

The Honorable Frank J. Santoro
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Current Consumer Topics

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I. LIEN-STRIPPING IN CHAPTER 13 CASES.

A. Introduction

- The issue of lien stripping in Chapter 13 cases continues to attract attention and debate.
- This segment of the presentation reviews the statutory basis for lien-stripping, the history behind the “strip-down” versus “strip-off” distinction, and concludes by discussing two emerging issues: lien avoidance involving properties owned as tenants by the entirety and lien avoidance in Chapter 20 cases.

1. The Statutory Framework.

- Generally, mortgages secured only the debtor’s principal residence cannot be modified in a Chapter 13 case based on the limitation imposed by Section 1322(b)(2) (the “Anti-modification Provision”), which states:
 - **11 U.S.C. 1322. Contents of Plan**
 - ...
 - (b) Subject to subsection (a) and (c) of this section, the plan may—
 - ...
 - (2) modify the rights of holders of secured claims, *other than a claim secured only by a security interest in the 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*;
- However, if a senior mortgage or lien on a debtor’s home exceed the property’s value, a junior lienholder would not be considered the “holder of a secured claim” under Section 506(a) and, therefore, would not be entitled to the protection afforded by the Anti-modification Provision.
- Section 506(a)’s treatment of consensual liens is important in this regard:
 - Consensual liens are those that arise by contract. 11 U.S.C. § 101(51) (defining “security interest” as a “lien created by an agreement”).
 - The amount owed under a consensual lien—including mortgages—may exceed the value of the collateral securing them.

- o Outside of bankruptcy, such a claim is given undersecured status: foreclosure and sale of the collateral will not provide for full payment of the claim.
- o Section 506(a) preserves the state-law status of undersecured claims by bifurcating them into respective secured and unsecured portions.
- o Section 506(a) provides:

- **11 U.S.C. § 506. Determination of Secured Status**

(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, 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*. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

2. History of Lien-Stripping & the “Strip Down” vs. “Strip Off” Distinction.

- Prior to 1993, Chapter 13 debtors could use Section 506's bifurcation process to reduce the balance owed on their mortgage to their home's current value.
- Courts allowing such bifurcation reasoned that the Anti-modification Provision only prohibited modification of secured claims and that, under Section 506(a), claims are only secured to the extent of the value of the underlying collateral.
- The Supreme Court addressed—and rejected—this practice in Nobelman v. Am. Savs. Bank, 508 U.S. 324 (1993):

- o Facts:

- Nobelman involved a single mortgage holder: respondent, American Savings Bank, loaned the debtors \$68,250 to purchase their principal residence, a condominium in Dallas, Texas.

- Debtors' schedules and modified plan valued the condominium at \$23,500, although the bank filed a proof of claim in the amount of \$71,335, including principal, interest, and fees due on the underlying note.
 - Relying on Section 506(a), the debtors' modified plan included secured payments only for the actual value of the condominium plus arrearages.
 - The remainder of the bank's claim was treated under the Debtors' plan as being unsecured for distribution purposes.
 - The Bank and Chapter 13 Trustee objected to the plan, arguing that "the proposed bifurcation of the bank's claim into a secured claim for \$23,500 and an effectively worthless unsecured claim modified the bank's rights as a homestead mortgagee in violation of Section 1322(b)(2)."
- o Holding: Section 1322(b)(2) protects the total claim of an undersecured home mortgage holder as long as there is a modicum of equity.
- o Reasoning:
- The Supreme Court focused on Section 1322(b)(2)'s use of the term "rights."
 - Observing that "rights" was not defined in the Bankruptcy Code, the Supreme Court analyzed that term by reference to non-bankruptcy law.
 - Under Texas state law, "rights of secured creditors" included, among other things, "the right to bring an action to recovery any deficiency remaining after foreclosure."
 - Noting that Section 506(a) "itself uses the phrases 'claim . . . secured by a lien' to encompass both portions of an undersecured claim, the Court concluded that "the bank's contractual *rights* are contained in a unitary note that applies at once to the bank's overall claim, including both the secured and undersecured components" and therefore "[p]etitioners cannot modify the payment and interest terms for the unsecured component, as they proposed to do without also modifying the terms of the secured component."

- Thus, the Court concluded that allowing bifurcation of the claim into secured and unsecured portions for plan purposes would negate the statutory language of Section 1322(b)(2), which prohibits the modification of the rights of a secured holder where the mortgage-encumbered collateral was the debtor's principal residence.
- Nobelman is clear that a Chapter 13 debtor cannot take advantage of Section 506(a) to effectuate a "strip down:" *i.e.*, bifurcating into separate secured and unsecured components a claim of a mortgagee that is secured by a debtor's principal residence.
- However, Nobelman did not address—and the Supreme Court has not subsequently considered—the practice of "strip offs:" the practice of reducing a *wholly* unsecured junior lienholder—including mortgages on the debtor's principal residence—to an unsecured claim.
- Post- Nobelman, the majority of Courts of Appeal have upheld the strip-off wholly unsecured junior mortgages in chapter 13 cases.
 - This practice was upheld by the United States Court of Appeals for the Eleventh Circuit in Tanner v. FirstPlus Fin., Inc. (In re Tanner), 217 F.3d 1357 (11th Cir. 2000) (holding that the Anti-modification Provision does not apply to wholly unsecured junior mortgagees).
 - The Fourth Circuit has not specifically addressed the practice of strip-offs in Chapter 13 cases. But see Ryan v. Homecomings Fin. Network (In re Ryan), 253 F.3d 778 (4th Cir. 2001) (holding that Chapter 7 debtor was not entitled to strip-off a wholly unsecured consensual residential lien).

B. Procedure: Contested Matter vs. Adversary Proceeding

- The Federal Rules of Bankruptcy Procedure do not address the appropriate mechanism for stripping-off a wholly unsecured mortgage in a Chapter 13 case.
- There is a split of authority as to whether this should be accomplished via adversary proceeding or contested matter.

1. Adversary Proceeding.

- A minority of courts have held that debtors must initiate an adversary proceeding in order to effectuate a strip-off. According to these courts, debtors may not rely upon a Chapter 13 plan provision to achieve this result.

- This is the rule in the Fourth Circuit, as articulated by the Court of Appeals in Cen-Pen Corp. v. Hanson, 58 F.3d 89 (4th Cir. 1995) (“Because confirmation of a Chapter 13 plan is *res judicata* only as to issues that can be raised in the less formal procedure for contested matters . . . confirmation generally cannot have preclusive effect as to the validity of a lien, which must be resolved in an adversary proceeding.”).
- In those jurisdictions where strip-off must be effectuated via complaint, such actions are typically brought pursuant to Rule 7001(2) which provides:
 - **Rule 7001. Scope of Rules of Part VII**
 An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings:
 . . .
 (2) a proceeding to determine the validity, priority, extent of a lien or other interest in property, other than a proceeding under Rule 4003(d).
- The rationale for this interpretation was explained by Judge S. Martin Teel, Jr. of the United States Bankruptcy Court for the District of Columbia in In re Chukes, 305 B.R. 744 (Bankr. D.D.C. 2004):

“The Advisory Committee Note (1983) to Rule 3012 states that ‘[a]n adversary proceeding is commenced when the validity, priority, or extent of a lien is at issue as prescribed in Rule 7001,’ and characterizes such matters as ‘relevant to the basis of the lien itself’ in contrast to valuation under Rule 3012. In other words, if the relief sought in the proceeding turns in part on the priority of the lien, the proceeding is an adversary proceeding by reason of Rule 7001(2), and it must be commenced by the filing of a complaint under Rule 7003, not a motion under Rule 3012. Thus, a Rule 3012 motion:

[M]ay be used to determine the value of the collateral encumbered by a creditor’s lien, and to declare the lien unsecured to the extent that the collateral is worth less than the amount of the claim[;]

[B]ut may not be used to determine that the claim is unsecured based on senior liens that exceed the value of the collateral (or based on the extent or validity of the creditor’s lien).”

In re Chukes, 305 B.R. at 744-45 (citations omitted).

2. Contested Matter.

- In contrast, a majority of courts have held that an adversary proceeding is not necessary to achieve a strip-off, and that the issue may be raised as a contested matter. In re Stassi, No. 09-71563, 2009 WL 3785570, at *2 (Bankr. C.D. Ill.

Nov. 12, 2009) (“ Courts differ on the proper procedure to be followed to effectuate a lien strip off. The majority of courts hold that lien strip offs are contested matters and, therefore, may be raised by motion or included within the provisions of a proposed Chapter 13 plan.”) (citing cases).

- o Courts adopting this view reason that a strip-off is the logical extension of a valuation proceeding to determine valuation, and is not governed by the language of validity, priority or extent in Rule 7001(2) of the Federal Rules of Bankruptcy Procedure. See, e.g., In re King, 290 B.R. 641, 648 (Bankr. C.D. Ill. 2003)
- o Such Courts have held that “the term ‘validity’ means the existence or legitimacy of the lien itself, ‘priority’ means the lien’s relationship to other claims to or interests in the collateral, and ‘extent’ means the scope of the property encompassed by or subject to the lien.” Id. (citing Matter of Beard, 112 B.R. 951 (Bankr. N.D. Ind. 1990)).
- o The theory here is that, because strip-offs deal exclusively with wholly unsecured junior liens, the validity, priority, and extent of the junior lien(s) is not an issue. See id.
- Among those Courts that have adopted the majority view, there is no consensus about what type of contested matter should be used.
 - o Some Courts have concluded that the strip-off can be achieved through the plan confirmation process pursuant to Section 1327(c).
 - o Other Courts have held that strip-off should be initiated by motion practice.
 - For example, in the United States Bankruptcy Court for the North District of Alabama, such motions are typically filed as motions to determine value pursuant to Rule 3012. See, e.g., In re Sullivan, 386 B.R. 355 (Bankr. N.D. Ala. 2008); In re Clardy, No. 06-71703-CMS-13, 2007 WL 1697007, at *1 (Bankr. N.D. Ala. June 12 2007).
 - o At least one Court has concluded that strip-off may be achieved through plan confirmation or via motion. See In re Millspaugh, 302 B.R. 90, 98 (Bankr. D. Idaho 2003) (“[T]he Court concludes the attempt to strip off wholly unsecured liens may occur through a Rule 3012 valuation motion and does not require an adversary proceeding. Such a motion may be subjoined with a plan brought up for confirmation or it may be separately asserted and prosecuted.”)
- Irrespective of the kind of contested matter used, the issue of notice is paramount.
 - o Rule 2002(b) of the Federal Rules of Bankruptcy Procedure requires twenty-eight (28) days’ notice of plan confirmation to all creditors.

- Some courts have suggested that a motion for valuation pursuant to Bankruptcy Rule 3012 should be filed at the same time as the plan, and should be heard along with the confirmation hearing. See, e.g., In re Bennett, 312 B.R. 843, 848 (Bankr. W.D. Ky. 2004) (“Ordinarily debtors should file the motion with the plan of reorganization and expect a resolution at the confirmation hearing.”)
 - A Chapter 13 plan cannot be confirmed unless its treatment of claims complies with the requirements of the Bankruptcy Code. 11 U.S.C. § 1325(a)(1).
 - A plan that proposes to strip-off a wholly unsecured junior mortgage cannot take place until valuation issues have been resolved.
- o Rule 9014 of the Federal Rules of Bankruptcy Procedure makes applicable to contested matters the service rules contained in Bankruptcy Rule 7004. See id.
- Notable among these are Rules 7004(b)(3)—governing service on a corporation or other fictitious legal entity—and 7004(h), which governs service of process on federally-insured depository institutions:

Rule 7004. Process; Service of Summons, Complaint

...

(b) Service by First Class Mail. Except as provided in subdivision (h), in addition to the methods of service authorized by Rule 4 (e)–(j) Fed. R. Civ. P., service may be made within the United States by first class mail postage prepaid as follows:

...

(3) Upon a domestic or foreign corporation or upon a partnership or other unincorporated association, *by mailing a copy of the summons and complaint to the attention of an officer, a managing or general agent, or to any other agent authorized by appointment or by law to receive service of process* and, if the agent is one authorized by statute to receive service and the statute so requires, by also mailing a copy to the defendant.

...

(h) Service of Process on an Insured Depository Institution. Service on an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act) in a contested matter or adversary proceeding shall be made by certified mail addressed to an officer of the institution unless—

(1) the institution has appeared by its attorney, in which case the attorney shall be served by first class mail;

(2) the court orders otherwise after service upon the institution by certified mail of notice of an application to permit service on the institution by first class mail sent to an officer of the institution designated by the institution; or

(3) the institution has waived in writing its entitlement to service by certified mail by designating an officer to receive service.

o Two words of caution with respect to the Rule 7004:

- *First*, Rule 7004(b)(3) does not permit simply service via first-class mail on mailing address listed on the debtor's schedules.
- *Second*, Rule 7004(h) requires federally insured depository institutions to receive service via certified mail, unless only of the three exceptions to the default rule apply.

C. Current Issues Regarding Chapter 13 Lien Stripping

1. Lien Avoidance Involving Property Owned as Tenants by the Entirety.

- One common lien issue that has been recently litigated is whether a debtor may avoid a lien on real property that is owned tenants by the entirety, when only one of the owners is in bankruptcy.
- There is a split of authority on this issue, with courts ruling both in favor of, and against, the debtor.
- One of the cases that is often cited by courts on this issue is Hunter v. Citifinancial, Inc. (In re Hunter), 284 B.R. 806 (Bankr. E.D. Va. 2002).
 - o In In re Hunter, the bankruptcy court concluded that because the property was owned as tenants by the entirety, the debtor could not avoid the junior lien because: (a) the spouse had not sought bankruptcy relief under Title 11 of the United States Code, and therefore the debtor was seeking to provide the spouse with a benefit of having filed for relief without her having any of the bankruptcy burdens typically placed on debtors; and (b) the non-filing spouse's interest was in the whole of the property, not just one-half of the property.
 - o Even if the lien was avoided as to the debtor, the lien would remain in place, as against the entire property, with respect to the non-filing spouse.

- The court reasoned that if the avoidance was allowed, it would result in a severance of the entirety estate, which was not permitted by applicable state law.
- In contrast, the United States Bankruptcy Court for the Eastern District of Michigan's ruling in Strausbough v. Co-op Servs. Credit Union (In re Strausbough), 426 B.R. 243 (Bank. E.D. Mich. 2010), is an example of a bankruptcy court going the opposite direction, and allowing the avoidance of a lien against property owned tenants by the entirety even if only one spouse is in bankruptcy.
 - This case involved two separate bankruptcy cases.
 - In both cases, the Chapter 13 debtors were seeking a determination of the extent of a lienholder's lien in their property, and in both cases only one spouse had filed, although they were attempting to avoid the lien of the mortgage companies.
 - In reaching its decision, the bankruptcy court for the Eastern District of Michigan concluded that there was no state law or bankruptcy code section that precluded the plaintiffs from avoiding the liens and therefore allowed the avoidances.
- There are no reported decisions on this issue from any bankruptcy court in Alabama. However, in two recently issued opinions, Chief Judge Karen S. Jennemann of the United States Bankruptcy Court for the Middle District of Florida and Judge A. Jay Cristol of the United States Bankruptcy Court for the Southern District of Florida expressly adopted the reasoning of In re Hunter, and rejected approach of Strausbough.
 - In re Alvarez, No. 11-44246-BKC-AJC, 2012 WL 1425097, at *3 (Bankr. S.D. Fla. Apr. 24, 2012) ("The Court is not persuaded by the Debtor's cited authority, In re Strausbough, 426 B.R. 243 (Bankr. E.D. Mich. 2010), and instead agrees with the rulings of Hunter and Pierre") (citations omitted).
 - In re Pierre, -- B.R. ---, 2012 WL 928192, at *5 (Bankr. M.D. Fla. Mar. 16, 2012) ("The court agrees with this ruling and finds that nothing in Florida TBE law would posit a different result.") (citing In re Hunter, 284 B.R. 806 (Bankr. E.D. Va. 2002)).

2. Avoiding Liens in Chapter 20 Cases

- Another hot topic that has developed in the wake of the real estate market decline is whether a Chapter 20 debtor may avoid a lien although he is not entitled to receive a discharge in the Chapter 13 case.

- The key factor here is determining when: (a) upon completion of the plan payments; or (b) upon entry of the discharge order. In reviewing the various decisions on this issue, it does appear that the popular approach is one where there is no *per se* rule on whether avoiding a lien is permitted, but rather to review the totality of the circumstances in each case and based upon those facts decide whether avoiding the lien is allowed.
- Those courts that have allowed the avoidance of the liens have found that the requirement of a discharge was inapplicable.¹
 - For example, in the recent case of In re Kotey, Judge Kenney of the United States Bankruptcy Court for the Eastern District of Virginia, Alexandria Division, held that it is irrelevant whether the debtor was entitled to a discharge when deciding whether the debtor could strip off a lien that had no equity securing it due to the amount owed on the first mortgage.
 - As Judge Kenney explained: “[t]he benefit of avoiding a junior lien in chapter 13 does not depend on the debtor’s eligibility for discharge, since a discharge has no effect on the lien one way or another.”
- A key consideration in this domain is whether the plan has been proposed in good faith.
 - See, e.g., In re Scantling, 465 B.R. 671, 682 (Bankr. M.D. Fla. 2012) (Williamson, J.) (“But debtors do not enjoy an absolute right to strip off unsecured liens in a no-discharge Chapter 13 case . . . [c]ourts allowing Chapter 20 strip offs have consistently noted that the bankruptcy court must still determine whether the Chapter 13 plan was filed in good faith.”).
- Other important factors considered when determining whether to allow a chapter 20 debtor to avoid a lien include:
 - (1) The timing between the two filings;
 - (2) The nature and amount of unsecured claims in the current case;
 - (3) The percentage of proposed repayment to creditors;
 - (4) Change in circumstances between the filings;

¹ In re Kotey, Case No. 11-01202-BFK (Bankr. E.D. Va. 2012); In re Fisette, 455 B.R. 177, 185 (B.A.P. 9th Cir. 2011); In re Hill, 440 B.R. 176, 182 (Bankr. S.D. Cal. 2010); In re Blendheim, 2011 Bankr. LEXIS 5122 (Bankr. W.D. Wash. 2011); Frazier v. Real Time Resolutions, Inc. (In re Frazier), 2012 U.S. Dist. LEXIS 32046 (E.D. Cal. 2012).

(5) Whether creditors are being treated fairly; and

(6) Whether the debtor is attempting to manipulate the system.²

- On the other side of this issue are those courts that have looked carefully at the language of the statute and concluded that a discharge is required if a lien is to be avoided.³
- These courts rely upon the language of 11 U.S.C. § 1325(a)(5), which provides, in relevant part:

11 U.S.C. § 1325. Confirmation of Plan

...

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

(A) the holder of such claim has accepted 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;

- This position is explained in detail in the decision, In re Sadowski, --- B.R. ----, 2011 WL 4572005, *1 (Bankr. D. Ct. Sept. 30, 2011).
- In this case, the United States Bankruptcy Court for the District of Connecticut held “that the phrase ‘allowed secured claim’ as used in § 1325(a)(5), refers to any claim that is allowed under § 502 and for which the creditor holds a lien to secure payment; whether such claim is recourse or nonrecourse, collectible or uncollectible.”

² See, e.g., Helton v. The Bank of New York Mellon (In re Helton), No. 11-06028 (Bankr. W.D. Va. 2011)(Anderson, J.) (considering the first three factors); In re Khan, 2010 Bankr. LEXIS 1965 (Bankr. E.D. Va. 2010) (discussing these factors).

³ In re Orkwis, 457 B.R. 243, 252 (Bankr. E.D.N.Y. 2011); In re Erdmann, 446 B.R. 861 (Bankr. N.D. Ill. 2011); In re Gerardin, 447 B.R. 342 (Bankr. S.D. Fla. 2011); In re Mendoza, 2010 Bankr. LEXIS 664 (Bankr. D. Colo. Jan. 21, 2010); In re Jarvis, 390 B.R. 600 (Bankr. C.D. Ill. 2008).

- Because a Chapter 20 debtor is not eligible for a discharge, which is one of the three alternative requirements of Section 1325(a)(5), the debtor could not avoid the lien unless the creditor in question accepted the proposed treatment in the plan or unless the creditor retained its lien until the full amount of the debt owed to it had been paid under non-bankruptcy law.
- If the plan failed to meet the requirements of Section 1325(a)(5)(B), the plan could not be confirmed.
- Given the current state of property values and the likelihood that property values will not increase substantially over the next few years, this issue will continue to be litigated for some time.
- From the debtor's perspective, it is wise to be prepared to make the arguments in favor of lien stripping even if the debtor is not entitled to a discharge and to meet the burden of proof on this matter.
- For example, the debtor should be prepared to establish value of the property, and it is a good idea to use an appraisal, rather than the tax assessment value.⁴ In addition, counsel for a Chapter 13 debtor should make sure to file an adversary proceeding if attempting to avoid the lien, not just filing the plan that contains a motion to value the residence and avoid a deed of trust.

II. 401(K) LOANS, LOAN COMPLETION & PLAN PAYMENT “STEP-UP”

A. Introduction

- Another issue that bankruptcy courts have recently faced is whether income that has been freed-up upon repayment of a 401(k) loan is projected disposable income that must be used to “step up” plan payments to the Chapter 13 trustee.
- The Sixth Circuit Court of Appeals addressed this question in its February 2012 decision In re Seafort, 669 F.3d 662 (6th Cir. 2012).

B. In re Seafort

1. The Facts.

- In Seafort, the United States Bankruptcy Court for the Eastern District of Kentucky consolidated two cases to determine if debtors could exclude from estate property and projected disposable

⁴ A CMA may not be sufficient to establish value of a property, since it does not provide any analysis on how fair market value was determined. See, e.g., In re Gray, Adv. No. 09-1224, 2010 Bankr. LEXIS 181, *1 (Bankr. E.D. Va. Jan. 15, 2010) (Mayer, J.).

income post-petition earned income proposed to be used for future 401(k) retirement plan contributions.

- Debtors were eligible to participate in their employers' ERISA-qualified 401(k) plans, and had taken out loans from these plans.
- At the time of filing, debtors were not making contributions to the plans, and were in the process of repaying their 401(k) loans.
- Debtors each proposed five-year plans:
 - o Both plans provided for full repayment of their loans before completion of plan payments (by months 19 and 48).
 - o Both plans proposed debtors would use the income free up by repayment of the 401(k) loans to start making contributions to their 401(k) plans.
 - o Neither plan proposed for a step-up in plan payments to the Chapter 13 trustee.
- Trustee objected to both plans on grounds that: (1) debtors were not making prepetition payments to their 401(k) plans; and (2) debtors were attempting to exclude from both estate property and projected disposable income the proposed 401(k) contributions.
- The Trustee argued that 401(k) contributions are excludable only if they were made prepetition.

2. Procedural History.

- The bankruptcy court held that Section 541(b)(7) of the Bankruptcy Code permitted the debtors to exclude future 401(k) contributions from disposable income.
- On appeal, the Bankruptcy Appellate Panel for the Sixth Circuit reversed, holding that the Section 541(b)(7) exclusion only applies where a debtor contributes to an ERISA-qualified plan at the commencement of the case.
- Debtors appealed to the United States Court of Appeals for the Sixth Circuit.

3. The Holding.

- Decision of the Bankruptcy Appellate Panel affirmed.

- Income that becomes available during the court of a Chapter 13 plan after the full repayment of a 401(k) loan is projected disposable income that must be used to repay unsecured creditors.

4. Reasoning.

- The Sixth Circuit began its analysis by examining Section 1325(b)(1)(B) of the Bankruptcy Code, which states, in pertinent part:

11 U.S.C. § 1325. Confirmation of Plan

...

(b)(1) If the Trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—

...

(B) the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

- Because the Trustee objected to the debtors' proposed plan, the Sixth Circuit concluded that it was tasked with deciding whether post-petition income available upon repayment of the 401(k) loans constituted "projected disposable income" that must be committed to the Chapter 13 plan.
- The Sixth Circuit noted that, although there was a lower court split on this question, no other circuit court had addressed the issue.
- After canvassing the lower court case law, the Court ultimately embraced the reasoning employed by the United States Bankruptcy Court for the District of Montana in In re Prigge, 441 B.R. 667 (Bankr. D. Mont. 2010).
- In In re Prigge, the bankruptcy court concluded that Section 541(b)(7) does *not* permit postpetition voluntary retirement contributions in any amount, regardless of whether a debtor was making retirement contributions prepetition.
- This basis for the interpretation flows from BAPCPA's treatment of 401(k) loan payments:

- o Although 401(k) loan payments were formerly treated as disposable income, BAPCPA included two important exclusions.
- o *First*, newly added Section 1322(f) excludes amounts required to repay 401(k) loans from disposable income under Section 1325:

11 U.S.C. § 1322. Contents of Plan

...

(f) A plan may not materially alter the terms of a loan described in section 362(b)(19) and any amounts required to repay such loan shall not constitute “disposable income” under section 1325.

- o *Second*, Section 541(b)(7) excludes from property of the estate monies withheld by an employer for employee contributions to ERISA-qualified plans “except that such amount . . . shall not constitute disposable income under Section 1325(b)(2):”

11 U.S.C. § 541. Property of the Estate

...

(b) Property of the estate does not include—

...

(7) any amount—

(A) withheld by an employer from the wages of employees for payment as contributions—

(i) to—

(I) an employee benefit plan that is subject to title I of the Employee Retirement Income Security Act of 1974 or under an employee benefit plan which is a governmental plan under section 414(d) of the Internal Revenue Code of 1986;

- o The Sixth Circuit concluded that Congress intended to treat voluntary 401(k) contributions differently from 401(k) loan repayments.
- o Although “[i]t is true . . . that BAPCPA added new protections for retirement funds that did not exist under pre-BAPCPA law, namely § 1322(f) and § 541(b)(7) . . . BAPCPA’s ‘core purpose’ is to ensure that debtors devote their full disposable

income to repayment creditors and maximizing creditor recoveries.”

III. RULE UPDATE: MORTGAGE CLAIMS & DOCUMENTATION

A. Introduction

- Five amendments to existing bankruptcy rules and two new Federal Rules of Bankruptcy Procedure went into effect on December 1, 2011.
- Among these changes are a newly added Rule 3002.1, and an amended Rule 3001, both of which affect creditors with claims secured on a debtor’s principal residence.

B. Amended Rule 3001

- Rule 3001 now specifies the documentation creditors must attach to their proofs of claim related to mortgage matters, and provides for sanctions if the rule is not followed.
- In individual cases, a creditor claiming that a debtor owes money other than in the form of principal must provide an itemized statement of the interest, fees, expenses and charges claimed as due. Fed. R. Bankr. P. 3001(c)(2)(A).
- If the claim is secured by real property, the creditor must also attach a statement of the amount needed to cure any claimed existing defaults on the account as of the bankruptcy filing date.
- The proof of claim form has also been updated.
 - It now requires the declarant to sign under penalty of perjury that the information in the form is, to the best of that person’s knowledge, information and belief, to be true and correct.
 - There is also a box required to be checked, indicating whether the signer is the creditor, an agent of the creditor, a trustee or debtor, or the guarantor.
 - The signer should also list his title and the name of his company. If the agent is a servicer, the servicer is named as the company.
- In addition to the changes in the rules, three new forms have been created, all related to mortgage claims.

- o The first is **Form B10A**.
 - If the creditor's claim is secured by the debtor's primary residence, the creditor must use this form to list and itemize the arrearage, breaking out the following amounts: principal, insurance, escrow, late fees, charges, expenses, advertising fees, attorneys' fees, et cetera.
 - If there is an escrow account maintained, then the form should also provide a statement for the escrow account, prepared as of the petition date.
- o The second new form is **Form B10 S1**.
 - This form is designed to address changes in the monthly mortgage payments.
 - If such a change is scheduled, the creditor is required to file and serve, within twenty-one (21) days before the change is set to occur.
 - This form is required to be completed any time there is a change in principal, the interest rate or the escrow account.
 - The basis for the change should also be indicated, as well as the new amounts and the date of the change.
 - The notice of the change is to be served on the debtor, debtor's counsel, and the trustee.
 - This form does not have to be filed on the main docket but rather as a supplement to the proof of claim.
- o If there are fees or charges assessed against the debtor post-petition, the mortgage creditor must disclose these fees/charges within one hundred and eighty (180) days of the date they are incurred on **Form B10 S2**.
 - This form is only to be used if the fees are connected to the claim and the creditor believes the fee is recoverable against the debtor and/or the debtor's primary residence.
 - The notice should be served on the debtor, debtor's counsel and the trustee.

C. Rule 3002.1

1. Relationship to Section 1322(b)(5).

- Rule 3002.1 was added to “aid in the implementation of [Section] 1322(b)(5), which permits a chapter 13 debtor to cure a default and maintain payments on a home mortgage of the course of a debtor’s plan.” Advisory Committee Notes on Rule 3002.1.
- Although Section 1322(b)(5) covers various kinds of arrearages and maintenance payments, Rule 3002.1 deals exclusively with claims secured by the debtor’s principal residence.
 - o Section 1322(b)(5) provides:

11 U.S.C. § 1322. Contents of Plan

...

(b) Subject to subsections (a) and (c) of this section, the plan may—

...

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

- Relevant Advisory Committee Notes:
 - o “[T]o fulfill the obligations of Section 1322(b)(5), a debtor and the Chapter 13 Trustee need to know the exact amount needed to cure any prepetition arrearage and the amount of the postpetition payment obligations.”
 - o “If the latter amount changes over time, due to the adjustment of the interest rate, escrow account adjustments, or the assessment of fees, expenses, or other charges, notice of any change in payment amount needs to be conveyed to the debtor and trustee.”
 - o “Timely notice of these changes will permit the debtor or trustee to challenge the validity of any such charges, if appropriate, and to adjust postpetition mortgage payments to cover any undisputed claimed adjustment.”
 - o “Compliance with the notice provision of the rule should also eliminate any concern on the part of the holder of the claim that informing a debtor of a change in postpetition payment obligations might violate the automatic stay.”

2. Notice Regarding Payment Changes, Fees, Expenses, and Charges.

- Rule 3002.1 imposes two new requirements on claimholders with respect to notice.
- *First*, subdivision (b) requires notice of any payment change due to a change in interest rate or an adjustment to an escrow account at least twenty-one (21) days prior to the date that the new payment amount is due.
- *Second*, subdivision (c) requires an itemized notice of any fees, expenses and charges incurred after the bankruptcy case was filed that the creditor believes can be recovered.
 - These fees might include things such as late fees or inspection fees.
 - This notice is required within one hundred eighty (180) days of the date incurred.
 - Subdivision (e), in turn, specifies the manner by which the debtor or trustee may dispute the notice of fees, expenses, and charges identified in subdivision (c):

(e.) Determination of Fees, Expenses, or Charges. The debtor or trustee may file and serve a motion disputing the charges within one (1) year after being served with the notice pursuant to subdivision (c).
- It is important for creditors to understand that these notices are required whether the debt is being paid by the trustee within the plan or by the debtor outside the plan.

3. Notice of Final Cure Payment & Requirement of Response.

- Subdivision (f) provides that within thirty (30) days after the debtor has made all of the payments due under the plan, the trustee is to file and serve on the claimholder, the debtor, and debtor's counsel a notice indicating that the debtor has made all of the payments necessary to cure the default amount due under the claim.
- This notice also indicates to the creditor how to file a response to this notice under subdivision (g).
- Subdivision (g) provides that the claim holder shall, no later than twenty-one (21) days after service of the notice, serve a response on the debtor, debtor's counsel and the trustee.

- This response is required to be filed and must indicate whether the creditor agrees with the statement that the debtor has made all of the payments, and whether the debtor is current on all payments.
- If the creditor disagrees with the notice, that creditor must provide an itemization of what amounts remain outstanding.
- If the creditor files a response indicating the debtor is not current, then the debtor/trustee may file a motion with the Court seeking a determination whether the debtor has cured the default with the creditor and made all required post-petition payments.
- Subdivision (h) provides the procedure for judicial resolution of any disputes that may arise about payment of a claim secured by the debtor's principal residence.
 - "Within twenty-one days after the service of the statement under [subdivision] (g), the trustee or the debtor may move for a determination by the court of whether any default has been cured and whether any other non-current obligations remain outstanding." Advisory Committee Notes on Rule 3002.1.

4. Enforcement Mechanism.

- Finally, subdivision (i) identifies sanctions that may be imposed on the claim holder for failing to provide information required by subsections (b), (c), or (g):

(i) Failure to Notify. If the holder of a claim fails to provide any information as required by subdivision (b), (c), or (g) of this rule, the court may, after notice and hearing, take either or both of the following actions:

 - (1) preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless; or
 - (2) award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure.
- In short, a creditor that fails to make the disclosures required by these subdivisions may be barred from introducing at a later hearing the information that was not timely provided, may be required to reimburse the debtor for reasonable expenses and other attorneys fees, and may be subject to other sanctions subject to the court's discretion.
- These sanctions are modeled after those for failure to make court-ordered discovery under Rule 27 of the Federal Rules of Civil Procedure.

**ALABAMA BAR ASSOCIATION
2012 BANKRUPTCY ON THE BEACH SEMINAR**

Current Consumer Topics

**Hon. Frank J. Santoro
United States Bankruptcy Court
Eastern District of Virginia
Norfolk and Newport News Divisions**

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I. Lien-Stripping in Chapter 13 Cases.

A. The Statutory Framework.

11 U.S.C. 1322. Contents of Plan

...

(b) Subject to subsection (a) and (c) of this section, the plan may—

...

(2) modify the rights of holders of secured claims, *other than a claim secured only by a security interest in the 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. § 506. Determination of Secured Status

(a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, *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.* Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

B. History of Lien-Stripping & the “Strip Down” vs. “Strip Off” Distinction.

- Nobelman v. Am. Savs. Bank, 508 U.S. 324 (1993).
- Holding: Section 1322(b)(2) protects the total claim of an undersecured home mortgage holder as long as there is a modicum of equity.
- Reasoning: Allowing bifurcation of the claim into secured and unsecured portions for plan purposes would negate the statutory language of Section 1322(b)(2), which prohibits the modification of the rights of a secured holder where the mortgage-encumbered collateral was the debtor’s principal residence.

B. Procedure: Contested Matter vs. Adversary Proceeding

1. Adversary Proceeding.

Rule 7001. Scope of Rules of Part VII

An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings:

...

(2) a proceeding to determine the validity, priority, extent of a lien or other interest in property, other than a proceeding under Rule 4003(d).

In re Chukes, 305 B.R. 744, 744-45 (Bankr. D.D.C. 2004) (Teel, Jr., J.):

“[A] Rule 3012 Motion:

- [M]ay be used to determine the value of the collateral encumbered by a creditor’s lien, and to declare the lien unsecured to the extent that the collateral is worth less than the amount of the claim[;]
- [B]ut may not be used to determine that the claim is unsecured based on senior liens that exceed the value of the collateral (or based on the extent or validity of the creditor’s lien).”

2. Contested Matter.

- Plan Confirmation & 11 U.S.C. 1327(c).
- Motion Practice via Fed. R. Bankr. P. 3012.
 - See, e.g., In re Sullivan, 386 B.R. 355 (Bankr. N.D. Ala. 2008).
 - See, e.g., In re Clardy, No. 06-71703-CMS-13, 2007 WL 1697007, at *1 (Bankr. N.D. Ala. June 12 2007).
- Plan Confirmation or via Motion.
 - See In re Millspaugh, 302 B.R. 90, 98 (Bankr. D. Idaho 2003) (“[T]he Court concludes the attempt to strip off wholly unsecured liens may occur through a Rule 3012 valuation motion and does not require an adversary proceeding. Such a motion may be subjoined with a plan brought up for confirmation or it may be separately asserted and prosecuted.”)

C. Current Issues Regarding Chapter 13 Lien Stripping

1. Lien Avoidance Involving Property Owned as Tenants by the Entirety.

- Hunter v. Citifinancial, Inc. (In re Hunter), 284 B.R. 806 (Bankr. E.D. Va. 2002).
- Strausbough v. Co-op Servs. Credit Union (In re Strausbough), 426 B.R. 243 (Bank. E.D. Mich. 2010).
- In re Alvarez, No. 11-44246-BKC-AJC, 2012 WL 1425097, at *3 (Bankr. S.D. Fla. Apr. 24, 2012) (“The Court is not persuaded by the Debtor’s cited authority, In re Strausbough, 426 B.R. 243 (Bankr. E.D. Mich. 2010), and instead agrees with the rulings of Hunter and Pierre”) (citations omitted).
- In re Pierre, -- B.R. ----, 2012 WL 928192, at *5 (Bankr. M.D. Fla. Mar. 16, 2012) (“The court agrees with this ruling and finds that nothing in Florida TBE law would posit a different result.”) (citing In re Hunter, 284 B.R. 806 (Bankr. E.D. Va. 2002)).

2. Avoiding Liens in Chapter 20 Cases.

- In re Scantling, 465 B.R. 671, 682 (Bankr. M.D. Fla. 2012) (Williamson, J.) (“But debtors do not enjoy an absolute right to strip off unsecured liens in a no-discharge Chapter 13 case [c]ourts allowing Chapter 20 strip offs have consistently noted that the bankruptcy court must still determine whether the Chapter 13 plan was filed in *good faith*.”).
- Other Factors:
 - (1) The timing between the two filings;
 - (2) The nature and amount of unsecured claims in the current case;
 - (3) The percentage of proposed repayment to creditors;
 - (4) Change in circumstances between the filings;
 - (5) Whether creditors are being treated fairly; and
 - (6) Whether the debtor is attempting to manipulate the system.

II. 401(k) Loans, Loan Completion & Plan Payment “Step-Up”

In re Seafort, 669 F.3d 662 (6th Cir. 2012).

1. The Facts.

- Debtors eligible to participate in employers' ERISA-qualified 401(k) plans, and had taken out loans from their plans.
- At the time of filing, debtors were not making contributions to the plans, and were in the process of repaying their 401(k) loans.
- Debtors both proposed five-year plans; neither proposed plan payment step-up to the Chapter 13 trustee.
- Trustee objected to both plans on grounds that: (1) debtors were not making prepetition payments to their 401(k) plans; and (2) debtors were attempting to exclude from both estate property and projected disposable income the proposed 401(k) contributions.
- The Trustee argued that 401(k) contributions are excludable only if made prepetition.

2. Procedural History.

- United States Bankruptcy Court, Eastern District of Kentucky:
 - 11 U.S.C. § 541(b)(7) permits debtors to exclude future 401(k) contributions from disposable income.
- Bankruptcy Appellate Panel for the Sixth Circuit:
 - Section 541(b)(7) exclusion only applies where a debtor contributes to an ERISA-qualified plan at the commencement of the case.

3. The Holding.

Income that becomes available during the court of a Chapter 13 plan after the full repayment of a 401(k) loan is projected disposable income that must be used to repay unsecured creditors.

4. Reasoning.

11 U.S.C. § 1322. Contents of Plan

...

- (f) A plan may not materially alter the terms of a loan described in section 362(b)(19) and any amounts required to repay such loan shall not constitute “disposable income” under section 1325.

11 U.S.C. § 541. Property of the Estate

...

- (b) Property of the estate does not include—

...

- (7) any amount—

- (A) withheld by an employer from the wages of employees for payment as contributions—

- (i) to—

- (I) an employee benefit plan that is subject to title I of the Employee Retirement Income Security Act of 1974 or under an employee benefit plan which is a governmental plan under section 414(d) of the Internal Revenue Code of 1986;

III. Rule Update: Mortgage Claims & Documentation

B. Amended Rule 3001

- New Documentation Requirement.
- Updated Proof of Claim Form.
- Three New Forms:
 - 1.) Form B10A;
 - 2.) Form B10 S1; and
 - 3.) Form B10 S2.

C. Rule 3002.1

1. Relationship to 11 U.S.C. § 1322(b)(5).

11 U.S.C. § 1322. Contents of Plan

...

(b) Subject to subsections (a) and (c) of this section, the plan may—

...

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

2. Notice Regarding Payment Changes, Fees, Expenses, and Charges.

Rule 3002.1 Notice Relating to Claims Secured by Security Interest in the Debtor's Principal Residence

...

(b) Notice of Payment Changes. The holder of the claim shall file and serve on the debtor, debtor's counsel, and the trustee a notice of any change in the payment amount, including any change that results from an interest rate or escrow account adjustment, no later than 21 days before a payment in the new amount is due.

(c) Notice of Fees, Expenses, and Charges. The holder of the claim shall file and serve on the debtor, debtor's counsel, and the trustee a notice itemizing all fees, expenses, or charges (1) that were incurred in connection with the claim after the bankruptcy case was filed, and (2) that the holder asserts are recoverable against the debtor or against the debtor's principal residence. The notice shall be served within 180 days after the date on which the fees, expenses, or charges are incurred.

3. Notice of Final Cure Payment & Requirement of Response.

(f) Notice of Final Cure Payment. Within 30 days after the debtor completes all payments under the plan, the trustee shall file and serve on the holder of the claim, the debtor, and debtor's counsel a notice stating that the debtor has paid in full the amount required to cure any default on the claim. The notice shall also inform the holder of its obligation to file and serve a response under subdivision (g). If the debtor contends that final cure payment has been made and all plan payments have been completed, and the trustee does not timely file and serve the notice required by this subdivision, the debtor may file and serve the notice.

(g) Response to Notice of Final Cure Payment. Within 21 days after service of the notice under subdivision (f) of this rule, the holder shall file and serve on the debtor, debtor's counsel, and the trustee a statement indicating (1) whether it agrees that the debtor has paid in full the amount required to cure the default on the claim, and (2) whether the debtor is otherwise current on all payments consistent with § 1322(b)(5) of the Code. The statement shall itemize the required cure or postpetition amounts, if any, that the holder contends remain unpaid as of the date of the statement. The statement shall be filed as a supplement to the holder's proof of claim and is not subject to Rule 3001(f).

4. Enforcement Mechanism.

(i) Failure to Notify. If the holder of a claim fails to provide any information as required by subdivision (b), (c), or (g) of this rule, the court may, after notice and hearing, take either or both of the following actions:

(1) preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless; or

(2) award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure.