No. 10-cv-1128-RTR

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF WISCONSIN

In re SANDRA LEE FAIR,
Debtor.

SANDRA LEE FAIR

v.

GMAC MORTGAGE, LLC

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

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ARGUMENT

"Nothing in the Bankruptcy Code precludes a debtor who is not eligible for a discharge from filing a chapter 13 case, obtaining confirmation of a chapter 13 plan, and with the exception of the right to a discharge, from enjoying all the rights of a chapter 13 debtor, including the right to strip off liens." *In re Tran*, 431 B. R. 230 (Bankr. N.D. Cal. 2010). "The Court concludes as a matter of law that a discharge is not a necessary prerequisite to a lien strip." Judge Steven W. Rhodes, *In re Coryell*, No. 09-54760, Hearing Transcript at 8, Addendum A.

I. The right to modify secured claims in chapter 13 is universally accepted, and that right, combined with claim bifurcation, permits debtors to strip off wholly unsecured mortgages without a discharge.

Since the Bankruptcy Code was enacted in 1978, debtors' ability to modify creditors' rights in chapter 13 has been explicit and broad. The plain language of section 1322(b)(2) permits debtors to "modify the rights of holders of secured claims…or holders of unsecured claims, or leave unaffected the rights of holders of any class of claims." In creating this section of the Code, Congress made a definitive and significant departure from the former chapter XIII of the Bankruptcy Act of 1898, which gave debtors no effective way for dealing with secured creditors.[1]

This ability to modify creditors' rights in chapter 13 is constrained by a limited exception for claims only secured by a security interest in real property that is the debtor's principal residence. 11 U.S.C. § 1322(b)(2). This special protection for residential mortgages applies only if the creditor has an "allowed secured claim" as

[1] Under chapter XIII of the Bankruptcy Act of 1898, a repayment plan could not be approved unless every secured creditor that would receive payments in the plan consented to it. *See* Bankruptcy Act of 1898, §§ 651–52, 11 U.S.C. §§ 1051–52 (1976).

determined by section 506(a). *See Nobelman v. American Sav. Bank*, 508 U.S. 324 (1993). The rights protected by anti-modification provision of section 1322(b)(2) include the "right to repayment of the principal in monthly installments over a fixed term at specified adjustable rates of interest, the right to retain the lien until the debt is paid off, the right to accelerate the loan upon default and to proceed against [debtor's] residence by foreclosure and public sale, and the right to bring an action to recover any deficiency remaining after foreclosure." *Nobelman*, 508 U.S. at 329. Conversely, absent special protection, section 1322(b)(2) permits a debtor to modify any of the listed rights. Thus, chapter 13 explicitly allows debtors to modify the rights of junior mortgage holders, including avoiding the lien attached to the collateral, if the anti-modification provision of section 1322(b)(2) does not apply. *See In re Zimmer*, 313 F.3d 1220 (9th Cir. 2002); *In re Lane*, 280 F.3d 663 (6th Cir. 2002); *In re Pond*, 252 F.3d 122 (2d Cir. 2001); *In re Tanner*, 217 F.3d 1357 (11th Cir. 2000); *In re Bartee*, 212 F.3d 277 (5th Cir. 2000); *In re McDonald*, 205 F.3d 606 (3d Cir. 2000); *In re Griffey*, 335 B.R. 166 (B.A.P. 10th Cir. 2005); *In re Mann*, 249 B.R. 831 (B.A.P. 1st Cir. 2000). The availability of a discharge is not a prerequisite to the application of section 506(a) and 1322(b)(2).

A. In this case, GMAC does not have an "allowed secured claim," and it is therefore not protected by the anti-modification provision of section 1322(b)(2).

The starting point in this analysis is a determination of the status of GMAC's claim as secured or unsecured under section 506(a). *See Nobelman v. American Sav. Bank*, 508 U.S. 324 (1993). Section 506(a) is designed to deal with the situation, not uncommon in bankruptcy, where the lien amount exceeds the current value of the property. In relevant part, section 506(a) provides:

> (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…and is an unsecured claim to the extent that the value of such creditor's interest…is less than the amount of such allowed claim.

11 U.S.C. § 506(a). "[T]his section separates an undersecured creditor's claim into two parts—he has a secured claim to the extent of the value of his collateral; he has an unsecured claim for the balance of his claim." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 356 (1977) (506 effectively "abolishes the use of the terms 'secured creditor' and 'unsecured creditor' and substitutes in their places the terms 'secured claim' and 'unsecured claim.'").

The Supreme Court has repeatedly explained that in the reorganization chapters of bankruptcy, section 506 "governs the definition and treatment of secured claims, i.e., claims by creditors against the estate that are secured by a lien on property" and that for bankruptcy purposes "a claim is secured only to the extent of the value of the property on which the lien is fixed." *United States v. Ron Pair Enter., Inc*., 489 U.S. 235, 241 (1989)(chapter 11). In *Nobelman v. American Sav. Bank*, the Supreme Court held that in chapter 13 whether a claim secured by residential property is entitled to protection from modification under section 1322(b)(2) is determined by looking to section 506(a). The Court stated that if the lien is supported by at least some value, the lien holder is the "holder of a secured claim" under the Bankruptcy Code, and its claim may be entitled to protection under 1322(b)(2). *Nobelman*, 508 U.S. at 329 ("The portion of the bank's claim that exceeds $23,500 is an 'unsecured claim componen[t]' under § 506(a)"). However, implicit in the *Nobelman* decision is the corollary principle that if the lien has no true economic worth based on the value of the underlying collateral, and is therefore

totally unsecured, then the anti-modification provision does not come into play and the claim may be modified because the creditor is not the holder of an allowed secured claim. While not yet addressed by the Seventh Circuit Court of Appeals, this corollary principle has been adopted by six other courts of appeals and two bankruptcy appellate panels. *See In re Zimmer*, 313 F.3d 1220 (9th Cir. 2002); *In re Lane*, 280 F.3d 663 (6th Cir. 2002); *In re Pond*, 252 F.3d 122 (2d Cir. 2001); *In re Tanner*, 217 F.3d 1357 (11th Cir. 2000); *In re Bartee*, 212 F.3d 277 (5th Cir. 2000); *In re McDonald*, 205 F.3d 606 (3d Cir. 2000); *In re Griffey*, 335 B.R. 166 (B.A.P. 10th Cir. 2005); *In re Mann*, 249 B.R. 831 (B.A.P. 1st Cir. 2000). The majority of lower courts in the Seventh Circuit have reached the same conclusion. *See In re King*, 290 B.R. 641, 646 (Bankr. C.D. Ill. 2003), and cases cited. As a matter of common sense, a lien that attaches to nothing provides no security to the lien holder.

In this case the parties appear to agree that the lien held by GMAC is presently not supported by any value in the collateral. Applying section 506(a), GMAC is not the holder of an "allowed secured claim" and is not entitled to protection of the anti-modification provision.

B. The plain language of section 1328(f)(1) deals only with the discharge of personal liability; it has no effect on liens.

In relevant part, section 1328(f)(1) provides that

> the court shall not grant a discharge of all debts provided for in the plan or disallowed under 502, if the debtor has received a discharge—(1) in a case filed under chapter 7, 11, or 12 of this title during the 4-year period preceding the date of the order for relief under this chapter…

The bankruptcy discharge referred to in section 1328(f)(1) eliminates the debtor's personal liability for a discharged debt. 11 U.S.C. § 524(b). It prevents creditors from

beginning or continuing actions against the debtor to collect the amount owed to it by the debtor prior to bankruptcy. *See id*. (the discharge operates as an injunction against an act, to collect, recover or offset any such debt as a **personal liability** of the debtor). The discharge has no effect on liens one way or another. "[A] bankruptcy discharge extinguishes only one mode of enforcing a claim—namely, an action against the debtor *in personam*—while leaving intact another—namely, an action against the debtor *in rem*." *Johnson v. Home State Bank,* 501 U.S. 78, 84 (1990); *see also In re Frazier,* 2011 Bankr. LEXIS 78 at * 13 (discharge "does not release a lien from the Debtor's property."). Because the discharge only affects personal liability and has no effect on liens, it can not be a precondition for modifying liens if a chapter 13 debtor has satisfied all statutory requirements for plan confirmation and successfully performs that plan.

The bankruptcy court, therefore, erred in concluding that section 1328(f)(1) precluded the debtor from avoiding a wholly unsecured junior mortgage. The starting point for the court's inquiry should be the statutory language itself. *See Lamie v. U.S. Trustee*, 540 U.S. 526, 534, 124 S.Ct. 1023, 1030 (2004). In interpreting the statutory language, the court must assume that Congress said in the statute what it meant and meant in the statute what it said. *See Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992). Thus, it has been well established that when the "statute's language is plain, the sole function of the court, at least where the disposition required by the text is not absurd, is to enforce it according to its terms." *Hartford Underwirters Ins. Co. v. Union Planters Bank, N.A.,* 530 U.S. 1, 6 (2000) (internal quotations omitted). A result will only be deemed absurd if it is unthinkable, bizarre or demonstrably at odds with the intentions of its drafters. *See In re Spradlin*, 231 B.R. 254, 260 (Bankr. E.D. Mich. 1999)

(*citing Public Citizen v. Dept of Justice*, 491 U.S. 440, 109 S. Ct. 2558, 105 L.Ed.2d. 377 (1989)).

When Congress amends the bankruptcy laws, it does not write on a clean slate and therefore courts should be reluctant to interpret the Code to effect a major change in longstanding bankruptcy practice. *See Matter of Snyder*, 967 F.2d 1126, 1129 (7th Cir. 1992) (citations omitted). Indeed, there is a presumption that Congress is aware of the judicial construction of existing law, and thus newly enacted amendments must be read in conjunction with previous interpretations of the law. *See United States v. Professional Air Traffic Controllers Org*., 653 F.2d 1134, 1138 (7th Cir. 1981) (citations omitted). Here longstanding bankruptcy law and policy has permitted chapter 13 debtors to modify or avoid liens that are not supported by any value in the collateral. *See* Part I, *supra*. There is no legislative history suggesting that the 2005 amendment to section 1328(f)(1) was intended to modify the longstanding ability of debtors to avoid liens in chapter 13. The bankruptcy court cites none. There is simply nothing in the text or legislative history of section 1328(f)(1) that can be said to demonstrate a clear intent to modify more than thirty years of bankruptcy jurisprudence on this issue. *See Snyder*, 967 F.2d at 1129.

Because neither the plain language of the Bankruptcy Code nor longstanding bankruptcy practice prohibits chapter 13 debtors from modifying liens even in the absence of a discharge of personal liability, the bankruptcy court relies on logical fallacy to reach the opposite result. First, the court finds that because there is no evidence in the 2005 amendments or their legislative history that supports chapter 13 debtors' rights to modify liens, the opposite must be true. Court Minutes at 2. However, arguments based on silence are inappropriate given our rules of statutory construction that presume

Congress would not affect a major change in practice without saying so. Here, Congress specifically limited debtors' ability to obtain a discharge of personal liability, but did not affect debtors' rights to modify liens.

Second, the court conflates *in rem* liability with *in personam* liability in reaching its conclusion. Proverbially, it mixes apples and oranges. The courts finds that avoiding *in rem* liability is the functional equivalent of granting the debtor a discharge as to personal liability for the unsecured mortgage debt. Court Minutes at 3. Creditor's ability to collect debts personally from the debtor and a creditor's lien rights are apples and oranges, respectively under the Bankruptcy Code. Lien rights are unaffected by the discharge of personal liability. *See Johnson v. Home State Bank,* 501 U.S. 78, 84 (1990). Conversely, creditors' lien rights may be affected irrespective of debtor's discharge of personal liability. For example, under section 522(f) a debtor may avoid a non-possessory, non-purchase money lien in household goods so long as the debtor can exempt the property. Section 522(c) makes clear that, unless the case is dismissed, the **property** shall not be liable for the debt.

By way of illustration, take the creditor that has a non-purchase money lien on the debtor's refrigerator, which is located in the debtor's house. The creditor's lien would be considered non-possessory and non-purchase money. The debtor has filed for bankruptcy and exempts the refrigerator under section 522(b)(1). *See* 11 U.S.C. § 522(b)(3) (allowing debtor to exempt household furnishings). Pursuant to section 522(f), the debtor avoids the lien on the refrigerator. Unless, the case is dismissed, the creditor may no longer seek satisfaction of the debt by repossessing the refrigerator. If the debtor does not receive a discharge, he or she may still be personally liable for the debt owed to the

creditor, but the refrigerator is no longer collateral for the debt. Code section 522(c), which protects exempt property from creditors holding unsecured prepetition debts is not limited to debts that are discharged, which is made clear by the fact that only two types of nondischarged debts—taxes and domestic support obligations—are listed as exceptions to the general rule. Thus, *in rem* relief is provided irrespective of discharge of the particular debt.

The bankruptcy court's decision in this case is akin to grafting a discharge requirement onto lien avoidance under section 522(f) and 522(c) where none exists. A chapter 13 debtor's ability to modify the rights of lienholders is governed by section 506(a) and 1322(b)(2). Nothing in these two sections requires a discharge, and the bankruptcy court went too far in creating one without any basis in the statutory language or a clear indication from Congress that it intended to change this longstanding bankruptcy practice.

II. The fact that debtor is not entitled to discharge under section 1328(f)(1) does not effect her ability to strip off the valueless junior mortgage.

The only limitation on the Debtor's ability to modify the rights of GMAC in chapter 13 is the anti-modification provision of section 1322(b)(2). Nothing in the Code prevents Debtor, who is ineligible for a discharge, from enjoying all the rights of a chapter 13 debtor, including the right to strip off. *See Tran*, 431 B.R. at 235; *see also In re Frazier,* 2011 Bankr. LEXIS 78 (Bankr. E.D. Cal. January 11, 2011) (allowing strip off of wholly unsecured lien on residential property); *In re Grignon*, 2010 Bankr. LEXIS 4279 (Bankr. D. Or. Dec. 7, 2010) (overruling trustee's objection and confirming chapter 13 plan stripping off wholly unsecured junior lien in no discharge chapter 13); *Hart v. San Diego Credit Union*, 2010 U.S. Dist. LEXIS 130761 (S.D. Cal. March 1, 2010)

(availability of discharge irrelevant to ability to modify lien where right to modify stems from status of claim under section 506(a)). Rather, the right to strip off a wholly unsecured junior lien "is conditioned on the debtor's obtaining confirmation of, and performing under, a chapter 13 plan that meets all the statutory requirements." *Tran*, 431 B.R. at 235; *Hart*, 2010 U.S. Dist. LEXIS 130761, at * 19 (strip-off of wholly unsecured lien under section 506(d) is effective upon confirmation of Plan even though debtor not entitled to discharge under section 1328(f)(1)).

III. *Jarvis*, and the cases that follow it, rest on a weak foundation because *Jarvis* misapplies both *King* and *Lilly* in reaching its conclusion that a chapter 13 discharge is necessary to strip a lien.

The bankruptcy court correctly held that *In re Jarvis*, 390 B.R. 600 (Bankr. C.D. Ill. 2008), which held that lien avoidance was conditioned upon discharge, was incorrectly reasoned. *Jarvis* was the first case to address the issue of lien stripping in a no discharge chapter 13. The *Jarvis* court improperly extended the holdings in *In re King*, 290 B.R. 641, 646 (Bankr. C.D. Ill. 2003), and *In re Lilly*, 378 B.R. 232 (Bankr. C.D. Ill. 2007), to reach its conclusion. Subsequently, several courts have followed *Jarvis* in holding that a discharge is necessary to strip a lien in chapter 13. *See In re Trujillo*, 2010 WL 4669095 (Bankr. M.D. Fla. Nov. 10, 2010); *In re Colbourne*, 2010 WL 4485508 (Bankr. M.D. Fla. Nov. 8, 2010); *In re Mendoza*, 2010 WL 736834 (Bankr. D. Colo. Jan. 21, 2010); *In re Blosser*, 2009 WL 1064455 (Bankr. E.D. Wis. Apr. 15, 2010).

In addressing the issues raised in *Jarvis* the court examined the cases underlying the *Jarvis* decision and properly limited them to their true significance. The bankruptcy court found that, contrary to the interpretation in *Jarvis, In re King*, 290 B.R. 641, stands for the proposition that a "debtor who is eligible for a Chapter 13 discharge can use the

Chapter 13 process to avoid a wholly-unsecured mortgage lien." Court Minutes, October 25, 2010. With respect to *In re Lilly*, 378 B.R. 232, the bankruptcy court correctly held that that case allows "a debtor who is not eligible for a Chapter 13 discharge [to] use the Chapter 13 process to cram down the interest rate on a non-§1322(b)(2) secured claim, but only for the duration of the plan." Court Minutes.

The majority of cases holding lien avoidance is contingent on eligibility for a discharge rely on *Jarvis*. Therefore, as determined by the court below, the weak foundation upon which this stack of cases is built cannot support a requirement that a chapter 13 discharge is necessary to avoid lien for which is not supported by value in the collateral.

IV. Allowing debtor to strip off a lien that is secured in name only and that is not supported by any true economic value is not unfair to junior mortgagees.

Courts have repeatedly noted a distinction between the first and second mortgage markets. *See In re Bartee*, 212 F.3d at 292 ("[B]ecause second mortgages are not in the business of lending money for home purchases, the same policy reasons for protection of first mortgages under section 1322(b)(2) do not exist for second mortgages.") (internal quote omitted); *Lam v. Investors Thrift (In re Lam)*, 211 B.R. 36, 40-41 (9th Cir. B.A.P. 1994). "Because secondary lending is targeted primarily at personal spending, allowing wholly undersecured second mortgages under the umbrella of the antimodification clause would be unlikely to positively impact home building and buying." *In re Bartee,* 212 F.3d at 293. "The only class of creditors who can complain are those who are wholly unsecured, but as we set forth above, these creditors are not worse off than other secured creditors who operate outside of mortgage lending." *In re McDonald*, 205 F.3d at 614.

Review of the recent history of the secondary mortgage market supports this distinction. Beginning in the mid-1990's the second mortgage market expanded rapidly as lenders pushed high loan-to-value (LTV) mortgages.[2] In issuing a warning to lenders about the risks involved with such loans in comparison to traditional mortgage loans, the Office of Thrift Supervision described the practice as follows:

> An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property…Until recently, the high LTV home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders.

Thrift Bulletin TB 72, Office of Thrift Supervision, Department of the Treasury, August 27, 1998, at 1. Lenders that make such high LTV loans, or no equity loans, take their illusory security in the debtor's home not for its economic value or the ability to foreclose, but for the threat of foreclosure.

In the early 2000's, lenders aggressively pitched "piggyback" loans to borrowers unable to come up with a larger down payment, or any down payment at all. Piggyback loans feature two mortgages—an 80 percent first mortgage and a second mortgage for 10, 15 or 20 percent of the purchase price. The structure typically combined a traditional fixed-rate or adjustable-rate first mortgage with either a closed-end second lien or a home equity line of credit. The risks of piggyback loans were well known to the second mortgage industry by mid-2005. *See* Broderick Perkins, Piggyback Loan Growth Poses Mortgage System, Realty Times (July 13, 2005), available at

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[2] In 1995, home equity lenders had made $1 billion in high LTV loans. By 1997, the amount of these loans had increased to $8 billion. High Loan-To-Value Lending, General Accounting Office, GAO/GGD 98-169, August 13, 1998; Paine's High LTC Specialist is Out," National Mortgage News, October 27, 1997, 1997 WL 12863567.

http://realtytimes.com/rtpages/20050713_piggyback.htm. ("The potential for risk is that already over-extended home buyers will be left with an upside down mortgage should the bubble burst and price drop.") The additional risks borne by piggyback and other high LTV lenders caused them to charge higher interest rates on these second mortgages. Now that the housing bubble has burst and home values have dropped, creditors can hardly argue that they were not aware of the potential risk that debtors would be left with upside down junior mortgages—risk that they priced into their products

Finally, debtors do not receive a "windfall" at the expense of high LTV lenders. It is not certain if, or when, the value of Debtor's property will increase. The only thing known with any degree of certainty is that GMAC's right to foreclose will not currently result in any monetary gain. Bankruptcy is not intended to benefit either the creditor in securing a potential increase in property value, or the debtor. However, where the future is uncertain, the lien should be avoided. *In re Cook*, 2010 WL 4687953 (Bankr. E.D. Va. Nov. 10, 2010) (no statutory or case authority stands for the proposition that lien avoidance may be denied solely based on anticipated future increase in the value of the secured creditor's collateral).

Bankruptcy policy should not be used to protect piggyback and high LTV lenders who would not otherwise be protected outside of bankruptcy and who knowingly made riskier loans. Any other result will create a perverse incentive for lenders to make high LTV loans knowing that they will gain an unfair advantage in bankruptcy.

CONCLUSION

Longstanding principles of chapter 13 that allow debtors the broad right to modify creditors' claims and the absence of any statutory language requiring a discharge to avail themselves of those rights, dictate that wholly unsecured liens may be stripped off in chapter 13 cases regardless of whether the debtor is eligible for a discharge.

Respectfully submitted,

/s Abraham Michelson

Abraham Michelson, Esq.

ADDENDUM A

In re Coryell, No. 09-54760
Hearing Transcript