

Stripping of Unsecured Second Mortgages in Chapter 7 Bankruptcies in the Crosshairs

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Since its 1989 opinion in *Folendore v. Small Business Admin.*, the Eleventh Circuit Court of Appeals has allowed debtors to completely strip off and void wholly unsecured junior liens in Chapter 7 bankruptcies under Section 506(d) of the Bankruptcy Code. Complete lien stripping forever prevents creditors from seeking relief against a debtor's collateral if it is underwater, even if the property value later increases. Since Chapter 7 debtors are also discharged of personal liability, subordinate debt is, in such cases, rendered worthless. That may soon change. The Eleventh Circuit's position on lien stripping conflicts with that of the Fourth, Sixth, and Seventh Circuits – the only federal Courts of Appeal to have addressed the issue. Now the Supreme Court appears ready to resolve the conflict, accepting *certiorari* review of two Eleventh Circuit cases dealing with the issue. **Most commentators expect the Supreme Court to side with the Fourth, Sixth, and Seventh Circuits and hold unsecured junior liens may not be stripped in Chapter 7 cases;** it has, after all, already held, post-*Folendore*, that debtors may not partially strip down undersecured subordinate liens, reasoning that if a claim "is secured by a lien with recourse to the underlying collateral, [it cannot be stripped under] § 506(d)... [because] the creditor's lien stays with the real property until foreclosure [as this] is what was bargained for by the mortgagor and the mortgagee." Even the Eleventh Circuit has signaled it may reconsider the issue. In a recent opinion affirming the stripping of an unsecured second mortgage, the panel acknowledged that the Supreme Court has "rejected the reasoning of [its prior holding in] *Folendore*" but noted the court was bound by the prior panel precedent rule until reversed on appeal *en banc* or by the Supreme Court. The court then invited the creditor to seek *en banc* review of its own decision. In response, debtors in the Eleventh Circuit have expedited their efforts to strip off underwater subordinate debt before the Supreme Court addresses the issue. Some debtors are even attempting to reopen long dormant cases to seek such relief. In such instances, home equity lenders and other debt holders, who have historically abandoned subordinate claims given the grim prospects of recovery, should reevaluate their position. Loans once considered worthless may be given new life by the Supreme Court in the coming months. Until a final ruling on

the issue is reached, creditors should seek to stay enforcement of orders allowing subordinate liens to be stripped in Chapter 7 cases.

Authored By



Christopher M. Paolini

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