Concurrent Session

Lien Stripping: A to Z

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LIEN STRIPPING: AN EVER EXPANDING REMEDY?

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I. INTRODUCTION

The old adage that "liens float through bankruptcy cases" is not always true. Although the basic tenet remains the same in liquidation cases, a debtor's ability to modify liens in reorganization cases has been steadily expanding. This article covers the statutes and rules applicable to lien stripping, a brief history of the remedy, and recent developments in the law. The newer cases illustrate that debtors and their counsel continue to seek new ways to expand the remedy without running afoul of the Supreme Court's admonishment not to create a "broad new remedy" where Congress intended none.[1] Attorneys who are endeavoring to protect and improve the rights of their clients with respect to liens on real estate would be wise to observe the developments in the law and take appropriate steps (even in advance of a bankruptcy filing) to advance their clients' goals.

II. APPLICABLE STATUTES AND RULES

A. 11 U.S.C. § 506(a)(1)

> 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.

B. 11 U.S.C. § 506(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 -

[1] *Dewsnup v. Timm*, 502 U.S. 410, 420, 112 S. Ct. 773, 779 (1992).

> (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.

C. 11 U.S.C. § 1322(b)(2)

Debtors may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence[.]"

D. 11 U.S.C. § 101(13A)

The term "debtor's principal residence" -

> (A) means a residential structure, including incidental property, without regard to whether that structure is attached to real property; and
> (B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer.

E. 11 U.S.C. § 349(b)(1)(C)

> (b) Unless the court, for cause, orders otherwise, a dismissal of a case other than under section 742 of this title –
> (1) reinstates –
> (C) any lien voided under section 506(d) of this title
> . . . .

F. FEDERAL RULE OF BANKRUPTCY PROCEDURE 7001

Federal Rule of Bankruptcy Procedure 7001 states in relevant part:

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, or extent of a lien or other interest in property, other than a proceeding under Rule 4003(d);
. . . .
(9) a proceeding to obtain a declaratory judgment relating to any of the foregoing . . . .

Fed. R. Bankr. P. 7001(2) and (9).

III. HISTORY

A. BANKRUPTCY ACT OF 1898

Under the Bankruptcy Act of 1898 (the "Bankruptcy Act"), liens on real estate were not affected in liquidation cases.[2] *Dewsnup v. Timm*, 502 U.S. at 418, 112 S. Ct. at 778 (1991); *Long v. Bullard*, 117 U.S. 617, 620-21, 6 S. Ct. 917, 918 (1886). In other words, a debtor could discharge or modify personal liability in a bankruptcy case, but could not modify or change a property right, such as a real estate mortgage or lien. 502 U.S. at 418 (citing *Farrey v. Sanderfoot*, 500 U.S. 291, 297, 111 S. Ct. 1825, 1829 (1991) ("'Ordinarily, liens and other secured interests survive bankruptcy.'") and *Johnson v. Home State Bank*, 501 U.S. 78, 84, 111 S. Ct. 2150, 2154, 115 L. Ed. 2d 66 (1991) ("'Rather, 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'"*)).

In reorganization cases the traditional rule was that liens could be stripped down to the value of the secured creditor's collateral. *Wade v. Bradford*, 39 F.3d 1126, 1128 (10th Cir. 1994) (quoting *Dewsnup*, 502 U.S. at 418-19, 112 S. Ct. at 779 ("'Apart from reorganization proceedings, . . . no provision of the pre-Code statute permitted involuntary reduction of the amount of the creditor's lien for any reason other than payment on the debt.'"). Hence, lien stripping (also called "cramdown") was available in a reorganization prior to 1978.

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[2]As the Court noted in *Dewsnup*, Section 67d of the Bankruptcy Act, 30 Stat. 544, 564, stated in part:

> "Liens given or accepted in good faith and not in contemplation of or in fraud upon this Act, and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impact notice, shall not be affected by this Act."

502 U.S. at 418, 112 S. Ct. at 778, n. 4.

B. BANKRUPTCY REFORM ACT OF 1978 AND RELATED CASES

Congress enacted the Bankruptcy Reform Act of 1978[3] (the "Bankruptcy Code") against the "pre-Code background that allowed debtors to strip a creditor's lien" in reorganization cases. 39 F.3d at 1128. The decisions following its enactment illustrate the courts' struggles to determine whether or not Congress meant to change lien stripping law with the new Bankruptcy Code. Title 11 U.S.C. §§ 506 and 1322 are among the statutes carefully analyzed by courts following the introduction of the Bankruptcy Code. The cases below illustrate the development of the remedy of lien stripping under the Bankruptcy Code.

1. No lien stripping for Chapter 7 debtors

In *Dewsnup*, a widow whose real property was subject to a consensual lien granted in a Deed of Trust filed a Chapter 7 case in which she brought a complaint to avoid a portion of the lien. She filed the complaint after the property had been abandoned from the estate. The bankruptcy court ruled in favor of the lienholders, determining that the debtor could not utilize § 506 to avoid a lien on property which was no longer part of the bankruptcy estate. The district court affirmed. The United States Supreme Court accepted certiorari because the lower courts' rulings were contrary to the decision of the Court of Appeals for the Third Circuit in *Gaglia v. First Federal Savings & Loan Assn.*, 889 F.2d 1304, 1306-1311 (3rd Cir. 1989).

The Supreme Court held a Chapter 7 debtor could not "strip down" a creditor's allowed secured claim to the value of the real estate securing the claim. Pre-Code law would not have permitted the avoidance of a lien on real estate absent some defect in the mortgage or its recording. The Court was "not convinced that Congress intended to depart from the pre-Code rule that liens pass through bankruptcy unaffected" and determined that an allowed claim that otherwise could not

[3]Pub. L. No. 95-598, 92 Stat. 2549 (1978).

have been avoided did not fall within the realm of 11 U.S.C. § 506(d). 502 U.S. at 415 & 417, 112 S. Ct. at 777 & 778. The Court determined that the better view was "that the creditor's lien stays with the real property until foreclosure" as the parties bargained in the mortgage, thus giving the creditor the benefit of any upswing in the value of the property prior to foreclosure.[4] *Id.* at 417, 112 S. Ct. at 778.

In *Talbert v. City Mortgage Servs. (In re Talbert)*, 344 F.3d 555 (6th Cir. 2003), the Court of Appeals for the Sixth Circuit went a step further and determined that a debtor could not "strip off" a lien with *no equity* in a Chapter 7 case. Such a result "would mark a departure from the pre-Code rule that real property liens emerge from bankruptcy unaffected" and would "rob the mortgagee of the bargain it struck with the mortgagor, i.e., that the consensual lien would remain with the property until foreclosure." *Id.* at 561. A lien strip also would give a possible windfall to the debtor if the property rose in value after the lien strip thereby affording some value to the creditor's previously undersecured lien. *Id.* The purpose of § 506 is "''to facilitate valuation and disposition of property in the reorganization chapters of the Code, not to confer an additional avoiding power on a Chapter 7 debtor.''" *Id.* at 561 (quoting *Ryan v. Homecomings Fin'l Network*, 253 F.3d 778, 783 (4th Cir. 2001) (quoting *Laskin v. First Nat'l Bank of Keystone (In re Laskin)*, 222 B.R. 872, 876 (9th Cir. BAP 1998))).[5]

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[4]Justices Scalia and Souter dissented, submitting that a natural reading of §506(d) "automatically voids a lien to the extent the claim it secures is not both an 'allowed claim' and a 'secured claim' under the Code." 502 U.S. at 420, 112 S. Ct. at 780.

[5]As the Court of Appeals for the Tenth Circuit noted in *Morris v. St. John Nat'l Bank (In re Haberman)*, 516 F.3d 1207, 1213 (10th Cir. 2008) (emphasis added), "courts generally have <u>not</u> extended *Dewsnup*'s restriction on strip downs to Chapters 11, 12, and 13 contexts, reasoning that to prohibit lien stripping in reorganization cases would be inconsistent with pre-Code law, with key statutory provisions and principles applicable in reorganization chapters, and with *Dewsnup*'s own admonition that it should be read narrowly.

2. No modification of partially secured residential mortgages in Chapter 13

In *Nobelman v. American Savings Bank*, 508 U.S. 324, 113 S. Ct. 2106 (1993), the United States Supreme Court determined that a Chapter 13 debtor cannot strip a *partially secured* mortgage on the debtor's principal residence. In *Nobelman*, the debtors obtained a loan in the amount of $68,250 from American Savings Bank secured by a mortgage on their residence. At the time of their Chapter 13 filing, the debtors owed $71,335 to the bank and the undisputed value of their home was only $23,500. Based upon 11 U.S.C. § 506(a), the debtors proposed to pay the bank its allowed secured claim of $23,500 and to treat the remainder of the bank's claim as an unsecured claim which would receive no distribution under the plan. The bank objected to this proposed treatment, arguing that it violated § 1322(b)(2)'s special protection for residential mortgages.

The debtors argued that they were not modifying the bank's rights pursuant to § 1322(b)(2), since § 506(a) already divided the indebtedness owing to the bank into secured and unsecured claims. The Court summarized the debtors' position, stating:

> Petitioners contend that the valuation provided for in § 506(a) operates automatically to adjust downward the amount of a lender's undersecured home mortgage before any disposition proposed in the debtor's Chapter 13 plan. Under this view, the bank is the holder of a "secured claim" only in the amount of $23,500 - the value of the collateral property. Because the plan proposes to make $23,500 worth of payments pursuant to the monthly payment terms of the mortgage contract, petitioners argue, the plan effects no alteration of the bank's rights as the holder of that claim. Section 1322(b)(2), they assert, allows unconditional modification of the bank's leftover "unsecured claim."

508 U.S. at 328, 113 S. Ct. at 2109. The Court disagreed with the debtors, pointing out that § 1322(b)(2) deals with a creditor's "rights," not "claims." *Id.*, 113 S. Ct. at 2110. The valuation of the secured and unsecured portions of the bank's claim under § 506(a) "does not necessarily mean that the 'rights' the bank enjoys as a mortgagee, which are protected by § 1322(b)(2), are limited by the valuation of its secured claim." *Id.* at 329, 113 S. Ct. at 2110. The bank's rights --

"includ[ing] 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 petitioners' residence by foreclosure and public sale, and the right to bring an action to recover any deficiency remaining after foreclosure" -- were a matter of state law and were "protected from modification by § 1322(b)(2)." *Id.* at 329-30; 113 S. Ct. at 2110. The Court recognized that the lender's rights were affected by the bankruptcy filing, but declined to stretch the meaning of § 1322(b)(2) to permit the debtor to modify of the unsecured portion of the creditor's claim. Such an interpretation of §§ 506(a) and 1322(b)(2) "would be a significant modification of a contractual right" that the drafters had not intended.[6] *Id.* at 331, 113 S. Ct. at 2111.

3. Avoidance of wholly unsecured residential mortgages in Chapter 13

Later, the United States Court of Appeals for the Sixth Circuit determined in *Lane v. Western Interstate Bancorp (In re Lane)*, 280 F.3d 663 (6th Cir. 2002), that the debtors could avoid a *completely unsecured* second mortgage on their residence pursuant to 11 U.S.C. §§ 506(a) and 1322(b)(2). Recognizing a split on the issue and observing that the *Nobelman* Court had not addressed a proposed strip off of completely unsecured lien, the Sixth Circuit concluded that the mortgage holder could not be the holder of secured claim under § 506(a) if no portion of its claim were in fact "secured." *Id.* at 667. The court determined that the first inquiry under § 506(a) is whether or not the creditor holds any secured claim at all. *Id.* If the creditor holds a secured claim on the debtor's principal residence, its claim falls under § 1322(b)(2) protection and cannot be

[6]Justice Stevens concurred, noting that "[a]t first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets." *Id.* at 332, 113 S. Ct. at 2111-2112. The legislative history, however, explains that the "favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market." *Id.,* 113 S. Ct. at 2112 (citation omitted).

modified. If the claim is wholly underwater, it can be "stripped" and treated as unsecured. "[T]he dividing line drawn by § 1322(b)(2) runs between the lienholder whose security interest in the homestead property has some 'value,'" and the lienholder who does not. *Id.* at 668.

In *In re Bennett*, 2008 WL 4489139, at *1 (Bankr. M.D. Tenn. 2008), the court addressed a proposed a strip off of a second mortgage. By the time of the bankruptcy court's ruling, five other courts of appeals (the Ninth, Second, Eleventh, Fifth and Third Circuits) and two bankruptcy appellate panels (the First and Ninth)[7] had joined the Sixth Circuit's ruling in *Lane*, solidifying the rule of law that wholly unsecured residential mortgages may be stripped off in reorganization cases. *Id.* The *Bennett* court noted that at least one court questioned the wisdom of protecting a creditor whose mortgage was secured by only a penny of equity and to provide no protection at all to a creditor without any equity. *Id.* (citing *Am. Gen. Fin., Inc. v. Dickerson (In re Dickerson)*, 222 F.3d 924, 926 (11th Cir. 2000)). Although the court was uncomfortable in its role as a valuator, it recognized the established precedent and the concluded that a court must make the best decision possible on the value of the property based upon the evidence submitted.

C. BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

Lien stripping accordingly was well-established in bankruptcy law prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The courts preserved § 1322(b)(2)'s exception for mortgages on the debtor's principal residence,

[7] *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir. 2002); *Pond v. Farm Specialist Realty (In re Pond)*, 252 F.3d 122 (2d Cir. 2001); *Tanner v. FirstPlus Fin., Inc. (In re Tanner)*, 217 F.3d 1357 (11th Cir. 2000); *Bartee v. Tara Colony Homeowners Ass'n (In re Bartee)*, 212 F.3d 277 (5th Cir. 2000); *McDonald v. Master Fin., Inc. (In re McDonald)*, 205 F.3d 606 (3d Cir. 2000); *Domestic Bank v. Mann (In re Mann)*, 249 B.R. 831 (1st Cir. BAP 2000); *Lam v. Investors Thrift (In re Lam)*, 211 B.R. 26 (9th Cir. BAP 1997).

notwithstanding the push of some debtors to undercut the breadth of its "safe harbor."[8] In BAPCPA, Congress did not materially change the laws which permit lien stripping in reorganization cases. Congress did, however, add a new definition for a "debtor's principal residence" which has caused the litigants and courts alike to grapple with its intended consequences. The new definition states:

> (A) means a residential structure, including incidental property, without regard to whether that structure is attached to real property; and
>
> (B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer.

11 U.S.C. § 101(13A).

In *Kinder v. Vanderbilt Mortg. and Finance*, 2008 WL 2230694 (S.D. Ohio 2008), the court addressed the issue of whether Congress meant to change the scope of 11 U.S.C. § 1322 when it added this definition. In *Kinder*, the debtor owned a mobile home and real estate which was the subject of a $81,355.22 secured claim. The creditor had a lien on the certificate of title for the mobile home and a mortgage on the real estate. Under the applicable state law, the mobile home remained personal property. The debtor sought to cram down the lender's interest in the property to its fair market value of $35,000, arguing that the mobile home did not fall within the safe harbor of § 1322(b)(2). The creditor objected.

The court framed the issue before it as whether the new definition of "debtor's principal residence" in § 101(13A) "changed the interpretation of 11 U.S.C. § 1322(b)(2) to . . . prohibit the modification of a claim secured by both real property and a mobile home even if the mobile home qualified as personal property under state law." *Id.* at *3. The court recognized a split of authority on the issue as well as the decision in *Davis v. Green Tree Serv., LLC (In re Davis)*, 386 B.R. 182

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[8]The law review article by Robert M. Zinman and Novica Petrovski, *The Home Mortgage and Chapter 13: An Essay on Unintended Consequences*, 17 Am. Bankr. Inst. L. Rev. 133, 134-140 (Spring 2009), sets forth an excellent summary of the history of the enactment of the safe harbor of § 1322(b)(2), and the unintended consequences of the statute, including its possible contribution to the subprime lending crisis of our day.

(6th Cir. BAP 2008), which held that the added definition of a debtor's principal residence does not alter the scope of 11 U.S.C. § 1322(b)(2). *Id.* at *3. The court determined that the creditor's claim would be protected from modification under § 1322(b)(2), only if the mobile home qualified as real property under the applicable state law. The court remanded the matter for a "traditional fixture analysis" under Ohio law. *Id.* at *4.

In *Reinhardt v. Vanderbilt Mortgage and Finance, Inc. (In re Reinhardt)*, 563 F.3d 558 (6th Cir. 2009), the Sixth Circuit considered the same issue with a different outcome. The creditor held liens on the debtor's mobile home and the real estate on which it was located. The mobile home was the debtor's principal residence. The debtor proposed a cram down of the creditor's interest. The sales agreement for the mobile home stated:

> "Buyer will not let the Manufactured Home become part of any real estate. Buyer agrees that the Manufactured Home sold by the terms of this contract is personal property. Unless Seller gives prior written consent, Buyer shall not allow the Manufactured Home to become a part of real estate or to otherwise lose its status as personal property under applicable law[.]"

Id. at 560 (quoting Jt. Appx. at 250). The court noted that § 1322(b)(2) includes two requirements: (1) "'the security interest must be in real property; and'" (2) "'the real property must be the debtor's principal residence.'" *Id.* at 562 (quoting *Ennis v. Green Tree Serv., LLC (In re Ennis)*, 558 F.3d 343, 345-46 (4th Cir. 2009)). The court found that the mobile home did not qualify as real property under the applicable Ohio law and the loan could be modified under § 1322.[9]

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[9]Notably, the outcome of this case appears to have resulted primarily from the language of the parties' original contract which prohibited the attachment of the mobile home to the land. Without this language, one would expect a different result -- i.e., a determination that the mobile home was affixed to the land and that the creditor's interest could not be modified under § 1322(b)(2).

IV. RECENT CASES

A. "PARTIAL STRIP OFF" PROHIBITED IN CHAPTER 7 CASES

In a follow-up to the Supreme Court's decision in *Nobelman*, the debtors in *Hares v. Sage Financial Ltd. (In re Hares)*, 431 B.R. 796 (Bankr. S.D. Ohio July 19, 2010), sought to reopen their Chapter 7 case to avoid a *partially secured* judgment lien on their residence. The debtors submitted that the value of their residence was $147,000 and the two mortgages on the property totaled $144,850, leaving just over $2,000 to secure the judgment lien. The judgment lien was woefully undersecured, but partially secured nonetheless. The debtors filed a complaint to avoid the lien and the defendant failed to respond. The debtors then filed a motion for summary judgment which the bankruptcy court denied based upon the Supreme Court's ruling in *Dewsnup,* finding that no basis existed for the relief requested. On reconsideration, the debtors asserted that the court had failed to follow *Nobelman's* direction to analyze whether or not the claim was secured under § 506(a) in reaching its decision.

The court found that § 506 did not apply in determining the status of the judgment lien in part because the property had already been abandoned from the bankruptcy estate and also because "the provisions of § 506 do not inure to the benefit of Chapter 7 debtors. *Id.* at 799 (citing *Dewsnup*, 502 U.S. 410, 112 S. Ct. 773). The debtors argued that *Dewsnup* did not apply because that "case involved an allowed secured claim." *Id.* In *Hares,* no claims were actually allowed in the case because the case was a no asset case in which no claims were to be filed. *Id.* at 799 n. 4. Hence, the claim was not "allowed" as in the *Dewsnup* case. The court, however, determined that the lack of a filed claim was not the deciding factor in determining whether or not the creditor held a lien securing its claim. *Id.* The court pointed out that § 506(d)(2) expressly states: "'[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, *unless* . . . (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.'" *Id.* (quoting 11 U.S.C. § 506(d)(2) and adding emphasis). The court found that the creditor held a secured claim in spite of the current value of the property or its failure to file a proof of claim. The court further knocked out the debtors' argument that the judgment lien should be avoided due to the fact that it was non-consensual, noting that § 506(a) makes no distinction between consensual and non-consensual liens. *Id.* at 801. "Because the Sixth Circuit Court of Appeals has determined that § 506 is unavailable to Chapter 7 debtors seeking to avoid a consensual junior mortgage, it stands to reason that it is unavailable to Chapter 7 debtors seeking to strip off a judgment lien." *Id.*

B. ADVERSARY PROCEEDING REQUIRED TO STRIP LIEN (SPLIT)

A split of authority exists on the issue of whether or not an adversary proceeding is required to strip a lien.[10] The case of *SLW Capital, LLC v. Mansaray-Ruffin (In re Mansary-Ruffin*), 530 F.3d 230, 234-235 (3d Cir. 2008),points out that Federal Rule of Bankruptcy Procedure 7001 addresses those issues which *must* be determined by adversary proceedings in the bankruptcy court. These matters include: proceedings to determine the "'validity, priority, or extent of a lien or other interest in property.'" *Id.* at 234 (quoting Fed.R.Bankr.P. 7001(2)). An adversary proceeding guarantees that the defendant will receive "all the trappings of traditional civil litigation" in connection with the action brought against it, including the issuance and service of a summons, the opportunity to answer the complaint and present defenses, discovery, summary judgment and other similar rules and procedures. *Id.* at 234-35.

[10]Notably, Administrative Order 09-09 in the Eastern District of Michigan requires the filing of an adversary proceeding in such circumstances.

Notwithstanding Rule 7001, many courts have permitted liens to be stripped without adversary proceedings. These courts consider the issue to be one of "valuation", rather than "validity" of the lien. *Id.* at 236 (citing *In re Bennett*, 312 B.R. 843 (Bankr. W.D. Ky. 2004); *Dickey v. Beneficial Finance (In re Dickey)*, 293 B.R. 360 (Bankr. M.D. Pa. 2003); *In re Hudson*, 260 B.R. 421 (Bankr. W.D. Mich. 2001) (Gregg, J.); *Lee Servicing Co. v. Wolf (In re Wolf)*, 162 B.R. 98 (Bankr. D.N.J. 1993)). Similarly, other courts simply value the secured claim without addressing whether or not the lien is valid. *Id.* (citing *In re Fesq*, 153 F.3d 113 (3d Cir. 1998); *In re Holmes*, 225 B.R. 789 (Bankr. Colo. 1998)). The *Mansary-Ruffin* court pointed out the problems with the valuation stance of these courts, noting that Chapter 13 plans often are not even sent to creditors – instead a summary of the plan may be issued. *Id.* Notice of Chapter 13 plans further is not required "'to be served in any particular manner or upon any particular person.'" *Id*. at 237 (citing *Educ. Credit Mgmt. Corp. V. Mersmann (In re Mersmann)*, 505 F.3d 1033, 1043 (10th Cir. 2007)). The court felt that the better (and mandated) approach was for the debtor to "file a complaint and serve a summons with a copy of the complaint on the defendant" if she hoped to avoid its lien. *Id.* She could not avoid this duty by mailing out a plan and obtaining its approval in the absence of objection. *Id.*

The Ninth Circuit *Brawders v. County of Ventura (In re Brawders)*, 503 F.3d 856 (9th Cir. 2007), stressed the importance of providing due process by means of an adversary proceeding in a lien strip case, stating:

> Neither the statute nor the rules say, 'oh, by the way, we [plan proponents] can also sandbag you by sneaking an objection in to a reorganization plan and hoping you do not realize that we can use this device to circumvent the claim objection procedure mandated by the rules.' That is not the law, and if it were the law, it would be a material disservice to public confidence in the integrity of the bankruptcy system.
>
> While we do not hold that a plan can never be used to object to a claim of a creditor who does not actually consent to such an objection, by holding that the essence of

> Rule 3007 must be complied with, we are holding that *considerations of due process mandate great caution and require that the creditor receive specific notice (not buried in a disclosure statement or plan provision) of at least the quality of specificity, and be afforded the same opportunity to litigate one-on-one, as would be provided in a straightforward claim objection under Rule 3007.*

503 F.3d at 871, quoting *Varela v. Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)*, 293 B.R. 489, 497 (9th Cir. BAP 2003) (emphasis added) (additional citations omitted), *aff'g, County of Ventura Tax Collector v. Brawders (In re Brawders)*, 325 B.R. 405 (9th Cir. BAP 2005). The Appellate Panel found that although the Plan adversely impacted the creditor's claim, it did not divest the creditor of its interest in the property, *i.e.*, its lien. To do so, the Debtors would have to file an adversary proceeding.

C. STRIPPING DOWN INTEREST AND COSTS PROHIBITED IN CHAPTER 13

In *Deutsche Bank National Trust Co. v. Tucker,* No. 09-5867, ___ F.3d ____, 2010 WL 3565185 (6th Cir. Sept. 15, 2010), the Court of Appeals for the Sixth Circuit determined that a debtor who wished to retain a home subject to an undersecured mortgage and cure the arrearage through her Chapter 13 plan must pay the full amount of the arrearage, including fees and advances. The debtor had a mortgage with Deutsche Bank National Trust Co., in the amount of $103,328.84, including $23,286.89 in pre-petition arrearages, per the secured creditor's claim. The creditor included fees and costs of $4,660.42 in the arrearage total. The debtor valued the home at only $88,000.00. She took the position that the creditor's arrearage claim could not exceed $18,626.47 and that the fees and costs could not be included as part of the arrearage because the mortgage on the home was "underwater." The debtor relied on the court's decision in *In re Evans*, 336 B.R. 749 (Bankr. S.D. Ohio 2006), which held that the required cure amount included only the portion that was secured under 11 U.S.C. § 506(b). *Id.* at *1. *Contra In re Thompson*, 372 B.R. 860, 864

(Bankr. S.D. Ohio 2007) (holding that 11 U.S.C. § 1322(e) requires a debtor to pay all sums due under the mortgage to cure the default). The bankruptcy court ruled in favor of the debtor.

On appeal, the district court certified the matter for direct appeal to the Court of Appeals. The Sixth Circuit found that the clear language of § 1322(e) ruled out the debtor's interpretation, stating:

> In this case, the language Congress used is unambiguous: Congress expressly resolved any potential conflict between section 1322(e) and section 506(b) in favor of section 1322(e):
>
> > **Notwithstanding** . . . section [] 506(b) . . . of this title, if it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.
>
> 11 U.S.C. § 1322(e) (emphasis added). When it comes to cure under section 1322(e), Congress says that section 506(b) is beside the point if the parties' agreement says otherwise.

Id. at *2. The court rejected the view that one must look to § 506 to determine the appropriate cure amount and found that "a creditor meeting the requirements of section 1322(e) may add interest, fees, and costs that are properly recoverable outside of bankruptcy, regardless of whether the creditor is fully secured under section 506." *Id.* at *3 (citation omitted).

D. LIEN STRIPPING WITH A NON-FILING SPOUSE

In *Strausbough v. Co-op Services Credit Union (In re Strausbough)*, 426 B.R. 243 (Bankr. E.D. Mich. March 25, 2010) (Rhodes, J.), the court considered the interesting issue of whether or not a debtor may strip a second residential mortgage on tenancy by the entireties property when the debtor's spouse is <u>not</u> a debtor in the bankruptcy case. In both cases considered by the court, the non-filing spouse had already filed a Chapter 7 case and received a discharge of the first and second mortgage obligations. The defendants argued that the debtors could not avoid the lien because one of the two spouses, "acting alone, cannot alienate, encumber or convey [tenancy by entireties] property." *Id.* at 246. The court rejected that argument, submitting that the only inquiry required under § 506(a) is (1) the nature of "'the estate's interest in such property'" and (2) "'the value of such creditor's interest'" therein. *Id.* (quoting § 506(a)).

The court found that the bankruptcy estate's interest in the property was "whatever equity is available in the entireties property that can be liquidated for the benefit of the joint creditors of the debtor and the non-filing spouse." *Id.* The court found that tenancy by the entireties property is included in the debtor's estate. *Id*. at 247 (citing *Finneran v. Assoc. Finance Servs. (In re Blair)*, 33 F.3d 54 (Table), 1994 WL 408192, *1 (6th Cir. 1994) among other cases.). This property may be liquidated for the benefit of the joint creditors of the couple. As result, the defendants' arguments that the debtor by himself or herself cannot avoid the lien and that the non-filer is somehow obtaining the benefits of a Chapter 13 filing without actually filing a bankruptcy case fail.

The court pointed out that non-filing spouses receive the benefits of bankruptcy cases filed by their spouses "every day," including primarily the right to "maintai[n] possession of the entireties property while curing the default in the mortgage on the property." *Id.* at 250. The court found that the benefits of lien avoidance under § 506(a) and (d) were no different. *Id.* In fact, such benefits were "completely consistent with the function and effect of entireties law:"

> "The tenants by the entirety enjoy certain rights. They both enjoy the right to possession and use of the entire property and the right to exclude third parties from the property. The property is not subject to the debts of either party but only joint debts of both the parties. Neither party may alien, convey or encumber his or her interest although both together can alien, convey or encumber the estate. They may not by their individual act sever the tenancy although they may do so by their joint act. The property vests in the survivor of the parties and is not subject to any provision of a will of the first party to die."

Id. (quoting *Hunter v. Citifinancial, Inc. (In re Hunter)*, 284 B.R. 806, 811 (Bankr. E.D. Va. 2002) (citations omitted)).

The court observed that the rights of a holder of tenancy by the entireties property do not prevent one spouse from improving the estate held by both. "Indeed, such enhancements of an entireties estate by one party are quite common outside of bankruptcy. For example, one party can make a payment on a joint mortgage on the entireties property, or can pay for an improvement on the property, or can pay the taxes on the property." *Id.* at 250. The court found nothing in state law or the Bankruptcy Code that prevented the improvement of stripping a lien by only one of the two property holders in a bankruptcy case. *Id.*

E. LIEN STRIPPING AND THE "APPLICABLE COMMITMENT PERIOD"

In *Blaies v. Carroll (In re Blaies)*, __ B.R. ___, 2010 WL 3170065 (E.D. Mich. Aug. 11. 2010) (O'Meara, J.), the debtors argued that they should be permitted to deduct monthly mortgage payments for two stripped mortgages from their disposable income for purposes of determining the applicable commitment period of their plan. They noted that as of the petition date, they were liable to make these payments and that the liens would not be stripped until the debtors received their Chapter 13 discharge. *Id.* at *2. The district court did not agree. The court observed that "Debtors' arguments fail to take into account the unsecured nature of the second and third mortgages. Under the bankruptcy code, a lien and a secured interest are not synonymous." *Id.* (citing *Lane*, 280 F.3d at 665). The court found that the mortgagees' interests had no actual value. Therefore, the debtors were prohibited from taking deductions for the mortgage payments in their Chapter 13 Statement of Current Monthly Disposable Income and Calculation of Commitment Period and Disposable Income Form 22 C. *Id.*

F. SURRENDER IN FULL SATISFACTION LIEN STRIP PROHIBITED IN CHAPTER 13

In *In re Finley*, 408 B.R. 111 (Bankr. E.D. Mich. 2009), Judge McIvor considered a debtor's attempted surrender of non-residential real estate in full satisfaction of the debt in a Chapter 13 proceeding. The debtors's former residence was valued at $100,000 and was secured by a mortgage in the amount of $203,236.24. The debtors sought to surrender the property to the creditor in full satisfaction of the debt pursuant to 11 U.S.C. § 1322(b)(2). The creditor in turn argued that § 506 leaves it with an unsecured deficiency claim which cannot be eliminated.

The court observed that the Code gives a debtor two options when a creditor has not accepted the plan: (1) the debtor can keep the property and make payments subject to 11 U.S.C. § 1325(a)(5)(B), or (2) the debtor can surrender the property under § 1325(a)(5)(C). *Id.* at 112. "[Section] 1325(a)(5)(C) is silent on how to determine the value of the secured interest in the surrendered property." *Id.* Section 506(a)(1), however, provides the means of determining that value. Judge McIvor noted that the two courts who previously addressed the issue before her had determined that § 506(a)(1) affords the secured creditor "an allowed general unsecured claim for any deficiency balance" when property is surrendered under § 1325(a)(5)(C). *Id.* at 113 (citing *In re Hughes*, 402 B.R. 404 (Bankr. M.D. Fla. 2008); *In re Brooks*, 2009 WL 1490486 (Bankr. M.D. Fla. 2009)). The Sixth Circuit also had ruled in *AmeriCredit Fin'l Serv. v. Long (In re Long)*, 519 F.3d 288, 290-98 (6th Cir. 2008) that §§ 506 and 1325(a)(5) do not permit a debtor to surrender a vehicle purchased within 910-days of the filing in full satisfaction of the debt). Considering these cases, Judge McIvor determined that the Code did not permit the surrender of real estate in full satisfaction of the underlying mortgage debt. Judge McIvor "[found] no meaningful distinction, for purposes of determining the secured status of a creditor's claim, between the surrender of real property and the surrender of a vehicle." *Id.* at 114.

G. CHANGES IN COLLATERAL: WHEN DOES ONE DETERMINE IF A CLAIM CAN BE MODIFIED UNDER § 1322(b)(2)?

Section 1322(b)(2) prohibits a debtor from modifying a secured creditor's claim if the claim is secured only by the debtor's principal residence. What happens, however, if the debtor moves or changes his or her interest in the property after the filing of the bankruptcy petition? The court in *In re Baker*, 398 B.R. 198 (Bankr. N.D. Ohio 2008), addressed this issue. The Bakers' original mortgage was secured by two properties. The legal description set forth in the mortgage described only one of the two properties. Approximately three years after executing the mortgage, the debtors filed their Chapter 13 petition. They lived in the property described in the legal description and no longer had any interest in the other property. In their amended plan the debtors sought to modify the creditor's mortgage by treating the creditor as secured up to the value of their residence and unsecured as to the remaining parcel. The creditor objected, arguing that the debtor was not entitled to modify the mortgage which was originally secured by two properties.

The court noted that § 1322 does not itself state when one should decide if bifurcation under § 506(a) should occur. *Id.* at 201. Some courts hold that the date of the parties' contract is the appropriate time to determine the issue. *Id.* at 202 (citing *In re Williamson*, 387 B.R. 914, 920 (Bankr. M.D. Ga. 2008); *In re Smart*, 214 B.R. 63, 67 (Bankr. D. Conn. 1997)). Otherwise, the debtor could easily modify the use of their property and "'sidestep the . . . home mortgage exception by adding a second living unit to the property on the eve of the commencement of his Chapter 13 proceeding.'" *Id.* at 202 (quoting *In re Bulson*, 327 B.R. 830, 846 (Bankr. W.D. Mich. 2005) (Hughes, J.)). A majority of courts, however, takes the opposite view – holding that the petition date is the pertinent time for determining if a claim should be bifurcated. *Id.* (citing *In re Howard*, 220 B.R. 716, 718 (Bankr. S.D. Ga. 1998); *In re Lebrun*, 185 B.R. 665, 666 (Bankr. D. Mass. 1995); *In re Wetherbee*, 164 B.R. 212, 215 (Bankr. D.N.H. 1994); *In re Churchhill*, 150 B.R. 288, 289 (Bankr. D. Me. 1993) and 2 K. Lundin, Chapter 13 Bankruptcy § 121.2 at 121-3-121-9 (3d ed. 2000) (collecting cases)). Some courts taking this view have found that using the contract date might permit the creditor to disclaim an interest in property that is not a debtor's principal residence in order to fall within the protection of § 1322(b)(2). *Id.* (citing *In re Dinsmore*, 141 B.R. 499, 505-06 (Bankr. W.D. Mich. 1992)).

The *Baker* court took a "hybrid approach" and determined that both the contract date and the petition date are relevant to the court's inquiry under § 1322(b)(2). *Id.* at 203. The court stated:

> First, consideration of the petition date will make it impossible for creditors to unilaterally disavow, on a postpetition basis, a security interest in nonresidential property for the purpose of gaining the protections of the antimodification clause. Conversely, looking also to the loan agreement will afford creditors the benefit of their bargain by preventing debtors from later modifying the use of their property for the purpose of denying a creditor the protections of the antimodification clause.

Id. In *Baker,* the creditor had granted a bridge loan secured by the debtors' former residence and their new residence to enable the debtors to purchase their new home. The original contract was secured by both homes. Once the old home was sold, the contract secured only the new home. The court determined that "[t]he whole structure of the Parties' agreement, therefore, was to have the obligation secured by only a single parcel of real estate, that being the Debtors' [new home]." *Id.* at 204. In reality, the mortgage on the prior home was only a temporary measure to permit the debtors to sell that home and move into the new one. As a result, the court found that the mortgage secured only one property as of the petition date – their principal residence – and the mortgage could not be modified by debtors in their Chapter 13 plan. *Id.*

H. STRIPPING A BLANKET JUDGMENT LIEN

In *In re Grimes*, 376 B.R. 811 (Bankr. W.D. Ky. 2007), the bankruptcy court addressed the issue of whether or not the debtors could strip off a judicial lien filed against the debtors' real estate. Notably, this lien was a blanket lien covering *any* real property owned by the debtors in the county. The debtors argued that "§ 1322(b)(2) and [the Sixth Circuit's decision in *In re Lane*, 280 F.3d 663, did] not apply because the Judgment Lien could attach to any of the Debtors' real estate, not just their principal residence." *Id.* at 813. The bankruptcy court found otherwise, holding that the real estate had value to which the creditor's judicial lien could attach. As a result, the debtors had no right to strip the lien notwithstanding the fact that the lien could attach to other property. *Id.*

I. FAILURE TO MAINTAIN PROPERTY IS NOT A DEFENSE TO A LIEN STRIP

The Chapter 13 Trustee filed a complaint seeking to strip a creditor's mortgage lien on the debtors' principal residence in *Pees v. DAN Joint Venture II (In re Claar)*, 368 B.R. 670 (Bankr. S.D. Ohio 2007), taking the position that the mortgage was entirely unsecured based upon the value of the real estate. The creditor did not deny that no equity existed in the property as of the petition date, but submitted that the low value of the property was attributable to the debtors' lack of maintenance of the property. The home needed numerous repairs, including a new kitchen floor, a new roof and painting, at an estimated cost of $10,000. The undisputed evidence before the court included an appraisal valuing the property at $84,000 in 2002 and an appraisal valuing the property at $48,000 on the petition date - approximately four years later. *Id.* at 675. The creditor asked the court to deny the complaint to strip the mortgage lien based upon the debtors' alleged negligence in caring for the home and the resulting devaluation of the property.

The court rejected the creditor's argument, noting that "[the creditor] fails to offer any legal support for its theory that the Debtors' alleged failure to maintain the Property in good repair precludes the application and operation of § 506(a)." *Id*. at 678. The court noted that if the creditor had a claim for damages for the debtors' negligent conduct, it could have filed a claim which included those damages. *Id.* The debtors' alleged negligence in caring for their home did not change the court's determination of the value of the creditor's secured claim under § 506(a) or impact the strip down of the lien under § 1322(b)(2). *Id.* at 679.

J. EFFECT OF DISMISSAL ON LIEN STRIP OR MODIFICATION

The United States Bankruptcy Court for the Northern District of Ohio determined that a lien release effected by strip down of the lien under § 506(a) in a Chapter 13 case is "effected by the confirmation order" but "conditioned upon performance and completion of the plan." If the case is dismissed, voluntarily or otherwise, "then Debtors shall not be entitled to the benefits of strip off of the . . . mortgage in accordance with the *Lane* case. *In re DeLong*, 2007 WL 1121245, at *2 (Bankr. N.D. Ohio 2007) (citing 11 U.S.C. § 349(b)(1)(C)).

K. STRIPPING TAX LIENS

In *Emerson v. United States (In re Emerson)*, 2007 WL 1054135 (Bankr. W.D. Ky. 2007), the court held that a debtor may not use 11 U.S.C. § 506(d) to strip a tax lien held by the United States Internal Revenue Service on property that the debtor was purchasing on contract. The court in *Dippel v. United States*, 2005 WL 758801 (S.D. Fla. 2005), reached a similar result. The *Dippel* court found that the debtor's effort to strip down a federal tax lien in a Chapter 7 case violated the Supreme Court's ruling in *Dewsnup*, 502 U.S. 410, 112 S. Ct. 773 (1992) (which prohibited lien stripping in Chapter 7 cases), as well as other published decisions applying the *Dewsnup* ruling to taxes. The court stated:

> Numerous courts in the Eleventh Circuit have followed the *Dewsnup* rule. In the particularly instructive case of *In re Houze*, 1994 WL 389475 (Bankr. S.D. Fla. April 4, 1994), a debtor attempted to avoid federal tax liens based upon taxes that had been discharged, arguing that there was no equity in his property to which the tax liens could attach. This Court correctly found the debtor's assertion to be in direct contravention of the *Dewsnup* rule that federal tax liens pass through bankruptcy unaffected . . . .
>
> Federal tax liens automatically attach to and are secured by all property and rights to property, whether real or personal, belonging to a debtor, as a matter of course . . . . According to well-established precedent, any federal tax lien attaching to the Debtors' property and interests in property pass through the bankruptcy unaffected, and the Debtors lack any basis for asking that a lien be avoided.

2005 WL 758801, at *4 (citations omitted).[11]

L. CONVERSION FROM CHAPTER 11 TO 7 - ARE LIENS REINSTATED?

The Court of Appeals for the Fifth Circuit considered the issue of whether or not a creditor's lien was avoided in a Chapter 11 case that had converted to Chapter 7 after confirmation. *Elixir Industries, Inc. v. City Bank & Trust Co. (In re Ahern Enterprises, Inc.)*, 507 F.3d 817 (5th Cir. 2007). The creditor held a judgment lien on the debtor's business property. A prior mortgage on the business property exceeded the property's value. In the Chapter 11 proceedings the court found that the judgment lien creditor held a general unsecured claim and the plan was confirmed. A few months later, the debtor converted its case to Chapter 7. Following conversion, the mortgage holder and the Chapter 7 Trustee sought to sell the business property to the mortgage holder in satisfaction of a portion of the mortgage debt. After the court-approved sale, the original mortgage holder discovered various liens on the property, including the judgment lien that had been determined to be unsecured in the Chapter 11 case. The mortgage holder filed an adversary proceeding asking the bankruptcy court to determine that the liens had been wiped out in the bankruptcy case. The bankruptcy court agreed, finding that its order on the debtor's objection to the judgment lienholder's claim had extinguished the lien. On appeal, the district court likewise held that the lien was void.

On appeal to the Fifth Circuit, the judgment lienholder argued that the bankruptcy court had only valued the claim for purposes of the plan and did not extinguish the lien. The mortgage holder

[11]The court reached a contrary result in *Hammond v. Allegheny Co. Treasurer (In re Hammond)*, 420 B.R. 633 (Bankr. W.D. Pa. 2009). This Chapter 7 case involved county and other local tax liens, not federal liens. The debtor's property had already been sold at a sheriff's sale prior to the filing of her bankruptcy petition. The court found that the debtor could redeem her property through her Chapter 13 plan by paying the taxes paid by the purchaser at tax sale. The debtor also could strip the tax liens down to the value of the property. *Id*. at 637. Notably, under Pennsylvania law, a party who purchases property at a tax sale "acquires an inchoate, defeasible title which does not change the status or title of the property owner until the redemption period has passed." *Id.* at 635 (citations omitted). The debtor thus could "stretch out" the redemption of her property through her Chapter 13 plan and strip down the tax liens against the property pursuant to § 1322(b)(2). *Id.* at 636 (citations omitted).

in turn argued under § 506(d) that the court had determined that no secured claim existed; thus voiding the judgment lien. *Id.* at 820. "[U]under section 1141(c), the confirmation of a Chapter 11 plan voids liens on property dealt with by the plan unless they are specifically preserved, if the lien holder participates in the reorganization."[12] *Id.* The court felt that resolving the status of the lien at confirmation would be more economical than leaving the issues in limbo after confirmation. 50 F.3d at 821. The court was not inclined to rule in favor of the judgment creditor who had failed to object to the plan and take steps to preserve its lien in the event of a conversion. The court found that the creditor had sufficient notice of the treatment of the property subject to its lien as well as its claim. *Id.* at 823.

Query: Should lienholders be more careful about "participating" in a plan by filing a proof of claim or taking other action? Should lienholders object to plans that do not preserve their liens in the event of a conversion? What practical problems would take place in the Register of Deeds if liens "came back to life" upon conversion to Chapter 7? Is it fair to give the debtor who fails to perform under a confirmed Chapter 11 Plan the benefit of the lien strip off upon a conversion? What steps could be taken to protect the lienholder's position (albeit presently unsecured)?

M. PLAN TERM IS THE MAXIMUM LENGTH FOR EXTENDING MODIFIED CLAIMS

In *Enewally v. Washington Mut'l Bank (In re Enewally)*, 368 F.3d 1165 (9th Cir. 2004), the debtors attempted to strip down a mortgage and pay the secured portion of the creditor's claim over

[12]The Fifth Circuit relied on other circuit rulings, including: *In re Penrod*, 50 F.3d 459, 462 (7th Cir. 1995) ("'when lienholders participate in a bankruptcy proceeding, and especially a reorganization, they know that their liens are likely to be affected, and indeed altered.'"); *FDIC v. Union Entities (In re Be-Mac Transport Co., Inc.)*, 83 F.3d 1020, 1025 (8th Cir. 1996) ("'a secured creditor who participates in the reorganization may also lose its lien by confirmation of a reorganization plan which does not expressly preserve the lien.'"); *Amer. Bank & Trust Co. v. Jardine Ins. Servs. Texas, Inc. (In re Barton Industries)*, 104 F.3d 1241, 1246 (10th Cir. 1997) (holding that a plan which did not mention the property, the creditor's interest therein or the effect of the plan on the property did not provide sufficient notice to void the creditor's lien); *In re Regional Bldg. Systems, Inc.*, 254 F.3d 528, 533 (4th Cir. 2001) (a plan voids liens not specifically preserved). *Id.*at 820.

a period that extended beyond the plan term. The Court of Appeals determined, relying upon the Supreme Court's admonishment in *Dewsnup* and *Nobelman*, that courts should not "fashion[] a 'broad new remedy' under § 506(a) where the remedy was not 'mentioned somewhere in the Code itself or in the annals of Congress.'" *Id.* at 1172 (quoting *Dewsnup*, 502 U.S. at 420, 112 S. Ct. 773). The court found that the debtors' proposal both to strip a mortgage and then to modify the secured portion by paying it beyond the plan term went too far beyond the scope of the relief intended by Congress in enacting §§ 506(a) and 1322(b)(2). The debtors' proposed plan modification accordingly was denied.

V. CONCLUSION

The old adage that "liens float through bankruptcy" is still the general rule with a growing number of exceptions in reorganization cases. Practitioners are becoming more creative in applying lien stripping in Chapter 13 cases. Clearly, limits exist to the expansion of the remedy given the Supreme Court's instructions to interpret the Code narrowly and not to invent broad new remedies where Congress intended none. Although the rule that "one dollar in equity" is enough to preserve a lien and the lack of a dollar is enough to wipe it out entirely seems to be unfair in application, the rule clearly defined what liens may be avoided in reorganization cases. In such cases, the appraisers likely will win the day. Creditors can attempt to protect themselves from failed reorganization plans by objecting to plans that fail to preserve or revive their liens if the case converts to Chapter 7. Debtors, on the other hand, will do well to make sure that the property subject to underwater liens is clearly addressed in their plans with full notice of the intended "lien stripping" consequences of the plan.