# Shedding the Pounds of Debt: Mortgage Lien-Stripping in Chapters 7 and 11

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# LIEN STRIPPING IN CHAPTER 7

## I. Stripping Junior Mortgages under § 506(d).

Resolving a circuit split, the Supreme Court recently reaffirmed and extended its holding in *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L. Ed. 2d 903 (1992) that junior mortgages cannot be "stripped off" under 11 U.S.C. § 506(d) in cases pending under Chapter 7 of the Bankruptcy Code. *Bank of Am., N.A. v. Caulkett*, --- U.S. ---, 135 S. Ct. 1995 (June 1, 2015).

### A. The statutory language: 11 U.S.C. § 506(a)(1) and (d).

> (a) (1) **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 i**s 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.
>
> . . .
>
> (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(b)(5) or 502 (e) of this title; or
>
> (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

11 U.S.C. § 506(a)(1) and (d) (emphasis supplied).

### B. The landscape prior to *Caulkett*: *Dewsnup* on partially secured liens and the circuit split on wholly unsecured liens.

#### 1. *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L. Ed. 2d 903 (1992).

In *Dewsnup,* the Supreme Court considered whether partially secured junior mortgages could be "stripped down" in Chapter 7 bankruptcy cases under 11 U.S.C. §

506(d). *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L. Ed. 2d 903 (1992). Section 506(a) bifurcates "an allowed claim of a creditor secured by a lien on property in which the estate has an interest" into two parts: a secured claim up to the value of the collateral and an unsecured claim for the debt owed in excess of the value of the collateral. 11 U.S.C. § 506(a). Section 506(d), in turn, voids any lien that is "not an allowed secured claim." *Id.* § 506(d). The Debtor in *Dewsnup* urged the Court to read § 506(a) and (d) in conjunction with one another: "§ 506(a) bifurcates classes of claims allowed under § 502 into secured claims and unsecured claims; any portion of an allowed claim deemed to be unsecured under § 506(a) is not an 'allowed secured claim' within the lien-voiding scope of § 506(d)." *Dewsnup,* 502 U.S. 414-15.

The Supreme Court disagreed with Debtor, finding that § 506(d) was ambiguous and that the term "allowed secured claim" need not take the same meaning in § 506(d) as in § 506(a). *Id.* at 416. The Court adopted the statutory construction wherein "the words ["allowed secured claim" in § 506(d)] should be read term-by-term to refer to any claim that is, first, allowed, and, second, secured. Because there is no question that the claim at issue here has been "allowed" pursuant to § 502 of the Code and is secured by a lien with recourse to the underlying collateral, it does not come within the scope of § 506(d), which voids only liens corresponding to claims that have not been allowed and secured." *Id.* at 416.

In reaching its holding that "§ 506(d) does not allow petitioner to 'strip down' respondents' lien, because respondents' claim is secured by a lien and has been fully allowed pursuant to § 502," the Supreme Court also relied on policy considerations and the lack of any evidence of Congressional intent to alter the pre-Bankruptcy Code rule "that liens pass through bankruptcy unaffected." *Id.* at 417.

2. **The Circuit split with respect to wholly underwater mortgages.**

After *Dewsnup,* most lower courts extended its holding to deny attempts by debtors to strip off wholly underwater junior liens, including the Fourth, Sixth and Seventh Circuit Courts of Appeal. *Ryan v. Homecomings Financial Network*, 253 F. 3d 778 (4th Cir. 2001); *In re Talbert*, 344 F. 3d 555 (6th Cir. 2003); *Palomar v. First American Bank*, 722 F. 3d 992 (7th Cir. 2013); *see also Wachovia Mortgage v. Smoot*, 478 B.R. 555 (E.D.N.Y. 2012); *In re Cook*, 449 B.R. 664 (D.N.J. 2011); *In re Bowman*, 304 B.R. 166 (Bankr. M.D. Pa. 2003).

However, the Eleventh Circuit viewed *Dewsnup's* holding as limited to its facts – where a debtor sought to strip down a *partially* secured lien – and continued to allow Chapter 7 debtors to strip off wholly underwater liens based on prior Eleventh Circuit precedent. *See, e.g., McNeal v. GMAC Mortgage, LLC*, 735 F.3d 1263 (11th Cir. 2012).

**C. *Bank of Am., N.A. v. Caulkett*, --- U.S. ---, 135 S. Ct. 1995 (June 1, 2015).**

1. Facts – In each of the two consolidated cases, the debtor had two mortgage liens on his house. The bank held the junior mortgage lien, which was "wholly underwater" because the amount owed on the senior mortgage lien was greater than the house's market value. *Caulkett*, 135 S. Ct. at 1998.
2. Procedural History – The debtor filed for bankruptcy under Chapter 7 and moved to void – or "strip off" – the second mortgage under § 506(d). The Bankruptcy Court for the Middle District of Florida granted the motion and the District Court and Court of Appeals for the Eleventh Circuit affirmed. *Id.*

3. Holding – Extending the holding in *Dewsnup* to wholly underwater liens: "a debtor in a Chapter 7 bankruptcy proceeding may not void a junior mortgage lien under § 506(d) when the debt owed on a senior mortgage lien exceeds the current value of the collateral." *Id.* at 2001.
4. Rationale – Nothing in the statute, or *Dewsnup's* interpretation of the term "allowed secured claim" in § 506(d) (first, allowed pursuant to § 502, and, second, secured by a lien with recourse to the collateral) makes a distinction between liens that are partially or wholly underwater. *Id.* at 2000. Moreover, adopting a different rule for partially and wholly unsecured claims "would not vindicate § 506(d)'s original meaning, and it would leave an odd statutory framework in its place. Under the debtors' approach, if a court valued the collateral at one dollar more than the amount of a senior lien, the debtor could not strip down a junior lien under *Dewsnup*, but if it valued the property at one dollar less, the debtor could strip off the entire junior lien." *Id.* at 2001.
5. The Footnote – "From its inception, *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992), has been the target of criticism. See, *e.g.*, *id.,* at 420–436, 112 S.Ct. 773 (SCALIA, J., dissenting); *In re Woolsey*, 696 F.3d 1266, 1273–1274, 1278 (C.A. 10 2012); *In re Dever*, 164 B.R. 132, 138, 145 (Bkrtcy. Ct. C.D. Cal. 1994); Carlson, Bifurcation of Undersecured Claims in Bankruptcy, 70 Am. Bankr. L. J. 1, 12–20 (1996); Ponoroff & Knippenberg, The Immovable Object Versus the Irresistible Force: Rethinking the Relationship Between

Secured Credit and Bankruptcy Policy, 95 Mich. L. Rev. 2234, 2305–2307 (1997); see also *Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 463, and n. 3, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999) (THOMAS, J., concurring in judgment) (collecting cases and observing that "[t]he methodological confusion created by *Dewsnup* has enshrouded both the Courts of Appeals and ... Bankruptcy Courts"). Despite this criticism, the debtors have repeatedly insisted that they are not asking us to overrule *Dewsnup*."

6. 9 – 0 ? – All of the justices joined in the opinion. But Justices Kennedy, Breyer and Sotomayor did not join the footnote.

## II. Other Lien Stripping under § 506(d).

In *Caulkett*, the Supreme Court noted that the *Dewsnup* definition of "allowed secured claim" limited the scope of § 506(d); its "function reduced to 'voiding a lien whenever a claim secured by the lien itself has not been allowed.'" *Caulkett*, 135 S. Ct. at 1999 (quoting *Dewsnup*, 502 U.S. at 416, 112 S.Ct. 773).

For the most part, a secured claim that has been disallowed falls within the scope of § 506(d) (with the exception of certain disallowed claims for unmatured, non-dischargeable debts under§ 502(b)(5) and reimbursement or contribution under § 502(e)). But § 506(d) does not refer to *disallowed* secured claims. Rather, it refers to a presumably broader category of *not allowed* secured claims, so long as the claim is not allowed for a reason other than failure to file proof of claim. 11 U.S.C. § 506(d)(2).

What falls within this category of not allowed (as opposed to disallowed) claims? In a Chapter 13 case, the District Court for the Western District of Virginia applied the voiding

provision of § 506(d) to liens of creditors that filed unsecured claims, but not secured claims. *White v. FIA Card Services,* 494 B.R. 227 (W.D. Va. 2012). The Court found that by filing an unsecured proof of claim, the creditors elected for treatment as unsecured creditors, rather than secured creditors. *Id.* at 230 ("Here, the secured Creditors did not fail to file a proof of a claim. Instead, the Creditors chose to participate in the bankruptcy proceedings, albeit through the filing of an unsecured proof of claim."). Accordingly, the Court held that the creditors' liens should be avoided under § 506(d). *Id.* at 231. Although a Chapter 13 case, the rationale underlying this decision should apply equally to Chapter 7 and 11 cases. Notably, the Court questioned the propriety of a secured creditor filing an unsecured but not a secured claim: "the intentional filing of an unsecured claim by the creditor which in fact has a fully secured claim and is being so treated in the Plan may violate the provisions of Federal Rule of Bankruptcy Procedure 9011(b)(1), (2) and (4) and subject the creditor to possible sanctions." *Id.* (quoting *In re Burnette*, No. 11–71622, at 2 (Bankr. W.D. Va. November 18, 2011)).

## III. Lien Stripping and Avoidance under §§ 522 and 544.

"Lien stripping" under § 506(d) is a form of lien avoidance. When § 506(d) is not available to void a lien, a debtor or trustee should consider other options for lien avoidance under the Bankruptcy Code. Judgment liens, non-possessory, non-purchase money security interests, and liens that are defective under state law can be avoided in certain circumstances under §§ 522 and 544 of the Bankruptcy Code.

### A. Section 522(f) – avoidance of certain liens in exempt property.

Section 522(f) of the Bankruptcy Code provides that a debtor may avoid a judicial lien or a non-possessory, non-purchase-money security interest in certain household goods, tools of

the trade and health aids, to the extent that the lien or security interest impairs the debtor's exemption.

1. **The statutory provision: 11 U.S.C. § 522(f)(1) and (2).**

> (f) (1) Notwithstanding any waiver of exemptions but subject to paragraph (3), **the debtor may avoid the fixing of a lien on an interest** of the debtor in property **to the extent that such lien impairs an exemption** to which the debtor would have been entitled under subsection (b) of this section, if such lien is—
>
> (A) **a judicial lien**, other than a judicial lien that secures a debt of a kind that is specified in section 523 (a)(5); or
>
> (B) **a nonpossessory, nonpurchase-money security interest** in any—
>
> (i) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
>
> (ii) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
>
> (iii) professionally prescribed health aids for the debtor or a dependent of the debtor.
>
> (2)
>
> (A) For the purposes of this subsection, **a lien shall be considered to impair an exemption to the extent that the sum of**—
>
> (i) the lien;
>
> (ii) all other liens on the property; and
>
> (iii) the amount of the exemption that the debtor could claim if there were no liens on the property;
>
> **exceeds the value that the debtor's interest in the property would have in the absence of any liens**.
>
> (B) In the case of a property subject to more than 1 lien, a lien that has been avoided shall not be considered in making the calculation under subparagraph (A) with respect to other liens.

11 U.S.C. § 522(f)(1) and (2) (emphasis supplied).

2. **Calculating impairment of an exemption under § 522(f).**

A lien or interest is avoidable under § 522(f) to the extent that it impairs the debtor's exemption. "In calculating the extent of avoidance under § 522(f)(2)(A), the bankruptcy court adds the exemptions permitted on the subject property, any consensual liens encumbering the property (usually mortgages), and any other liens encumbering the property (judicial liens in this case). If that sum is more than the value assigned under § 522(a)(2), the difference is removed from the encumbering judicial liens (i.e., the difference is "avoided")." *Prangley v. Cokinos*, 509 B.R. 822, 831 (D. Md. 2014). Figure 1, below, illustrates the operation of § 522(f)(2).

**Figure 1**

| | **Target Lien (A)** | **Mortgage (B)** | **Exemption (C)** | **Property Value (D)** | **Impairment [(A)+(B)+(C)] – (D)** | **Target Lien Avoidable?** |
|---|---|---|---|---|---|---|
| **1** | **$20,000** | $100,000 | $5,000 | $100,000 | $125,000-$100,000 = **$25,000** | Yes, fully |
| **2** | **$20,000** | $90,000 | $5,000 | $100,000 | $115,000 -$100,000 = **$15,000** | Yes, partially* |
| **3** | **$10,000** | $80,000 | $5,000 | $100,000 | $95,000 - $100,000 = **-$5,000** | No |

*To the extent it impairs the exemption, or $15,000. The remaining $5,000 of the lien is not avoidable.

In the first scenario in Figure 1, the consensual mortgage lien equals the value of the property. Despite the lack of equity in the property, the debtor can avoid the target lien under § 522(f)(2)'s definition of impairment. *See In re Jakubowski*, 198 B.R. 262, 264 (Bankr. N.D. Ohio 1996) ("Because the amount of the impairment is greater than the amount of the lien sought to be avoided, the lien is avoided in full.").

In the second scenario in Figure 1, the consensual mortgage lien is less than the value of the property and, in the absence of the target lien, the debtor could claim her entire exemption. The sum under § 522(f)(2) of the liens and exemption exceeds the value of the property by

$15,000. Accordingly, $15,000 of the $20,000 target lien can be avoided. The lienholder will retain a lien against the property for $5,000. *See Prangley,* 509 B.R. at 831.

In the third scenario in Figure 1, the target lien, consensual mortgage lien and exemption are less than the value of the property. The exemption is not impaired; accordingly, the target lien is not avoidable.

3. **Other considerations when bringing § 522(f) claims.**

The debtor need not actually claim the exemption to void a lien under § 522(f). *See Botkin v. Dupont Cmty. Credit Union*, 650 F.3d 396, 400 (4th Cir. 2011) ("[W]e conclude that the Code plainly provides that debtors need not claim an exemption as a precondition of avoiding a lien that the debtor contends impairs the exemption.").

Unlike most other lien avoidance actions, which require the commencement of an adversary proceeding under Bankruptcy Rule 7001, actions under § 522(f) are contested matters and may be brought by motion under Bankruptcy Rule 9014. *See* Fed. R. Bankr. P. 4003.

**B. Sections 544(a) and 522(h) – avoidance of defective liens.**

Section 544(a) of the Bankruptcy Code, the so-called "strong arm powers," give the trustee the avoidance powers of three hypothetical parties under state or other applicable law – a judicial lien creditor; a creditor holding an unsatisfied execution against the debtor; and a bona fide purchaser of real property. Section 544(a), in conjunction with applicable state law, is often used to avoid unrecorded or otherwise defective liens and interests in property. Under 522(h), individual debtors under any chapter of the Bankruptcy Code may exercise § 544(a) powers to avoid involuntary transfers if the debtor could have exempted the property and if the trustee does not exercise such power.

1. **Lien avoidance under § 544(a).**

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> (1) **a creditor** that extends credit to the debtor at the time of the commencement of the case, and **that obtains**, at such time and with respect to such credit, **a judicial lien** on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
>
> (2) **a creditor** that extends credit to the debtor at the time of the commencement of the case, and **obtains**, at such time and with respect to such credit, **an execution against the debtor that is returned unsatisfied at such time**, whether or not such a creditor exists; or
>
> (3) **a bona fide purchaser of real property**, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

11 U.S.C. § 544(a) (emphasis supplied).

Section 544(a) looks to a single point in time – "the commencement of the case" – to determine the extent of the trustee's powers under applicable state law. *Highland Constr. Mgmt. Servs., LP v. Wells Fargo, N.A. (In re Highland Constr. Mgmt. Servs., LP),* 497 B.R. 829, 843 (Bankr. E.D. Va. 2013) ("The debtor cannot avoid the secured creditor's security interest under § 544(a) because as of the date of the filing of the petition, his lien was properly perfected. A § 544(a) avoidance action looks to that point in time, not a later lapse."). Typically, trustees use the powers of a judicial lien creditor and an unsatisfied execution creditor to avoid liens in, or transfers of personal property. The hypothetical bona fide purchaser powers can only be applied to avoid a lien in, or transfer of real property.

### 2. Lien avoidance under § 522(h).

Individual debtors may exercise § 544 avoidance powers under certain circumstances. 11 U.S.C. § 522(h). Courts have articulated a five-part test "(1) the transfer was **not a voluntary transfer** of property by the debtor; (2) the debtor **did not conceal** the property; (3) the **trustee**

**did not attempt to avoid** the transfer; (4) the debtor seeks to exercise an avoidance power usually used by the trustee, listed within § 522(h) [which includes § 544] ; and (5) the transferred property is of a kind that the debtor **would have been able to exempt** from the estate if the trustee had avoided the transfer under one of the provisions in § 522(g)." *Matter of Hamilton*, 125 F.3d 292, 297 (5th Cir. 1997); *See also In re Brugueras,* No. 11-17803-BFK, 2012 WL 6055603, at *6 (Bankr. E.D. Va. 2012)("the failure to actually claim the exemption is not fatal to the Plaintiff's avoidance claim").

### IV. Does Conversion to Chapter 7 Reinstate a Lien Avoided in Chapter 11?

As discussed subsequently in this outline, certain liens can be avoided in cases under Chapter 11 that cannot be avoided in cases under Chapter 7. This raises the question of whether a conversion to Chapter 7 reinstates a lien that was avoided in a debtor's Chapter 11 case, but was not avoidable in the Chapter 7 case. In considering this issue, the Court of Appeals for the Fifth Circuit answered "no." *Elixir Industries, Inc. v. City Bank & Trust Co. (In re Ahern Enterprises, Inc.)*, 507 F.3d 817 (5th Cir. 2007) ("We hold that confirmation of a Chapter 11 plan voids liens not preserved by the plan, provided that the plan dealt with the property to which they attach and the lien holder participates in the reorganization."); *see also In re Regional Bldg. Systems, Inc.*, 254 F.3d 528, 533 (4th Cir. 2001) (a plan voids liens not specifically preserved).

## LIEN STRIPPING IN CHAPTER 11

### V. Chapter 11

Unlike Chapter 7, and like Chapter 13, Chapter 11 has specific provisions that allow the debtor to modify a mortgage lien. *See, e.g.,* 11 U.S.C. § 1123 ("Contents of plan"), § 1124 ("Impairment of claims or interests"), § 1129 ("Confirmation of plan"), and § 1141(c) ("Effect of confirmation") (free and clear provision). *And see In re Johnson*, 386 B.R. 171, 177 (Bankr.

W.D. Pa. 2008) ("lien stripping is a fundamental aspect of reorganization proceedings"), *aff'd*, 415 B.R. 159, 169-70 (W.D. Pa. 2009). In addition, 11 U.S.C. § 103 makes Chapter 5 with all its avoiding powers applicable to Chapter 11 cases. *See also* 11 U.S.C. § 1111 ("Claims and interests") (enhancing the options available to secured creditors). Apart from the sure and specific grant of authority in Chapter 11 to modify the liens of secured creditors, the long-standing common law rationale in *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992) for not allowing lien avoidance in Chapter 7 does not apply in Chapter 11. *In re Heritage Highgate, Inc.*, 679 F.3d 132, 144-45 (3d Cir. 2012).

Under Chapter 7, the debtor's relief is discharge from personal liability on the underlying secured mortgage debt, including any unsecured deficiency, for which the creditor receives nothing in return. Leaving the lien on the property gives the creditor at least part of its bargained-for benefit under the prepetition contract and allows any increase in the value of the property to inure to the benefit of the creditor and not the debtor. *Dewsnup*, 502 U.S. at 417, citing *Long v. Bullard*, 117 U.S. 617 (1886), *Johnson v. Home State Bank*, 501 U.S. 78, 84-85 (1991); *and see* H.R. Rep. No. 95-595, *361; 1978 U.S.C.C.A.N. 5963, *6317.

Under Chapter 11, by contrast, the creditor receives something of value in exchange for the stripping (whole or partial) of its lien, generally periodic payments under a plan of reorganization. *In re Heritage Highgate, Inc.*, 679 F.3d 132, 144-45 (3d Cir. 2012); *In re Johnson*, 386 B.R. 171, 177 (Bankr. W.D. Pa. 2008), *aff'd*, 415 B.R. 159, 169-70 (W.D. Pa. 2009) (affirming that a statutory lien of Internal Revenue Service may be stripped from collateral which has no equity for the lien); *In re Bowen*, 174 B.R. 840, 855 (Bankr. S.D. Ga. 1994); *In re Dever*, 164 B.R. 132, 138-39 (Bankr. C.D. Calif. 1994). The Courts in *Johnson, Dever* and *Bowen* refuted the argument put forth by other Courts that *Dewsnup*, by operation of 11 U.S.C. §

506(d) through 11 U.S.C. § 103 in Chapter 11 cases, prohibits lien-stripping, notwithstanding clear statutory mandates in the Code to the contrary. *In re Johnson*, 386 B.R. at 177 and 415 B.R. at 167-69. *Cf. Taffi v. U.S.,* 144 B.R. 105 (Bankr. C.D. Calif. 1992) (case history omitted).

**A. 11 U.S.C. § 1123 Contents of plan.**

11 U.S.C. § 1123 ("Contents of plan") contains both mandatory and permissive subsections for treating liens. 11 U.S.C. § 1123(a) requires:

> (a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall—
>
> (5) provide adequate means for the plan's implementation, such as— . . .
>
> (E) *satisfaction or modification of any lien*; . . .
>
> (G) curing or waiving any default.

11 U.S.C. § 1123(a) (emphasis supplied). 11 U.S.C. § 1123(b) allows the following content in a plan:

> (b) Subject to subsection (a) of this section, a plan may—
>
> (1) impair or leave unimpaired any class of claims, secured or unsecured, or of interests; . . .
>
> (5) *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.

11 U.S.C. § 1123(b) (emphasis supplied). *See In re Berkebile*, 444 B.R 326, 330, 335 (Bankr. W.D. Pa. 2011) (an individual Chapter 11 debtor may use 11 U.S.C. §§ 506(a) and (d) and 1123(b) to file an action to bifurcate and partially to strip an IRS lien secured by real property). The anti-modification provision in 11 U.S.C. § 1123(a), as in 11 U.S.C. § 1322(b)(2) in Chapter 13, prohibits the modification of a secured claim for which the only collateral is the debtor's residence. *See In re Graham*, 506 B.R. 745, 749-50 (Bankr. W.D. Mich. 2014) (debtors'

guaranty of a business debt for which the guaranty was secured only by a mortgage on their residence was protected by the anti-modification provision of 11 U.S.C. § 1123(b)(5) and not subject to strip off or cramdown; even though other elements of the business loan were secured by other collateral, the guaranty was subject to separate enforcement and therefore "secured only" by the residence). Other types of secured claims may, however, be modified under the express provisions of the Code cited above and below, including 11 U.S.C. § 1129(a) and (b).

**B. 11 U.S.C. § 1124 Impairment of claims or interests.**

11 U.S.C. § 1124 ("Impairment of claims or interests") at 11 U.S.C. § 1124(2) establishes how much a debtor may modify a creditor's rights without being deemed to have impaired the creditor's claim:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or
>
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
>
> (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;
>
> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
>
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;
>
> (D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section

> 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and
>
> (E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

11 U.S.C. § 1124. That the modifications under 11 U.S.C. § 1124(2) do not constitute impairment is important because an unimpaired creditor is presumed to have accepted the plan and is not entitled to vote (but may be entitled to object if it is individually harmed under the "best interest" test of 1129(a)(7)). *See* 11 U.S.C. §§ 1127(f) and 1129(a)(8). *In re G.L. Bryan Inv., Inc.*, 340 B.R. 386, 389-90, n.3 (Bankr. D. Colo. 2006); *In re Central European Indus. Dev. Co., LLC*, 288 B.R. 572, 577 n.2 (Bankr. N.D. Calif. 2003).

**C. 11 U.S.C. § 1129(a) Confirmation of plan.**

11 U.S.C. §§ 1123 and 1124 having established the contents of the plan, the ordinary confirmation statute, 11 U.S.C. § 1129(a), addresses secured claims in a peripheral way:

> (a) The court shall confirm a plan only if all of the following requirements are met:
>
> (7) With respect to each impaired class of claims or interests—
>
> (A) each holder of a claim or interest of such class--
> (i) has accepted the plan; or
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or
>
> (B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims. . . .

11 U.S.C. § 1129(a).

If the plan proponent is required to seek confirmation by cramdown under 11 U.S.C. 1129(b), then confirmability with respect to a secured claim is measured by retention of the lien, transfer of the lien to sale proceeds, or "realization . . . of the indubitable equivalent" of the secured claimant's claim:

> (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.
>
> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) With respect to a class of secured claims, the plan provides--
> (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
>
> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
>
> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.

11 U.S.C. § 1129(b). The 10th Circuit B.A.P. described these three allowed treatments of a secured creditor in a cramdown confirmation as:

> (1) "writ[ing] a new loan for full payment at a market rate of interest secured by creditor's prepetition collateral";
> (2) "sell[ing] the creditor's collateral free and clear of the lien, so long as the lien attaches to all net proceeds of the sale"; or

> (3) "alter[ing] the rights of the secured creditor if, and only if, the creditor will receive the 'indubitable equivalent' of its claim."

*In re Investment Co. of the Southwest*, 341 B.R. 298, 318 (B.A.P. 10th Cir. 2006). The "indubitable equivalent" is substituted collateral assessed for both (1) value and (2) risk to "determine whether the new collateral is sufficiently 'safe' and 'completely compensatory' to meet the requirement of 11 U.S.C. § 1129(b)(2)(A)(iii)." *Id.* at 319 (internal citations omitted). Courts do not allow debtors to evade the lien-retention provision of § 1129(b)(2)(A)(i) or the lien-attachment provision of § 1129(b)(A)(ii) by seeking to have a loan modification or an asset sale confirmed under the more general "indubitable equivalent" provision of § 1129(b)(2)(A)(iii). *RadLAX Gateway Hotel v. Amalgamated Bank*, __ U.S. __, 132 S. Ct. 2065, 2071-72 (2012); *In re River East Plaza LLC*, 669 F.3d 826, 832-33 (7th Cir. 2012); *In re Olde Prairie Block Owner LLC*, 464 B.R. 337, 346-47 (Bankr. N.D. Ill. 2011).

**D. 11 U.S.C. § 1141 Effect of confirmation.**

11 U.S.C. § 1141(b) provides that all estate property vests in the debtor after confirmation, unless the Plan or Confirmation Order provides otherwise, and 11 U.S.C.s § 1141(c) renders this property "free and clear of all claims and interests of creditors":

> Except as provided in subsections (d)(2) and (d)(3) of this section [addressing discharge] and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.

11 U.S.C. § 1141(c).

Circuit Courts recognize that this statute provides ultimate lien-stripping in Chapter 11 but have over time formulated tests to make sure that the lienholder

understands this effect. *See In re Penrod*, 50 F.3d 459, 463-64 (7th Cir. 1995) (where the plan provided a treatment for the secured creditor's claim but did not explicitly say that the lien would be extinguished, 11 U.S.C. § 1141(c) served to extinguish the lien); *In re Regional Building Sys., Inc.,* 254 F.3d 528, 532-533 (4th Cir. 2001) ("Chapter 11 contemplates that every secured creditor whose rights will be impaired by the reorganization will be notified, assigned to a class, and will vote on a plan"; lienholder who filed proofs of claim and participated as a committee member but failed to object to its lien-avoiding treatment in the plan, ultimately, by operation of by 11 U.S.C. § 1141(c)), did not retain a lien which could attach to settlement proceeds).

Subsequently, in what is arguably a softening of the above, the court in *In re Ahern*, 507 F.3d 817, 822 (5th Cir. 2007) interpreted 11 U.S.C. § 1141(c) to provide that "confirmation of a Chapter 11 plan voids liens not preserved by the plan, provided that the plan dealt with the property to which they attach and the lien holder participates in the reorganization" and promoted a four-part test to determine whether a lien is voided by 11 U.S.C. § 1141(c):

(1) The plan must be confirmed;

(2) The property that is subject to the lien must be dealt with by the plan;

(3) The lien holder must participate in the reorganization;

(4) The plan must not preserve the lien.

*In re Ahern*, 507 F.3d at 822 (the Court acknowledged that this test is a "judicial gloss" on a statute and found criteria (2) and (4) met because the plan gave notice of the treatment of the property to which the creditor's lien ostensibly attached but provided a *pro rata* distribution to the creditor as unsecured, and because the creditor filed a proof of

claim). *Compare In re Be-Mac Transp. Co., Inc.*, 83 F.3d 1020, 1027 (8th Cir. 1996) (because the lienholder's proof of claim was deemed unsecured and its motion to amend its claim, denied, the lien was never "brought into" the proceedings and could not be stripped off by 11 U.S.C. § 1141(c)); *In re S. White Transp.*, 725 F.3d 494, 497-98 (5th Cir. 2013) ("passive" receipt of notice by the lienholder does not constitute participation under the *Ahern* test).

**E. 11 U.S.C. § 1111 Claims and interests.**

In contrast to lien stripping, 11 U.S.C. § 1111 ("Claims and interests"), particularly 11 U.S.C. § 1111(b), enhances a secured creditor's distribution and voting options under a Chapter 11 plan of reorganization:

> (b)(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless--
>
> > (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or
> >
> > (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (B) A class of claims may not elect application of paragraph (2) of this subsection if—
>
> > (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
> >
> > (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

11 U.S.C. § 1111. The statute provides (1) that an undersecured creditor will be treated as if it had recourse against the debtor and so preserve its right to vote the secured and the unsecured portions of its claim in separate classes; or (2) that an undersecured creditor may elect to be treated as wholly secured, losing its right to vote in two classes but preserving its full lien against the collateral and benefitting from any increased value of the property. *See* 11 U.S.C. § 1129(a)(7)(B) (requires debtor to pay full amount of secured claim (in present value payments) over the life of the plan).

11 U.S.C. § 1111(b) gives the debtor the status of

> a person who purchased the property 'subject to' a mortgage lien. . . . Section 1111(b) puts Chapter 11 debtors to the same choice of either paying off the debt or forfeiting the property . . . . By giving the lienholder recourse against the debtor personally for the amount of any deficiency, § 1111(b) provides the lienholder the benefit it would otherwise obtain from its nonrecourse loan bargain—i.e., either full payment (or at least a claim against the estate for the full amount of the debt and the ability to vote on the plan to the extent of its claim), or the right to foreclose and bid on the property at public auction.

*In re 680 Fifth Ave. Assocs.*, 29 F.3d 95, 97-98 (2d Cir. 1994). *Accord In re Montgomery Ward, LLC*, 634 F.3d 732, 739-40 (3d Cir. 2011) (11 U.S.C. § 1111(b) affords the non-electing undersecured creditor recourse status for the purpose of distribution and voting only and does not alter the structure of the underlying contracts).

The § 1111(b) election protects the undersecured creditor from a quick sale of the collateral when its value is likely to be depressed. *In re Weinstein*, 227 B.R. 284, 295, n.12 (B.A.P. 9th Cir. 1998). In order to apply the § 1111(b) election in conjunction with the cramdown provisions of 11 U.S.C. § 1129(b)(2)(A)(i) the plan must:

(1) provide that the creditor retain a lien equal to the total amount of its claim;

(2) receive a stream of payments with present value equal to the value of the collateral; and

(3) receive a stream of payments which ultimately satisfies the total amount of the claim.

*In re Weinstein*, 227 B.R. at 295; *In re Brice Road Devs., L.L.C.*, 392 B.R. 274, 285 (B.A.P. 6th Cir. 2008). As illustrated in *In re Brice Road* (where the real property securing the claim was valued at about $10,000,000 and where the electing creditor filed a claim for about $16,000,000) reconciling (2) and (3) requires attention and can be resolved by:

(1) providing a stream of payments with a present value equal to the value of the collateral;

(2) providing an amortization schedule which shows the point at which the stream of payments will accumulate to the total amount of the claim (that is, to the value of the lien); and

(3) providing for a payment premium to satisfy the amount of the claim if the debtor sells the property before the lien is satisfied.

*In re Brice Road*, 392 B.R. at 286-87. The creditor should be careful that any restructured note does not inadvertently reduce the creditor's claim and lien. *Id.* at 287. (The Court in *In re Brice Road* suggested a $16,000,000 note with a below-market rate of interest so that present value equaled $10,000,000 but the creditor would ultimately receive the full value of its lien. *Id*. at 287). The Court in *In re Brice* denied confirmation because the Plan did not make clear the debtor's intention to satisfy its three-part obligation to the electing creditor. *Id* at 287-88.

Alternatively, as noted above, the undersecured non-recourse creditor may elect to treat its claim as partially secured and partially unsecured. In that case, the creditor would be entitled to vote both its secured and unsecured claims (and receive distributions on those claims). This is a potentially powerful tool that can be used effectively to block confirmation where the unsecured portion of the claim controls the unsecured class, rendering the plan unconfirmable under 11 U.S.C. § 1129(a)(10) because there would not be an impaired accepting class in, for example, most single-asset cases. *See In re John Hancock Mut. Life Ins. Co.*, 987 F.2d 154, 161-

62 (3d Cir. 1993) (where the debtor separately classified the deficiency claim of the non-electing, disaffected mortgagee solely for the purpose of preventing it from controlling the class of general unsecured claims, the Court disallowed the classification, determined that there was no reasonable possibility of confirmation and granted the mortgagee's motion for stay relief).

**VI. Timing of valuation.**

11 U.S.C. § 506(a)(1) requires that the value of a "creditor's interest in the estate's interest" in property "be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." Case law reflects this instruction, and valuation dates and methods vary under different chapters of the Bankruptcy Code and according to the purpose to which property is put. *In re Heritage Highgate, Inc.*, 679 F.3d 132, 142 (3d Cir. 2012) (proper valuation of real estate development for purpose of confirmation was fair market value on the confirmation date, not enhanced value as lots were sold); *In re Abruzzo*, 249 B.R. 78, 81 (Bankr. E.D. Pa. 2000) (in the consumer context, noting that the valuation date may vary within a case depending upon whether valuation is sought for lien avoidance, confirmation, or stay relief).

**VII. Practice Tips and Questions.**