IN THE UNITED STATES BANKRUPTCY COURT FOR THE
SOUTHERN DISTRICT OF MISSISSIPPI
JACKSON DIVISION

IN THE MATTER OF:

GEORGE C. LOTT AND
RUBY W. LOTT — CASE NO. 8501242JC

GEORGE C. LOTT AND
RUBY W. LOTT — PLAINTIFFS

vs. — ADV. NO. 870070JC

FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL LAND BANK OF JACKSON AND BANK OF YAZOO CITY — DEFENDANTS

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Edward Ellington, Bankruptcy Judge

MEMORANDUM OPINION IN REGARD TO THE "MOTION TO DISMISS" FILED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION

The issue before the Court is whether a debtor who has filed bankruptcy pursuant to Chapter 7 of the Bankruptcy Code may extinquish or avoid a consensual lien to the extent that the lien exceeds the actual value of real property given as security.

FACTS AND PROCEDURAL HISTORY

On August 16, 1985, George C. Lott and his wife, Ruby W. Lott, filed a Chapter 11 proceeding in this Court. An order converting the case to a Chapter 7 proceeding was entered on February 19, 1987. On May 14, 1987, Dr. Lott and his wife filed the present adversary proceeding against the Federal Deposit Insurance Corporation (FDIC) seeking relief under §506 of the Bankruptcy Code. FDIC subsequently answered the complaint, setting forth various defenses, including the defense that the complaint failed to state a cause of action upon which relief may be granted. FDIC further alleged that certain necessary parties had not been joined in the litigation.

By order of October 8, 1988, the Court found that the Federal Land Bank of Jackson and the Bank of Yazoo City were indispensable parties and ordered the debtors to add the other financial institutions as defendants. Subsequently, an amended complaint was filed with the added parties.

FDIC has now brought on for hearing its motion to dismiss for failure to state a claim upon which relief may be granted pursuant to Bankruptcy Rule 7012 and Rule 12 of the Federal Rules of Civil Procedure.

For purposes of the pending motion the Court assumes that the Federal Land Bank of Jackson has a first deed of trust on the real property which is the subject of this adversary proceeding; that second in priority behind the Federal Land Bank is the Bank of Yazoo City, which is secured by virtue of a deed of trust on the same property; and, that in third position is the FDIC, with its debt being secured by a deed of trust on the same property. For purposes of the motion to dismiss, the Court assumes that a certain portion of FDIC's debt is undersecured. In its brief, the FDIC states that after comparing the total debt encumbering the subject real property with the appraisal which FDIC had obtained, the FDIC appears to be undersecured in the approximate amount of $100,000.00.

The debtors, through their amended complaint, seek to discharge FDIC's undersecured debt pursuant to §506(d) of the Bankruptcy Code.

CONCLUSIONS OF LAW

The relevant part of 11 U.S.C. §506 is as follows:

> (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. 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.
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> * * *
>
> (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless--
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> (1) such claim was disallowed only under Section 502(b)(5) or 502(e) of this title; or
>
> (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under Section 501 of this title.

11 U.S.C. §506(a) and (d).

The debtors allege in their amended complaint that by virtue of §506(d) the FDIC's deed of trust is a secured claim only to the extent that the value of the underlying real property exceeds the sums due the Federal Land Bank and Bank of Yazoo City, with all other amounts being void and thus dischargeable. The debtors' construction of this statute would effectively allow them to "cram down" against FDIC.

Numerous bankruptcy and district courts have analyzed this issue. Two divergent lines of cases have developed on the subject.

The line of cases in support of the proposition that §506 may be used to avoid liens on real property when the value of the collateral is less than the amount of the liens on the property was initiated by the case of Tanner v. Financeamerica Consumer Discount Co. (In re Tanner), 14 B.R. 933 (Bkrtcy.W.D. Penn. 1981). In that case, the court, acknowledging that the legislative history and case law on the issue were sparse, concluded that the "lien" under §506 included the lien created by a real property mortgage. A plain reading of the statute, said the court, appeared to allow the avoidance of the undersecured portion of the debt secured by a real property mortgage. The court further noted that this avoidance power was consistent with the "fresh start" policy of the Bankruptcy Code.

Other bankruptcy and district courts have adopted this construction of §506(d), including Vigne v. Equibank (In re Vigne), 18 B.R. 946 (Bkrtcy.W.D. Penn. 1982); Rappaport v. Commercial Banking Corp. (In re Rappaport), 19 B.R. 971 (Bkrtcy.E.D.Penn. 1982); Brace v. State Farm Mutual Automobile Ins. Co. (In re Brace), 33 B.R. 91 (Bkrtcy.S.D. Ohio 1983); Gibbs v. F & M Marquette National Bank (In re Gibbs), 44 B.R. 475 (Bkrtcy.D.Minn. 1984); Lyons v. First Pennsylvania

Bank (In re Lyons), 46 B.R. 604 (Bkrtcy.N.D.Ill. 1985); Everett v. Kirk Mortgage Co. (In re Everett), 48 B.R. 618 (Bkrtcy.E.D.Penn. 1985); Cleveringa vs. United States (In re Cleveringa), 52 B.R. 56 (Bkrtcy.N.D. Iowa 1985); Lindsey v. Federal Land Bank of St. Louis (In re Lindsey), 64 B.R. 19 (Bkrtcy.C.D.Ill. 1986); Worrell v. Federal Land Bank of St. Louis (In re Worrell), 67 B.R. 16 (C.D.Ill. 1986); In re Jablonski, 70 B.R. 381 (Bkrtcy.E.D.Penn. 1987); Crouch v. Pioneer Federal Savings Bank (In re Crouch), 76 B.R. 91 (Bkrtcy.W.D.Va. 1987).

The line of cases to the contrary which holds that §506 may not be used to avoid liens on real property when the value of the collateral is less than the amount of the liens on the property was initiated by the case of In Re Mahaner, 34 B.R. 308 (Bkrtcy.W.D. N.Y. 1983).

Other courts have adopted this construction of §506(d), including Spadel v. Household Consumer Discount Co. (In re Spadel), 28 B.R. 537 (Bkrtcy.E.D. Pa. 1983); In re Cordes, 37 B.R. 582 (Bkrtcy.C.D.Cal. 1984); In re Sloan, 56 B.R. 726 (Bkrtcy.D.Colo. 1986); In re Wolfe, 58 B.R. 354 (Bkrtcy.N.D.Ohio 1986); Maitland v. Central Fidelity Bank (In re Maitland), 61 B.R. 130 (Bkrtcy.E.D.Va. 1986); Nefferdorf v. Federal National Mortgage Assoc. (In re Nefferdorf), 71 B.R. 217 (Bkrtcy.E.D.Pa. 1984); Gaglia v. First Federal

Savings and Loan (In re Gaglia), 76 B.R. 82 (Bkrtcy.W.D.Pa. 1987); Dewsnup v. Timm (In re Dewsnup), 87 B.R.676 (Bkrtcy.D.Utah 1988); Hoyt v. United States (Matter of Hoyt), 93 B.R. 540 (Bkrtcy.S.D.Iowa 1988); and Folendore v. United States (Matter of Folendore), 85 B.R. 180 (M.D.Ga. 1988), rev'd, 862 F.2d 1537 (11th Cir. 1989).

Only two opinions on the Circuit Court level have been cited to or found by this Court. They are In re Lindsey, 823 F.2d 189 (7th Cir. 1987) and Matter of Folendore, 862 F.2d 1538 (11th Cir. 1989).

Counsel for the FDIC cites In re Lindsey, 823 F.2d 189 (7th Cir. 1987) as supporting his contention that §506 cannot be used to "cram down" a deed of trust in a Chapter 7 bankruptcy. Counsel quotes the following language from the opinion:

> The Lindseys forget that they chose to proceed under Chapter 7 of the Bankruptcy Code, which contemplates the liquidation of the bankruptcy estate. The real estate is the only asset of the estate; liquidation of the estate means sale of the real estate. Nothing in Section 506 suggests the contrary. If the Lindseys wanted to hold onto their property they should have sought reorganization under Chapter 13. In a reorganization, secured creditors may be prevented from foreclosing; may be forced to substitute a new security interest for the original interest; may experience, in short, the terrors of "cram down" (if necessary to protect junior or unsecured creditors, but that is not a

> consideration here). See 11 U.S.C.§§1325(a)(5), 1327. There is no cram down in a liquidation. Liquidation is liquidation.

Id. at 191.

From this Court's reading of the opinion, it interprets the case as supporting the proposition that a deed of trust on real property can be cramed down and that the question to be resolved in Lindsey was whether the creditor was then prevented from foreclosing on the deed of trust. The opinion opens with the following language:

> Section 506(a) of the Bankruptcy Code, 11 U.S.C. §506(a), provides that "an allowed claim of a creditor secured by a lien on property in which the [bankrupt] 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 beyond that is an unsecured claim. Section 506(d) provides (with immaterial exceptions) that a lien which is not an allowed secured claim is void. The combined effect of these subsections is to "strip down" a lien to the value of the security. The question for decision (one of first impression at the appellate level) is whether these provisions can be used to prevent the creditor from foreclosing his "stripped down" lien.

Lindsey, 823 F.2d at 189-190.

In the Lindsey case the debtors were hog farmers who owned real estate that was subject to a first mortgage of $209,000.00 held by the Federal Land Bank and a second mortgage of $341,000.00 held by the

Farmers Home Administration. The debtors defaulted on their loans and filed for bankruptcy under Chapter 7 of the Bankruptcy Code. A trustee was appointed and he abandoned the property from the bankruptcy estate when it became evident that there would be nothing for the unsecured creditors. The debtors asked the bankruptcy court to "strip down" mortgages to the current value of the real estate. The lenders argued, unavailingly, that §506 did not apply to liens on real estate. The Circuit Court noted that on appeal the lenders "have wisely abandoned the argument." The bankruptcy judge found the market value of the real estate to be $233,000.00 so that all of the first mortgage was secured but only $24,000.00 of the second mortgage of the FHA was secured. The bankruptcy judge gave the debtors thirty days to redeem their property by paying the two lenders the current value of $233,000.00, failing which the lenders would be entitled to enforce their liens (up to the new valuation) by foreclosure proceedings.

The debtors did not redeem but appealed. In their appeal to the district court they contended that the bankruptcy court should have let them continue making the monthly payments specified in the first mortgage and should have established a payment schedule for the stripped down second mortgage. The district court disagreed and affirmed the bankruptcy judge.

In its opinion, the Circuit Court affirmed the decision of the bankruptcy court and the district court. The opinion said in part:

> So the liens were stripped down. But once the stripdowns were complete and the secured claims allowed in their stripped-down amount, and given that only the two stripped-down creditors were in the picture (for they were senior, and there were not enough assets for junior creditors to get anything), the only thing that remained to do in the bankruptcy proceeding was to discharge the debtors and let the creditors foreclose their stripped-down liens, subject to whatever rights of redemption the debtors might have, under state law, in the foreclosure proceedings.

Lindsey, 823 F.2d at 191.

It seems clear to this Court that the Seventh Circuit readily acknowledged that in a Chapter 7 bankruptcy that a real estate mortgage can be "stripped down", "cramed down" or otherwise reduced to the current market value of the real estate which is pledged as security in the deed of trust. But that the debtors are not entitled to have the bankruptcy court establish a new payment schedule for the "cramed down" deed of trust.

In the case of Matter of Folendore, 862 F.2d 1537 (11th Cir. 1989) the Small Business Administration had perfected security interests in certain real and personal property. This lien was junior to those of the Federal Land Bank and the Central Georgia

Production Credit Association. The combined claims of the Federal Land Bank and the Central Georgia Production Credit Association exceeded the value of the property serving as collateral. Thus, the SBA held an unsecured claim at the time of the filing of the debtor's petition.

The debtors sought to avoid the SBA lien under §506. The bankruptcy court held that the lien was still in effect because the debtors had never formally made a request to disallow the debt secured by the lien under §502. The district court adopted the bankruptcy court's opinion and added that even if a proper request under §502 had been made, the lien would remain intact.

The Eleventh Circuit reversed on appeal. In its opinion it stated as follows:

> The SBA holds a lien junior to two liens that secure a debt greater than the value of the secured property. Consequently, its lien is **unsecured** under the Bankruptcy Code. **See** 11 U.S.C.A. §506(a) ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim"); **accord In re Spadel,** 28 B.R. 537, 538-539 (Bankr.E.D.Pa. 1983). The SBA's claim is an **allowed** claim, because the SBA filed a proof of claim under 11 U.S.C.A. §501 (1978). The parties dispute whether an unsecured lien supported by an allowed claim is voidable under 11 U.S.C.A. §506.

The key to resolving this dispute lies in 11 U.S.C.A. §506(d), which reads:

> (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless--
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> (1) a party in interest has not **requested that the court determine and allow or disallow** such claim under section 502 of this title; or
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> (2) such claim was disallowed only under section 502(e) of this title. (emphasis added).

The parties agree that the SBA does not have an allowed secured claim. Under the plain language of section 506(d), the Folendores may void the lien by making a request to disallow the claim secured by the lien. The claim need not actually be disallowed; the motion for disallowance serves to void the lien.

The request under section 506(d)(1) is not merely perfunctory--it serves the vital purpose of alerting the bankruptcy court to the existence of a claim of which it might otherwise be unaware due to a lienholder's failure to file a proof of claim. Because an unchallenged lien survives the discharge of the debtor in bankruptcy, a lienholder need not file a proof of claim under section 501. **See In re Tarnow,** 749 F.2d 464, 465 (7th Cir. 1984). Section 506(d) via section 502 makes the bankruptcy court aware of the claims secured by such a lien. If section 506(d) did not have the section 502 request requirement, claims underlying voidable liens might never come to the attention of the bankruptcy court.

> The majority view of the bankruptcy courts is that section 506(d) may be used to void a lien if the proper request is made under section 502, **even if the claim is not disallowed.**
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> * * *
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> The plain language of the statute, supported by the decisions of a majority of the bankruptcy courts, inferences drawn from the 1984 amendments, and common sense, requires the SBA's lien be voidable whether or not its claim has been disallowed under section 502. Consequently, we adopt the majority view that section 506(d) allows the voiding of a lien when a court has not disallowed the claim. (Footnotes omitted).

Matter of Folendore, 862 F.2d at 1538-1539.

The Court specifically considered In re Tanner, supra, and In re Mahaner, supra, and the rationale supporting each of those lines of cases. It accepted the rationale of Tanner and rejected that of Mahaner. The Court then went on to explain:

> Section 506(d) does not really "redeem" the property of the debtor. The Folendores' only interest in the property is possession--the two banks effectively own the property. While it is true that the Folendores might in the future pay off the mortgages on the property, at this moment the banks could foreclose on the property and cut out the SBA and the Folendores completely. The SBA admits the banks' power to foreclose and annihilate the SBA lien. The SBA presumably hopes that sometime in the future the Folendores will have equity in the property which could be attached by the SBA.

> The SBA's position is self-defeating. It simply provides an incentive for the Folendores to abandon the property. There is no reason the Folendores should remain on a piece of property on which the SBA can attach any equity they manage to generate. They, and any other post-discharge possessors of real property, would be far better off finding unencumbered property upon which to start their financial life afresh. This, of course, would leave a creditor like the SBA with nothing, which is exactly what section 506(d) on its face says it has.
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> The whole point of bankruptcy is to provide a debtor with a fresh start. Section 506 allows the debtor the option to begin anew on its former property. Section 506 does not give a debtor its property back as some sort of windfall. It simply permits the debtor to eventually repurchase an equity interest in it, something the SBA admits it has the right to do on any other piece of land. (Footnotes omitted).

Matter of Folendore, 862 F.2d at 1540.

This Court finds the reasoning contained in the Eleventh Circuit opinion of Matter of Folendore, supra, to be compelling and it appears to be the prevailing view. Therefore, this Court is of the opinion that in a Chapter 7 bankruptcy a debtor can use provisions of §506 of the Bankruptcy Code to extinquish or avoid a consensual lien on real property to the extent that the consensual lien exceeds the value of the property.

CONCLUSION

For the reasons hereinabove set forth the Motion to Dismiss filed by the FDIC will be dismissed by separate order.

THIS the 6TH day of September, 1989.

Edward Ellington
UNITED STATES BANKRUPTCY JUDGE