# Chapter 13 Plans – Sale and refinancing of real estate

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Unlike Chapter 7, which contemplates that creditors will be paid from the liquidation of a debtor's assets, Chapter 13 debtors pay their creditors a certain amount of money over a period of years, usually by providing the Chapter 13 trustee with a portion of their future earnings. As the real estate market has heated up, interest rates have dropped, and lenders have become more willing to accept the risks inherent in lending to someone who has had financial problems and is now in a bankruptcy proceeding, the sale or refinancing of property has become an attractive alternative for those individuals who were not able to resolve their problems with their mortgagee or creditors without first entering a bankruptcy proceeding. This paper will discuss the requirements set forth in 11 U.S.C. §§ 1325 and 1329 of the Bankruptcy Code and the approach of courts to a proposed sale or refinancing of the debtor's real estate. As Congress has recently passed, and the President has signed, bankruptcy legislation that has been pending for a number of years, this paper will attempt to integrate those aspects of the new legislation which will impact Section 1325.

**The Chapter 13 Plan and Order confirming plan.**

Under a Chapter 13 plan, also known as a wage earner plan, the debtor proposes to make payments on a monthly basis. Among the requirements set forth in § 1325 of the

Bankruptcy Code which the debtor must meet in order to obtain confirmation of a Chapter 13 plan is the disposable income test contained in 11 U.S.C. §1325 (b). That test requires the debtor to commit all of his projected disposable income to the plan for at least three years (and soon to be five years for those debtors whose monthly income exceeds the state's median family income). 11 U.S.C. § 1325 (b)(1)(B).

Orders used by the various courts confirming Chapter 13 plans are not consistent throughout the circuit. Confirmation orders in Rhode Island and Massachusetts, which are in all material aspects virtually identical, provide that unsecured creditors shall receive dividends of "not less than" a certain percentage of their claims. Maine's confirmation order provides for periodic plan payments in a specified amount and New Hampshire's, while providing for payments in a specify amount, goes on to state that the plan "calls for pro rata payment". Puerto Rico's Plan provides that debtor will make monthly payments in specified amounts and that unsecured creditors will receive pro rata disbursements from those funds after payment of all other obligations. The confirmation order merely references the plan.

Notwithstanding the difference in language each of the districts generally require confirmed plans be construed as "pot plans," not "percentage plans", although Puerto Rico does not per se preclude the filing of percentage plans The difference between "pot plans" and "percentage plans" is thoroughly discussed by the 7th Circuit in the case of In re Witkowski, 16 F. 3d. 739, 741 (7th Cir. 1994). As may be inferred by the terminology,

percentage plans provide that a specific amount will be paid to creditors without regard for the creditors who actually file claims and the amount of those claims allowed by the court. "Pot plans" provide for a specific amount to be paid over a specific period of time to creditors, thus allowing for an increase or decrease in the actual dividend received depending upon the amount of claims ultimately allowed. It matters not that the term of the plan exceeds the minimum mandated by Congress. Id. *See also* In re Stamm, 265 B.R. 10 (Bankr. D. Mass. 2001).

Regarding the vesting of property, Rhode Island and Massachusetts specifically provide that the property of the bankruptcy estate includes any appreciation in value of real estate. Maine's order of confirmation provides only that all property of the estate remains property of the estate notwithstanding Section 1327(b) of the Bankruptcy Code. Puerto Rico's order again references the plan, which contains a provision similar to that of Maine vesting property of the estate in the debtor only after the debtor is discharged. New Hampshire's confirmation order makes no mention of the vesting of property, thus re-vesting the property in the debtor upon confirmation of the plan under Section 1327(b).

**Does a sale or refinancing constitute a modification of the plan? Is the distinction important?**

Modification of a plan can be made at any time prior to completion of payments to; (1) increase or reduce the payments to be made, (2) extend or reduce the time to make the payments, or (3) alter the amount of a distribution to a creditor. See 11 USC § 1329. When determining whether a motion to sell or to refinance is in fact a modification of a confirmed

Chapter 13 plan, courts examine the substance of the plan and the nature of the debtor's obligation to his creditors, not the number of payments proposed. *See* Massachusetts Housing Finance Agency v. Evora, 255 B.R. 336 (D. Mass. 2000) (refinancing which accelerated payments under plan did not constitute a modification of the plan); In re Murphy, 2005 W.L. 327099 (Bankr. E. D. Va.) (refinancing did not constitute modification of a plan); *cf.* In re Kieta, 315 B.R. 192 (Bankr. D. Mass. 2004) (refinancing was a modification where it would enable the debtor to shorten the duration of the plan and thus reduce the dividend to be paid to creditors). The Bankruptcy Appellate Panel for the 1st Circuit has not addressed the matter but has agreed with the Evora court that bankruptcy courts must "examine the substance of the confirmed Chapter 13 plan, the nature of the Debtor's obligations to the Debtor's creditors and whether the motion seeks to alter the substance of the plan or the nature of the obligations". In re Muessel, 292 B.R. 712, 716 (1st Cir. B.A.P. 2003).

The issue is likely moot as the plan may be modified "upon request of the debtor, *the trustee, or the holder of an allowed unsecured claim*" (emphasis supplied). See 11 U.S.C. Section 1329(a). Parties must advance a legitimate reason for a modification and cannot use such a motion to modify or address matters which should have been or were raised at the time of confirmation. *See* In re Barbosa, 236 B.R. 540, 547 (Bankr. D. Mass. 1999), *aff'd*, 235 F. 3d. 31 (1st Cir. 2000). Although some jurisdictions require that a the debtor experience a substantial change of their financial situation not reasonably anticipated

at the time of confirmation before modification can be sought by a creditor or the trustee (*See*, *e.g.*, Arnold v Weist, 869 F. 2d. 240 (4th Cir. 1989)), the 1st Circuit has pointedly rejected that standard. *See* Barbosa, at 547, *aff'd*, 235 F. 3d. at 41. As a practical matter, therefore, should the trustee object to a sale or refinancing and file a motion to modify the existing plan, the debtor will likely be required to convince the court that modification as sought by the trustee or a creditor is not appropriate under the circumstances.

The more important issue is whether the effective date of the plan is the date it was originally confirmed or the date it was modified. Put more succinctly, for the purposes of determining whether the plan meets the requirements set forth in § 1325 (a)(4) (the so-called "best interest of creditors" test), should the bankruptcy court value property on the date of the proposed modification of the plan, or the date the plan was first confirmed? Most courts have found that the date for determination of the "best interest" test is the date of modification, not the initial date of confirmation. *See* In re Profit, 269 B.R. 51 (Bankr. D. Nev. 2001); In re Stinson, 302 B.R. 828 (Bankr. D. Md 2003); In re Nevins, 2005 W.L. 984182 (Bankr. E. D. Pa.) *cf.* In re Sanchez, 270 B.R. 322 (Bankr. D. N.H. 2001) (post petition personal injury not an asset of the estate to be considered in determining best interest test at time of filing amended plan); In re Forbes, 215 B.R. 183 (8th Cir. B.A.P. 1997) (settlement proceeds from post filing cause of action not to be included in best interest of creditors test.) Judge Feeney, in the initial Barbosa decision set forth the two competing positions before ultimately determining that the effective date should be the date

of the modification order. See Barbosa, 236 B.R. at 552-554. The 1st Circuit has yet to directly address the issue, although it came close in affirming the decisions of the lower courts in the Barbosa appeal. *See* In re Barbosa, 235 F. 3d. at 39-40, *citing* In re Witkowski, 16 F. 3d. at 745-746. In that decision the Appeals Court did state that "a modified plan is only available if §§ 1322(a), 1322(b), 1325(a) and (1329(c) of the bankruptcy code are met" and if it is proposed in good faith. Id. at 37. As previously stated § 1325(a) contains the best interest of creditors test.

**Who gets the benefit of a refinance or sale?**

Whether debtors seek to sell their property or to refinance it, their ultimate goal is usually to reduce the financial pressure they face and to enhance the prospects of their reorganization. In some cases, refinancing becomes the only means by which a debtor can satisfy post-petition arrears to his mortgagee. The goal of reducing or eliminating the financial pressure can be thwarted, however, if all of the savings generated by such refinancing or sale is seized by the trustee for the benefit of the creditors.

The Massachusetts bankruptcy courts typically confer the benefit of any sale or refinancing upon the trustee and the creditors. *See, e.g.,* Kieta, (debtor could not use refinancing to pay only a 10% dividend when the increase in value of the real estate was sufficient to enable the debtor to pay a 100% dividend to her creditors); In re Martin, 232 B.R. 29 (D. Mass. 1999) (court allowed a motion to refinance while simultaneously denying debtor's motion to modify plan seeking permission to pay as one lump sum the

balance of a 10% plan where, as a result of the increased value of the property, creditors might be entitled to a greater dividend). In re Muessel, 292 B.R. 712 (1st Cir. B.A.P. 2003) (reversing bankruptcy court order requiring debtor to pay 100% dividend from refinancing but on remand, and perhaps only because the term of the plan had expired, still requiring debtor to either pay plan arrearages or seek refinancing to pay balance of plan obligations). *Cf.* Evora, (nothing in Bankruptcy Code requires revaluation of secured claim at time plan is modified). The Massachusetts' courts seeming antipathy towards the debtor in these situations is found, in part, in the standard orders now entered by these courts. The Massachusetts orders appear to expand the notion of what constitutes assets of the bankruptcy estate to include not only those assets acquired during the pendancy of the Chapter 13 but also any appreciation in the value of the debtor's real estate.

The import of the Kieta case, and the Bankruptcy Court's decision in the Muessel case in particular, should give pause to those considering refinancing or selling, particularly in Massachusetts. Kieta involved a debtor who had difficulty meeting her monthly mortgage obligations as well as her obligations to the Chapter 13 trustee. The debtor's plan called for curing her mortgage defaults of over $18,000 and making a 10% plan payment to her unsecured creditors. The order confirming her plan contained the previously described standard language including appreciation in value as an asset of her bankruptcy estate. Over the next three years her failure to pay resulted in the filing of three separate motions for relief by her mortgagee as well as a motion to dismiss filed by her trustee. In spite of her

poor payment history, she was able to locate a lender willing to refinance the property; and, shortly after the filing of the third motion for relief, she filed her motion to do so.

Over the course of her bankruptcy proceeding, the value of Kieta's residence had appreciated by approximately $100,000. The Chapter 13 trustee objected to the refinancing, asserting that the debtor was required to file an amended plan providing for payment of a dividend of 100% and also to file amended Schedules I & J. The court agreed, relying upon the language in the confirmation order that included increased value as an asset, an order, which the court pointed out, had not been appealed by the debtor.

Muessel had even greater difficulties meeting her financial obligations to the trustee and her mortgagee. She also filed a plan calling for payments, in this case over a five-year period, with a 10% dividend to her unsecured creditors. In 2002, two years into the plan, Muessel modified it by increasing her payments and reducing the term to 54 months. The second confirmation order contained the language including any appreciation of real estate value as an asset of the bankruptcy estate. A little over a year later the debtor was eight months in arrears in her payments to, and facing a motion to dismiss filed by, the trustee. In an attempt to salvage her case, she filed a motion to refinance, generating objections from both the trustee and the major unsecured creditor.

The bankruptcy court allowed the motion to refinance and ordered the debtor to modify her plan to provide for payment in full to her creditors. On appeal, the B.A.P. reversed, stating that the bankruptcy court had no authority to independently dictate the

terms of a Chapter 13 plan, as only the debtor, the trustee or creditors may seek such modification. Furthermore, the B.A.P. stated that since 54-month term of the plan had expired, the debtor could seek refinancing to pay the balance due under her plan.

The fact that Keita and Muessel were unable to meet their obligations under their Chapter 13 plans as confirmed by the court is not unusual. The import of the two cases, however, illustrate the conundrum faced by the financially strapped Chapter 13 debtor. The debtor can either salvage his plan and his residence or he can leave himself open to a motion to modify filed by a creditor or a Chapter 13 trustee based upon either increased non-exempt equity and/or an increase in disposable income. While potentially resolving one problem, the debtor has opened the proverbial Pandora's box and exposed himself to substantial and theretofore unanticipated potential liability.

The problem similarly exists for those simply seeking some relief from the crushing monthly costs associated with making both their current monthly expenses and paying the Chapter 13 trustee. Refinancing prior to any bankruptcy proceeding is usually unavailable or available only on terms that are significantly higher than existing market rates. However, under current lending standards, those who are able to make their payments timely to the Chapter 13 trustee and to their mortgagee for one or two years in a chapter 13 proceeding may now be able to obtain credit at or near existing market rates. A drop in the interest rate on a $100,000 mortgage from 11% to 7% can save a borrower $285.00 in monthly mortgage expenses. Even after taking into account the increase in the principal balance of

the mortgage to satisfy the obligations then due (or at least initially due) to the Chapter 13 trustee, the debtor often is able realize a substantial savings in monthly debt service. Those savings can be immediately eliminated if a party in interest seeks to modify the existing plan based upon the increase in the debtor's disposable income.

**Solutions or throwing gasoline on the fire?**

Is it possible to avert the disasters faced by Martin, Muessel, and Nevins, and others or at least to eliminate the need for a debtor to continue making payments beyond the statutorily mandated minimum time frame? The answer is maybe.

First, debtors' counsel need to become familiar with both their client's current circumstances as well as likely changes to those circumstances and the impact such changes will have upon their client's bankruptcy proceedings. While a Chapter 13 debtor must provide his disposable income to the trustee for three years and propose a plan in good faith, he is also entitled to a fresh start. *See* In re Carvalho, 335 F. 3d. 45 (1st Ci.r. 2003) *citing* H.R. Rep. No. 95-595 at 118. Exceptions to the policy are supposed to be narrowly construed and courts should strike an equitable balance between the debtor's entitlement to a fresh start and the rights of creditors. Id.

The question arises whether the orders utilized by the courts in Massachusetts and Rhode Island, particularly the portion that incorporates any increase in value of real property into the definition of assets of the bankruptcy estate, are consistent with the mandates of Carvalho. While Section 1306 of the Bankruptcy Code includes earnings from

services performed and property the debtor *acquires* after the filing of the bankruptcy proceeding as assets of a bankruptcy estate it makes no mention of appreciation in value of property already owned by the debtor. By definition, to acquire requires some exertion, purchase, or other action by the acquirer. Black's Law Dictionary 25 (8th ed. 2004). Black's definition specifically excludes property obtained by gift, devise or bequest. Id. Rather than providing the debtor a fresh start, does a provision incorporating increases in value under the umbrella of "assets of the estate" provide the debtor with a delayed start? However, if the 1st Circuit ultimately agrees with those that find the "best interest of creditors test" must be determined in light of the value of assets at the time of modification, this issue could also be moot.

How, then, might counsel minimize the amount his client must pay to creditors and still meet the mandates of the Bankruptcy Code? Although many debtors do not have the disposable income necessary to enable them to cure in full arrearages on their mortgages and/or priority tax obligations within a three year period, the ability to obtain financing while still in bankruptcy proceedings now enables a number of debtors to propose feasible plans in good faith which specify that they will pay a lump sum amount at the end of the term of their plan. It is suggested that the solution (or the first bottle of gasoline on the fire) requires debtor's counsel to at least include in his plan provisions that the debtor intends to seek refinancing of his mortgage after the second year of the plan and to use the proceeds to pay the balance due under the plan. By including such a provision, counsel eliminates the

threshold argument by the trustee or creditors that he is modifying the existing plan.

Thus, plans exceeding the minimum payment term should be the exception, not the rule, even for those debtors unable to cure defaults on their mortgage(s), pay priority obligations in full, and meet their statutory obligation to unsecured creditors in that minimum time frame. If it becomes obvious that the Debtor will be unable to refinance his property, counsel can then move to modify the plan by increasing its length. Because of likely deferred maintenance and the debtor's inability to meet even the current lax lending standards such debtors' properties are less likely to increase substantially in value or equity, thus eliminating exposure of those debtors to the argument that their dividend to unsecured creditors should be increased.

The above proposal does not necessarily resolve the issue. If, in response to a motion to borrow, the trustee or a creditor files a motion to modify, counsel may be left with no alterative but to withdraw the motion. *See* In re Trumbas, 245 B.R. 764 (Bankr. D. Mass. 2000) (no cause existed entitling creditor to seek modification of plan even though debtor had filed and subsequently withdrawn motion to refinance).

**Conclusion**

The road for debtors seeking to refinance their property is fraught with pitfalls and potential detours. The best that counsel can hope for is to minimize the risk at the commencement of the case should refinancing be a possibility at any time during the bankruptcy proceeding.

[1] As the new legislation now references the Internal Revenue Service standard when determining allowed

expenses the author makes no attempt to determine how disposable income will be calculated.

[2] Interestingly, although many of the consumer aspects of the revisions to the Bankruptcy Code passed earlier this year were considered "creditor friendly" and were designed to compel debtors to repay their debts to the maximum extent thought possible, Congress made no change to Section 1327 of the Code. Neither did Congress expand the powers conferred in Section 1329 on the Chapter 13 trustee and creditors enabling them to seek modifications of the Plan which would increase the monthly plan payments or the total amount to be paid to creditors.

Although the debtor had initially claimed exemptions under the state statutory scheme, which could have entitled her to an exemption in the real estate of up to $300,000, she later amended her petition to claim exemptions under the federal scheme, thus limiting her exemption in the real estate to $17,425. The reason for the change is not apparent from the record.

# Chapter 13 Analysis
# Modification of Secured Claims
# How to Reconcile Apparent Conflicts
# Within the Plain Language of §1322

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In the early to mid-1990's, there was a substantial amount of activity, both judicial and legislative, dealing with a debtor's opportunities under Chapter 13 to formulate a plan that took into account fluctuations in real estate values as well as a debtor's desire to retain and afford properties in furtherance of the legislative intent behind the Bankruptcy Code. Although some issues were resolved by the United States Supreme Court there remain some conflicts with respect to modifications and the contents of a Chapter 13 plan. Specifically, a number of courts have analyzed the relationship among §1322(b)(2), §1322(b)(5) and §1322(d) of the Bankruptcy Code. The following attempts to highlight some recent court trends in reconciling those provisions.

With respect to the treatment of secured claims in Chapter 13 proceedings, §1322(b) provides, in relevant part, that:

> Subject to subsections (a) and (c) of this section, the plan may-
>
> (2) 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;
>
> (5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payment while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

Section §1322(d) provides that:

> The plan may not provide for payments over a period that is longer than three years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than five years.

A review of existing case law reveals a number of inconsistencies, in particular with respect to the relationship between §1322(b)(2) and §1322(b)(5). Specifically, courts are divided over whether or not debtors may modify a secured claim through bifurcation under §1322(b)(2) and also use the "cure and maintain" provisions of §1322(b)(5) to pay the reduced secured claim.

A recent decision in the 9th Circuit held that if a secured claim was modified under §1322(b)(2), the modified claim must then be paid during the life of the plan. In re Enewally, 368 F.3d 1165 (9th Cir. 2004).

In the underlying Enewally bankruptcy decision, the United States Bankruptcy Court for the Central District of California permitted the debtors to bifurcate a secured claim under §506(a) and then file a plan that permitted the debtors to cure and maintain payments under §1322(b)(5) by paying the reduced secured debt over the (shortened) life of the original note on the original interest terms. In re Enewally, 276 B.R. 643 (Bankr. C.D. Cal 2002). The property in question was a rental property subject to modification under §1322(b)(2) and the value of the property was established at the trial level by way of an uncontested affidavit. Once the value of the secured claim was established, the debtors proposed a plan that would allow them to continue making regular monthly mortgage payments at the original contract terms until the secured claim was paid in full with a portion of the unsecured claim being paid through the plan. There was no prepetition arrearage. The secured creditor timely objected to the treatment of its claim, arguing that the debtors were improperly modifying the secured claim and that once the debtors utilized the provisions of §1322(b)(2), they were obligated to pay the secured claim in full through the life of the plan.

The debtors then sought the entry of summary judgment in their favor and in a written decision on the motion, the bankruptcy court granted the debtors' motion. In support of its findings, the bankruptcy court acknowledged that certain secured debt in Chapter 13 cases can be treated either by modification under §1322(b)(2) or by utilizing the so-called "cure and default" provisions of §1322(b)(5). Because the property in question was a rental property, it was subject to modification. In addressing whether the modified claim could be paid over a period of time that exceeded the plan term, the bankruptcy court acknowledged that existing case law would not permit the debtors to modify the secured claim under §1322(b)(2) by reducing the monthly payment amount for the remainder of the loan term. However, the bankruptcy court held that because the debtors proposed to continue making the same payments at the contract rate until the modified secured claim was paid in full, the debtors were merely utilizing §506(a) to determine the amount of the secured claim and that the debtors then essentially chose their §1322(b)(5) "cure and maintain" option thus avoiding any conflict with §1322(b)(2).

The United States District Court for the Central District of California reversed the bankruptcy court's determination, finding that the bankruptcy court's analysis was inconsistent with the U.S. Supreme Court's decision in Nobelman vs. American Savings Bank, 508 U.S. 324 (1993). The district court determined that Nobelman required a modification in a Chapter 13 proceeding be done within the parameters of §1322(b)(2) and that repayment must be completed during the term of the plan.

The 9th Circuit Court of Appeals affirmed the ruling of the district court, holding that:

> Although the bankruptcy court's analysis is arguably much closer to the original vision of the Bankruptcy Code than the district court's holding, we are not writing on a clean slate. The Supreme Court has spoken directly in *Dewsnup* and *Nobelman.* *Dewsnup* cautioned against courts fashioning a 'broad new remedy' under §506(a) where the remedy was not 'mentioned somewhere in the Code itself or in the annals of Congress.' (citation omitted). In *Nobelman,* the Supreme Court explained that, in a Chapter 13 plan, stripping down an undersecured lien to the value of the underlying collateral pursuant to §506(a) valuation, 'would require a modification of the rights of the holder of the security interest' pursuant to §1322(b)(2). (citation omitted). In order to hold that the debtor's lien stripping proposal is viable under the 'cure and maintain' provision of §1322(b)(5), we would have to hold that §506(a) coupled with §1322(b)(5) provides a new remedy allowing modification of secured debts in Chapter 13 independent of §1322 (b)(2). The logic of *Dewsnup* and *Nobelman* do not permit this construction. As both the district court and the bankruptcy court noted, lien stripping on debts secured by real property that is not the debtor's primary residence is permissible in Chapter 13, even after *Nobelman.* However, it must be accomplished in a manner consistent with §1322(b)(2). Because §1322(b)(2) does not allow a modified secured debt to be paid over a period of time longer than the plan term, the debtors' proposed plan modification must be disallowed. In re Enewally, 368 F.3d 1165 at 1171-1172, citing Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993) and Dewsnup v. Timm, 502 U.S. 410 (1992).

Taking a different approach from the Enewally court, the United States District Court for the District of Rhode upheld the bankruptcy court's decision determining that §1322(b)(2) and §1322(b)(5) are not mutually exclusive. See In re Ferreira , 223 B.R. 258 (Dist. Ct. RI 1998). In the underlying Ferreira bankruptcy case, the debtors submitted a plan bifurcating a secured creditor's claim with respect to non-residential real estate and providing for payment of the secured claim over the remaining term of the 30 year note. The secured creditor therein appealed, arguing that payments of a modified claim could not go beyond the 5 year limit set forth in §1322(d) and further arguing that §1322(b)(2) and §1322(b)(5) are mutually exclusive. The secured creditor also argued that §1322(b)(5) is triggered only when dealing with curing arrearages.

In affirming the bankruptcy court's decision, the district court appears to have read §1322(b)(5)

literally, in that it permits a plan to cure and maintain payments on "any unsecured claim or secured claim".(emphasis added). The court looked to §506(a) which defines a claim as "a secured claim to the extent of the value of a creditor's interest." (emphasis added). Therefore, §1322(b)(5) applies to modified claims, concluding that the secured portion of an undersecured claim is a "secured claim" within the meaning of §1322(b)(5). Id. at 261. Furthermore, the district court relied on a number of bankruptcy court decisions in the First Circuit, stating that "[t]hose courts have universally held that although bifurcation may modify a creditor's 'rights' within the meaning of subsection (b)(2), it does not preclude application of subsection (b)(5) when payments are 'maintained' in accordance with the terms of the original indebtedness." Id. at 262, citing In re Kheng, 202 B.R. 538, 539 (Bankr. D.R.I. 1996); Brown v. Shorewood Fin., Inc., GTE, 175 B.R. 129, 133 (Bankr. D. Mass. 1994); In re Murphy , 175 B.R. 134, 137 (Bankr. D. Mass. 1994), In re McGregor, 172 B.R. 718, 721 (Bankr. D. Mass. 1994).

In Connecticut, there are conflicting approaches to the relationship between §1322(b)(2) and §1322(b)(5). In In re Kinney, 2000 U.S. Dist. LEXIS 22313 (Dist. Ct. Conn. 2000), the United States District Court for the District of Connecticut considered the issue of whether a secured claim, once bifurcated, must be paid in full during the period of as well as within the plan or whether payments could be extended past the term of the plan if all other contractual provisions remained in place. The underlying bankruptcy court permitted confirmation of the debtor's plan which bifurcated a secured claim and which further provided for the pre-petition arrearage to be paid through the plan. In addition, the plan proposed to pay contract principal and interest payments outside the plan until the modified portion of the secured claim was paid in full, even if that occurred after the final payment due under the plan. In affirming the bankruptcy court's decision, the district court reviewed the relationship among §1322(b)(2), §1322(b)(5) and §1322(d) as well as prior case law, relying heavily on In re McGregor, 172 B.R. 718 (Bankr. D. Mass. 1994). In particular, the court discussed the McGregor court's conclusion that if a debtor attempted to change the contract terms after bifurcation, that did not constitute a "maintenance of payments" under §1322(b)(5) but if the contract rate and payment amounts called for under the loan documents remain the same until the secured claim is paid in full, then payments on the bifurcated claim could extend outside the life of the plan. Id. at 17-18, referencing McGregor, 172 B.R. at 718-720.

The Court in Kinney thus concluded that:

> [u]nder §1322(b)(5), bifurcation of a claim into secured and unsecured portions is a form of modifying a creditor's rights under the terms of a security agreement which ordinarily requires payment in full pursuant to §1322(b)(2) and §1322(d). However, §1322(b)(5) provides an alternative to the debtor whereby he can modify the creditor's rights under the security agreement, *so long as the payments under the agreement remain the same.* The debtor may utilize §1322(b)(5) to pay off a bifurcated secured claim provided that: (1) he pays off any arrearage during the five-year life of the plan; (2) he makes monthly payments of principal and interest in the same amount called for by the security agreement during the life of the plan and during such further period of time as necessary to pay

> in full *the secured claim* as valued under §506(a); (3) the interest rate on the secured principal debt is the same as provided in the security agreement; and, (4) the creditor retains a lien on the property. Id. at 21-22. (Citations omitted).

Not long after the Kinney decision, a contrary opinion was set forth in In re Koper. (Bankr. Conn 2002) 284 B.R. 747. In that case, a debtor proposed a plan for confirmation that appears to have met the criteria set forth in Kinney. The property in question was a multi-family with a value of approximately $35,000.00. The first mortgagee was owed approximately $80,000.00 and there was a pre-petition arrearage due and owing of approximately $7,000.00. The proposed Chapter 13 plan bifurcated the mortgagee's claim into a $35,000.00 secured claim with the balance being treated as an unsecured claim. Debtor proposed making ongoing mortgage payments at the contract rate until the secured claim was paid in full with the arrearage to be treated as a secured claim and paid in full at a 6% interest rate. The plan also provided for the lender to retain its lien on the property until paid.

The bankruptcy court denied confirmation of the plan, specifically declining to follow the ruling in Kinney as well prior practice by the bankruptcy court itself. Instead, the court found that the debtor's plan improperly combined §1322(b)(2) and §1322(b)(5) and that the bifurcated claim must be paid within the five-year limitation set forth in §1322(d).

In its decision, the court designated debtor's proposed plan as a so-called "Hybrid Plan" and determined that such a plan was not permissible under the Code. Essentially, the court looked at §1322(b)(5) first because of the cure and maintain provision in the proposed plan and noted that in no way does §1322(b)(5) permit any authority to modify a secured claim. "By its terms, Section 1322(b)(5) does not provide any license for *modification* of secured claims, through bifurcation or otherwise. Hence, if the Debtor purports to premise treatment of secured claims exclusively upon that subsection, bifurcation cannot be an element of the Plan. Bifurcation can only occur under the modification license of subsection (b)(2). Consequently, a Hybrid Plan's treatment of mortgage claims is necessarily premised upon subsections (b)(2) *and* (b)(5). And as has already been established here, any attempt to modify a claim pursuant to subsection (b)(2) requires compliance with the plan distribution time limitations of Section 1322(d)." Id. at 753.

The Court went on to state that even if subsection (b)(5) could somehow be interpreted to allow a bifurcation, both subsections (b)(2) and (b)(5) are subject to the five-year plan limitation set forth in §1322(d). "A secured claim that is modified by a plan is plainly 'provided for' by that plan...." Id. at 752. and §1322(d) states that a plan "…may not *provide* for payments over a period that is longer than three years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than five years." 11 U.S.C. §1322(d) (emphasis added).

In addressing those courts that have held otherwise, including In re McGregor, 172 B.R. 718 (Bankr. D. Mass 1994), the court noted that those cases pre-dated the 1994 Amendments to the Code and that the court was not able to find any statutory provisions that would permit it to distinguish subsection (b)(5) from the other subparts of §1322(b) which are bound by the five

year limit set forth in §1322(d).

> McGregor and its progeny focus, if at all, on the fact that subsection (b)(5), by its terms, addresses claims 'on which the last payment is due after the date on which the final payment under the plan is due' (hereafter, the 'Long Term Debt Reference'). In essence, these authorities interpret the Long Term Debt Reference as a license for long term *treatment*, i.e. treatment which extends beyond the permissible duration of a plan. Yet this court can formulate no reasonable construction of subsection (b)(5) under which the Long Term Debt Reference could be read as a substantive license. Instead, that Reference merely *identifies* the *type* of claim to which a 'cure and maintain' plan can be addressed. Finally, the Prefatory Language of Section 1322(b) explicitly renders *all* of its enumerated subparts subject to the time constraint of Section 1322(d). Id. at 754.

Furthermore, the court determined that a Second Circuit Court of Appeals case which supported the use of a Hybrid Plan under §1322(b)(5), In re Bellamy, 962 F.2d 176 (2d. Cir. 1992), was overruled by Nobelman v. American Savings Bank, 508 U.S. 324 (1993). The court specifically noted that the Bellamy decision was premised upon the notion that a bifurcation is not a modification, contrary to the holding in Nobelman.

Finally, the court discussed legislative intent in support of its holding, referring to H.R. Rep. No. 595, 95th Cong. 1st Sess. 117-18 (1977) and stating that "[t]his Court's construction of Section 1322 is also consistent with the principal legislative purposes of Chapter 13 – minimization of creditor loss, preservation of debtor property, and facilitation of the debtor's 'fresh start'". Id. at 755. The court, in acknowledging that as a result of its findings some debtors may not be able to avail themselves of the relief afforded by §1322(b)(2) due to financial constraints, expressed the opinion that those debtors were still provided with opportunities to reorganize under the protection of the Bankruptcy Code. "Specifically, it may disable that subset of debtors from reaping the economic windfall of bifurcation. However, because this Court views a debtor's ability to bifurcate an undersecured claim as more in the nature of a 'head start' rather than a 'fresh start', that limitation is consonant with Congressional purposes." Id. at 755-756.

In addressing the inconsistencies within its own district, the Court stated that "[t]his Court is naturally reluctant to dissent from established district authority, especially when that authority is partly of its own making. However, upon the more considered reflection afforded by this matter, the Court respectfully departs from prior authority in favor of a statutory construction which accurately harmonized the plain meaning of the relevant Code Sections with controlling judicial authority and underlying legislative intent." Id. at 755.

Unfortunately, the United States Supreme Court declined to grant certiorari in the Enewally decision so that no clear resolution to the conflicting analyses and opinions appears to be

forthcoming anytime soon.

# EXCEPTIONS TO MODIFICATION OF CLAIMS SECURED ONLY BY A SECURITY INTEREST IN REAL PROPERTY THAT IS THE DEBTOR'S PRINCIPAL RESIDENCE [11 U.S.C. §1322(b)(2)]

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## INTRODUCTION

The Bankruptcy Code ("Code") permits a debtor to modify the rights of holders of secured claims through a Chapter 13 Plan, 11 U.S.C. §1322(b)(2). However, there is an important exception to this provision which prohibits modification of claims secured only by a security interest in real property that is the debtor's principal residence. Although on its face a particular claim may seem to fall squarely within the "antimodification" provision, a closer examination may be warranted. As discussed below, there are some exceptions to the prohibition of modification of mortgages.

## CODE PROVISION AND LEGISLATIVE INTENT

Section 1322 (b)(2) provides in pertinent part that:

(i) Subject to subsections (a) and (c) of this section, the Plan may….

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

The legislative history of §1322(b)(2) seems to suggest that the antimodification provision was intended to encourage the flow of capital into the home lending market. *See Nobelman v. American Savings Bank*, 508 U.S. 324, 332, 113 S.Ct 2106, 124 L.Ed.2d 228 (1993). The testimony given during hearings related to the bill stated that if residential mortgages could be modified through a Chapter 13 Plan, it would cause "residential mortgage lenders to be extraordinarily conservative in making loans in cases where the general financial resources of the individual borrower are not particularly strong." *See Lomas Mortgage, Inc. v. Louis,* 82 F.3d 1 (1st Cir. 1996) citing Hearings Before the Subcommittee on Improvements of the Judicial Machinery of the Senate Committee on the Judiciary, 95th Cong., 1st Sess. 707 (1977) (Statement of Edward J. Kulik, Senior Vice President, Real Estate Div., Mass Mut. Life Ins. Co.)

Subsequent to the enactment of the Code, one issue that developed over the years was whether the antimodification provision prohibited a Chapter 13 debtor from utilizing §506(a) of the Code to reduce the under-secured home mortgage to the fair market value of

the residence. The circuits were divided on this issue; for example the 2nd, 3rd, 9th and 10th had appellate decisions that held that §1322(b)(2) only limited the modification of the secured portion of the claim. *See In re Bellamy,* 962 F.2d 176 (2nd Cir. 1992*); In re Wilson v. Commonwealth Mortgage Corp.,* 895 F.2d 123 (3rd Cir. 1990); *In re Hougland,* 886 F.2d 1182 (9th Cir. 1989); and *In re Hart,* 923 F.2d 1410 (10th Cir. 1991). A contrary view was held by the Fifth Circuit which rendered a decision in the case of *In re Nobelman*, 968 F.2d 483 (CAS 1992). It affirmed the lower court is holding that the debtors could not propose in the plan to bifurcate the home mortgage into a secured claim (the value of the property) and an unsecured claim for the difference. The debtors appealed and the Supreme Court granted certiorari, *Nobleman v. American Sav. Bank,* 506 U.S. 1020, 113 S.Ct. 654, 121 L.Ed.2d 580 (1992).

## THE NOBELMAN INTERPRETATION

In *Nobelman*, the Supreme Court held that a Chapter 13 debtor could not modify the rights of a holder of a claim secured only by the debtor's principal residence into secured and unsecured parts and treat only the secured part as subject to the antimodification claim. In other words, the Court interpreted §1322(b)(2) as preventing a debtor from stripping down the mortgage to the value of the property pursuant to §506(a).

The facts of *Nobelman* are as follows: In 1984, the mortgagee, American Savings Bank ("ASB"), lent the debtors $168,250.00 for the purchase of a residential condominium and secured the loan on the property. In 1990, the debtors filed Chapter 13. At the commencement of the case, ASB was owed $71,335 in principal, interest and fees. The debtors' Chapter 13 plan valued the property at $23,500 (which was uncontested), and proposed to pay ASB under the mortgage, but only to the value of the property, with the difference to be treated as an unsecured claim.

In its analysis, the Supreme Court stated that it was appropriate for the debtors to examine §506(a) to ascertain the status of ASB's secured claim. Id. at 326. §506(a) provides in relevant part that:

> "An allowed claim of a creditor secured by a lien on property in which the estate has an interest, is a secured claim to the extent of the value of such creditors' interest in the estate's interest in such property ……., and is an unsecured claim to the extent that the value of such creditors' interest ……. is less than the amount of such allowed claim." 11 U.S.C. §506(a).

Pursuant to §103(a) of the Code, §506(a) applies to all chapters of bankruptcy.

Accordingly, applying §506(a) to the facts of *Nobelman*, the Court concluded that ASB was the holder of a secured claim in light of the fact that the property was valued at $23,500. Id. at 329. As such, the Court concluded that ASB's rights could not be modified. Justice Thomas, who delivered the opinion of the Court, analyzed that the focus of §1322(b)(2) should be on the words "rights of holders". However, the word "rights" is not defined in the Code. Therefore, Justice Thomas stated that in such situations, it is generally assumed that Congress "left the determination of property rights to state law". Id. at 329. From this point, Justice Thomas concluded that when the antimodification clause applies, a Chapter 13 debtor could not modify a mortgage holder's rights to repayment. The Court stated that "this is what was bargained for" by the mortgagor and the mortgagee, and are the rights protected from modification by §1322(b)(2). *See Dewsnup v. Timm,* 502 U.S. 410, 417, 112 S.Ct. 773, 778, 116 L.Ed.2d 903 (1993).

## TOTALLY UNDERSECURED CLAIMS

The principal issue that evolved after *Nobelman* was whether the decision applies to situations where there is no equity in the property over and above a senior mortgagee claim. After some initial decisions that protected mortgage holders, [ SEQ CHAPTER \h \r 1*American General Finance, Inc. v. Dickerson*, 229 B.R. 539 (Bankr. M.D. Ga. 1999), Fitzpatick, J. (M.C. Ga., January 27, 1999); SEQ CHAPTER \h \r 1*In re Diggs*, 228 B.R.

611, 614 (Bankr. W.D. La. 1999), SEQ CHAPTER \h \r 1*See also In re Dickerson*, Doc. No. 98-71071(Bankr. E.D.Okla. 1999); *In re Bauler*, 215 B.R. 628 (Bankr. D.N.M. 1997)], all Circuit Court opinions on the issue as well as 1st Cir. B.A.P., have held that *Nobelman* is distinguishable, and concluded that a totally underwater creditor is not a "holder of a secured claim" and that the antimodification does not apply. *See In re Mann*, 249 B.R. 831 (1st Cir. BAP 2000); *In re Zimmer*, 313 F.3d 1220 (9th Cir. 2002); *In re Lane*, 280 F.3d 663 (6th Cir. 2002); *In re Pond*, 252 F.3d 122 (2nd Cir. 2001); *In re Dickerson,* 222 F.3d 924 (11th Cir. 2000); *In re Tanner*, 217 F.3d 1357 (11th Cir. 2000); *In re Bantee*, 212 F.3d 277 (5th Cir. 2000); *In re McDonald*, 205 F.3d 606 (3rd Cir. 2000). *See also* Collier on Bankruptcy 1322.06 [1](a)(i) at 1322-21 (15th ed. rev. 1998).

Although the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* adds restrictions on modifying motor vehicle loans in §1325(a)(9), it does not amend §1322 as it relates to totally under-secured mortgages. Congress' silence could be interpreted as approval of the overwhelming court opinions permitting modification of junior mortgages that are totally under-secured.

## WHERE THERE IS ADDITIONAL COLLATERAL

The antimodification provision of §1322(b)(2) does not apply if there is security in collateral in addition to the real property that is the debtor's principal residence. An example where the antimodification provision did not apply was in the First Circuit decision of *Lomas Mortgage v. Louis*, 82 F.3d 1 (1st Cir. 1996). In *Lomas*, the court was faced with the question as to whether §1322(b)(2) was prevented from bifurcating a mortgage on property that was a three-family house in which the debtor resided in one of the units. The First Circuit held that the antimodification provision did not prevent the modification of the secured claim. In its analysis, the First Circuit concluded that the legislative history was not clear on how a mortgage on mixed property (both residential and investment characterized) should be treated. However, the First Circuit found guidance by examining the subsequent legislative history to the Bankruptcy Reform Act of 1994 ("Reform Act"). Pub.L. No. 103-394, 108 Stat. 4106 (1994). The Reform Act added an antimodification provision to Chapter 11 with its enactment of §1123(b)(5). The Court examined these amendments and ascertained that "Congress referred favorably to case law under Chapter 13 holding that the antimodification provision did not apply to multi-family housing, and established that it wished petitions under Chapter 11 and Chapter 13 to treat the matter the same way." Id. at 6.

There are also cases where the mortgage/security agreement includes more than just a mortgage interest in real property. *See In SEQ CHAPTER \h \r 1re Rolle*, 218 B.R. 636 (Bankr. S.D. Fla 1998), where the security interest included an assignment of rents and various appliances and fixtures. Concerning the assignment of rents, the Bankruptcy Court ruled that rent generated from real property is an interest in the real property, so that reference in the Code to a "security interest" in the real property permitted a security interest in rents. This is consistent with many state laws which in their common law description of mortgages include an assignment of rents. Concerning the language regarding other appliances and fixtures, this presents different issue. Fixtures are a part of the real estate, so that need not be discussed further. However, a security interest in appliances (or, in this case "all gas, steam, electric, water and other heating, cooking, refrigeration, lighting, plumbing, ventilating, irrigating and power systems, machines, appliances, fixtures and appurtenances, which now are or may hereafter pertain to, or be used with, in or on said premises, even though they be detached or detachable") is more difficult. Id. at 638. Here the Bankruptcy Court found that this security interest attached to a stove and refrigerator, which were not fixtures. Still the Bankruptcy Court ruled that these two items did not preclude §1322(b)(2)'s prohibition because (i) these items had little independent value; and (ii) it undermined Congress's intent. The Court cited several decisions on this point, with few exceptions. For the exceptions, *See In re Hammond*, 27 F.3d 52, 58 (3rd Cir. 1994).

The District Court in *In re Loper*, 222 B.R. 431, 432 (D. Vt. 1998) threw its weight on the side of the debtors. There the mortgage included "all improvements and personal property now or later attached thereto or reasonably necessary to the use thereof, including, but not limited to ranges, refrigerators, cloth washers, clothes dryers, or carpeting purchased . . . with the loan funds . . . " This clause had the result of including carpeting, a refrigerator, a wood stove, a range, and satellite dish in the mortgage. The Bankruptcy Court ruled in favor of the debtors, and the District Court reaffirmed. The District Court noted that the Third Circuit had ruled in favor of the debtors' position, *See In re Hammond*, 27 F.3d 52, 58 (3d Cir. 1994), while the appellate panels of the First and Ninth Circuits ruled in favor of the secured creditor. *In re Lee*, 215 B.R. 22 (9th Cir. Bankr. 1997) where the property was considered part of the real property or of such insignificant value, so that it would be inequitable to allow the stripping of the mortgage. *In re Marenaro*, 217 B.R. 358, 360 (1st Cir. Bankr. 1998)(*citing In re French*, 174 B. R. 1 (Bankr. D. Mass. 1994)(the test is whether the additional collateral is an component of the real property or is of little or no independent value). The District Court, however, ruled in favor of the debtors due to (i) the plain meaning of §1322(b)(2), (ii) the applicability of state law, and (iii) the legislative history of §1123(b)(5) (the Chapter 11 equivalent of §1322(b)(2)). Although the reasoning of the District Court was extensive, it can be best summed up in one quote: "[t]his Court finds, however, that the issue of whether a

residential mortgagee's claim may be bifurcated turns on the nature of the property securing the claim, not on the value of that property." *In re Lopez,* 222 B.R. at 438.

These last set of decisions revolve around whether the "additional" items have real "value". In the immediately preceding decision, value is not the issue. If there is a lien on personal property that is not a fixture, that takes it outside the scope of §1322(b)(2) preclusions. If one argues that value should not matter, then one may query if these items have no value, why are they included in the mortgages. Furthermore, if one argues that a junior mortgage always has some value under *Nobleman* even if an evaluation of the collateral provides value to only the senior lien holders, then that is inconsistent with the valuation in these cases. I understand that boilerplate language is difficult to change, but the consequences can be significant.

## IT MUST BE REAL PROPERTY

Finally, the antimodification provision of §1322(b)(2) has been held not to apply to a mobile home even if it is the debtor's principal residence because it is not considered realty under state law. *See In re Thompson,* 217 B.R. 375 (B.A.P. 2nd Cir. 1998)