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LIEN SURVIVAL IN CHAPTER 13: THE AFTERMATH OF *DEWSNUP**

I. INTRODUCTION

When the country is in a depressed housing slump and mortgage foreclosures are on the rise, debtors could benefit by (1) stopping foreclosures and keeping their homes, (2) cutting years of payments off their mortgages, and (3) dragging out payback of arrearages over three to five years without interest. Distressed homeowners, with the help of the Bankruptcy Code (Code),¹ may have found a way to accomplish these tasks by filing a petition under Chapter 13.² However, in light of a recent United States Supreme Court decision in *Dewsnup v. Timm*³ and varying arguments among bankruptcy courts, "lien stripping" in Chapter 13 may not be allowed.

This comment addresses the possibility of stripping down a secured creditor's lien on a home mortgage in Chapter 13, utilizing section 1322(b)(2).⁴ "Lien stripping" is a popular nickname for the process of separating an undersecured claim into a secured claim equal to the value of the collateral and an unsecured claim equal to the remainder of the debt or unsecured deficiency pursuant to section 506(a).⁵ By the provisions set forth in section 506(a), the lien is stripped from the mortgaged property to the extent of any deficiency and relegated to the status of a general unsecured claim. The portion of the claim that remains secured is paid in full, with interest, while the deficiency may be paid in less than its full amount and the unpaid balance discharged.⁶

* This paper addresses how lien stripping would be treated in a Chapter 13 bankruptcy case in light of the Supreme Court's decision in *Dewsnup v. Timm*, 112 S. Ct. 773 (1992). However, during the editorial production process, the Supreme Court decided that lien stripping would not be allowed in a Chapter 13 case. *Nobelman v. American Savings Bank*, 124 L. Ed.2d 228 (1993).

1. Title 11 United States Code, known as the Federal Bankruptcy Code, shall hereinafter be referred to as the "Code," and all statutory provisions cited in the text are located within U.S.C. title 11 unless otherwise specified.

2. 11 U.S.C. §§ 1301-1330 (1979) (providing for the reorganization of individual debtors).

3. 112 S. Ct. 773 (1992).

4. 11 U.S.C. § 1322(b)(2) (1979); see also Margaret Howard, *Stripping Down Liens: Section 506(d) and the Theory of Bankruptcy*, 65 AM. BANKR. L.J. 373 (1991); Alexander L. Cataldo et al., *Residential Mortgage Bifurcation Under Chapter 13 of the Bankruptcy Code*, 96 COM L.J. 225 (1991).

5. 11 U.S.C. § 506(a) (1979).

6. *Id.* § 542(a)(2).

This comment also discusses: the interplay of section 506(a) and 506(d) with section 1322(b)(2); the impact in Chapter 13 of the United States Supreme Court's opinion in *Dewsnup*, a Chapter 7 case involving lien stripping; and possible redflags, problems, and practical applications involved when a debtor lien-strips in Chapter 13.

II. THE BASICS OF LIEN STRIPPING

A. *Basic Principles*

Lien stripping is comprised of at least three basic elements: (1) a debt;⁷ (2) a lien,⁸ mortgage, or other security interest⁹ that designates some item of property as collateral for that debt; and (3) the amount of the debt exceeds the value of the collateral.

In the past, "lien stripping" has involved two steps: (1) bifurcation, a process of separating an undersecured claim into a secured claim equal to the value of the collateral and an unsecured claim equal to the remainder of the debt or unsecured deficiency pursuant to 506(a);¹⁰ and (2) avoidance of the lien pursuant to section 506(d).¹¹ However, in light of *Dewsnup*,¹² step two, lien *avoidance*, is no longer allowed. Still, *Dewsnup* did not overrule lien stripping *per se*.

Filing a petition in bankruptcy creates a bankruptcy estate.¹³ The estate consists of assets which formerly belonged to the debtor but are now held in trust.¹⁴ At the same time, creditors' interest in property of the estate become "claims" against the estate.¹⁵ If the debtor filed a petition under Chapter 7, then the property of the estate is liquidated, and the proceeds are distributed to the creditors in proportion to the size of their respective original interests. In contrast, if the debtor filed under Chapters 9, 11, 12, or 13, the debtor's property is managed, and their debts are restructured affording the debtor some relief which provide

7. "Debt" is defined as a liability on a claim. *Id.* § 101(12). A "claim" is defined as a right to payment whether or not is as been (1) reduced to a judgment, (2) liquidated, (3) fixed, (4) matured, (5) disputed, or (6) secured. *Id.* § 101(5) It can also be a right to an equitable remedy for breach of a contract or some other breach of performance. *Id.*

8. A "lien" is a charge against or interest in property which secures payment of a debt or performance of an obligation. *Id.* § 101(37).

9. A "security interest" is a lien created by an agreement. *Id.* § 101(51).

10. *Id.* § 506(a) (1979).

11. *Id.* § 506(d).

12. 112 S. Ct. 773 (1992).

13. *Id.* § 541(a).

14. *Id.*

15. *Id.* §§ 101(5), (12), and 502.

creditors a prorated stream of reimbursement under a restructured payment plan.¹⁶ However, in practice there are major exceptions to prorated reimbursement. In particular, if a debtor's asset were subject to a lien before bankruptcy, it continues to be subject to the lien after bankruptcy, and the creditor holding the lien is entitled to full compensation free of the claims of other unsecured creditors.¹⁷

Generally, if the non-exempt collateral¹⁸ is worth more than the debt (if the creditor is oversecured), then the excess value or equity in the property may be taken and used by the bankruptcy estate for the benefit of unsecured creditors.¹⁹ But, if the collateral is worth less than the total amount of the debt (if the creditor is undersecured), then the property's entire value is committed to that secured creditor alone.²⁰ Such a secured creditor might insist on foreclosing its lien on the property by taking the property away from both the bankruptcy estate and the debtor.²¹ Even after the value of the property has been applied to the debt, some of the debt may remain unpaid and a "deficiency" will remain. The partially-unsatisfied creditor might then continue to claim an unsecured claim for the deficiency against the bankruptcy estate or the debtor.²² If the trustee or debtor want to save the property from foreclosure, he or she may make an arrangement with the secured creditor to postpone foreclosure in return for installment payments on the debt.²³ As payments continue to be made, the total amount of the debt shrinks, but the collateral cannot be freed from the security interest until all of the debt has been paid in full. Thus, a debtor may be forced to repay all of a debt to save a sensitive item of collateral that is worth far less than the total amount of the debt. From a debtor's point of view, he must buy back his property from the secured creditor at a price that exceeds its fair market value. To prevent this, a debtor's attorney commences to lien strip.

B. *Steps to Commence Lien Stripping*

In order to lien strip one must first invoke section 506(a) which provides as follows:

16. *Id.* § 726; see §§ 542, 543, 546, 548, and 554 for an understanding of what may or may not constitute property of the estate for purposes of reimbursing creditors.

17. *Id.* § 725.

18. See 11 U.S.C. § 522 for a list of the various federal exemptions a debtor may claim in order to keep certain personal and real property excluding it from property of the estate.

19. DAVID G. EPSTEIN, ET AL., *BANKRUPTCY* 676 (1993); 11 U.S.C. § 726.

20. 11 U.S.C. §§ 724, 725.

21. *Id.* § 725.

22. *Id.* § 506.

23. *Id.* § 722.

An 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, or to the extent of the amount subject to setoff, as the case may be, and is an *unsecured claim* to the extent that the value of such creditor's interest or the amount so subject to setoff 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.²⁴

After invoking section 506(a), the debtor's attorney will, by motion, ask the bankruptcy court to officially determine the value of the collateral.²⁵ This value can be something less than the total amount of the creditor's claim. According to section 506(a), once these amounts have been determined, the total claim is bifurcated: (1) a secured claim equal to the fair market value of the collateral and (2) an unsecured claim equal to the remainder of the debt.

The debtor's next step in the process of lien stripping is to invoke section 506(d). This subsection states that:

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) such claim was disallowed only under section 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.²⁶

When invoking section 506(d), the debtor requests the court to void the portion of a creditor's lien that is deemed unsecured pursuant to section 506(a).

The bankruptcy court, following these provisions, will then cut the secured creditor's debt into two parts. One part of the claim will be equal to the present value of the collateral, as previously determined by the bankruptcy court and continues to attach to the collateral. The other part of the debt, equal in amount to the deficiency, no longer attaches to the collateral. The deficiency will then be relegated to unsecured status.

In the final step of this process, the debtor receives a discharge of all scheduled debts that are dischargeable. The bankruptcy discharge is an

24. *Id.* § 506(a) (emphasis added).

25. FED. R. BANKR. P. 3012 (providing that a court may determine the value of a secured claim "on motion of any party in interest"); see *In re Doss*, 143 B.R. 952, 954 (Bankr. E.D. Okla. 1992) (holding that a request for valuation under section 506 must be made pursuant to motion under Bankruptcy Rule 3012).

26. 11 U.S.C. § 506(d).

injunction that allows a creditor to collect any unpaid debts in rem,²⁷ but it forbids any further collection activities in personam.²⁸ After the debtor's discharge, the creditor may still foreclose on the collateral since foreclosure is an in rem action, and the debtor will be forced to pay the creditor in full to retain possession of the collateral. However, after lien stripping, the debtor will have to pay only the judicially determined value of the collateral and not the full amount of the debt. The unsecured deficiency is separated from the collateral by section 506(a) and (d) and is discharged by section 524.

In summary, after lien stripping, the collateral secures only that part of the debt equal to the collateral's fair market value at the time of bankruptcy; the rest of the debt becomes entirely unsecured. The debtor can buy back his property from the secured creditor for what the property was worth when the debtor went bankrupt, regardless of the size of the debt which the property secured.

This could result in a tremendous benefit to debtors while detrimentally affecting creditors. The debtor, who originally borrowed the full amount of the debt and not just the present value of the collateral, can keep the collateral and a substantial part of the money he originally borrowed. This certainly improves a debtor's financial obligation, but it also grants a debtor a sizeable windfall at the expense of a secured creditor, which can be unfair and dangerous to the citizenry at large because it threatens to discourage credit access. The creditors are, in theory, assuming the risk of the property depreciating in value faster than the debt. But is this utilization of section 506 consistent with legislative intent? The United States Supreme Court was asked this question in *Dewsnup v. Timm*.²⁹

III. THE SUPREME COURT SPEAKS OUT: *DEWSNUP V. TIMM*

A. *Facts*

In *Dewsnup v. Timm*, the Supreme Court ruled that the Code did not allow a Chapter 7 debtor to strip down an undersecured creditor's lien on real property.³⁰ The debtor had borrowed \$119,000.00, which was secured by a deed of trust on two sections of farmland. During the

27. Actions taken against a "thing" instead of against a "person." This action determines the right in specific property against all of the world and is equally binding on everyone. BLACK'S LAW DICTIONARY 404 (5th ed. 1979).

28. 11 U.S.C. § 524. An action against the person involving his personal rights and not against a specific piece of property. BLACK'S LAW DICTIONARY 404 (5th ed. 1979).

29. 112 S. Ct. 773 (1992).

30. *Id.* See generally Bankr. Serv. L. Ed. § 6A:28; Bankr. Desk Guide § 23:28.

next year the debtor defaulted on the note.³¹ Three bankruptcies and nearly fourteen years later, the creditor had not been paid or allowed to foreclose on the property. The creditor moved for abandonment of the property. The Bankruptcy Court, after a hearing, valued the property at \$39,000.00, barely one-third of the total debt which the property was supposed to secure. Because there was no equity in the property over and above the amount of the debt, the property was of no value to the estate, and the trustee abandoned it.³²

The debtors then filed an adversary proceeding,³³ seeking first to value the property down to its fair market value of \$39,000.00 and to then use section 506(a)³⁴ to divide the claim into a \$39,000.00 secured claim and an \$80,000.00 unsecured claim. Next, the debtors attempted to use section 506(d)³⁵ to void the undersecured portion, thus effectively avoiding the lien on the undersecured portion of the claim and keeping the property by paying merely \$39,000.00 to the lienholder, who may recover all or none of his remaining unsecured claim. The amount of the lienholder's recovery will depend on the amount of money received from the liquidation of the property of the estate.³⁶ However, the Supreme Court held that section 506(a) could not be invoked by the Chapter 7 debtor to split the claim and to avoid the undersecured portion of the lien.³⁷

31. *Dewsnup*, 112 S. Ct. at 775.

32. See 11 U.S.C. § 554 (concerning abandonment of property of the bankruptcy estate).

33. See FED. R. BANKR. P. 7001-7087 (comprising the requirements for filing of an adversary proceeding).

34. 11 U.S.C. § 506(a). This section provides:

(a) An allowed claim of a creditor secured by a lien on property 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, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff 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.

Id.

35. *Id.* § 506(d). This section states:

(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) such claim was disallowed only under section 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.

Id.

36. *Dewsnup v. Timm*, 112 S. Ct. 773, 776 (1992).

37. *Id.* at 778.

B. *Dewsnup Analysis*

The Supreme Court perceived the problem as one of properly interpreting the interplay between section 506(a) and (d). The Court focused specifically on legislative intent in reaching their conclusion that the lien should stay with the real property until the time of foreclosure, thus determining that lien avoidance is prohibited.³⁸

The debtors argued that section 506(a) and (d) are complementary and should be read together to allow lien stripping. Under section 506(a) the creditor "would have an allowed secured claim only to the extent of the judicially determined value of the collateral."³⁹ Then, under section 506(d), the bankruptcy court should void the lien on the remaining unsecured claim, because it is not an "allowed secured claim" pursuant to section 506(a).⁴⁰

The creditor argued that section 506(a) and (d) were not to be strictly applied.⁴¹ According to the creditor, section 506(a) merely functions to insure that each unsecured claimant is treated fairly by classifying claims by their status as either secured or unsecured at the time the property of the estate is distributed.⁴² Consequently, 506(d) works to void the lien only at the time of foreclosure, rather than at the time of the section 506 hearing.

In the alternative, the United States, as *amicus curiae*, argued that the words, "allowed secured claim" must be looked at in a much broader sense.⁴³ The government argued that the words should be separated and read word by word to mean any claim that is first "allowed" and then "secured."⁴⁴ An allowed claim is a claim against an estate that is a debt or charge which is valid in law and should be enforced.⁴⁵ Pursuant to section 502(a), a proof of claim that is filed under section 501 is deemed to be allowed unless objected to by a party in interest.⁴⁶ A secured claim is supported or backed by security or collateral that gives assurance of payment of a particular debt or discharge of an obligation.⁴⁷ Therefore,

38. *Id.* at 778-79.

39. *Id.* at 776-77.

40. *Id.* Section 506(a) divides claims which are allowed under section 502 into secured and unsecured claims. Any portion of the allowed claim found to be unsecured under section 506(a) is not an "allowed secured claim" within the lien avoiding scope of section 506(d). *Id.*

41. *Id.* at 777.

42. *Id.*

43. *Id.* ("[Section] 506(d) need not be read as an indivisible term of art defined by reference to § 506(a), which by its terms is not a definitional provision.").

44. *Id.*

45. BLACK'S LAW DICTIONARY 40 (5th ed. 1979).

46. 11 U.S.C. §§ 502(a), 501.

47. BLACK'S LAW DICTIONARY 703 (5th ed. 1979). One may give security in the form of either

the lien should not be voided because the claim at issue was not within the scope of section 506(d) since the claim had been fully "allowed" and was "secured."⁴⁸ Section 506(d) has a much narrower application in that a lien which secures a claim against the debtor may only be voided when the claim is an unallowed secured claim, an allowed unsecured claim, or an unallowed unsecured claim.

The Supreme Court⁴⁹ chose to follow the argument of the United States. The *Dewsnup* Court held that due to the ambiguity of the text, it was not convinced that Congress wanted to establish laws contrary to well established pre-Code rules, which provided that liens secured by real property pass through bankruptcy unaffected.⁵⁰ There were insufficient reasons to attribute to congress an intent to upset established bankruptcy principles and grant debtors a broad new remedy against undersecured claims.⁵¹

However, the dissent in *Dewsnup* argued that whenever a claim that secures a debt is not both an "allowed claim" and a "secured claim," the lien will be automatically avoided under section 506(d).⁵² They also disagreed with the majority's conclusion that the language was ambiguous and the meaning of "allowed secured claim" was left to speculation.⁵³ The dissent believed that even when the phrase "allowed secured claim" appears outside of section 506, it inevitably means that the secured claim is the amount of a creditor's allowed claim that is secured after the required calculations for that particular provision have been performed.⁵⁴

a lien, mortgage, pledge or some other form of security to be used if the debtor fails to fulfill his obligation. *Id.*

48. *Id.* The United States also pointed out that to allow the lien to be avoided would go against the legislative intent to preserve such type of liens. This is evidenced by the fact that there is nothing in the legislative history that reflects any intent to change the pre-Code bankruptcy law that preserved such liens. This would also impair the "fresh start" policy, which would not permit an in rem claim against property. *Id.*

49. The Supreme Court reached their decision by a 6-2 vote. *Id.*

50. *Id.* at 778. The Court focused heavily on the law before establishment of the 1978 Act, where liens and other secured interests survived bankruptcy. With the exception of the Code sections 616(1) and (10) (1976), no provision would permit the involuntary reduction of a creditor's lien for any reason other than payment on the debt. Thus, to effect a major change in the pre-Code practice, it has been reluctantly applied. *Id.*; see *United Sav. Assoc. of Texas v. Timbers of Inwood Forest Assoc.* 484 U.S. 365, 380 (1988).

51. *Dewsnup*, 112 S. Ct. at 778.

52. *Id.* at 780. To hold differently would replace what Congress said with what the Court thinks Congress should have said. This would "impair for future use, well-established principles of statutory construction." *Id.*

53. *Id.* at 780.

54. *Id.* at 780; see, e.g., 11 U.S.C. § 722 (permitting a Chapter 7 debtor to redeem certain tangible personal property from liens securing dischargeable consumer debt by "paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien"); *id.* § 1225(a)(5) (describing treatment of allowed secured claims in family farmers' reorganization plans); *id.* § 1325(a)(5) (describing treatment of allowed secured claims in regards to an individual

Consequently, there is a clear and convincing pattern of using the phrase "allowed secured claim" to mean exactly what it says, as suggested in 506(a), and not to be broken up and read term by term.⁵⁵

The *Dewsnup* majority further concluded that to allow the creditor's secured interest to be frozen at the judicially determined value, rather than at the value at time of foreclosure, could create a "windfall" for the debtor.⁵⁶ The *Dewsnup* Court reasoned that the lien must stay with the property until foreclosure because that is what the parties bargained for in executing the home mortgage.⁵⁷ This would allow any increase in the value of the property after it is judicially determined to accrue to the benefit of the estate and not to the benefit of the debtor or to other unsecured creditors whose claims had nothing to do with the mortgagor-mortgagee agreement.⁵⁸

In focusing on legislative intent and the word by word analysis of 506(d), the Supreme Court declared that, in a Chapter 7, if a claim is disallowed under section 502(b), then the lien on the property that is undersecured must be avoided pursuant to section 506(d). However, if a secured claim is allowed, section 506(d) may not be used to avoid the unsecured portion.⁵⁹ Thus, section 506(d) does not allow the avoidance of a lien on a claim that has been fully allowed pursuant to section 502. However, a lien might still be avoided under some authority other than

reorganization) (emphasis added); see also *Gaglia v. First Fed. Sav. and Loan Assoc.*, 889 F.2d 1304 (3rd Cir. 1989); (holding that the language of section 506(a) and (d) is not ambiguous, and that there is no need to look further into the legislative history or intent); *In re Moses*, No. 89-03267-C (N.D. Okla. 1990) (memorandum opinion and order) (adopting the analysis used in *Gaglia*, stating that these sections clearly mean that when a claim against property is not an allowed secured claim, the lien securing that claim is voided).

The Code is also consistent with its use of the phrase "allowed unsecured claim" in describing how a claim that is "unsecured" is treated under section 506(a). See, e.g., 11 U.S.C. § 507(a)(7) (concerning priority of "allowed unsecured claims of governmental units"); *id.* § 726(a)(2) (providing for payment of "allowed unsecured claim[s]" in Chapter 7 liquidations); *id.* § 1225(a)(4) (providing standards for treatment of "allowed unsecured claim[s]" in family farmer reorganization plans); *id.* § 1325(a)(4) (providing standards for treatment of "allowed unsecured claim[s]" in individual reorganizations).

55. *Dewsnup*, 112 S. Ct. at 780.

56. *Id.* The increase in the value of the property from the time of judicial determination to the value at time of foreclosure would accrue not to the estate but to the debtor creating a "windfall." *Id.* See *infra* pp. 864-65.

57. *Id.* at 778.

58. *Id.*

59. The Court focused on the legislative history of the word "allowed" rather than "secured." They specified that section 506(d) could not be used to avoid the lien but did not refer to the term "bifurcate," thus leaving a path open to find a way to use another code section to bifurcate an allowed secured claim. *Id.*

section 506(d), if such exists.⁶⁰

IV. GOING FORWARD: LIEN-STRIPPING AND ITS APPLICATION IN CHAPTER 13

A. *General Application in Chapter 13*

1. Mechanics of Chapter 13

Chapter 13 provides debt relief for individuals with regular income.⁶¹ Its primary purpose is to enable such an individual to develop and implement a "plan"⁶² to repay his debts over a period of time.⁶³ Section 1322 sets forth the requirements for a Chapter 13 plan.⁶⁴ The plan must be approved by the bankruptcy court and usually provides for payments to the creditors over a three to five year period.⁶⁵ This is accomplished by distributing all of the debtor's net disposable income to creditors on a percentage basis.⁶⁶ The debtor is given enough time during the plan to repay a large portion of his debts. In return, the debtor is shielded from creditors' piecemeal collection efforts,⁶⁷ and any unpaid balance due after the term of the plan may be discharged.⁶⁸ To receive a discharge of the portion of unsecured debts not repaid, the debtor must complete the plan.⁶⁹

2. Chapter 13 Lien Stripping—Secured and Unsecured Claims

The debtor's power to modify secured creditors' claims is provided

60. *Id.* The *Dewsnup* Court left open the issue as to whether lien avoidance could be accomplished through some other provision of the bankruptcy code or by application to a different set of facts under a chapter other than Chapter 7.

61. 11 U.S.C. § 303(a). This provision is only available to individuals with regular income and must be voluntary, and who, upon the date of filing the petition, must owe "non-contingent, liquidated, unsecured debts of less than \$100,000.00, and non-contingent, liquidated, secured debts of less than \$350,000.00." *Id.* § 109(e).

62. *Id.* § 1321 (providing for filing of the plan); *id.* § 1322 (providing for contents of the plan).

63. *In re First Nat'l Fidelity Corp.*, 25 Collier Bankr. Cas. 2d (MB) 731, 735 (3rd Cir. 1991) (citing H.R. REP. No. 595, 95th Cong., 1st Sess. (1977), reprinted in 1978 U.S.C.A.N. 5787, 6079).

64. 11 U.S.C. § 1322.

65. *Id.* §§ 1322, 1324, and 1325.

66. *Id.* §§ 1322 and 1326.

67. *Id.* § 362.

68. *Id.* § 1328.

69. *Id.* § 1328(a); see *id.* § 1328(b) (listing exceptions for granting discharge under a "hardship"). Most creditors are less aggrieved by debtors' resort to Chapter 13 than to Chapter 7, because Chapter 13 constitutes an attempt to repay one's creditors. BAXER DUNAWAY, *THE LAWS OF DISTRESS REAL ESTATE, FORECLOSURE, WORKOUTS, PROCEDURES* §§ 24A.01[1], [2][a] (1993). See generally COWANS, *BANKRUPTCY LAW & PRACTICE*, 201-57 (1987); MARTIN A. FREY ET AL., *AN INTRODUCTION TO BANKRUPTCY LAW*, 397-423 (2nd ed. 1992); GEORGE M. TREISTER ET AL., *FUNDAMENTALS OF BANKRUPTCY LAW*, 315-327 (1986) (providing background for petitions under Chapter 13).

for by section 1322(b)(2).⁷⁰ Section 1322(b)(2) allows the debtor to "modify" the rights of secured creditors and provides in part:

the plan 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 or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.⁷¹

Section 1322(b)(1) authorizes modification with respect to the rights of unsecured creditors. Modification is defined as "a change; an alteration or amendment which introduces new elements into the details, or cancels some of them, but leaves the general purpose and effect of the subject matter intact."⁷² Thus, a debtor may not change the payment, interest rate, or terms of the original agreement. Also, because section 1322(c) allows a three to five year plan, the Chapter 13 debtor may not modify the rights of a secured claim holder whose debt is payable over a term longer than five years.⁷³

In comparison to a Chapter 13 modification, the standard modification of an unsecured claim is to write the claim down to an amount no lower than an amount that would be paid if it was a Chapter 7 case and then pay that value plus interest over the life of the plan. A modification that satisfies this standard is deemed to be in the best interest of creditors, and this standard is appropriately referred to as the best interest of creditors test.⁷⁴ The test, as it applies to secured creditors, is laid out in section 1325(a)(5), which provides:

[the court shall confirm the plan if] with respect to each allowed secured claim provided for by the plan (A) the holder of such claim has accepted the plan; (B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and (ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or (C) the debtor surrenders the property securing such claim to

70. Chapter 11 also provides for modification of secured creditor's claims. *See, e.g.*, 11 U.S.C. § 1123 (providing for modification of secured creditor's claims). Chapter 11 allows the Debtor in Possession ("DIP") to divide a loan into two claims: one secured claim equal to the value of the collateral and an unsecured claim for the deficiency. The DIP may then either sell the asset free of the security or substitute one piece of collateral for another; change the term of the loan and the amount of each installment; or decelerate a loan on which there has been a default and acceleration of a debtor. EPSTEIN, *supra* note 19, at 708.

71. 11 U.S.C. § 1322(b)(2) (emphasis added).

72. BLACK'S LAW DICTIONARY 905 (5th ed. 1979). This term is not defined in the Code.

73. *See, e.g., In re Foster*, 61 B.R. 492 (Bankr. N.D. Ind. 1986). A debtor has no right to modify a debt whose last payment is due after the end of its proposed plan. He may only cure and reinstate the debt. *Id.*

74. 11 U.S.C. § 1325(a)(4). *See infra* pp. 865-66.

such holder.⁷⁵

Basically, this test mandates that the secured creditor should get the value of its collateral either through secured payments with a present value equal to the collateral or by the debtor's surrender of the property to the secured creditor.

Application of the test is best illustrated by a hypothetical involving a secured loan on an automobile with final payment due during the plan period. If the car's value is \$10,000.00 and is secured by a \$15,000.00 loan, then section 506(a) allows the debtor to write the loan down to the value of the car and treat the remaining \$5,000.00 as an unsecured debt.⁷⁶ Payment of the unsecured portion is relegated with other unsecured creditors who may receive only a residue of their original claim.

Thus, in inflationary times, this provision has great benefits for Chapter 13 debtors. Because most debtors' liability will be payable in less than five years, these debts will be allowed modifications under section 1322(b)(2). The only exception to this rule is the debtor's home mortgage.

B. *Lien Stripping the Home Mortgage in Chapter 13*

One of the most important reasons debtors file under Chapter 13 is to avoid the loss of their home when foreclosure is being threatened. Thus, the ability to modify a secured creditor's claim secured by a home mortgage to the depressed fair market value appears attractive to the debtor. The debtor could buy his house at the fair market value rather than the original loan amount. The question therefore, is whether this avenue is authorized by the Bankruptcy Code. To answer this question, this section will examine (1) the legislative intent of section 1322(b)(2), (2) how the *Dewsnup* Court's opinion applies to Chapter 13, and (3) the ability of section 1322(b)(2) to strip liens on a home mortgage.

1. Background: Legislative Intent and Statutory Interpretation

Courts should only look to legislative intent of a statute when they feel that the ambiguity of its language makes its intent unclear.⁷⁷ Thus, some courts have often looked to legislative intent in settling controversies regarding lien splitting of a home mortgage. The following section discusses (1) the legislative history of the statute's language and how it

75. 11 U.S.C. § 1325(a)(5).

76. EPSTEIN, *supra* note 19, at 709.

77. Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982).

has been changed, and (2) how various courts have interpreted the language in section 1322(b)(2) in connection with legislative intent.⁷⁸

This search into the legislative intent reveals that the original draft of the Code recommended that secured indebtedness on personal property be subject to modification.⁷⁹ The House version allowed this modification to extend to both real and personal property.⁸⁰ The Senate then wanted to restrict the House version by adding the phrase "modify the rights of holders of secured claims (other than claims wholly secured by mortgages on real property) or of holders of unsecured claims."⁸¹ Consequently, the final version reflected the compromise of both committees.⁸² The word "wholly" was changed to the word "only."

No one could explain the reason behind the change⁸³ until *In re Grubbs*, where the Fifth Circuit Court of Appeals reasoned that Congress wanted to protect the home mortgage industry:

With regard to § 1322(b)(2), the Senate receded from its position that no "modification" was to be permitted of any mortgage secured by real estate; it instead agreed to a provision that modification was to be barred only as to a claim "secured only by a security interest in real property that is the *debtor's principal residence*." This limited bar was apparently in response to perceptions, or to suggestions advanced in the legislative hearing [by advocates for secured creditors], that home-mortgagor lenders, performing a valuable social service through their loans, needed special protection against modification thereof (i.e., reducing installment payments, secured valuations, etc.).⁸⁴

For similar reasons, the bankruptcy court in *In re Strober* held that the legislative history of this section clearly settles controversies by prohibiting modification of residential mortgages in Chapter 13.⁸⁵ However, the Tenth Circuit Court in *In re Hart* followed a different route in

78. See, e.g., *In re Strober*, 136 B.R. 614, 620 (Bankr. E.D. N.Y. 1992).

79. H.R. REP. No. 595, 95th Cong., 1st Sess. (1977), reprinted in 1978 U.S.S.C.A.N. 5787.

80. H.R. 8200, 95th Cong., 1st Sess. (1977).

81. S. 2266, 95th Cong., 2d Sess. (1978); see *Grubbs v. Houston First American Sav. Assoc.*, 730 F.2d 236, 245 n.14 (5th Cir. 1984).

82. See *In re Woodall*, 123 B.R. 95, 96 (Bankr. W.D. Okla. 1990) ("The House version was more favorable to debtors and the Senate version was more favorable to lenders."), *rev'd*, 931 F.2d 64 (10th Cir. 1991). Thus, Congress literally "split the baby" by allowing bifurcation of claims into secured and unsecured claims. *Id.*; see also Hon. Alexander Paskay, *Determination of Secured Status & Section 506 Lien Stripping, Is There Life for Lien-Stripping After Dewsnup?*, AM. BANKR. INST. NEWSLETTER, May 1992, at 26.

83. *Grubbs*, 730 F.2d at 245 n.14.

84. *Id.* at 246 (emphasis added); see also *In re Glenn*, 760 F.2d 1428, 1433-34 (6th Cir. 1985), *cert. denied*, *Miller v. First Federal of Michigan*, 474 U.S. 849 (1985); *In re Harris*, 94 B.R. 832, 836 (D. N.J. 1989); *In re Foster*, 61 B.R. 492, 495 (Bankr. N.D. Ind. 1986).

85. *In re Strober*, 136 B.R. 614, 620 (Bankr. E.D. N.Y. 1992) (interpreting the legislative history which indicates the statute was drafted to avoid any detrimental effects on the home mortgage industry; thus, disallowing the bifurcation of the Strober's home mortgage); see *First Nat'l Fidelity*

determining Congress' intent.⁸⁶

The court began with the assumption that whenever Congress enacts laws, the "ordinary meaning" of the language clearly states its purpose.⁸⁷ The plain intended meaning should be very straight forward unless a "rare case" occurs where the literal application of a statute will foster conclusions that are on the far side of the spectrum from what the drafters originally intended.⁸⁸ The Tenth Circuit concluded that looking to the plain meaning of the statute to determine the section's true meaning was less speculative than trying to weed through the legislative history. By applying the plain meaning of the statute the court was not producing a drastically different intent than the one initially intended by its drafters.⁸⁹ The *Hart* court determined that nothing in the plain language of section 1322(b)(2) requires going beyond the Code's statutory definition of the term "secured claims" to search for protection for the unsecured amount of an undersecured home mortgage. Thus, the court concluded that modification of the undersecured home mortgage claim was allowed.⁹⁰

C. *Dewsnup's Application In Chapter 13*

In determining whether *Dewsnup's* construction of universal section 506 applies to undersecured home mortgage creditors in Chapter 13, the first statute that should be addressed is section 103(a). Section 103, a universal chapter, provides: "Except as provided in section 1161 of this title, chapter 1, 3, and 5 of this title apply in a case under chapter 7, 11,

Corp. v. Perry, 25 Collier Bankr. Cas. 2d (MB) 731, 736 (3rd Cir. 1991) (stating that the prohibition against modification of home mortgage lender's rights was designed to protect homeowners by giving them access to mortgage money on affordable terms).

86. 21 Bankr. Ct. Dec. (CRR) 385, 388 (10th Cir. 1991).

87. *Id.*; see *Justice v. Valley Nat'l Bank*, 849 F.2d 1078, 1084 (8th Cir. 1988) (quoting *Park'N Fly, Inc. v. Dollar Park & Fly, Inc.*, 469 U.S. 189, 194 (1985)).

88. *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982); see *Dewsnup v. Timm*, 112 S. Ct. 773, 786 (1992) (stating that the court should simply enforce the new Code by interpreting its terms by their plain meaning without insisting upon at least some discussion of the legislative intent and the change from its prior law).

89. *In re Hart*, 21 Bankr. Ct. Dec. (CRR) 385, 388 (1991).

90. See *Moore v. Wade*, No. 92-0019 at 6 (Bankr. N.D. Okla. March 25, 1992) (order denying motion to dismiss). The Court concluded that:

various other provisions of the Bankruptcy Code become difficult to explain—for example § 1111(b) would seem to become superfluous, for every secured creditor would have an automatic '1111(b) election.' If allowed secured claims are not allowed to be broken into two separate claims, one secured and the other unsecured, and treated separately, leaving the unsecured parts not necessarily paid in full, then the majority of plans filed under Chapters 11, 12, and 13 would be unworkable. The reorganization or rehabilitation of nearly all debtors would become an impossible task.

Id.

12, or 13 of this title.”⁹¹ In light of section 103, it is reasonable to conclude that the court’s interpretation of section 506(d) would also apply in other chapters. However, *Dewsnup* merely prohibited lien avoidance on an allowed secured claim under Chapter 7, but failed to address whether a undersecured lien on a home mortgage could be stripped in a Chapter 13.

Some bankruptcy courts have resolved the issue by inferring that section 1322(b)(2) takes priority over section 506(a).⁹² In *In re Davidoff*,⁹³ a Florida bankruptcy court held that although section 506 is applicable in Chapter 13 cases, it is limited by the specific language of section 1322(b)(2).⁹⁴ Because the bank had a secured claim which was allowed, the lien could not be avoided because to do so would modify the rights of the security interest holders, which is strictly prohibited by section 1322(b)(2). Other federal bankruptcy courts have interpreted *Dewsnup* as not being applicable in Chapter 13 cases.⁹⁵ One Judge in the Bankruptcy Court for the Western District of Oklahoma ruled that *Dewsnup* did not overrule controlling circuit court precedents that allowed lien stripping because it did not specifically address the issue under a case in Chapter 13.⁹⁶

However, the Tenth Circuit Court in *In re Hart* disagreed with the *Davidoff* court, believing it to be an incorrect reading of the Code.⁹⁷ The Tenth Circuit decided that when a mortgage is undersecured, section 506’s purpose is to value the secured claim and bifurcate the claim into secured and unsecured. Thus, the secured claim remains protected under section 1322(b)(2), and only the unsecured claim is modified or stripped of the lien.⁹⁸

The *Dewsnup* Court led the reader to a dead end as to whether the decision would apply in other bankruptcy chapters. The *Dewsnup* Court

91. 11 U.S.C. § 103(a).

92. *Hart*, 21 Bankr. Ct. Dec. (CRR) at 387.

93. 136 B.R. 567, 569 (Bankr. M.D. Fla. 1992).

94. *Id.* (holding due to the limitations of section 1322(b)(2), the bank’s claim was an allowed secured claim in which the lien could not be stripped).

95. *In re Ward*, No. 91-01868 at 4 (Bankr. W.D. Okla. July 12, 1991) (order on motion to reconsider).

96. *Id.* (stating that the Supreme Court would have at least cited, discussed, or acknowledged the existence of precedents which would overrule the circuits’ rulings).

97. *Id.* at 388.

98. *In re Hart*, 21 Bankr. Ct. Dec. (CRR) 385, 388 (1991) (holding that Congress had left no unanswered questions regarding the treatment of under secured claims). Congress provided that an undersecured claim be divided into two parts and that in Chapter 13 the secured portion has special protection when residential real estate lending is involved. However the unsecured portion is not offered that same protection. *Id.* at 387 (citing *In re Houghland*, 886 F.2d 1182, 1185 (9th Cir. 1989)).

limited its focus to the case before them and allowed "other facts to await their legal resolution on another day."⁹⁹ Therefore, it would seem that with *Dewsnup* and the contradicting opinions among the various circuits and no further supreme court determination yet on this issue,¹⁰⁰ both debtors and creditors are left only with their circuit as to whether lien stripping of a home mortgage lien is allowed in Chapter 13.¹⁰¹ In continuing to find the correct answer, the next step is an in depth analysis of section 1322(b)(2) and its affect on liens secured by home mortgages.

3. Stripping Home Mortgage Liens Under Section 1322(b)(2)

The courts have developed three approaches to the bifurcation of a creditor's lien that is secured only by a lien on a debtor's principal residence in Chapter 13.¹⁰² One approach permits the debtor to divide the creditor's claim into a secured and unsecured claim, but prohibits modifying the unsecured claim if the debtor does not propose to pay off the entire secured claim in the plan. A second approach which relies on *Dewsnup*, strictly prohibits claim modification. The creditor's secured

99. *Dewsnup*, 112 S. Ct. at 778; see 3 COLLIER ON BANKRUPTCY § 506.07 (15th ed. 1986) (applying section 506 to the other chapters in Bankruptcy).

100. See *Nobleman v. American Sav. Bank*, 23 Bankr. Ct. Dec. (CRR) 584 (5th Cir. 1992), cert. granted, 113 S. Ct. 654 (1992).

101. Courts in the Fourth, Six, and Seventh Circuits allow protection of only the secured portion of a home mortgage under section 1322(b)(2) by applying section 506(a), then giving the protection of section 1322(b)(2) only to the secured portion; see *McNair v. Chrysler First Fin. Servs. Corp.*, 115 B.R. 520, 523 (Bankr. E.D. Va. 1990); *In re Demoff*, 109 B.R. 902, 915 (Bankr. N.D. Ind. 1989); *In re Hill*, 96 B.R. 809, 813-14 (Bankr. S.D. Ohio 1989); *In re Frost*, 96 B.R. 804, 807 (Bankr. S.D. Ohio 1989).

Courts in the Fifth, Eighth, and Eleventh Circuits have held that bifurcation is inappropriate. These courts have relied on four different rationales as follows:

(1) the legislative history mandated protection of the home mortgage lender, and bifurcation impermissible dilutes that protection; (2) as a matter of statutory construction, the requirements of a specific section, in this case section 1322(b)(2), control those of a general section, in this case section 506(a); (3) as a matter of statutory construction, the courts should look to the definition of "claim" from section 101(4), which includes both secured and unsecured claims, rather than the definition of "secured claim" from section 506(a); and (4) analysis of the legislative history should look back to Chapter XIII of the now-repealed Bankruptcy Act, predecessor to the Code, for guidance in the definition of secured claims.

Hart, 2, Bankr. Ct. Dec. (CRR) at 387-88; see also *In re Chaves*, 117 B.R. 733, 736-37 (Bankr. S.D. Fla. 1990); *In re Sauber*, 115 B.R. 197, 199 (Bankr. D. Minn. 1990); *In re Schum*, 112 B.R. 159, 162 n.3 (Bankr. N.D. Tex. 1990); *In re Kaczmarczyk*, 107 B.R. 200, 202-03 (Bankr. D. Neb. 1989); *In re Catlin*, 81 B.R. 522, 524 (Bankr. D. Minn. 1987).

Even in the Tenth Circuit's jurisdiction, courts are split as to whether to apply bifurcation. See *In re Hart*, 21 Bankr. Ct. Dec. (CRR) at 389; *In re Brouse*, 110 B.R. 539, 543-44 (Bankr. D. Colo. 1990); *In re Ross*, 107 B.R. 759, 762 (Bankr. W.D. Okla. 1989); *In re Simmons*, 78 B.R. 300, 303 (Bankr. D. Kan. 1987).

102. *Third Circuit Allows Strip Down of Lien on Unadministered Property*, Bankruptcy Service Current Awareness Alert 2, 6 (December 1989).

claim is the original amount of the claim and not the amount of the secured claim after the section 506(a) split. A third approach permits splitting the claim into two parts pursuant to section 506(a), an unsecured part and a secured part and avoidance of the lien as to the unsecured portion of the indebtedness.¹⁰³ These varying approaches have left both debtors and creditors in a shadow of confusion.

As discussed earlier, a secured creditor's claim, other than one secured by a home mortgage, may be modified pursuant to section 1322(b)(2). This special protection offered by section 1322(b)(2) does not permit a debtor to modify monthly payments, change the rate of interest, or make any other changes in the agreement with respect to a creditor whose claim is secured only by a security interest in real property that is the debtor's principal residence.¹⁰⁴

Thus, if a debtor is continuing to make the same mortgage payments at the same interest rate and is curing the default by payments through the plan, the creditor's secured claim is not being modified. It could be argued that once the claim has been divided pursuant to section 506(a), only the unsecured portion of the mortgagee's claim is being modified, and that the secured claim after the section 506 calculations is not being modified. In conclusion, this modification would not be prohibited by section 1322(b)(2) because it concerns only the unsecured portion of the claim.¹⁰⁵

IV. PLAN CONFIRMATION AND POSSIBLE PROBLEMS ASSOCIATED WITH LIEN STRIPPING

Whenever a debtor's attorney attempts to strip home mortgage liens, the attorney should be aware of potential problems that may arise in obtaining a plan that will be confirmable by the court. Some of these problems that will be discussed in the following section are: (1) whether the plan's contents satisfy the requirements in section 1322, (2) whether lien stripping creates a windfall to the debtor, and (3) whether the plan can pass the best interest of creditors test.

103. *Id.* at 6-7.

104. *In re Hayes*, 22 Collier Bankr. Cases 2d (MD) 1009 (Bankr. S.D. Ill. 1989).

105. One exception to this rule is the hardship provision found in 11 U.S.C. § 1328(b). *See In re Davidoff*, 136 B.R. 567, 569 (Bankr. M.D. Fla. 1992) (holding that bifurcating a claim which valued debtors' principal residence pursuant to section 506 into secured and unsecured claims was a modification prohibited under section 1322(b)(2) due to the failure of the claimant to receive its note and mortgage in full as bargained).

A. *Fulfilling the Plan's Requirements: Section 1322*

In determining whether a plan that purports to modify a secured creditor's originally filed claim, which is secured only by a home mortgage, complies with the requirements of Section 1322(a), the court must make several determinations. The language contained in section 1322(b)(2) expressly states that the plan may modify the rights of holders of secured claims "other than *claims secured only by*" a principal residence. The problem is the placement of the word "secured." In the phrase "secured claims," it functions as an adjective modifying the word claim. This entire phrase can be read to mean a "wholly secured claim."¹⁰⁶ In the phrase "claim secured only by," "secured" is an adverb describing the character of the claim. This phrase does not necessarily mean the original amount of the "secured claim" but could be read to mean the "claim" (i.e., the amount of the claim after the required calculations are performed under section 506(a), which splits the home mortgage claim into a secured claim only for the judicially determined value and an unsecured claim for the deficiency; the unsecured claim being the only claim modified) that it is "secured by."¹⁰⁷

This play on the placement of the word "secured" can also be seen in section 506(a). Section 506(a) provides in part, "an allowed claim of a creditor *secured by* a lien on property . . . is a *secured claim* to the extent of the value of such creditor's interest in the estate's interest in such property." Thus, just because a creditor's claim is "secured by" property doesn't mean that they have a "wholly secured claim."¹⁰⁸ The secured portion of a creditor's claim is determined by the value of the creditor's interest in the property. The claim may or may not be a "secured claim," but it can still be a "claim secured by" a lien on property.

A debtor, pursuant to section 506(a), may divide a claim secured by a security interest only in the debtors' principal residence into an allowed secured claim and an allowed unsecured claim with the lien stripped on the unsecured claim only upon completion of the debtor's plan.¹⁰⁹

106. *In re Strober*, 136 B.R. 614, 619 (Bankr. E.D. N.Y. 1992).

107. *Id.*

108. *Id.* at 620.

109. See *In re Hart*, 923 F.2d 1410 (10th Cir. 1991); *Wilson v. Commonwealth Mortgage Corp.*, 895 F.2d 123 (3rd Cir. 1990); *In re Hougland*, 886 F.2d 1182 (9th Cir. 1989). Under Chapter 13 a debtor, exclusive of the trustee, has the rights and powers of a trustee under sections 363(b), (d), (e), (f), and (l); thus, is permitted to invoke section 506(a). 11 U.S.C. § 1303. But see 11 U.S.C. § 704, where under a case in Chapter 7, only a trustee can invoke section 506(a) for the benefit of the estate.

However, some courts disagree with this interpretation. The Eastern District of New York in *In re Strober* held that any plan that conforms to section 1322(b)(5)¹¹⁰ and affects any unsecured or secured claim is subject to the limitations imposed by section 1322(b)(2), and 1322(b)(2) prohibits the modification of the mortgage debt.¹¹¹ Section 1322(b)(5) calls for regular payments while the case is pending on unsecured claims equally with secured claims, provided the last payment on the claim is due after the plan is completed.¹¹² Thus, the *Strober* court ruled that such bifurcation could not be given the special protection offered by section 1322(b)(5), which provides for curing of any default within a reasonable time and maintenance of payments while the case is pending, due to the failure of the debtor to cure the existing default. However, in most cases allowing bifurcation, the debtor is merely curing the default only to the extent that such default, together with any unpaid principal balance, does not exceed the present value of the debtor's principal residence ignoring any excess.¹¹³

The *Strober* court also brought to life the issue of confirmation of the plan under section 1325(a)(5).¹¹⁴ A plan that fulfills the requirements set forth in section 1322(b)(5) will not be denied confirmation under section 1325(a)(5) because "cure" under section 1322(b)(5) is *not* a modification of the mortgagee's rights.¹¹⁵ However, pursuant to section 1325(a)(5), one of three conditions must be met in regards to allowed secured claims:

(A) the holder of such claim has accepted the plan; (B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and (ii) the value, as of the effective date of the plan, of property

110. This section provides for the curing of any default within a reasonable period of time and continuance of payments while the case is pending on any unsecured claim or secured claim upon which the last payment will be due after the date of the final payment as provided for under the plan.

111. 11 U.S.C. § 1322(b)(5) provides in full: "notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due."

112. *Id.* § 1322(b).

113. *In re Strober*, 136 B.R. 614, 623 (Bankr. E.D. N.Y. 1992).

114. *Id.* at 623. In determining whether a plan is confirmable, the court decides various issues: (1) whether the plan complies with the provisions provided for in chapter 13 and other applicable chapters; (2) whether the required fees and charges have been paid; (3) whether the plan was proposed in good faith; (4) whether the best interest of creditor's test is satisfied; (5) whether allowed secured claim holders which are provided for in the plan have either accepted the plan or if the holder of such claim retains the lien and the value of the property to be distributed under the plan is not less than the allowed amount of such claim or if the debtor has surrendered the property securing such claim to the holder; and (6) whether the debtor will be able to make all the payments under the plan. 11 U.S.C. § 1325(a).

115. *Strober*, 136 B.R. 623 (citing *Landmark Fin. Serv. v. Hall*, 918 F.2d 1150, 1154 (4th Cir. 1990)); see also 5 COLLIER ON BANKRUPTCY, § 1322.09[4] (15th ed. 1986).

to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or (C) the debtor surrenders the property securing such claim to such holder.¹¹⁶

The court stated that if the mortgagee's claim is allowed to be divided into a secured claim and unsecured claim and then the mortgagee refuses to accept the plan, the debtor must distribute under the plan to the mortgagee not less than the allowed amount of the secured portion of the divided claim if he or she wants to retain their home. If this is true, it could create difficulties for debtors due to the short life of plans under Chapter 13. They would be forced to pay off the current value of the their residence during the life of the plan which few debtors have the capability to do. However, the court failed to recognize that "property to be distributed under the plan" does not mean during the life of the plan. When a debtor provides for a secured claim in a Chapter 13 plan, the debtor provides for payment equal to the value of the claim with maintenance of regular monthly payments at the same interest rate and cures any arrearages during the life of the plan. Consequently, the plan may be confirmed pursuant to section 1325(b)(5) because the value of the claim is being provided for under the plan, and the secured claimant's rights are not being modified.

B. *Avoiding a Windfall*

In confirming a plan the debtor should not receive an undue windfall. Whenever a creditor's secured interest is frozen at a judicially determined value pursuant to section 506, the creditor will either (1) gain a bonus if the property's value depreciates from the time its value is judicially determined or (2) lose any benefit if the value of the property appreciates from that same time. Any increase will enure to the benefit of the debtor rather than the bankruptcy estate, while any decrease will enure to the creditor. This decrease or increase is referred to as a "windfall."¹¹⁷ Thus, in a Chapter 13, does a debtor get more than a fresh start if this windfall is allowed to occur?

The Bankruptcy Court for the Western District of Oklahoma in *In re Woodall*¹¹⁸ believed a windfall occurs.¹¹⁹ The *Woodall* court ruled

116. 11 U.S.C. § 1322(a)5).

117. *Dewsnup v. Timm*, 112 S. Ct. 773, 778 (1992) (holding that in a Chapter 7 the lien stays with the real property until the foreclosure, because this is what the parties originally bargained for and the voidness language in section 522(d) applies only to the security aspect of the lien and then only to the "real deficiency in the security"); see *In re Strober*, 136 B.R. 614, 619 (Bankr. E.D. N.Y. 1992).

118. 123 B.R. 95 (Bankr. W.D. Okla. 1990).

119. *Id.* at 97.

that the debtor should not be allowed to reap the benefit of their discharged "unsecured" claim if the value of the property rises between the time of the judicial determination and the foreclosure sale.¹²⁰ However, in *Dewsnup*, the dissent explained that the feared "windfall" to the debtor is prevented pursuant to section 551¹²¹ which preserves liens that are voided under section 506(d) or through other provisions of the Code for "the benefit of the estate" (i.e., for the benefit of the general unsecured creditors).¹²² Therefore, a "windfall" to the debtor is avoided.

C. *Passing the Best Interest of Creditors Test*

For a plan to be confirmed by a bankruptcy court it must meet the best interest of creditors test.¹²³ The goal of section 1325(a)(4) is to put the creditor in the same position that he would have been in if the debtor's estate had been liquidated under a Chapter 7; that is, does the plan pass the best interest of creditors test. Thus, the court must make a hypothetical determination as to the net amount that would be available to unsecured creditors in a Chapter 7 liquidation.¹²⁴ The bankruptcy court must determine whether distribution of the funds were made in accordance with section 726(a) (i.e.: payments to section 507 claimants, payments to allowed timely filed, unsecured claims; payments to unsecured claims filed late, etc.), the creditors would receive as much as they would receive in a Chapter 7? If the answer is yes, the Chapter 13 plan is confirmable. It appears that if a claim secured by a home mortgage is allowed to be lien stripped in a Chapter 13, the creditor would receive over time an amount equal to only the present market value of

120. *Id.*

121. 11 U.S.C. § 551 provides in part: "Any lien void under § 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate." *Id.* This section prevents junior lien holders from improving their position at the expense of the estate when a senior lien is avoided.

122. *Dewsnup*, 112 S. Ct. at 781 n.1. See Tracy Springer, Note, *An Individual Debtor's Right to Avoid Liens Under Section 506(d) of the Bankruptcy Code*, 12 CARDOZO L. REV. 263, 280-281 (1990); see also *In re Ward*, 42 B.R. 946, 952-53 (Bankr. M.D. Tenn. 1984).

123. 11 U.S.C. section 1325(a)(4) provides:

(a) Except as provided in subsection (b), the court shall confirm a plan if — (4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date.

Id.; see *Johnson v. Home State Bank*, 111 S. Ct. 2150 (1991); *Education Assistance Corp. v. Zellner*, 827 F.2d. 1222, 1224 (8th Cir. 1987); *In re Rogers*, 65 B.R. 1018, 1020 (Bankr. E.D. Mich. 1986).

124. *In re Hieb*, 88 B.R. 1019, 1021 (Bankr. D. S.D. 1988).

the property which is less than he would receive in a Chapter 7 liquidation case. Thus, the plan would be denied confirmation because it fails to satisfy the best interest of creditors test.

However, the Bankruptcy Court for the Western District of Oklahoma viewed this problem differently. In *In re Ward*, the Chapter 13 plan was confirmed. The language in section 1322(a)(4), the "best interest of creditors test," requires that the present value of amounts to be distributed under a Chapter 13 plan must be no less than the amount that the creditor would receive on such claim in a Chapter 7.¹²⁵ Thus, in a Chapter 7 case, the creditor holding a lien on the debtors' home would either receive (1) the present market value of the property after it is liquidated by or on behalf of the trustee, or (2) its property back and would have an unsecured claim for any deficiency that may result after sale of the property. The debtor, in most cases, would therefore receive no dividend on its unsecured claim in this hypothetical Chapter 7 liquidation. But in the same scenario under Chapter 13, even though the creditor's lien on the undersecured property may be stripped, its remaining unsecured claim would participate in any payments to unsecured creditors under the Chapter 13 plan, resulting in the creditor receiving more than it would have under the hypothetical Chapter 7 case, satisfying the test.

VI. RAMIFICATIONS OF LIEN STRIPPING IN CHAPTER 13

In a Chapter 13 the ramifications once a lien has been stripped from an undersecured claim can be far reaching and serious. While the ability to strip the lien may have an advantageous effect for some parties, it can have an equally detrimental effect on other interested parties. The following section will address the effects of lien stripping upon: (A) the debtor; (B) the creditor and the home mortgage industry; and (C) the attorney.

A. *Affects On the Debtor*

There is doubt that the effects of lien stripping in Chapter 13 upon a debtor are very advantageous. The debtor is not only able to drag out any arrearages through the Chapter 13 plan over three to five years but is also able to reduce the length of his mortgage by several years. This enables the debtor to keep his house by paying only the fair market value

125. *In re Ward*, No. BK-91-1868-LN at 14-16 (Bankr. W.D. Okla. July 12, 1991).

and whatever dividend the mortgage holder will receive as an undersecured creditor, allowing the debtor to retain the original amount borrowed, which could be substantially greater than the amount he or she is actually going to repay the creditor. Even though the debtor is not able to modify the interest rate or the amount of the payments, he or she does receive a benefit by reducing the length of time in making mortgage payments. Depending on the amount his or her house has decreased in value, this could result in several years being cut off of his or her loan, resulting in a reduced amount being paid in total principal and interest. Thus, although there is some doubt that lien stripping is beneficial in a Chapter 13, great advantages are still evident for the debtor.

B. *Affects On the Creditors*

On the other hand, the creditors who hold the mortgages of these debtors suffer a substantial detriment. Creditors including the real estate mortgage industry have long spoken against the debtor's ability to lien strip. During the 95th Congressional hearing on both the Senate and the House bills regarding lien stripping, testimony was given against lien stripping.¹²⁶ The testimony reflected that bankruptcy proceedings, such as those involving lien stripping, have an adverse affect on the real estate lending community. The effect is the dramatic decrease in funding for new mortgages. Lien stripping causes the lenders to be extremely careful and conservative in making loans to individuals whose financial resources are questionably weak.¹²⁷

It is not difficult to see why creditors would be against lien stripping. They initially enter into a bargain with the debtor on agreed terms to lend a specific amount of money to be repaid over a specified period of time at a certain rate of interest. Whenever a debtor files for bankruptcy under chapter 13 and commences to lien strip pursuant to section 506(a), the creditor has their lien stripped from the debtor's property to the extent of the excess of the fair market value over the amount of the debt. The creditor, now holding an unsecured claim for the deficiency, stands in line with the rest of the unsecured creditors for the remaining balance.

Even though these circumstance may seem harsh, in reality the creditor is receiving more than he would have if the debtor had filed under Chapter 7 by virtue of any dividends he may receive on his unsecured claim. Outside of bankruptcy, if the debtor would have been foreclosed, he would have received the same as he would have under

126. *In re Strober*, 136 B.R. 614, 621 (Bankr. E.D. N.Y. 1992).

127. *Id.*

chapter 7; the fair market value of the property. At least in Chapter 13, the creditor will still retain its lien for the fair market value of the property and will receive payments on its unsecured claim during the term of the plan.

However, one possible disadvantage is that under a Chapter 7, if the debtor does not reaffirm on the mortgage and instead relinquishes possession back to the creditor, the creditor has the choice of waiting until a point in time to sell the property at which the market value may be higher. This allows the creditor to wait and hopefully recover the full debt if the real estate market returns to normal conditions and the value of the property increases. Under a Chapter 13 strip down, the creditor is not afforded this advantage and has its secured claim determined at the time when the court determines its value.¹²⁸

C. *Affects On Counsel*

The most dramatic effect on counsel is the time involved in bringing the motion or adversary proceeding to avoid the lien on the mortgage. Usually, a debtor's attorney is paid a flat fee in a sum certain for filing the Chapter 13 plan. A portion of this fee is paid directly to the attorney before filing the plan with the remainder of the fees paid through the plan. However, in the filing of an adversary proceeding or motion to strip a lien on a home mortgage, the attorney's fees could be substantially increased. This would require an amendment to the plan providing for payment of these additional attorney fees. Because these attorney fees

128. Some jurisdictions have local rules which specify that a motion for a section 506 hearing must be brought within 15 days from the date of the meeting of creditors. *Agricredit Corp. v. Harrison*, (*In re Harrison*) No. 92-5068 at 1 (10th Cir. March 3, 1993). An attorney should always consult the local rules in his or her jurisdiction in determining whether such a limitation exists.

Other possible problems, such as case dismissal or case conversion, plague the creditor by forcing him to incur more legal fees due to the increased litigation and costs involved. Upon dismissal of a Chapter 13 case, 11 U.S.C. section 349(b)(1)(C) provides that "[u]nless 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." *Id.* This puts the debtor back in the same shoes as before filing for bankruptcy regarding his mortgage and lien. The stay is removed upon dismissal and the creditor can pursue foreclosure action against the debtor if he so chooses.

However, if the Chapter 13 case is converted to a Chapter 7 case under 11 U.S.C. section 348, the implications can be much more complicated. Unlike the dismissal provision, 11 U.S.C. section 348 provides no guidance as to the voided lien. Some very real concerns on practitioners minds' are whether the mortgage goes back to its prior amount, or does the mortgage remain the same due to the order which was granted in the Chapter 13 case, or does it make any difference if the debtor converts at the end of one month, two months or four years?

The creditor should either (1) look to the language of the order itself because the judge may have specifically dealt with conversion in the order or (2) the creditor should file a motion with the court asking for the bifurcation order to be vacated due to the precedent established by the United States Supreme Court in *Dewsnup*, which disallowed lien stripping in Chapter 7. This insures the creditor the protection he is warranted in a Chapter 7 bankruptcy case.

are paid from the debtor's post-petition income through the plan, this takes away money from the unsecured creditors. This could create difficulties in formulating a plan that the court will confirm. The additional hours that the attorney will expend along with the extra costs should be considered before the debtor's attorney commences to lien strip.

Another factor to be considered is the additional amount of time that could be involved. The debtor's attorney can expect that if a debtor is successful in stripping a lien on his home mortgage, the order will be appealed by the creditor. This involves not only more of the attorney's time but more of the debtor's money.¹²⁹

VII. CONCLUSION

Lien stripping involves an undersecured claim that has been divided into two parts: (1) a secured claim in the amount of the current value or judicially determined value of the collateral and (2) an unsecured claim for the difference between the determined value and the amount of the debt. The lien is thus stripped from the unsecured claim and continues to attach to the secured claim.

In *Dewsnup* the Supreme Court ruled that a Chapter 7 debtor could not invoke section 506(a) to bifurcate a secured claim into a secured claim for the fair market value and an unsecured claim on the deficiency and then use section 506(d) to avoid the lien on the unsecured claim. However, in a Chapter 13 the debtor may invoke section 506(a) to bifurcate the claim and strip the lien on the unsecured portion of the claim. Due to the language contained in Section 1322(b)(2), this procedure becomes questionable when the claim is one that is secured by a home mortgage. Some jurisdictions believe that because the claim is an "allowed secured claim," revaluing the originally filed secured claim pursuant to section 506(a) and stripping the lien from the unsecured portion is a modification that is prohibited by section 1322(b)(2). These jurisdictions contend that the claim which is secured by the home mortgage is the original claim and not the value of the claim after invoking section 506(a). Thus, the lien continues to attach to the original amount of the claim and not just the fair market value of the claim.

However, to give this broad new meaning to the Code would destroy

129. Attorneys in Oklahoma should note that Congress may turn the tables when Congressman Mike Synar and the House of Representatives announce their own bankruptcy reform measure soon. It contains a clause which bars Chapter 13 cramdowns which involve a debtor's principal residence. This bill should be enacted some time this year when Congress reconvenes. James S. Byrne, *Appeals Court Hands Lenders Another Cramdown Defeat*, AM. BANKER-BOND BUYER, May 25, 1992, at 1.

any predictability of how it was designed to work. Even though a claim is allowed, it can still be divided into two claims: one secured in the amount of the judicially determined value of the collateral and one unsecured for the deficiency. Since the debtor continues to make the same mortgage payments and does not attempt to change the amount of the payment or interest rate, the creditor who holds a claim secured by a home mortgage is not having its rights modified. The unsecured claim is the only claim being modified which is allowed in a Chapter 13 plan as long as the debtor completes the plan. But, the plan may still not be confirmable if the plan fails to meet the best interest of creditors test.

Thus, with the embers barely smoldering from the United States Supreme Court's decision in *Dewsnup*, the cloud of smoke still remains as to the ability to lien strip in Chapter 13 or any other chapter in bankruptcy.

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