 114 Bankr. 453 (Bankr. E.D. Va. 1990); *In re Brouse*, 110 Bankr. 539 (Bankr. D. Colo. 1990); *In re Demoff*, 109 Bankr. 902 (Bankr. N.D. Ind. 1989); *In re Ross*, 107 Bankr. 759 (Bankr. W.D. Okla. 1989); *In re Kessler*, 99 Bankr. 635 (Bankr. E.D. Pa. 1989); *In re Hill*, 96 Bankr. 809 (Bankr. S.D. Ohio 1989); *In re Harris*, 94 Bankr. 832 (Bankr. D. N.J. 1989).

mits modification of the rights of any claimant, secured or unsecured.⁶³ Section 1325(a)(5)(B)(ii) entitles any secured claimant to payments under the plan amounting to no less than its "allowed secured claim."⁶⁴ That amount is the value of the collateral determined by either section 506 or by stipulation. When section 1322(b)(2) permits modification of secured claims, it cannot be addressing the issue of what the secured claimant's entitlement under the plan is, since section 1325(a)(5) directly provides for entitlement once the section 506 determination of the amount of the secured claim is made. Thus, the function of section 1322(b)(2) regarding strip-down is mere reiteration of the lien strip-down that the other cited sections accomplish.

The exception of the home mortgage from this strip-down reiteration can have only one meaning: that a chapter 13 debtor has all the modification rights, including strip-down per section 506, that debtors in other chapters have,⁶⁵ except when the home mortgage is used as the sole security for a debt. There are no other substantial modification rights which would not otherwise be available to the chapter 13 debtor.⁶⁶ However, *Hougland* and *Wilson* suggest that substantial meaning remains in section 1322(b)(2) because these decisions bar the debtor from payment under the plan of less than the contractually agreed-upon monthly installment.

Thus, under this view the non-modifiability of the monthly payment is what section 1322(b)(2) accomplishes. The courts could have understood section 1322(b)(5) to provide as much.⁶⁷ However, the

63. 11 U.S.C. § 1322(b)(2).

64. 11 U.S.C. § 1325(a)(5)(B)(ii).

65. Section 506 applies in all chapters of the Code unless displaced by a particular provision in a chapter. 11 U.S.C. § 103(a) (1988).

66. For example, there is the right of cure of default which presumably includes the right to decelerate, reverse a mortgagee's acceleration of the debt. 11 U.S.C. § 1322(b)(5).

67. Section 1322(b)(5) requires the "maintenance of payments while the case is pending on any . . . secured claim on which the last payment is due after the date on which the final payment under the plan is due." 11 U.S.C. § 1322(b)(5). The "payments" to which this subsection refers must be the amounts promised prior to the bankruptcy because the sentence begins with the idea of curing default, which is connected to the quoted text with "and." *Id.* It is unimaginable that a debtor would have been thought by Congress to have either desire or need to cure a pre-bankruptcy default and then maintain any payments other than those which would not create another default. As well, this subsection applies while a case is pending, which typically refers to both pre- and post-confirmation periods. Presumably, no modifications could precede confirmation of the chapter 13 plan. So, what payment the debtor would maintain

grammatical argument within section 1322(b)(2) accepted by the *Houglund* and *Wilson* courts, is far less convincing once one recognizes maintenance of monthly payments to fall under section 1322(b)(5).

Secondly, these recent cases overlook the confirmation rule for an "allowed secured claim" applicable when the secured claimant has neither accepted the plan,⁶⁸ nor has the debtor surrendered the collateral to the creditor.⁶⁹ The confirmation rule provides that the secured creditor retain its lien⁷⁰ and mandates that "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim."⁷¹ Modification of the home mortgage, through strip-down to current value of the lien and payment merely of the monthly installment, cannot satisfy this controlling confirmation rule, unless payments under the plan will fully pay-off the newly determined mortgage balance.⁷² Section 1325(a)(5)(B)(ii) requires payments not less than the allowed amount of the secured claim.⁷³ Few debtors in chapter 13 will be able to satisfy the rule since even a bankruptcy-reduced outstanding balance of the mortgage will far exceed the sum of 3 or 5 years of regular payments.⁷⁴ Also, refinancing is not easily available to such

would have to be the contractual amount. Finally, this subsection applies "notwithstanding [1322(b)(2)]." *Id.*

68. 11 U.S.C. § 1325(a)(5)(A). "Acceptance" of a chapter 13 plan is not defined in chapter 13. Traditionally, plan acceptance in reorganization means voting favorably on the plan. *See e.g.*, 11 U.S.C. § 1126 (1988). As well under chapter 11, an unimpaired class as defined in section 1124(1) is deemed to have accepted a plan. *See* § 1126(f). A class of claims is unimpaired when the plan does not alter its pre-bankruptcy rights. § 1124(1). The pro-modification cases seem to assume that a home mortgage which will receive its regular installment payments under a plan has not been impaired and is thus deemed to have accepted the plan. Not only has chapter 13 no such impairment/non-impairment provision, it also lacks any rule presuming an unimpaired creditor to have accepted a plan.

69. 11 U.S.C. § 1325(a)(5)(C).

70. 11 U.S.C. § 1325(a)(5)(B)(i).

71. 11 U.S.C. § 1325(a)(5)(B)(ii).

72. *In re Cobb*, 122 Bankr. 22 (Bankr. E.D. Pa. 1990).

73. 11 U.S.C. § 1325(a)(5)(B)(ii).

74. A debtor may not confirm a chapter 13 plan which exceeds 3 years unless the court, for cause, approves a longer period, not to exceed 5 years. 11 U.S.C. §§ 1322(c), 1329(c) (1988). Chapter 13 may not require that a debtor include a home mortgage debt in the plan. Chapter 13 only governs the plan and the debt provided for in the plan. However, in order to modify or cure a claim, under section 1322(b), the debtor must do so in the plan. The right to cure arrearages on a mortgage, for example, under section 1322(b)(5) is a right exercisable "under the plan." To cure arrearages, the

debtors on normal credit considerations or on a refinancing agency's discovery of the debtor's proposal.

C. *Serial Bankruptcy Filings: Saylor's*⁷⁵

If *Folendore* may truly be used in a chapter 7 to accomplish strip-down of the home mortgage, debtors should continue to favor chapter 7 for the traditional reasons.⁷⁶ Debtors for whom chapter 13 relief is important⁷⁷ and who also desire home mortgage strip-down, may be able to pursue a serial bankruptcy strategy. Under this strategy, debtors first file chapter 7 to obtain lien strip-down and later file, or convert, to chapter 13. Although no less controversial than the other recent developments discussed in this article, serial bankruptcy filings were approved by the Eleventh Circuit recently in *Saylor's*.⁷⁸

Quite apart from lien-stripping, a debtor in a chapter 7 may incur difficulty with the home mortgage or other property on which a creditor holds a lien. Although a chapter 7 debtor has some protections against an aggressive secured creditor in a chapter 7, including the automatic stay of creditor action⁷⁹ and personal property redemption under section 722,⁸⁰ the former may be lifted on behalf of a creditor who has "cause for relief from stay."⁸¹

In *Saylor's*, the mortgagee on the debtor's home obtained relief from stay, in order to foreclose, shortly before the debtor's chapter 7 case was closed.⁸² The debtor filed chapter 13 the next day, even while

debtor must include payments on the arrearages during the 3-5 years of the plan. § 1322(b)(5).

75. *In re Saylor's*, 869 F.2d 1434 (11th Cir. 1989).

76. Chapter 7 does not require post-petition payment from post-petition income, nor does it subject a debtor to continuing supervision for up to five years.

77. These debtors would generally include those who need to cure or modify claims including secured claims. See § 1322(b)(2)(5). It also includes those who are without an opportunity for discharge of debt. See 11 U.S.C. § 727(a) (1988). Also included are debtors who have nondischargeable chapter 7 debt dischargeable under the broader chapter 13 discharge. See 11 U.S.C. §§ 523(a), 1328(a) (1988). And, debtors with substantial properties not exempt in a chapter 7.

78. 869 F.2d at 1437.

79. 11 U.S.C. § 362(a) (1988).

80. 11 U.S.C. § 722.

81. 11 U.S.C. § 362(d)(1).

82. Presumably, the debtor was in default on the debt which justified the relief from stay. See 11 U.S.C. § 362(d).

the chapter 7 case remained open.⁸³ The debtor filed⁸⁴ chapter 13 for two related reasons: first, to obtain another⁸⁵ automatic stay to preclude the mortgagee from foreclosing, and secondly, to obtain confirmation of a chapter 13 plan which would permit cure of mortgage arrearages and retention by debtor of his home.

Saylor's chapter 7 discharge eliminated his personal liability on the note secured by his home mortgage. Nevertheless, the mortgage lien remained on his home, and the mortgagee retained his rights against the home without personal recourse against debtor, Saylor's. Nonrecourse claims⁸⁶ do not expressly fall under the definition of "claim" in section 101(4). Nor does chapter 13 further elaborate the meaning of claim. But, the court ruled that Saylor's could cure⁸⁷ this nonrecourse claim because of the rule of construction provided by section 102(2): "'[C]laim against the debtor' includes claim against the property of the debtor."⁸⁸ So long as a mortgagor, like Saylor's, retains a property interest in the land, such as provided by local law in this case,⁸⁹ the court ruled that even a nonrecourse claim may be treated in

83. The court ruled that the previous filing under chapter 7 did not preclude a second filing under chapter 13 during the period after the chapter 7 discharge and before the chapter 7 case was closed. *Saylor's*, 869 F.2d at 1437.

84. The debtor chose to file under chapter 13, rather than convert the case from chapter 7 to chapter 13, because the debtor sought to stay the foreclosure. Conversion may have produced merely the same stay of creditor action which the debtor had in his chapter 7. If so, the relief from that stay which the creditor had obtained may have been unaffected by the conversion. *See In re States Airlines, Inc.*, 873 F.2d 264 (11th Cir. 1989) (holding conversion from chapter 11 to chapter 7 does not reimpose stay against parties previously granted relief from stay). "The filing of a petition under section 301, 302, or 303 operates as a stay under section 362. A conversion under section 348 does not." *Id.* at 268.

If a conversion by Saylor's would not have affected the automatic stay, then his creditor who had previously received relief from stay, would not have its rights affected by conversion. Thus, the need to file a new case under chapter 13 arose and carried the cost of a new filing fee.

85. Whether a debtor with an open bankruptcy case can obtain another stay by filing under another chapter, or by filing a new petition under the same chapter, is unclear under the Code. *Saylor's* rules on the former.

86. A nonrecourse claim in this context means a claim against particular property of the debtor but without recourse against the debtor personally or his other assets for any deficiency.

87. 11 U.S.C. § 1322(b)(5).

88. *Saylor's*, 869 F.2d at 1436.

89. Saylor's had an equitable right of redemption under Alabama law.

a chapter 13 plan.⁹⁰ Further, Saylor's continuing property interest in the home gave the chapter 13 bankruptcy court jurisdiction over this property.⁹¹

Had Saylor simply filed chapter 13 to deal with a nonrecourse claim against his home, the foregoing would hold some technical significance. The greater interest in *Saylor* is the serial bankruptcy or the "chapter 20"⁹² that the court approved. The court held the fact that the chapter 13 was filed while the chapter 7 was still pending, did not betray the debtor's necessary good faith.⁹³ "A per se rule . . . [would] conflict with the purpose of Congress in adopting and designing chapter 13 plans."⁹⁴ More broadly, the court held: "A bankruptcy court's de-

90. *Id.*

91. *Id.*

92. "Chapter 20" does not exist in the Code. But, a debtor who files chapter 7 and takes what relief that offers, and then files chapter 13, and takes the relief there offered, has perhaps created a new Code chapter. Other numerical combinations have appeared, such as a "chapter 26". *E.g., In re Jones*, 105 Bankr. 1007, 1011 (N.D. Ala. W.D. 1989) (2 chapter 13 filings). The Code does not specifically impose any limitations on the use of chapter 13 when a debtor has had previous bankruptcy relief. Under chapter 7, however, the Code limits the availability of discharge where a debtor has had previous bankruptcy relief. *See* 11 U.S.C. §§ 727(a)(7)-(9). Courts have disagreed about "chapter 20" and other serial filings. *Compare In re Fulks*, 93 Bankr. 274 (Bankr. M.D. Fla. 1988) *with In re Samarripas*, 107 Bankr. 366 (Bankr. M.D. Fla. 1989) (Judge Baynes soundly concludes that a chapter 13 plan should not be confirmed if the previous chapter 7 case should have been dismissed as a "substantial abuse" under section 707(b)).

Prior to the Code, the Supreme Court in *Perry v. Commerce Loan Co.*, 383 U.S. 392 (1966), permitted a debtor to file a chapter XIII extension plan, although within the prior six years he had received a discharge in the predecessor to chapter 7. *Saylor* relied on *Perry*. But, the latter uttered a clear dictum that the decision would not apply to a chapter XIII composition (debt-reduction) plan. *Perry*, 383 U.S. at 397-98. As chapter 13 does not permit composition of a secured claim such as Saylor's mortgage's, unless the secured claimant assents, the Eleventh Circuit was perhaps correct in *Saylor* in relying on the *Perry* precedent. However, where the creditor holds an undersecured claim, the unsecured portion is subject to composition in chapter 13. 11 U.S.C. §§ 1325(a)(4), 1325(b). To that extent *Perry* would disapprove a chapter 20. As well, a serial chapter 13 may not be effective under *Perry* in another foreseeable context: where a debtor does not discharge an unsecured debt in chapter 7 because the debt is nondischargeable under section 523(a), the debtor may wish to file chapter 13 and pay the appropriate percentage of the debt under the plan. *Perry* would find this composition impermissible.

93. 869 F.2d at 1437. A chapter 13 plan must be "proposed in good faith." 11 U.S.C. § 1325(a)(3).

94. *Saylor*, 869 F.2d at 1437.

termination whether a chapter 13 plan has been proposed in good faith is a finding of fact reviewable under the clearly erroneous standard."⁹⁵ Since the bankruptcy court was in the best position to judge the credibility of the debtor, and it found one of the factors suggesting good faith under controlling case law,⁹⁶ the finding of good faith was not clearly erroneous. Clearly then, chapter 13 filings following chapter 7 cases will receive serious scrutiny in the bankruptcy court. That determination will almost certainly stand on appeal, given the high standard of clearly erroneous. As a device to accomplish lien-stripping of a home mortgage,⁹⁷ a "chapter 20" will have formidable hurdles. First, a court may as a matter of law deny the combined effect of the two chapters as doing indirectly what cannot be done directly under chapter 13 because of section 1322(b)(2). Second, a court should factually find that a chapter 13 plan has not been proposed in good faith if the prior or pending chapter 7 case might have been dismissed as a substantial abuse under section 707(b).⁹⁸ Third, debtors will usually pay more under the chapter 13 plan on the stripped-down mortgage than their regular monthly payments to meet the secured claim cramdown standard.⁹⁹

II. CONCLUSION

All the implications of *Folendore* and the other recent cases need not come to pass. The courts can, and should, limit *Folendore* and the others so far as possible. Congress did not intend to imperil undersecured claims for the benefit of an individual chapter 7 debtor. Nor did Congress intend to jeopardize the home mortgage as have *Wilson*

95. *Id.* at 1438.

96. *See In re Kitchens*, 702 F.2d 885, 888-89 (11th Cir. 1983). The bankruptcy court had found good faith in that Saylor's income had increased by \$283 between the time of his two filings. *Saylor's*, 869 F.2d at 1438.

97. This assumes the local courts will not follow *Wilson* and *Houglund*. *See supra* notes 54-74 and accompanying text.

98. *See Samarripas*, 107 Bankr. at 366. A substantial abuse under section 707(b) consists of a debtor's filing chapter 7 when the debtor has the ability to pay creditors. *See, e.g., In re Rushing*, 93 Bankr. 750 (Bankr. N.D. Fla. 1988) (chapter 7 dismissed where debtors could have paid all unsecured claims within three years but debtors sought to retain ski boat by reaffirmation).

99. 11 U.S.C. § 1325(a)(5)(B)(ii); *see supra* note 68 and accompanying text.

and *Hougland*. Finally, the courts should follow *Saylors* and permit serial bankruptcy filings, but only upon a careful scrutiny of a debtor's good faith.