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A Thoughtful Bankruptcy Lawyer's Opportunity to Anticipate

A lawyer's usual task is to help solve the client's current problem: resolve a dispute; close a loan; obtain a permit; avoid a conviction; etc. Lawyers are so task oriented that some consultants advise us to have task specific engagement understandings and send dis-engagement letters when a task is complete. For bankruptcy lawyers representing individuals in a Chapter 13 bankruptcy, the task at hand is getting clients to and through a confirmed Chapter 13 plan with the promised debt relief and fresh start.

Thoughtful and thorough lawyers can and should sometimes look beyond the current task to anticipate a problem clients will face and plan to prevent that problem. This is particularly true when (i) the problem can be identified, (ii) the problem is likely to occur, and (iii) the problem is much easier to prevent than cure. One such problem and resulting opportunity for thoughtful lawyers was created by changes to bankruptcy rules controlling Chapter 13 cases.

This blog post is divided into parts: a recap of Chapter 13's ability to extinguish liens on the debtor's property; and what evidence is available to subsequent real property title searchers to demonstrate that liens were extinguished.

Extinguishing Lens In Chapter 13 Cases.

Chapter 13 cases often eliminate unsecured liens from assets the debtor will retain. In bankruptcy parlance, debtors engage in "lien avoidance" or "lien stripping." This desirable (for bankrupts) result is accomplished using:

- 11 U.S.C. Section 506 defining secured claims as "[a]n 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 . . .." Under 11 USC Section 103(a), section 506 is

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applicable to all filing chapters available to debtors, that is chapters, 7. 11. 12 and 13 of the Bankruptcy Code. Hence, a creditor's claim secured by a lien exists only to the extent the lien attaches to a debtor's equity in the property;

- 11 U.S.C. Section 1322 that permits a bankruptcy plan to deal with secured claims and claims that initially appeared to be "secured claims" but are now accurately treated as "unsecured claims" due to the value of the collateral;
- 11 U.S.C. Section 1325 related to confirmation of Chapter 13 plans; and
- 11 U.S.C. Section 1327(a) that makes the provisions of confirmed plans binding on "the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan."

A congressionally approved and court enforced benefit available to Chapter 13 debtors is the retention of property that is now free of prior junior liens that did not in fact provide secured claims to the junior lienors on the relevant date[1] or which impaired an exemption to which the debtor is entitled. If all goes well, the Chapter 13 debtor will make the required plan payments, exit bankruptcy and someday want to sell the retained property that is now free of prior existing liens – anticipating this development, a bankruptcy lawyer can act now to help insure that future sale will go smoothly.

Prior practice had many debtor's counsel filing an adversary proceeding to avoid liens, including mortgages, in Chapter 13 cases. With recent bankruptcy rule amendments and the creation of the national Chapter 13 form plan, adversary proceedings are not required and use of them for lien avoidance has been discontinued in many courts. The 2017 revisions of Bankruptcy Rule 3012(b) provide that requests to determine the value of nongovernmental secured claims generally "may be made by motion, in a claim objection, or in a plan filed in a chapter 12 or chapter 13 case"[2] and if the value of the "secured claim" is zero, then no secured claim exists and the lien that now secures nothing can is eliminated.

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Bankruptcy Rule 4003(d) permits avoidance actions to be accomplished by motion as a contested matter or through the plan. Bankruptcy Rule 7001(2) specifically excepts "proceedings under Rule 3012 or Rule 4003(d)" from the adversary proceeding process. When the validity, priority, or more than valuation of a lien is at issue, an adversary complaint may be appropriate. If the only issue is valuation, an adversary complaint is unnecessary.

All this does not mean that lienors will not get proper notice. The bankruptcy rules require service of the plan in accordance with Rule 7004 which includes a summons and several courts have established procedures to insure that service is provided. See, for example, General Order 17-01, available at https://www.ohnb.uscourts.govisites/default/files/general-orders/interim-general-order-17-1-service-ch-13-plans-electronic-signatures.pdf, which also governs service of plans containing embedded motions in the Northern District of Ohio.

If a plan confirmation request is properly served, confirmation serves as a ruling on the embedded avoidance motion in the plan. This warning is clearly stated in the form Chapter 13 plan found at http://www.uscourts.gov/sites/default/files/b_113_and_cn_0.pdf which contains this in section 3.2 which deals with liens that secure no value:

The debtor(s) request that the court determine the value of the secured claims listed below. For each non-governmental secured claim listed below, the debtor(s) state that the value of the secured claim should be as set out in the column headed *Amount of secured claim*. ....

The portion of any allowed claim that exceeds the amount of the secured claim will be treated as an unsecured claim under Part 5 of this plan. If the amount of a creditor's secured claim is listed below as having no value, the creditor's allowed claim will be treated in its entirety as an unsecured claim under Part 5 of this plan. ....

The holder of any claim listed below as having value in the column headed *Amount of secured claim* **will retain the lien on the property interest of the debtor(s) or the estate(s) until** the earlier of: (a) payment of the underlying debt determined under

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nonbankruptcy law, or (b) discharge of the underlying debt under 11 U.S.C. § 1328, at which time the lien will terminate and be released by the creditor. (bold added).

Similarly, section 3.4 of the form Chapter 13 plan contains this regarding liens that will be eliminated because they impair an exemption to which a debtor is entitled:

The judicial liens or nonpossessory, nonpurchase money security interests securing the claims listed below impair exemptions to which the debtor(s) would have been entitled under 11 U.S.C. § 522(b). Unless otherwise ordered by the court, a **judicial lien or security interest securing a claim listed below will be avoided to the extent that it impairs such exemptions** upon entry of the order confirming the plan. The amount of the judicial lien or security interest that is avoided will be treated as an unsecured claim in Part 5 to the extent allowed. (bold added).

Section 1327 of the Bankruptcy Code states that "[e]xcept as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan." This section has been understood to mean that avoided liens and liens determined to secure nothing are extinguished. See, *In re Martin*, 491 B.R. 122 (Bankr. E.D. Calif. 2013) (Debtor's plan that provided for payment of junior lender's allowed secured claim, in amount to be determined by court, meant that lender's secured claim, which court had fixed at $0.00, was satisfied and since there was no longer any obligation for the lien to secure, under California law, that lien has no existence.) and *In re Scott*, 376 B.R. 285 (Bankr. D. Idaho 2007) [3] ("The courts in this circuit and district have held that a valueless lien may be stripped under a chapter 13 debtor's plan. As these cases instruct, the effect of a lien-strip in this context is to negate a creditor's lien in its entirety." (citations omitted)).

Showing that Liens Have Been Extinguished in Local County Records

Most if not all states have a procedure for the recordation of court orders in real property records and other places where lien

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information is publicly available. The filing may require a cover affidavit or a certified copy of the court order, but it can be done. As discussed above, however, if the liens are extinguished through the confirmation of a Chapter 13 plan, no such specific order is generated. Moreover, the plan confirmation order does not automatically reference the extinguished liens. See, for example, http://www.uscourts.gov/forms/bankruptcy-forms/order-confirming-chapter-13-plan-0 which is a form Chapter 13 plan issued under Bankruptcy Rule 9009(b) by the Director of the Administrative Office of the United States Courts.

Bankruptcy lawyers usually are not experienced with real estate title records and searching those records for the status of liens. Real estate title specialists usually do not practice bankruptcy law. But, both recognize the importance of the other. For example, Standard 12.140 titled The Discharge And Judgment Liens in 3A Tex. Prac., Land Titles And Title Examination § 11.13 (3d ed.) includes this:

An examiner may presume that an abstract of judgment filed against a person who was a debtor in a bankruptcy case is extinguished as a lien against property of the debtor if: (1) the debtor files a motion in the bankruptcy case pursuant to 11 U.S.C. § 522(f) to extinguish the lien as to homestead, notifies the creditor in accordance with the applicable Bankruptcy Rules and local rules, **and secures a final order** of the bankruptcy court removing the lien; (2) ...; or, (3) the property is exempt or is not abandoned in the bankruptcy proceeding, and the debtor receives a discharge from the debt. (bold added)

That direction to Texas title examiners is followed by this comment:

A proceeding under 11 U.S.C.A. § 522(f) by the debtor to avoid a judicial lien must be treated as a contested matter, and notice must be served in accordance with Fed. R. Bankr. P. 7004. Fed. R. Bankr. P. 4003(d), 9014. An order will not be final until 14 days after **the entry of the order** (or after a timely motion to amend, or alter a judgment, or for mistake or fraud). Fed. R. Bankr. P. 8002(c)(2). ... A judgment lien is automatically released if the debt is discharged and the land is exempt or is otherwise not abandoned. (bold added).

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The above-quoted Texas information was last amended in 2014 and clearly does not reflect the above discussion of 2017's changes to Bankruptcy Rule 3012. The point is that title examiners are accustomed to looking for and finding a specific court order reflecting that liens are extinguished. Recognizing this, a memo from the Northern District of Ohio Bankruptcy Court discussing the 2017 revisions of Bankruptcy Rule 3012(b) and the fact that liens could be extinguished through a Chapter 13 plan included this: "[c]ounsel may desire to file a comfort motion in order to obtain a specific order for recording with county agencies." If this is done, debtor's counsel will have generated a court order specifically addressing the extinguished liens.

So, what is a forward-looking bankruptcy lawyer to do for clients in Chapter 13 cases who are retaining property and who extinguished liens during the bankruptcy case?

- Filing a protective motion is a choice in courts where permitted so that the resulting order is created and can be used by title examiners at some unknown point in the future; that option, however, creates additional work for both counsel and courts.
- Alternatively, counsel might alter the form Chapter 13 plan confirmation order to expressly reference the extinguished liens, if permitted by the bankruptcy court. Note that the above-discussed form plan has blanks for additional terms. Or,
- Counsel could prepare for the eventual need to demonstrate to title examiners that the Chapter 13 plan and its confirmation order extinguished the liens. This might mean that those documents will have to be recorded or, at least, that you will be providing documents title examiners.[4] This preparation could include specifically warning clients to retain documents they will eventually need to provide to title examiners.

Mr. Mauer is a member of the litigation department at Frost Brown Todd. His practice includes bankruptcy court cases and state court cases that involve complex real estate title issues.

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[1] The value of a junior lien is enhanced by (i) the senior lien creditor's debt being reduced by the debtor's periodic payments or (ii) an increase in the value of the collateral. A bankruptcy filing eliminates those opportunities for junior lienors. A discussion of Congress' decision on this issue is beyond the scope of this blog post.

[2] The form Chapter 13 plan can appear to be a common innocuous form document. Recognizing that it can impact substantive rights that previously were handled more formally, Rule 3012(b) requires that "[w]hen the [lien impacting] request is made in a chapter 12 or chapter 13 plan, the plan shall be served on the holder of the claim and any other entity the court designates in the manner provided for service of a summons and complaint by Rule 7004." Rule 7004 applies in adversary proceedings – the process that formerly was often used for lien avoidance activities; so, creditors still receive the same level of warning that their liens are about to be extinguished.

[3] Eliminating liens through the Chapter 13 plan was used by the *In re Scott* court for years, as noted by that court in this 2007 statement from the cited case: "[t]his Court has held that an adversary proceeding is not required to strip a lien; it may be accomplished through the chapter 13 plan confirmation process. *In re Millspaugh, 302 B.R. at 97–98* ('This sort of valuation process is regularly conducted, in regard to partially secured creditors, through plan confirmation and plan-related motions. The Court sees no compelling reason to require a different procedural vehicle for valuation of an allegedly wholly unsecured creditor.')"). *In re Scott*, 376 B.R. at 291-2. Hence, the 2017 bankruptcy rule change is not new for all courts.

[4] Chapter 13 plans contain financial information from a debtor's past that most want to leave behind. Those persons who are now trying to sell property may wish to avoid dissemination of this information if possible.

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