Chapter 13 Plans:
Creativity Can Lead to Confirmation

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BIFURCATING MULTI-FAMILY PRINCIPAL RESIDENCE LOANS, AND MAINTENANCE OF PAYMENTS IN CHAPTER 13

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Summary:

Historically, principal residence mortgages (a.k.a homestead mortgages) have been treated differently that other mortgage loans. Bankruptcy Code Section 1322(b)(2) contains an anti-modification clause proscribing bifurcation of homestead mortgage that are secured only by real property that is the principal residence. It is well accepted that multi-family structures are not subject to the anti-modification clause even where the debtor claims a homestead in one of the units. Yet, there is conflicting case law on the applicability of the anti-modification clause where the homestead mortgage is also secured by non-real property such as rents, escrows, and/or fixtures, or other real or personal property.

Even when a homestead mortgage can be bifurcated, § 1325(a)(5)(b) requires that secured claims are paid in full by the end of the life of the plan. Alternatively, § 1322(b)(5) provides that payments can extend past the life of the plan if the debtor provides "maintenance of payments," meaning payments as contemplated by the underlying note.

Some of the requirements for "maintenance of payments" are illustrated, as well as a discussion of those two seemingly conflicting sections.

I. INTRODUCTION

Home ownership and their mortgage loans have been treated with preference (to both creditor and debtor) ever since President Lincoln signed the Homestead Act in 1862. Back then as now, general conscience holds that promoting home ownership promotes the greater interests of the country, increases financial stability and it is in general, a good thing.

President Obama is not the first to try to assist home mortgage debtors. To bolster home ownership stability during economic bad times, Government sponsored institutions sprang from emergency actions during and after the Great Depression:

i. The Federal Home Loan Bank Act of 1932 leading to creation of the FHA of 1937;

ii. The Veteran's Administration was created in 1944 with special loan provisions for principal residences;

iii. Fannie Mae was given authority to trade mortgage securities beginning in about 1938; and

iv. Freddie Mac followed in 1970.

Bankruptcy Code changed over the years too. Chapter XIII of the 1898 Bankruptcy Act was replaced with Chapter 13 in 1938. Therein, Section 1322(b)(2) was born allowing cram-down and lien stripping of secured claims without lender consent, and for the first time allowed adjustment of debts secured by real property.

But during the Bankruptcy Reform Act of 1978 the Senate and House disagreed over changes to an anti-modification clause to become part of § 1322(b)(2). The House wanted a version that would allow modification of any secured loan even if secured by a mortgage on any real estate. The Senate wanted a version that would preclude modification of mortgage loans entirely. A comprise was reached carving out anti-modification for home mortgages. The anti-modification clause agreed upon proscribes modifying the rights of holders of secured claims secured only by a security interest in real property that is the debtor's principal residence.

Separately, section 1325(a)(5)(B) states that for a plan to be confirmed the secured claims must be satisfied in full by the termination of the plan, that is, within at least 5 years. But section 1322(b)(5) permits the debtor to cure defaults within a reasonable time and to provide "maintenance of payments" while the case is pending on any unsecured or secured claim on which the last payment is due after the date on which the final payment under the plan is due.

Courts have clarified to some extent when a debtor can apply § 1322(b)(5) to allow payments past the life of the plan by providing *maintenance of payments*, but the definition of that term is not always clear and can be fact based depending on the intentions of the underlying note.

Today's presentation discusses what constitutes a claim secured only by a security interest in real property that is the debtor's principal residence; and when "maintenance of payments" is satisfied allowing for payments on the note after discharge of the case.

II. § 1322(b)(2) – SECURED ONLY BY A SECURITY INTEREST IN REAL PROPERTY THAT IS THE DEBTOR'S PRINCIPAL RESIDENCE…

The homestead mortgage anti-modification provision of § 1322(b)(2) permits a chapter 13 plan to propose modifying the rights of secured and unsecured creditors

EXCEPT as to a claim secured only by a security interest in real property that is the debtor's principal residence. Section 1322(b) read, in pertinent part, as follows:

> **(b)** 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;

11 U.S.C. 1322 (emphasis added).

Thereby, § 1322(b)(2) allows bifurcation of a mortgage loan into secured and unsecured portions – **but <u>not</u> when the security interest is <u>only</u> in real property that is the debtor's principal residence.**

The definition of that phrase has been the subject of much litigation, and is not entirely clear, as many mortgages have security that is not real property that is the debtor's principal residence, but close enough to still block modification of the mortgage loan.

1. In the first circuit, it is generally accepted that a multi-family building where the debtor resides in one unit, is sufficient other collateral to allow bifurcation.

➔ BUT there may shortly be litigation to determine if the non-principal portion must be *capable* of producing income, or if the other unit must *actually* be producing income, and if so, at what point in time must it be so capable or performing:

- *In re Legowski*, 167 B.R. 711, 713 (Bankr.D.Mass. 1994)(claim secured by *income producing property* is not precluded from modification by § 1322(b)(2).
- *In re Torres Lopez*, 138 B.R. 348, 351 (D.P.R. 1992)(the property itself *must have some inherent income-producing power*; mere fact that debtors place of business is located on the premises does not imbue debtor's property with income producing potential).
- *Lomas Mortgage, Inc., v. Louis,* 82 F.3d. 1, 2 (1st Cir. 1996)(§1322(b)(2) does not bar modification of a secured claim on a multi-unit property in which one unit is the principal residence and the security interest extends to the other *income-producing units*.

2. Test to determine if other collateral is sufficient to allow modification: must have independent value:
   - *In re French*, 174 B.R. 1, 7 (Bankr.D.Mass. 1994)(whether the "additional collateral" is more than an enhancement which is or can,

by agreement of the parties, be made a component part of the real property or is of little or no independent value)

- *In re Marenaro*, 217 B.R. 358 (1st Cir. B.A.P. 1998)(boiler plate add-on for improvements, easements, rights, mineral, oil, gas rights and profits… now sufficient to allow modification – must determine independent value), citing *In re Gleckman*, 212 B.R. 204 (Bankr.D.R.I. 1997); *In re Fountain*, 197 B.R. 748 (Bankr.D.N.H. 1996); *In re Smith*, 176 B.R. 298 (Bankr.D.N.H. 1994).
- *In re Gleckman, 212 B.R. 204 (Bankr.D.R.I. 1997)(* determination of "secured only by a principal residence" should examine whether the secured interest is more than mere enhancement of real property and whether it has significant independent value)
- *Assignment of rents is additional collaterial with independent value. In re DaCosta, 204 B.R. 1 (Bankr.D.Mass. 1996)*

3. Most of the cases involve multi-family residences where the Debtor has a principal residence in one unit. First Circuit cases are pretty firm in holding that such multi-family units are sufficiently collateralized by property that is not the principal residence that bifurcation is permitted.

4. Further issues:
   - Current case law, and probably the vast majority of circumstances, centers on multi-family dwellings, or multi-use dwellings (e.g., residential/business use in separate units), in other words, the "other collateral" is attached or real property. There doesn't seem to be any case law where the other collateral is not real property, e.g., security interest in principal residence and automobile.
   - In practice one should **look to the intent of the lender** via the mortgage document to see if the lender intended to take a security interest in other than the principal residence. For example, dividing a single-residence in to a two-family after a mortgage is granted **does not** nullify the antimodification clause as it was not the intent of the lender to loan on a multi-family structure. *In Re Scarborough,* 461 F.3d 406 (3rd Cir. 2006)(look to the terms of the mortgage and nature of the collateral at the time the mortgage was granted.)
   - Some clarity is still required where a homestead mortgage includes an explicit security interest in tax and insurance escrows. In *In re Steslow, 225 B.R. 883 (Bankr.E.D.P.A. 1998)* it was held that because state law defines escrows as personal rather then real property, the homestead mortgage was secured by more that real estate and was subject to bifurcation. Conversely, in *In re Rodriquez, 218 B.R. 764 (Bankr.E.D.P.A. 1988),* although escrows were personal rather than real property they were sufficiently *intertwined* with the real property to preclude bifurcation.

5. A final word on mobile homes: Merged with the Land??

- A mobile home on land not owned by debtor is not real property subject to the anti-modification clause. *In re Shepard, 381 B.R. 675 (Bankr.E.D.Tenn. 2008)*. But where a debtor's mobile home had a cinderblock foundation with its wheels removed, a septic system and drilled water well, it was sufficiently merged into the land as to be real property. *Williamson v. Washington Mut. Home Loans, Inc.*, 400 B.R. 917 (Bankr.M.D.Ga. 2009)

From the above, it is evidence that a factual analysis is required to determine if additional collateral is sufficient to avoid the anti-modification clause. It is not always clear, and varies substantially between jurisdictions. Thus, special care must be taken when analyzing homestead mortgages as there are many variations that can allow modification of homestead claims.

III. § 1325(a)(5)(B) versus § 1322(b)(5): FULL PAYOFF DURING LIFE OF CHAPTER 13 PLAN or MAINTENANCE OF PAYMENTS EXTENDING BEYOND THE TERMS OF THE PLAN

For a chapter 13 plan to be confirmable under section 1325(a)(5)(B), when a secured claim is bifurcated the debtor must fully satisfy the secured portion of the claim during the life of the plan (i.e., within 5 years). Alternatively, pursuant to section 1322(b)(5), if the plan proposes "maintenance of payments" to the lender the debtor may extend payments after the termination of the chapter 13 plan. *Maintenance of payments*, however, is not always clear leading to confirmation issues.

Section 1325(a)(5)(B)(ii) holds that the chapter 13 plan is confirmable if, "… the value, as of the effective date of the plan, or property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim . . ." Simply put, the note must be paid off within the life of the plan or property may be distributed to satisfy the debt, during the 3 to 5 year life of the plan. While possible in some cases, debtors generally do not have sufficient resources to pay off a homestead mortgage within the three or five year life of the plan.

Section 1322(b)(5) provides an alternative. A debtor can provide *maintenance of payments* thereby extending payments to the lender beyond the life of the plan. Maintenance of payments is held to be those payments as contemplated by the note.

Exactly what *maintenance of payments* requires is not entirely clear. It has been defined to mean payments as contemplated by the underlying note. *See, e.g., In re Veliz, 2009 WL 3418638 (Bankr.D.R.I. 2009)(maintenance of payments means making the same principal and interest payments as provided in the note, within the time frame specified in the note), reprinted post.* Payments can not be pro rated or adjusted to account for a cram-down of the note (although the term of the note is shortened), nor can the interest rate be adjusted, unless the debtor is repaying the secured portion in full within the life of the plan. *See, e.g., In re Plourde, 402 B.R. 488 (Bankr.D.N.H. 2009)(change in monthly payments requires the secured claim to be paid over life of the plan).*

In *In re Velize,* the debtor bifurcated a mortgage loan secured by a multi-family principal residence. The loan was past due, and the plan provided cure payments. The debtor proposed to reduce the secured portion by the amount of the cure payments. The Court found the plan was not confirmable because arrearage payments are a "third component" of a bifurcated claim that is contemplated by the mortgage note. As such, they must be paid as part of the maintenance of payments.

In re McGregor, 172 B.R. 718 (Bankr.D.Mass. 1994) holds that adjusting the interest rate of the note in the plan does not constitute "maintenance of payments," and because the debtor's plan did not propose payment in full within the five-year maximum the plan could not be confirmed.

Examples of what is NOT maintenance of payments:

- Change in monthly payments. In re Plourde, 402 B.R. 488 (Bankr.D.N.H. 2009)
- Attempt to amortize secured portion over the life of the loan rather than through payments contemplated by the note. In re Murphy, (Bankr.D.Mass. 1993).
- Elimination of mortgagee's right to accelerate principal payments. In re Legowski, 167 B.R. 711 (Bankr.D.Mass. 1994)
- Change in interest rate. In re McGregor, 172 B.R. 718 (Bankr.D.Mass. 1994).
- Reducing principal amount by the pre-petition arrears. In re Veliz, 2009 WL 3418638 (Bkrtcy.D.R.I. 2009)
- Reopening a matured obligation. In re Baxter, 155 B.R. 285 (Bankr.D.Mass. 1993); In re French, 174 B.R. 1 (Bankr.D.Mass. 1994)
- Treating pre-petition arrearage as unsecured debt receiving a dividend. In re Brown, 175 B.R. 129 (Bankr.D.Mass. 1994).

IV. Conclusion

Homestead mortgages should be analyzed to determine if there is any securied interest other than real property that is the debt's primary residence. If so, an analysis should be undertaken to determine if that additional security interest is sufficient to overcome the anti-modification clause of section 1322(b)(2). Further, an analysis should made to determine whether under section 1325(a)(5)(B) it is advantageous to modify the note's terms and satisfy it in full within the 5 year life of the chapter 13 plan, or rather to invoke section 1322(b)(5) maintenance of payments to extend payments to the lender.