

2014

Consumer Bankruptcy Panel Strip Off in Chapter 7: The Limits of Dewsnap

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Recommended Citation

Lawrence Ponoroff, The Honorable Mary Grace Diehl, The Honorable A. T. Small & Beth A. Harrill, *Consumer Bankruptcy Panel Strip Off in Chapter 7: The Limits of Dewsnap*, 30 Emory Bankr. Dev. J. 291 (2014).

Available at: <https://scholarlycommons.law.emory.edu/ebdj/vol30/iss2/2>

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CONSUMER BANKRUPTCY PANEL

STRIP OFF IN CHAPTER 7: THE LIMITS OF *DEWSNUP*

Lawrence Ponoroff (Presenting)^{*}

The Honorable Mary Grace Diehl (Responding)^{**}

The Honorable A. Thomas Small (Responding)^{***}

Beth Anne Harrill (Moderating)^{****}

MS. PRIOLA: Good morning, everyone. My name is Sophia Priola, and as many of you know I am the current Executive Symposium Editor for the *Emory Bankruptcy Developments Journal*. I'd like to welcome you all to the *Emory Bankruptcy Developments Journal* Eleventh Annual Symposium. As many of you know, this year marks our 30th anniversary as a journal, and I'd like to take this opportunity to thank the people who not only helped start the *Journal*, but have helped it thrive and to grow over the past three decades. Specifically, I'd like to thank the Southeastern Bankruptcy Law Institute, Dean James Elliott, Professor Charles Shanor, Professor David Epstein, our alumni advisor, Keith Shapiro. I'd also like to thank our past faculty advisors such as Frederick Tung and Ralph Brubaker. Our current faculty advisor, Professor Rafael Pardo, who over the last two years has been such a great help to this *Journal*. Also, the current Dean of Emory Law School, Dean Robert Schapiro, and of course all the others who have helped us over the years.

Before we move forward with our first panel, I'd like to invite Dean Schapiro to the stage to say a few words.

DEAN SCHAPIRO: Well, thanks very much for all of you being here today. Thanks very much for our panelists who travelled from near and far. I'd also like to thank our sponsors. Please note their names on the poster outside. We certainly appreciate all of their support.

Now this of course would not be possible without the hard work of all the students on the *Emory Bankruptcy Developments Journal*, so I'd especially

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like to thank them and especially among them the Executive Symposium Editor, Sophia Priola, and the Editor-in-Chief, Alex Clamon.

At Emory Law School, we emphasize a curriculum that integrates theory and practice, and we seek positive transformation through the ideas we create, the students we educate, and the service we perform, and our bankruptcy program is central to this mission. It brings together the academy, the bench, and the bar. It provides practical experience for our students, and we hope it provides illumination and guidance in law reform efforts. And for thirty years now, the *Emory Bankruptcy Developments Journal* has been at the heart of this bankruptcy program.

Part of the bankruptcy program of course is the *Journal* that we put out every year. It's also these wonderful, intellectual events such as the symposium today, looking at issues like § 363 and lien stripping.

I hope you'll allow me a little personal reflection here on the importance of the *Journal*. I'd like to take you back to August 1991. There were four recent law school graduates sitting around. They were law clerks for Justice Stevens. I was among them, and it was time to divide up the cases that were going to be argued in the October term in 1991. There were twenty cases. We went through a kind of draft system. There were four of us, we go through one round, the next round, five rounds. I think the first round maybe it was the *Bray* case that was chosen, which was about the application of civil rights laws to abortion protesting. There was the *Simon & Schuster* case about a Son of Sam Law in New York, whether New York could take the proceeds when a criminal published a book. There was the *Cipollone* case about whether people could sue tobacco companies for the harm caused by cigarettes. There was *Freeman v. Pitts*, a desegregation case out of DeKalb County, Georgia, and round and round it went.

Now, then there came up this interesting bankruptcy case out of the 10th Circuit, *Dewsnup v. Timm*.¹ Now, I don't remember if it was the last case chosen but I think it was in round five. And then in October, the case was argued, and it was clear that perhaps the justices were having a little trouble with the case. I was looking back at the oral argument transcript. One of the questions began with a somewhat unpromising beginning question, "I'm a little dense on this, counsel." So the Court I think had a little trouble with the case. And of course the clerks did not have the benefit. None of us had been on the

¹ *Dewsnup v. Timm*, 502 U.S. 410 (1992).

Emory Bankruptcy Developments Journal to get the illumination that this would have offered us.

So the opinion was issued and I know it was eventually subject to certain academic criticism. I believe one of the members of today's panel has talked about it as a historical anomaly, a deviation from consistent practice. I've been told that one of our panelists is going to describe the case as the worst decision ever rendered by the United States Supreme Court. So all of this is to say that the important work that the *Emory Bankruptcy Developments Journal* will do to make sure clerks of the future are better educated and won't make this kind of mistake, and also with the law reform project as illustrated by the symposium today, to clean up all the mistakes made by judges and by clerks in the past.

So with that, we look forward to an outstanding program. Thank you so much for being here, and thanks again to our panelists.

MS. PRIOLA: Thank you, Dean Schapiro. At this time, I'd like to welcome our first panel, our consumer panel. This morning we're very pleased to have Professor Lawrence Ponoroff present his article entitled, *Hey, the Sun Is Hot and the Water Is Fine: Why Not Strip Off That Lien?*² Professor Ponoroff's article is published in our current issue of the *Journal* which is at the printer right now.

Professor Lawrence Ponoroff is the Samuel M. Fegtly Chair in Commercial Law at the University of Arizona James E. Rogers College of Law where he also served as Dean from 2009 to 2012. Prior to joining the Rogers College, Professor Ponoroff was the Dean of Tulane University Law School in New Orleans. Formerly, Professor Ponoroff was a partner with the Denver-based law firm of Holme Roberts & Owen, which is now Bryan Cave. Professor Ponoroff is the author or co-author of numerous law review articles as well as five books in the areas of business and consumer bankruptcy, contracts, and commercial law. He has served by appointment of the Chief Justice of the United States on the Advisory Committee on Bankruptcy Rules to the U.S. Judicial Conference, and the Bankruptcy Judges Education Committee of the Federal Judicial Center. A graduate of Stanford Law School, he is also a member of the American College of Bankruptcy.

² 30 EMORY BANKR. DEV. J. 13 (2013).

Responding to Professor Ponoroff's article today is the Honorable Thomas Small and the Honorable Mary Grace Diehl.

Judge Thomas Small serves as a United States Bankruptcy Judge for the Eastern District of North Carolina. Judge Small is a former chair for the U.S. Judicial Conference Advisory Committee on Bankruptcy Rules, and was President of the National Conference of Bankruptcy Judges in 2000 and in 2001. In addition, Judge Small has been a member of the Collier on Bankruptcy Board of Editors since 2007, and a member of the National Bankruptcy Conference since 2006. Judge Small served as the Vice President and Associate General Counsel for First Union National Bank, now Wells Fargo, from 1969 to 1982. He received his Bachelor of Arts from Duke University and his Juris Doctor from Wake Forest University School of Law.

Judge Mary Grace Diehl, also responding this morning, was appointed to the Bankruptcy Court for the Northern District of Georgia in February of 2004. Prior to that time, she was a partner at Troutman Sanders where she chaired the Bankruptcy Practice Group. She received a B.A. in history *summa cum laude* from Canisius College in Buffalo, New York, and her J.D. *cum laude* from Harvard Law School. Judge Diehl has chaired the bankruptcy sections of both the Atlanta Bar Association and the State Bar of Georgia. She is a fellow and Vice President of the American College of Bankruptcy and a former President of the Southeastern Bankruptcy Law Institute. She received the Woman of the Year in Restructuring Award in 2008 from the International Women in Restructuring Confederation. She is on the Board of Governors of the National Conference of Bankruptcy Judges and served as Education Chair in 2009. She is on the Certification and Education Oversight Committee of the Turnaround Management Association and a member of the Board of Directors of the American Bankruptcy Institute.

Moderating today we have Ms. Beth Anne Harrill. Beth Anne Harrill serves as law clerk to the Honorable Paul Bonapfel. Ms. Harrill graduated *magna cum laude* from the University of Tennessee with a B.A. in history and religious studies and received her Juris Doctor from Emory University School of Law. She is a member of the State Bar of Georgia and Atlanta Bar Association, and serves on the Advisory Board for the *Emory Bankruptcy Developments Journal*.

At this time, I'd like to turn it over to her. Thank you.

MS. HARRILL: Thank you, Sophia. Let me just tell you all a little bit how we're going to proceed. Professor Ponoroff is going to present his paper, take about half an hour or so on that. And, as Sophia mentioned, Judge Diehl and Judge Small will respond. I'll have questions for everyone, but before we get to the questions, Judge Diehl will kind of give a rundown of what the state of the law in the Eleventh Circuit is with respect to lien stripping in chapter 7 cases and chapter 13 / 20 cases. So I will turn it over to Professor Ponoroff at this time.

PROFESSOR PONOROFF: Thank you. I indicated to the tech people I don't sit that tall in the saddle, so I thought I would present from up here.

First of all, I sincerely, Sophia, thank you for the nice introduction, and I want to very much express my appreciation to the Board and staff of the *Emory Bankruptcy Developments Journal*, Alex Clamon, the Editor-in-Chief down there. They've worked very hard, done a terrific job in pulling this symposium together, and they did a fabulous job editing the article that I'm about to present, particularly given what they had to work with to start with. So thank you very much. I appreciate it. I think they deserve a round of applause.

Now, as indicated, the premise of that article is really a very simple one, and that is that strip-off of wholly underwater liens ought to be permitted in chapter 7, although so far only one of four circuit courts to date, the Eleventh, has agreed with me on the point. In that case, *McNeal*, as I'm sure many of you know, is not necessarily yet final.³ And as was indicated, Judge Diehl is going to speak I think in much greater depth about the state of the *McNeal* case and the law in the Eleventh Circuit generally.

So let me go back to the article because, while the premise of the piece may be simple, the rationale for it is more nuanced and I think more important for the bankruptcy system. It has several parts, but three of which are most critical. First, secured creditors only exist under state law. There is no such thing as a secured creditor in bankruptcy. Second, bankruptcy entails a closing of the books on the debtor's prepetition life in a way that has no analog under state law. And third, as Dean Schapiro indicated, my view that *Dewsnup v. Timm* was indeed the worst decision in the history of the Supreme Court of the United States. Okay, I know, *Dred Scott* was pretty rough, too, but *Dewsnup* was really, really bad.

³ *McNeal v. GMAC Mortg., L.L.C.* (In re *McNeal*), 735 F.3d 1263 (11th Cir. 2012) (originally 477 F. App'x 562).

So allow me to address if I may these points in order. As you well know, first in § 101 of the Code, the terms “claim” and “creditor” are defined terms of art. The phrase “secured creditor” or “secured party” is nowhere to be found because that creature does not exist in bankruptcy. Now, § 506(a)(1) of course differentiates the extent to which a creditor’s claim will be regarded as secured or unsecured for purposes of the bankruptcy case, but it does not do so based on the existence of a piece of paper that state law calls a security interest. Rather, the Code says of course, a creditor who holds a claim actually supported by a stated value is a creditor with a secured claim to that extent, not a secured creditor, but a creditor with a secured claim to that extent. Otherwise, you hold an unsecured claim. In other words, secured for bankruptcy purposes is a function not of the identity of the creditor, but rather it’s a function of the status of the claim as determined under § 506(a)(1).

Now this is quite different of course from what it means to be secured under state law, but it is this difference that highlights the essentiality of bifurcation to the accomplishment of the goals of a bankruptcy proceeding, separate and apart from state law, which brings me to my second main point.

If it’s to provide any meaningful relief at all to the debtor and to creditors as a group, bankruptcy demands that all prepetition obligations be accelerated, adjusted, and accorded the treatment called for under the Code, hence the broad definition of claim in § 101(5). At its essence, bankruptcy is a process designed to allow a beleaguered debtor to resolve all of her debt obligations in a single, expedited proceeding. It is the very point of bankruptcy to cleave a wide chasm between the debtor’s pre- and postpetition life, so as to close the books on all but a very select handful of prepetition obligations that are excepted from the discharge either because of opprobrious debtor conduct or competing policy interests. Beyond that, allowing creditor appropriation of postpetition value runs directly counter to fresh start policy, a phrase that appears nowhere in the Bankruptcy Code but which the Supreme Court has as late as 2007 in *Marrama v. Citizens Bank of Massachusetts* told us is the principal purpose of the Bankruptcy Code.⁴

And let me stress that these issues about the proper characterization of secured debt in bankruptcy are not simply individual creditor versus debtor issues, which is of course the fashion in which state law apprehends the matter. Bankruptcy as you know, by contrast, is also concerned with the rights of

⁴ *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007).

creditors *inter se*. So a conceptualization of security that insists on minimizing to the point of triviality the infringement on state law rights undermines the equality objectives of the system as well. In other words, allowing undersecured creditors to enjoy postpetition appreciation must come from somewhere, and it comes at the expense of other unsecured creditors, and thus runs directly counter to the bankruptcy goal of equality of distribution among similarly positioned creditors.

Now, ironically I think, the hanging paragraph following § 1325(a)(9), you know § 1325(a)(*), which prohibits the strip down of certain purchase money loans in a chapter 13 plan, I think that paragraph underscores the point about the centrality of § 506(a)(1) in defining what it means to be secured. Now, I say ironically because of course the hanging paragraph came in with BAPCPA, and BAPCPA has been accused of many things, but strengthening the hand of consumer debtors has never been one of those things. Nevertheless, while doubtless this provision was intended largely to benefit the financing subsidiaries of major automobile manufacturers and other financial institutions regularly engaged in secured auto lending, what is telling for our purposes is how Congress went about achieving that aim. How did Congress do it? By decommissioning the operation of § 506(a) as to those loans. The effect of doing so is that a claim now as defined in the hanging paragraph must be treated as fully secured for purposes of § 1322(b)(2), can't be modified.

My point is that implicitly this is a Congressional reaffirmation that an allowed secured claim as used throughout the Code derives fundamentally from the meaning assigned in § 506(a)(1), *Dewsnup* notwithstanding, unless that provision is made inoperative by Congress. While other Code provisions then may determine in a specific context what may or may not be done to those claims, the point is these claims owe their existence in the first instance to § 506(a). And this then helps to explain the third major point: why *Dewsnup* was such a terrible decision.

Now, I don't make this assertion based solely on its Alfred E. Newmanesque approach to statutory construction in holding that the phrase "allowed secured claim" under § 506(d) means something quite different than the exact same phrase in § 506(a). Rather, I make the assertion because that holding, if it had been broadly interpreted and applied, could have desiccated the bankruptcy system. Now, fortunately the Supreme Court's own statement that its holding was limited to the facts presented in the case and that it would allow other facts to await their legal resolution on another day has allowed the lower

courts to mitigate the worst harms that *Dewsnup* might have wrought. But I'd submit we can go even a step further. Now, let's look at how *Dewsnup* has been tamed, if you will.

Initially, as I'm sure you know, the lower courts quickly found a basis to continue strip-down modification of partially secured claims in reorganization cases, notwithstanding *Dewsnup*, based on the existence of alternative statutory authority to modify secured claims in those chapters. Next, courts gradually came to what is now the widely shared consensus that even though strip down of undersecured residential mortgage claims is barred under § 1322(b)(2) by the Supreme Court's *Nobelman* decision,⁵ this does not preclude the strip-off of subordinate liens for which there is zero current equity in the property. And indeed it was language from the *Nobelman* decision itself that allowed for this result, strip-off in chapter 13, and that was the language in the case that said, for the anti-modification provision in § 1322(b)(2) to apply, the creditor must have a secured claim to some extent and then its rights are protected. But it must have a secured claim to some extent, with "secured" defined by the Supreme Court in *Nobelman*, decided one year after *Dewsnup* in the traditional § 506(a)(1) fashion.

Now, of course, in the case of a wholly undersecured lien, the limitation in § 1322 against modification is therefore not applicable because it's not secured in any sense; hence, strip-off of wholly underwater liens in chapter 13 is pretty widely accepted.

The next step was in 2012 with the first circuit court opinion to address an issue that has split the lower courts. This was the decision in *In re Davis* from Judge Small's circuit, the Fourth Circuit, which has now permitted strip-off in chapter 20, notwithstanding § 1325(a)(5)(B), which says in the case of a secured claim, the plan, in order to be confirmed, must provide for retention of the lien until either full payment or discharge, neither of which will occur in a chapter 20 case since discharge is now precluded under § 1328(f)(1), if of course the debtor received a discharge in chapter 7 within the preceding four years.⁶

So the trustee in *Davis* made the argument that you can't strip off because of § 1325(a)(5)(B) and then also argued in the alternative that strip-off should be denied in chapter 20 cases because it would represent an end-run around

⁵ *Nobelman v. Am. Savs. Bank*, 508 U.S. 324 (1993).

⁶ *Branigan v. Davis (In re Davis)*, 716 F.3d 331 (4th Cir. 2013).

Dewsnup, as if end-running *Dewsnup* is a bad thing. The *Davis* court rejected both arguments. As for the language in § 1325(a)(5)(B)(i), and that's nothing. Section 1325(a)(5) now goes down past (i) to upper case Roman, to double lowercase Arabic letters. Thank you, BAPCPA.

The Court concluded that the language saying the creditor has to retain the lien until full payment, which isn't going to happen, or discharge, which isn't going to happen in a chapter 20, the Court concluded, well, yeah, that's true but that provision by its terms applies only to a creditor with an allowed secured claim. And how do we determine that? Duh, under § 506(a)(1). And that of course would exclude a wholly underwater lien which does not have a secured claim to any extent, basically the same analysis that has caused courts pretty uniformly to distinguish *Nobelman* in the case of strip-off of an unsecured lien versus strip-down of a partially secured lien in 13.

Now, as for the end-running or violating the spirit of *Dewsnup* argument, and the Fourth Circuit, unlike me, has to take the Supreme Court seriously, the Court in *Davis* observed, well, look, if the filing is really an abuse of the bankruptcy process, the debtor really has no need for restructuring her debt. This was undertaken solely for purposes of stripping off the underwater lien, and the Court said, look, there's an adequate response in the good faith requirement of § 1325(a)(3), and that's your remedy. Pretty much the same approach that the Supreme Court took way back in *Johnson v. Home State Bank* when it first sanctioned use of chapter 20.⁷

The point is that in *Davis* what the debtor had done in two steps was that which was precluded from being done in one step by *Dewsnup*, yet was not, according to the Court, sufficient reason to bar strip-off of the lien. You know, in sum, *Dewsnup*'s astonishing and nonsensical interpretation of the phrase "allowed secured claim" in § 506(d) posed such a pernicious and far-reaching consequence in areas of the practice well beyond strip-down that the only way to tame the decision was to ignore it. And for the most part, that's precisely what the lower courts have done. In a case cited a couple of years ago, *In re Woolsey* out of the Tenth Circuit, the Court observed, and quoting here, "*Dewsnup* has lost every game it has played. Its definition of secured claim has been rejected time after time."⁸ *Davis* now is just the latest nail in the coffin. And next I'm advancing the proposition that we take the next logical penultimate step which would be not to apply *Dewsnup* to strip-off as opposed

⁷ *Johnson v. Home State Bank*, 501 U.S. 78 (1991).

⁸ *Woolsey v. Citibank (In re Woolsey)*, 696 F.3d 1266, 1276 (10th Cir. 2012).

to strip-down in chapter 7 as well as chapters 13 and 20. Now, parenthetically if the Eleventh Circuit's panel decision in *McNeal* is upheld en banc, an added benefit would be that this will create a split in the circuits on the issue, and that could provide the opportunity for the Supreme Court to revisit and clarify its ham-handed interpretation of allowed secured claim in § 506(d). But that's for another day. I'm just talking about strip-off of a wholly underwater lien in chapter 7.

Now, surely the judges on the panel this morning will point out that strip-down or strip-off can only occur in the claims allowance process, and that, as you well know, in most chapter 7 cases there are no assets to administer and thus no claims to allow or disallow. Thus, I believe they will point out that the determination of secured status is kind of meaningless in chapter 7 unless the trustee proposes to sell the putative collateral. But respectfully, last I checked, the provisions of chapter 5 apply in chapter 7 and even *Dewsnup* agrees that § 506(d) avoids a lien when the claim it secures is not allowed, whatever that means. So if the debtor files a motion seeking strip-off of an unsecured lien, I think a claims allowance process and valuation must occur.

You know, the majority's reasoning in *Dewsnup* relied heavily on what it termed the pre-Code practice under which liens pass through bankruptcy unaffected, almost like a kidney stone I guess. But the Supreme Court itself, as recently as 2012 in the *RadLAX* decision,⁹ has repeatedly held that pre-enactment practice is relevant only to the interpretation of ambiguous text in the Code, which § 506(d) clearly is not. Moreover, the notion that liens pass through bankruptcy unaffected is simply not true under the Code, nor was it true under the former Act. The more accurate statement would be that liens pass through bankruptcy unaffected to the extent that the bankruptcy law doesn't alter those rights. In other words, what goes into bankruptcy may be defined by state law, but what comes out may look entirely different. And the Supreme Court's holding in *Butner*¹⁰ does not by any means dictate that simply because a creditor's contractual and property rights are established under state law, does not mean those rights cannot be affected in a subsequent bankruptcy proceeding when necessary to vindicate an important federal interest, such as fresh start and creditor equality, interests and policies that simply have no analog under state law.

⁹ *RadLAX Gateway Hotel v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

¹⁰ *Butner v. United States*, 440 U.S. 48 (1979).

Furthermore, despite the suggestion to the contrary in the majority's opinion in *Dewsnup*, there is no unconstitutional taking when Congress regulates property rights prospectively, even if that regulation eviscerates a state law lien. That proposition I think is implicit in the Supreme Court's decision in *United States v. Security Industrial Bank*, the case you'll recall that upheld the prospective application of the lien avoidance provisions in § 522(f)(2),¹¹ and similarly the *Dewsnup* court's reliance on the *Radford* case, a 1935 Supreme Court case that declared the Frazier-Lemke Farm Bankruptcy Act of 1934 unconstitutional.¹² What the majority in *Dewsnup* ignored is the fact that once Congress amended that Act to apply only prospectively and to assure the creditor of the current value of its collateral, the Supreme Court sustained the constitutionality of the Frazier-Lemke Act.

In short, I would maintain that the Code's classification of claims under § 506(a)(1) is central, pivotal to the attainment of the purposive goals underlying bankruptcy. You know, except in those isolated instances where Congress has wisely or not explicitly prohibited bifurcation, as in the hanging paragraph, or a creditor has exercised its statutory option to avoid bifurcation as under § 1111(b)(2), a debt secured by collateral that is devoid of economic value simply cannot be regarded as secured in bankruptcy. This is so because once the debtor files bankruptcy, that creditor that was a secured creditor under state law is now simply a creditor, the nature of whose claim will be determined and then provided for under the Code. It is the distinction between types of claims, rather than types of creditors as under state law, that is so essential to the accomplishments of the unique goals of the bankruptcy system.

In other words, bankruptcy recognizes but does not hold sacrosanct every aspect of the creditor's state law bargain. What's constitutionally protected is the value of the lien. That's why we don't protect the equity cushion, and that's why we don't compensate lost opportunity costs.

Rectification of *Dewsnup*'s unorthodox reading of "allowed secured claim" is going to have to wait another day. But my point is that it is not necessary for that redress to occur before a lien that is wholly underwater can be stripped off, not just in chapters 13 and 20, but also in chapter 7. And this is because in those situations, unlike the facts of *Dewsnup*, there is no secured claim. And if there is no secured claim, then the whole concept of lien becomes a non sequitur.

¹¹ *United States v. Sec. Indus. Bank*, 459 U.S. 70 (1982).

¹² *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935).

Dewsnup undoubtedly said the phrase “allowed secured claim” means something different under § 506(d) than § 506(a), but it did not say § 506(a) is irrelevant in chapter 7. In order to be secured, a claim must be supported by some value or Congress must have excluded the operation of § 506(a). Otherwise the so-called lienholder is in substance really no different than any other unsecured creditor, and bankruptcy equality policy demands that that creditor then be treated as such.

You know, we can argue as of when to value the collateral, although that’s usually not much of an issue in chapter 7. And we can argue, in cases to which § 506(a)(2) does not apply, we can still argue over the method of valuation. But what I would submit is unarguable is that a security interest’s only protectable property interest in bankruptcy is axiomatically its current value, so that if the measure of the collateral’s value is one dollar or greater than the sum of all prior liens, then a secured claim exists to that extent and *Dewsnup* requires that the lien remain with the property even after the in personam claim has been discharged. Though, it’s rather difficult to imagine what purposes this serves other than to frustrate the debtor’s fresh start without any corresponding social utility. We can’t help that. On the other hand, if the debtor successfully establishes that the value of the lien is zero, a determination that is hardly made in secret or ex parte, then there is simply no unsecured claim. It’s at that juncture that the lien becomes an unnecessary excrescence that should be amenable to strip-off, if not under the language of § 506(d), which after all does refer to a lien that secures a claim, then conceptually under another power of the bankruptcy court to go beyond the literal text of the Code.

Now, the stumbling block for a lot of courts to taking that next step, I think, has been the absence of alternative statutory authority to strip off a lien in chapter 7 such as exists in chapters 13 and 11 in § 1322(b) and § 1123(b)(5). So what I suggest in the article is, no, I don’t go running to § 105. What I suggest in the article is that this authority might be found in an approach the courts have been engaged in frankly for over a century, namely common lawmaking when necessary to serve important federal interests.

Now I know that conventional wisdom is that bankruptcy courts are not common law courts and that actually there is no federal common law. But where I ask you is the statutory authority for substantive consolidation or discharge or release of non-debtor affiliates or critical vendor orders? Just like equitable subordination for forty years, it doesn’t exist. Until the doctrine was codified under the Code, equitable subordination, like those other practices,

existed because they were simply necessary to achieving the goals of the system. Now this approach is not my invention. It was advanced by Adam Levitin in 2005 in a sort of inferior bankruptcy journal, the [*American Bankruptcy Law Journal*].¹³ And the article focuses on the relationship between Congress and the courts in bankruptcy matters. It does not purport to address the issue of the relationship between federal and state law.

Nonetheless, I think the analysis has the potential to say a great deal about that relationship as well. Inasmuch as we all know that the bankruptcy power when exercised is exclusively federal. And I also think that the lawmaking authority of the bankruptcy courts finds implicit congressional authorization in the decision made a long time ago to put bankruptcy proceedings where? Not in an administrative agency as Professor Pardo would put them, but in a court. What's the point of putting it in a court if there isn't an opportunity for judges to be judges?

In sum, what I've tried to demonstrate is I think there is an avenue available for those courts not bound by circuit precedent that seek both a clear and principled path for further limiting *Dewsnup* even more narrowly to its facts, and its facts were strip down of undersecured liens.

Now, obviously I believe that holding is also flawed, but only Congress or the Supreme Court can do something about that. In the meantime, I urge that strip-off in chapter 7 is not barred by *Dewsnup*, that core bankruptcy policy demands that it be permitted, and more generally that going forward we be a little more attentive to what it means to be secured in bankruptcy. Thank you.

MS. HARRILL: Thank you, Professor. I'm going to turn it over to Judge Diehl.

JUDGE DIEHL: As Professor Ponoroff knows, the Eleventh Circuit actually is the only circuit that agrees with what he's saying, and I'm just going to take a minute to trace how we got there. We go back to 1989, which is pre-*Dewsnup*, and the Eleventh Circuit had a case called *Folendore v. Small Business Administration*, and the holding of that case permitted a debtor to strip off a wholly unsecured lien in a chapter 7 case.¹⁴ Now, the parties in that case stipulated that the SBA had an allowed secured claim, so the discussion in

¹³ Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1 (2006).

¹⁴ *Folendore v. Small Business Administration (In re Folendore)*, 862 F.2d 1537 (11th Cir. 1989).

the case is not really about § 506(a); it's all about § 506(d), and what's the result of that.

So that case is out there, and then in 1992, the Supreme Court gives us *Dewsnup*. The Supreme Court there is looking at § 506(a) and § 506(d) in the context of a strip-down, not a strip-off, and the debtor there was attempting to cram down the second mortgage on his house, and the Court holds that he can't do that, no strip-down. And the reasoning is a bit contorted because they end up saying, well, allowed secured claim means something different in § 506(a) and § 506(d). We have to look at each modifier separately. We have to ask is the claim allowed, and then is there collateral for the claim, and they get there to that result.

So that's in 1992, and really you don't have too much happening I guess because the market at that point is going up, so you don't necessarily have a lot of undersecured mortgages. But we do have in 1998, the Ninth Circuit B.A.P. weighs in and says that you cannot strip off in a chapter 7. Then the Fourth Circuit in *Ryan* in 2001 says the same thing.¹⁵ The Sixth Circuit in 2003 in *Talbert* says the same thing.¹⁶ They're all following *Dewsnup*. There's also a number of bankruptcy courts that apply *Dewsnup* not to allow strip-off. But really there's very little law that's developing at that point in time.

Then we get 2009 and we get the mortgage crisis and we suddenly have a whole slew of second mortgages that are totally underwater. And the only circuits that have weighed in on that since then are the Eleventh Circuit and the Seventh Circuit, which in 2013 has the *Palomar* decision, which again says you can't do the strip-off.¹⁷ So we come to 2009 and Lorraine McNeal files her chapter 7 case in the Northern District of Georgia and she files a motion to strip off her second mortgage applying § 506(a) and § 506(d), and the motion is unopposed. But Judge Bonapfel nonetheless denies the motion citing *Dewsnup*, and his opinion is in April of 2010. And he emphasizes, number one, there's no substantive difference between a strip-down and a strip-off if you apply the rationale of *Dewsnup*. Secondly, it would be a departure from pre-Code law that liens pass through bankruptcy. And then he uses the *Nobelman* case, the 1993 Supreme Court case, to say that § 506(d) doesn't bifurcate because *Nobelman* uses § 1322(b)(2) to say you can't modify the rights of the holder of a secured claim. And he says § 506 is not an independent vehicle to

¹⁵ *Ryan v. Homecomings Fin. Network*, 253 F.3d 778 (4th Cir. 2001).

¹⁶ *Talbert v. City Mort. Servs. (In re Talbert)*, 344 F.3d 555 (6th Cir. 2003).

¹⁷ *Palomar v. First American Bank*, 722 F.3d 992 (7th Cir. 2013).

avoid the lien; it merely facilitates valuation and the disposition of property and reorganization chapters.

So I think no one was really surprised that that was the result because we have all the circuits saying exactly that. So the district court affirms and it goes to the Eleventh Circuit. And in May 2012, so now we're two years since Judge Bonapfel reached his initial decision, the Eleventh Circuit reverses and they rely on *Folendore* and the prior precedent rule of the Eleventh Circuit, and they say, well, *Dewsnup* was a strip-down, this is a strip-off. It's not exactly the same thing, so *Folendore* is still controlling.

To add to the curiosity of it all, the opinion is a per curiam and it's unpublished, and under the Eleventh Circuit rules, an unpublished decision is not binding precedent. It is merely persuasive authority.

And then while this is going on, the lender in *McNeal*, which was GMAC Mortgage, files its own bankruptcy. So that throws the Eleventh Circuit in a tizzy because they don't know what to do because now they have another party in bankruptcy.

In the Eleventh Circuit, the judges and the attorneys really sort of are in chaos because we don't have binding precedent, but we do have an opinion of a panel in our circuit that says that we can strip off in chapter 7. And at the same time, these motions are coming up with very little opposition. Probably because the lenders are underwater and they would have to basically reargue *McNeal*. So the judges don't know what to do. I think finally we all started granting them if they were unopposed, and I think that's pretty much what the judges throughout the Eleventh Circuit have been doing.

In *McNeal* then, there is a motion for rehearing en banc, and a motion that basically says please publish this decision so at least we know what's going on. Those motions are stayed because of the GMAC bankruptcy. So this decision in *McNeal* comes out in May of 2012. So in March of 2013, I have an opposed motion on one of these, basically re-arguing the *McNeal* rationales, and so I wrote an opinion that basically said I agreed with Judge Bonapfel in *McNeal*, but I'm just a little bankruptcy judge and I'm in the Eleventh Circuit so I'm going to follow my circuit. And the parties then took a direct appeal to the Eleventh Circuit hoping to get out of the procedural mess that was created by the bankruptcy of GMAC, and the Eleventh Circuit granted that. And so it's been up there now a year since they've granted the direct appeal with nothing really happening.

In August of 2013, the Eleventh Circuit published the original *McNeal* case. So in August of 2013 we finally have binding precedent in our circuit. And they said, we see there's a motion for rehearing en banc and we'll take that up after thirty days. Well, August, September, we're still waiting. But at least now we have a controlling decision by one panel.

In the *Malone* case, my case that is on direct appeal, the parties have filed a motion for hearing en banc; skip the panel, let's just go to the en banc hearing. That motion has been sitting there with no development.

Then Judge Sacca has a case called *Sinkfield*. In that case, the bank recognized it was stuck with *McNeal*, and so the parties entered into a stipulated order granting the lien strip but preserving the appeal rights of the bank, and then they got at the District Court level, they did a joint motion to affirm the bankruptcy court so that they could get to the Eleventh Circuit quicker. That was signed. Then it got to the Eleventh Circuit and somehow the Eleventh Circuit ends up denying the parties' motion for an en banc hearing. So we've got these other two en banc sort of sitting there. We've got this one denied. But that did give the bank, which is Bank of America, the ability to file a petition for a writ of certiorari with the Supreme Court, which they did, and the Supreme Court has requested a response from the other parties which is due tomorrow. And I'm told that when the Supreme Court asks for a response, that is at least some kind of preliminary indication that they're interested in looking at the issue.¹⁸ And of course the basis is we've got a split in the circuits. We don't have an en banc decision but we do have an Eleventh Circuit panel that goes a different way than these other four circuits. So I guess we've got sort of two ways of getting a reconsideration of the whole issue at the Eleventh Circuit level.

I should say there's also a whole bunch of these other stipulated cases that have now gotten up to the Eleventh Circuit where they stipulate in the bankruptcy court, they get the district court to affirm, and the Eleventh Circuit has consolidated all of those, and there's also a motion for an en banc hearing in those that was just filed in December. So there's a lot of different things going on that may lead to a reconsideration of the decision, but that's kind of where we are.

¹⁸ The Supreme Court has since denied the petition for writ of certiorari. *Bank of America, N.A. v. Sinkfield* 134 S. Ct. 1760, 2014 WL 1271326 (2014).

I will say that meanwhile back at the ranch, we're stripping liens in chapter 7 daily. There's just an awful lot of these cases that are coming through, and as I said, very few of them are opposed. Now, of course, in a chapter 7 context, and I'll get to this in responding sort of to the basic premise of Professor Ponoroff, but in a basic chapter 7 case, if you strip off the second lien, it doesn't really help you unless you have reaffirmed the debt on the first lien because otherwise you're getting through, you're discharged, and we can get into whether you can ride through or not.

JUDGE SMALL: Why doesn't it ride through?

JUDGE DIEHL: The law would say that, but if the lender doesn't take any action, you may be okay. But having said that, in both *McNeal* and my *Malone* case, there is not a reaffirmation agreement on the first mortgage. And most people going into bankruptcy are not current on their mortgages, so I really don't know what's happening in the underlying situation on those, and it may be the cases are open, there's still an automatic stay. The property hasn't been abandoned. But in any event, we're hoping that there's some resolution to this, and the Eleventh Circuit also does have the chapter 20 lien stripping issue up there, but it seems to me if they're going to say you can do it in chapter 7, it's real easy to say you can do it in chapter 20. You know, you could've done it that way to begin with.

MS. HARRILL: There won't be any more chapter 20.

JUDGE DIEHL: There's no end-run because there's a direct route to get there. So that's kind of where we are, and we're still sort of waiting to see what happens, but in the meantime, we do have this controlling precedent.

I know Beth Anne's got some questions, but I really wanted to address sort of the underlying premise that Professor Ponoroff has with respect to §§ 506(a) and (d). In my way of looking at it, § 506 is not an avoiding power. It is really something that is used in the claims allowance process. Section 506(a) talks about an allowed claim that's secured. And in order to have an allowed claim in a chapter 7 context, you have to have a proof of claim. And if there's not a claims allowance process going down, you just never get to § 506 in the way that I look at it.

And I think the Seventh Circuit case, the *Palomar* case, which is the most recent circuit affirming that you can't strip off in chapter 7, really does a good description of what § 506(d) means, and it is, like *McNeal*, an unopposed strip-off of a second mortgage. Judge Posner said the lien that § 506(d) voids is one

that is secured by a claim that is rejected by the bankruptcy court; it's not an allowed claim. In other words, somebody files a claim and it turns out that the mortgage has been paid but they never cancelled their lien. Well, they don't have an allowed claim so their lien would go away.

In a chapter 7 case, you don't have any claims filed. Secured creditors don't need to file proofs of claim in chapter 7. What § 506(a)'s bifurcation, Judge Posner says, is actually a pro-creditor statute because what it does is it gives a secured creditor two claims: their secured claim and then their unsecured claim in addition to that. If we didn't have that bifurcation, they would not get to share in the pool of the unsecured creditors. And he says now in chapter 13's we can have strip-off because part of the balance of chapter 13 is that you have to have the chapter 13 plan and there's payments and you're getting some benefit from all of that. And that just doesn't occur in a chapter 7.

So you can get hung up on the language and the sort of crazy reasoning of *Dewsnup*, but in my way of thinking, the whole § 506 just doesn't come into play in the chapter 7 cases.

JUDGE SMALL: So really, you're stripping off these liens in chapter 7 but you're a reluctant stripper.

JUDGE DIEHL: Correct. That's what my *Malone* case says.

JUDGE SMALL: I'm convinced by Professor Ponoroff. I would be an enthusiastic stripper. Notwithstanding the *Ryan* case in the Fourth Circuit. But it seems to me that *Dewsnup* really is limited. It's not a strip-off; it's a strip-down case, and I see that as a big difference. Secured creditors have rights, but really they're worthless. And as Professor Ponoroff, he calls them hold-up value or enormous unbargained strategic leverage. Well, it seems to me the claim may not be disallowed under § 502, but really it's worthless and should be disallowed as such by § 506, and I think it could be voided under § 506(d). I would enthusiastically, if that doesn't work, also go to § 105 because it promotes the fresh start.

Now I used to be a banker, and I remember those days when we would take worthless guarantees on corporate debt basically for leverage. And that's what these completely underwater third, fourth, and fifth mortgages are. You can get rid of the worthless guarantees in chapter 7. Why shouldn't you be able to get rid of these worthless third, fourth, and fifth liens in a chapter 7? That's my take on it.

JUDGE DIEHL: Well, why does a debtor want to keep a property that is underwater if the first is more than the value of the property? The only reason for a debtor to keep that is because we're in an up market and the value is going up and the debtor gets to realize that as opposed to the lender who presumably made the loan when there was value. That may not be true.

PROFESSOR PONOROFF: You want to take away the debtor's future wages, too?

JUDGE DIEHL: Well, you know, the reason you strip them in a chapter 13 is because you are getting the debtor's future wages in exchange.

JUDGE SMALL: You know, you might want to sell the house in the future. If you've got a completely underwater third or fourth—

JUDGE DIEHL: How are you going to sell it with—

JUDGE SMALL: —mortgage, you can't sell it.

JUDGE DIEHL: Well, that means that the first is already more than the house is worth. We're presuming this. So how are you going to sell it without getting an agreement from the lender or a short sale?

JUDGE SMALL: That's not all that uncommon to have these sales that are sold for less than the amount of the mortgage.

JUDGE DIEHL: Well, again, you always have the ability of the first to foreclose out the second, and that's probably one of the reasons why people don't oppose these is because they realize they're vulnerable, and if there's not a re-affirmation, they may well get foreclosed out very quickly.

MS. HARRILL: Before I pose any questions, let me just point out that we do have microphones set up, and the panel is happy to take questions from the audience, just if you will come up and I'll recognize you when you come up there.

Our panel obviously has got great things to say and they've anticipated a couple of my questions already. Let's start just with the fundamental notion of stripping off a lien in chapter 7. We have mechanisms for stripping off liens or modifying liens in all chapters. We've got § 522 lien avoidance. We have redemption of personal property in chapter 7 in § 722. We have modification provisions in the reorganization chapters. If Congress had intended for wholly

unsecured liens to be stripped off in chapter 7, why didn't it make it explicit in the Code?

PROFESSOR PONOROFF: Well, I'm not going to get into the business of trying to explain or understand why Congress does anything that it does in connection with the bankruptcy statute, or frankly the Supreme Court. It's astonishing how many Supreme Court cases are bankruptcy or bankruptcy-related because I think it's a place for the court to serve some other objectives when nobody's looking.

I think we have to simply take the Code as it's written and if a creditor is wholly underwater, in terms of the real economic nature of what it holds, who is that creditor more like, the first mortgagor or other unsecured creditors? I mean, I want to reiterate I'm not just up here with a bleeding heart for debtors. It is also an intra-creditor issue as well. I mean I suppose there's an argument if there really is future appreciation and you strip the lien under § 551, that's preserved for the trustee and the benefit of other unsecured creditors.

JUDGE DIEHL: Well, of course, I think that the fact there isn't explicit avoiding authority is an indication that this is not what you're supposed to be doing. In chapter 7 cases, occasionally you do have an asset case, but if you have a piece of secured property that has liens on it that exceed its value, the trustee isn't going to do anything with it. He's going to abandon the property unless, again, he can cut some side deal with the lenders to get some fees into the estate, but that's really not the subject of this panel. So you're never going to have a situation where this is going to come into play except for the second lienholder that wants to have an unsecured claim, going back to the *Palomar* method. If the trustee abandons the property or the trustee somehow sold the property and didn't get the second lienholder paid, the second lienholder could file a proof of claim in an asset case as an unsecured creditor. So then you're into the claims allowance process.

But in a 7, you're very seldom going to have a situation where you are valuing property. In a 13 or in an 11, yes, you've got to do that for terms of treatment in the plan. The secured claim gets treated one way; the unsecured, the other. But that's not what we have in chapter 7.

JUDGE SMALL: You know, strip-off is done a lot of different ways around the country. There are all different kinds of procedures. If you look at some of these opinions, some of them were brought as adversary proceedings.

JUDGE DIEHL: Right. And we do it by motion here, but yes, some courts require adversary proceedings. And perhaps even in the chapter 13 plan at some point you're going to be able to do that.

JUDGE SMALL: That's right. Sometimes it's done in the confirmation process in chapter 13, but in chapter 7 you're doing it by motion practice and—

JUDGE DIEHL: That's what we do here.

JUDGE SMALL: —most of these are uncontested; is that right?

JUDGE DIEHL: Correct.

JUDGE SMALL: And if they are contested, then you have a hearing? And has there been a proof of claim filed or anything like that?

JUDGE DIEHL: Usually at the hearing, the issue that people put up is the value of the property. The debtor says you're undersecured. The creditor says no, there's some value there so you can't strip me off. And other than the whole issue of you can't do this in chapter 7, even though you have controlling law in the circuit, and that's why we get all these stipulated appeals. But the hearings really don't contest anything other than, hey, you got the numbers wrong.

JUDGE SMALL: Let me ask you about a contested one because value is the key then.

JUDGE DIEHL: Correct.

JUDGE SMALL: And frequently of the cases I've had, they're usually pretty close as to at least the second mortgage. Maybe not the third or beyond that but—

JUDGE DIEHL: Well, the ones that contest generally are pretty close.

JUDGE SMALL: And what value do you use in a chapter 7 strip-off? Do you use a liquidation value? Do you use a market value? What value do you use?

JUDGE DIEHL: Well, normally there are appraisals on both sides and they're market value.

JUDGE SMALL: Okay. Even though chapter 7, of course, is based on liquidation, you don't use liquidation—

JUDGE DIEHL: Well, but when you're talking about a house, there's really not that much difference then between market value and liquidation value.

PROFESSOR PONOROFF: You have to apply *Rash*,¹⁹ don't you? I mean, it's real estate.

JUDGE DIEHL: Right, right.

JUDGE SMALL: So it would be a replacement value basis?

PROFESSOR PONOROFF: Yes, but—

JUDGE SMALL: Is *Rash* a chapter 13 case?

PROFESSOR PONOROFF: Yes.

JUDGE DIEHL: In a home when you're—

PROFESSOR PONOROFF: You have that infamous footnote 6 that says that replacement is not necessarily retail or fair market—

JUDGE SMALL: Don't you also have the section, maybe it's § 506(a) that it depends upon what purpose you're doing it for?

PROFESSOR PONOROFF: Yes, absolutely, and I think that's a criticism of *Rash*, that that was a strange interpretation.

JUDGE DIEHL: But this is real estate, what I'm talking about, and that's a whole lot easier to do I think than when you're talking about personal property, where there may be a serious difference between wholesale, retail.

JUDGE SMALL: Right. With an automobile you've got a liquidation value.

JUDGE DIEHL: Right, right.

JUDGE SMALL: You've got a replacement value.

JUDGE DIEHL: But what I'm seeing on the houses, it's an appraisal, a market appraisal based on comparable properties presumably in the neighborhood.

PROFESSOR PONOROFF: And to your earlier point about what's the reason to do this unless you've reaffirmed the first because you're underwater, Judge, another reality that you have to take into account in addition to market

¹⁹ *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953 (1997).

value or liquidation value, in the case of certain property, particularly a home, is sentimental value and the attachment that people may have to property regardless of the fact that they're going to keep making payments on a first, the principal of which is greater than the current value of the home.

JUDGE DIEHL: Well, that's a lot of what goes on in chapter 13. That's why people want to keep their houses.

MS. HARRILL: Let me ask the professor, in *Dewsnup* and its progeny, what the Supreme Court has really focused on in their discussion of the rights and liens of secured creditors, is this notion of the bargained for rights between a lienholder and a debtor. Is that a fair target to focus on, or is it a red herring?

PROFESSOR PONOROFF: No, I think that's really at the crux of the matter. And the Supreme Court waffles back and forth on this, as I think I mentioned, as to what extent are we going or are we obliged by the Constitution to recognize the state law bargain. After *Alyucan*²⁰ and after *Timbers*,²¹ I think we all understood that the only right that the secured creditor had that couldn't be altered in a bankruptcy proceeding was the right to the current value of the property. As I said, that's why we don't protect the equity cushion or provide lost opportunity costs. But when you read both *Dewsnup* and *Nobelman*, there is lots of language paying homage to the terms of the loan documents, the state law bargain of the secured creditor, and the Supreme Court goes back and forth on that.

But subject to the Fifth Amendment, it seems to me that the determinant ought not be, where are we going to put the fulcrum in terms of state law rights. It ought to be, okay, we're going to protect your value. That's axiomatic, but beyond that, what we recognize or don't recognize ought to be driven, as it is in a lot of other contexts, by attainment of the goals of a bankruptcy process. And those goals are goals that simply don't exist as a matter of public policy under state law. So look at all the bargains we undo in bankruptcy. I see the court as unduly deferential as opposed to focusing on well, was this part of the bargain, the right to foreclose, the right to a deficiency? They ought to be focused on beyond protecting the current value, which would be a taking, how much of the bargain can we enforce without beginning to erode the goals of the proceeding?

²⁰ Bankers Life Ins. Co. of Neb. v. Alyucan Interstate Corp. (*In re Alyucan Interstate Corp.*), 12 B.R. 803 (Bankr. D. Utah 1981).

²¹ United Savs. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Inc., 484 U.S. 365 (1988).

JUDGE DIEHL: But isn't there a fundamental difference when you're looking at that from a reorganization context, which I agree with you that we don't protect equity cushions, and we don't require adequate protection of those. But we're talking about chapter 7. This is not a process that is designed to leave the debtor with anything other than a discharge and exempt property, which is what I would say is the fresh start. Debtor gets a discharge and the debtor gets to keep the property that's exempt, and to avoid liens on exempt property, our § 522 situation. But what you're using the lien stripping to do in my mind has nothing to do with the fresh start, because if that property belongs to the debtor subject to the two liens—

JUDGE SMALL: Which have no value.

JUDGE DIEHL: But you're giving the debtor something. You're getting rid of a lien on property that's not exempt and letting them go and we're not in a reorganization context. It just doesn't seem like that has something to do with the policy. We're mixing up the reorganization policies with this.

JUDGE SMALL: Well, the fresh start is the key to chapter 7.

JUDGE DIEHL: Agreed.

JUDGE SMALL: And I just think it's more than what you say it is. It's an impediment to the fresh start. It's a big impediment. He's never going to be able to sell the house as long as you've got that lien there.

JUDGE DIEHL: Well, the house is not something he's entitled to keep in the chapter 7 unless he reaffirms the debt on it.

JUDGE SMALL: A pretty essential part of his fresh start it seems to me.

MS. HARRILL: Let me pose a question from that because traditionally in chapter 7 a debtor has the ability to do three things with property: surrender, reaffirm or redeem. And so where does lien stripping fit in with that then? When we start considering ideas of postpetition appreciation of property and who the benefit should come to, from a policy perspective, where does lien stripping fit in with that?

PROFESSOR PONOROFF: Well, again, I would simply reiterate. Take the facts of *Dewsnup*, which of course is strip-down, but here we're talking about larger policies and I think *Dewsnup* strip-down ought to be permitted, too. I just can't figure out an argument to say that.

What are most lenders going to do as soon as the stay is lifted? They're either going to get wiped out by a foreclosure of the first or they're going to foreclose to recognize that value that the debtor was willing to pay. And the reality is that if we're valuing the property at market value, that's probably more than is going to be garnered at a foreclosure sale. And there is the efficiency of avoiding the delay and the costs of that sale. So I really see no down side for that creditor other than one who says, well, I'm a private lender so I can keep it in my portfolio, and I think the property will appreciate and someday I'll get more of my lien paid off.

But you're unsecured with respect to the balance of that claim. You had an unsecured claim in the bankruptcy case and that notion of bankruptcy pulling a curtain down between the pre- and postpetition lives would cause me to argue that even if that postpetition appreciation is there, that it belongs to the debtor. And Judge Small mentioned what is likely to happen in the *Dewsnup* situation if the debtor really can take care of the first, is after the court says no strip-down, now the debtor, if the resources are available, goes to the lender and says, okay, what's it take? I know I can pay \$120,000 but I don't want to do that and my guess is you'll probably take less than \$120,000. \$49,000? You know, is that what we want to encourage?

JUDGE DIEHL: What about the situation which is becoming increasingly common now where the debtor is able to do a modification of the first which may involve a buy-down of the principal? It may be that the modified mortgage, suddenly the second, if it hadn't been stripped, is in the money.

JUDGE SMALL: That doesn't sound fair.

JUDGE DIEHL: That to me supports this notion of you don't strip off the mortgage and then leave the debtor with the ability to do whatever. I mean, this is a chapter 7. Again, if you're in a chapter 13, I think it's a whole different ballgame, and certainly a chapter 11. But in a chapter 7, we're in a liquidation proceeding and we're talking about a method that leaves the debtor with property subject to a lien, that property and what you've stripped off, there's not an exemption in that. So you're really creating a reorganization chapter that isn't there. Why do a chapter 13 if you can get in a chapter 7 and get rid of the second, and you're pretty current on the first?

PROFESSOR PONOROFF: Well, I think—

JUDGE DIEHL: And you don't have to pay your—

PROFESSOR PONOROFF: But that's just one asset of the estate. I think there may be very good reason to still do a chapter 13 in a lot of cases. And in point of fact, if the only reason to do the chapter 13 is to deal with this situation, I think the better approach is as long as you can get through the means test, is to deal with it in chapter 7, and look, where is the avoiding power is the big question out there. Well, until 1991, everybody said, well, there's the avoiding power. Read § 506(d), avoid a lien to the extent it doesn't support an allowed secured claim. So I hear you and I think the point is well taken. But that's also part and parcel of the question of to whom does postpetition wealth belong.

Now, there is another argument, which is as to why you would oppose strip-off even though it's completely underwater. If completely underwater is based on judicial valuation that maybe the lender doesn't buy into, and I get that one, but that's what we have courts for. You make your argument, you know, you win some, you lose some.

JUDGE DIEHL: But we're not valuing the properties in chapter 7 normally except now that people file motions to strip the lien, we have to when that's put in issue.

MS. HARRILL: Let's turn to the chapter 20 issue and just for the benefit of the students in the audience who may have not heard that term before, a chapter 20 is when a debtor has filed a chapter 7 and discharged their personal liability on all their debts and then thereafter files a chapter 13, making a chapter 20, to deal with their secured claims or taxes, debts that were not discharged in the chapter 7 case. So, Judge Small, we have a Fourth Circuit case from last year, the *Branigan* case, which says that a debtor in a chapter 20 case can strip off a wholly unsecured lien on real property. If you can share with us, tell us what the impact of that is in your courtroom and what are some of the issues that maybe the Fourth Circuit didn't anticipate from that decision?

JUDGE SMALL: One of the things I was thinking about was the timing of the strip-off. It's interesting. In the opinion, the debtor proposed a plan that would strip off the lien upon completion of payments. Yet, I think the bankruptcy judge, Judge Lipp, went ahead and stripped it off immediately upon confirmation. Of course, it springs back in the event that the plan is not completed. Well, what's the effect of having stripped it off? Well, maybe then you can sell the property but maybe as a practical matter you can't sell the property because if it's subject to a spring-back, nobody is going to want to

buy it if they're going to have these second and third liens coming back if the debtor doesn't complete the plan.

But I was thinking about, what are the consequences of modification of the chapter 13 plan? Because after BAPCPA, a plan can be modified until all the payments are made by the trustee, the debtor, or any unsecured creditor. Well, there's a Fourth Circuit case called *In re Murphy* involving the post-confirmation modification by a chapter 13 trustee.²² In the facts I had a condominium which was worth \$155,000, but it appreciated in value to \$235,000 in eleven months, so it was a rather significant appreciation and the trustee moved to modify the plan. The plan was modified and the property was being sold and the unsecured creditors got the benefit of that appreciation in the property.

Well, let's say you have a chapter 13 case where the lien has been stripped off and you have the same appreciation, \$155,000 going up to \$235,000. Well, who can ask for modification of that? I guess the trustee could, an unsecured creditor could, including the creditor—this is not a chapter 20 case but in a regular chapter 13 case, I assume the unsecured creditor whose lien had been stripped off could file that motion.

JUDGE DIEHL: Well, in your typical chapter 13 case, the strip-off of the lien doesn't occur until the discharge of the debtor which is at the end of the case. I understand in a chapter 20 context we don't have the discharge, but we have the same timeline for modification.

JUDGE SMALL: Okay. So if that's the case, if the strip-off comes at the end, how could you sell the property because it's subject to the lien, and really the only modification is for the benefit of the unsecured creditors of which the stripped-off creditor is one, but that stripped-off creditor would have to participate in the appreciation with all the other unsecured creditors.

PROFESSOR PONOROFF: The cases are split about the timing and I have a little bit of a discussion of that. A little bit because I didn't really understand it, about the timing of when the lien is stripped off. I think the *Fisette* case out of the [Eighth] Circuit B.A.P. said at the conclusion of payments under the plan, completion of the plan.²³ But you're right. In *Davis*, at least it appeared to me

²² *Murphy v. O'Donnell (In re Murphy)*, 474 F.3d 143 (4th Cir. 2007).

²³ *Fisette v. Keller (In re Fisette)*, 455 B.R. 177 (B.A.P. 8th Cir. 2011).

as I read it, that the strip-off was immediate with the spring-back right under § 340.

JUDGE SMALL: Okay. Well, let's think about *Davis*. In a chapter 20 concept, you have the appreciation of the property. Who can file the motion then to modify the plan? The trustee can. Any other unsecured or secured creditor can, and there were other unsecured creditors in the *Davis* case. But what about the stripped-off creditor?

JUDGE DIEHL: At least in our district, that stripped-off creditor is generally treated as an unsecured, the plan provides that they have an unsecured claim.

JUDGE SMALL: Except their claim had been discharged in the chapter 7 case and they no longer have an unsecured claim.

JUDGE DIEHL: Well, they have an unsecured. I mean, again, I don't know that this is a very sophisticated rationale, but a claim is either secured or unsecured. There aren't any other kinds of claims in the Bankruptcy Code. I mean, a priority claim is an unsecured claim. So if you don't have a secured claim, then you've got to have an unsecured claim.

JUDGE SMALL: Well, I think they would have an unsecured claim but it would have been discharged in the prior bankruptcy.

JUDGE DIEHL: But *Johnson v. Home State* says they have a claim so the claim—

JUDGE SMALL: That's right.

PROFESSOR PONOROFF: You can still restructure.

JUDGE DIEHL: —so the claim has got to be unsecured because it's not secured.

JUDGE SMALL: Right. Well, these are interesting questions, and it may be that if there is appreciation, and unless the debtor is willing to sell the property, then as a practical matter, I don't think you can force them to sell the property, and it maybe makes no difference whether the strip-off occurs at confirmation or after the completion because you're not going to be able to sell the property anyway as long as the lien can spring back.

PROFESSOR PONOROFF: Well, unless you get the lienor to agree to release the lien—

JUDGE SMALL: That's right.

PROFESSOR PONOROFF: —which most lenders will probably not do out of the goodness of their hearts.

JUDGE SMALL: Exactly.

JUDGE DIEHL: Well, you know, you have that same issue with respect to timing of the strip-off of the lien that comes up in chapter 20. You know, when you're not going to have a discharge, and there's obviously other reasons that debtors don't get discharges in chapter 13 such as they had a prior chapter 7 discharge within the statutory period, or they don't file their personal financial management certificate, or haven't complied with § 522(q). So those are cases where if your lien strip order says that this is effective upon discharge, then what happens when there is no discharge?

JUDGE SMALL: There's another interesting issue. When you have the chapter 7 followed immediately by a chapter 13 and you really don't have any other creditors, except in *Davis* that's what basically happened. She filed the chapter 7 and then filed the chapter 13 a week later, but she was dealing with tax debts and they didn't really raise the issue of good faith there.

PROFESSOR PONOROFF: I was going to say you're right. I mean, chapter 20 colloquially used to be understood as the rapid fire filing of the 13 as soon as the 7 was closed. After BAPCPA with § 1328(f)(1), we now sort of have a four-year temporal boundary around what's a chapter 20. A chapter 20 is anytime you file within four years of receiving a discharge in chapter 7.

JUDGE SMALL: You also have that other temporal argument about how long you have to be in chapter 13 and where you've discharged all the debt, you don't have any debt but you've got a stripped-off lien. Do you have to keep the plan open for five years because there's a possibility of some appreciation in the stripped-off lien?

JUDGE DIEHL: Well, that's what your applicable commitment period is.

JUDGE SMALL: Right. Right.

MS. HARRILL: Unless we have some questions from the audience, and feel free to come up. I do want to pose one question to the panel and get their input if they have any thoughts on it. If and when one of these issues gets up to the Supreme Court and they take certiorari, whether it's on the chapter 20 issue or stripping off a wholly unsecured lien in chapter 7, can they reconcile *Dewsnup*

with other cases, whether it's *Johnson* or *Nobelman*? Or do they have to go back and write on a clean slate? Or should they?

PROFESSOR PONOROFF: Well, you know, I mentioned earlier *Dred Scott* and the Supreme Court did acknowledge that it got it wrong. I honestly don't see how you reconcile that. And that *Woolsey* case from the Tenth Circuit is a great discussion of how, and the language is really lovely. But it's a great discussion of how this just sticks out like a sore thumb.

JUDGE SMALL: I would agree with that.

JUDGE DIEHL: I mean, again, I think the reconciliation has got to come in terms of viewing liquidation different than reorganization, notwithstanding the fact that chapter 5 does apply in all kinds of cases. I still think that whole claims allowance thing makes chapter 7 different for these purposes.

JUDGE SMALL: I think this whole lien-stripping strip-off thing is basically a chapter 13 issue, and I think a lot of the problems could be solved if they allowed bankruptcy judges to modify mortgages on the home residences, and I wish they had done that earlier. I think we would've come out of the recession a lot sooner.

MS. HARRILL: Do we have any questions from the audience? I want to thank our panelists. It was a fantastic discussion and I strongly encourage everyone to read Professor Ponoroff's article. It is excellent. You will learn very, very much. I know I did, and I think Alex has some remarks to make at this point.

MR. CLAMON: Professor Ponoroff, Judge Diehl, Judge Small, Ms. Harrill, thank you so much for that fruitful discussion.