Commercial and Residential Real Property Issues in Business and Consumer Cases

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Transferring Underwater Property – Vesting/Surrendering or Debt Payment: Does Either One Work?

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What we're going to discuss

The problem: Debtors can't afford their mortgage, but the home isn't worth as much as the mortgage balance—it's "underwater."

The question: Can debtors transfer the home to the mortgage holder to stop ongoing expenses, including maintenance, taxes, and homeowners association assessments?

1. Surrender plus vesting?

- § 1325(a)(5)(C) permits confirmation of a plan that "surrenders" collateral to the lien holder.
- § 1322(b)(9): allows a plan to "provide for the vesting of property of the estate . . . in . . . any . . . entity."
- So far, there are 13 decisions dealing with surrender/vesting; all accept that vesting transfers ownership.
- But they disagree about whether "surrender" lets a plan impose vesting on an unwilling mortgagee.

1. Surrender plus vesting?

Surrender outside of § 1325(a)(5)(C): "surrender value"
521(a)(4): "surrender to the trustee all property"

- The 13 decisions.
- 1. *In re Rosa*, 495 B.R. at 524: "[V]esting in addition to surrender. . . is confirmable only if the first standard [of § 1325(a)(5)]—acceptance—is met."
- Confirms the plan only because the mortgagee did not object.

1. Surrender plus vesting?

The 13 decisions.

- 2. *In re Rose*, 512 B.R. 790 (Bankr. W.D.N.C. 2014): similar result but greater protection to the mortgagee.
- If the mortgagee does not object to vesting, the debtor must give the mortgagee a quitclaim deed, effective only if the mortgagee fails to take action to refuse the deed within 60 days after receiving it.

1. Surrender plus vesting?

The 13 decisions.

- 3. *In re Watt*, 520 B.R. 834, 839 (Bankr. D. Or. 2014), allows surrender and non-consensual vesting:
- "[N]othing in . . . § 1322(b)(9) requires . . . consent. [A] plan . . . for vesting of property in a secured lender . . . may be confirmed over the lender's objection."
- The good faith requirement of § 1325(a)(5) prevents the transfer of negative-value property.

1. Surrender plus vesting?

The 13 decisions.

- 4. *Bank of New York Mellon v. Watt,* 2015 WL 1879680 (D. Or. 2015), reverses the bankruptcy court:
- "§ 1325(a)(5) . . . states that a plan is confirmable solely where surrender is proposed. . . . Here, debtors'. . . plan did not merely propose the cessation of their interest in the Property, it also forcibly transferred that interest, and the attendant liabilities . . . ."
- Now on appeal to the 9th Circuit.

1. Surrender plus vesting?

The 13 decisions.

- 5. *In re Sagendorph*, 2015 WL 3867955 (Bankr. D. Mass. June 22, 2015), agrees on all points with the bankruptcy court decision in *Watt*: "[A] transfer of property presupposes its surrender by the transferor."
- 6. *In re Zair*, 535 B.R. 15 (Bankr. E.D.N.Y. 2015), agrees with *Sagendorph*, and cites § 1327(a), which vests property in the debtor at confirmation unless the plan provides otherwise. Now on appeal.

1. Surrender plus vesting?

The 13 decisions.

- 7. *In re Stewart,* 536 B.R. 273 (Bankr. D.Minn. 2015): "While the 'surrender' concept . . . and the 'vesting' concept . . . are different, they may nonetheless be used in tandem when providing for the treatment of a secured claim in a chapter 13 plan."
- 8. *In re Williams,* 542 B.R. 514 (Bankr. D. Kan. 2015): agrees with the *Watt* reversal. Notes unpublished contrary opinion from another judge in the district.

1. Surrender plus vesting?

The 13 decisions.

- 9. *In re Weller*, 2016 WL 164645 (Bankr. D. Mass. Jan. 13, 2016). "This Court agrees with the conclusion in *Sagendorf* that §§ 1325(a)(5) and 1322(b)(9) are not in conflict," but holds that the provisions of § 1322(b) only are effective with creditor consent.
- 10. *In re Sherwood,* 2016 WL 355520 (Bankr. S.D.N.Y. Jan. 28, 2016). Agrees with the anti-vesting decisions.

1. Surrender plus vesting?

The 13 decisions.

- 11. *In re Tosi*, 2016 WL 859034 (Bankr. D. Mass. March 4, 2016). "[s]urrender [does] not merely . . . cede possessory rights, but . . . permit[s] the creditor to exercise its preexisting property rights as to the collateral."
- 12. *In re Brown,* No. 14-12357-JNF (Bankr. D. Mass. March 4, 2016). Allows vesting as payment: "[N]othing in § 1325(a)(5)(C) undercuts a debtor's ability to rely on the permissive provisions in § 1322(b)."

1. Surrender plus vesting?

The 13 decisions.

- 13. *In re Zair,* 2016 WL 1448647 (E.D.N.Y. April 12, 2016). Summarizes prior decisions; reverses bankruptcy court.
- Current score: 5 decisions allow nonconsensual vesting;
  8 don't.
- But note the effect of *Bullard.*
- Why pro bono appellate counsel can help.

2. Debt Payment?

- § 1322(b)(8): a plan may "provide for the payment of . . . a claim . . . from property of the estate . . . ."
- § 1325(a)(5)(B): allows payment of a secured claim with property having a value "not less than the allowed amount of such claim."
- Two conflicting opinions.

2. Debt Payment?

- *In re Lemming*, 532 B.R. 398, 410 (Bankr. N.D. Ga. 2015), says not in Chapter 13: § 1322(b)(8) "was enacted to enable payment of claims from property . . . only after such property was liquidated."
- But—cites questionable legislative history and does not explain interaction with § 1325(a)(5)(B)—which must allow direct payments of property without liquidation, otherwise no need to "value" the estate property used to pay the claim.

2. Debt Payment?

- *In re Kerwin*, 996 F.2d 552, 557 (2d Cir. 1993).
- Under a [1225(a)(5)](B) distribution of property a creditor's claim may be deemed fully satisfied provided the property 'to be distributed' has been valued as at least equal to the amount of that claim."
- So an objecting creditor is required to accept payment of its claim through the conveyance of all of its collateral.
- The language of § 1325(a)(5)(B) is identical.

2. Debt Payment?

- If collateral can be transferred to pay a secured claim under § 1325(a)(5)(B), the meaning of "surrender" under (5)(C) would no longer be relevant.
- Property would only be "surrendered" to junior lienholders, while the allowed secured claim of the first mortgagee would be fully satisfied by the transfer of the collateral, with the lien satisfied at discharge.
- State law property rights would be expressly preempted.

REAL ESTATE VALUATION ISSUES IN CONSUMER CASES

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THE BASICS.

WHY CARE ABOUT VALUATION?

- Disclosure / Due Diligence requirements:
  - Scheduling / disclosure of assets.
  - Scheduling / claiming exemptions.
- Treatment of Claims
  - Liquidation analysis
  - Stay relief
  - Lien Avoidance
  - Lien Stripping

WHAT IS "VALUE"?

- "Value" not a defined term under § 101
- "Value" incorporates concepts of timing and purpose
  - Timing
  - Method

IS VALUE WORTH THE FIGHT?

- Strategy:
  - Motion / Adversary / Plan
  - Burden of Proof
  - Standard of Review
  - Finality for Appeal
  - Stipulation
- Rules of Evidence
- Common value sources
  - Owner testifying as to value
  - Zillow.com/internet evidence
  - Tax assessed values
  - Scheduled value

SPECIAL ISSUES.

EXEMPTIONS

- § 522(a)(2) defines value as "fair market value as of the date of the filing of the petition or, with respect to property that becomes property of the estate after such date, as of the date such property becomes property of the estate.
- Schwab v. Reilly
  - Dollar value means dollar value
  - Alternative option 100% of FMV
- Lien Avoidance § 522(f)(2)

LIEN STRIPPING / CRAMDOWN

- § 506 secured status
- Valuation Method: motion vs. plan vs. adversary
- § 1322(b)(2) antimodification
- Cramdown interest rate
- Converse: Plight of the oversecured creditor.

CONVERSION

- Ch. 7 to Ch. 13
  - Less opportunity for appreciation/depreciation
- Ch. 13 to Ch. 7
  - Equity due to post-petition payments
  - Equity due to appreciation
  - Loss of equity due to depreciation

QUESTIONS?

Residential and Commercial Valuation Issues in Chapter 11

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Income-Producing Collateral – Valuation Methods and Issues

The problem: Collateral continues to produce income past the petition date.

The question: How does this post-petition income effect the value of an undersecured claim and the creditor's entitlement to post-petition interest?

Valuation of the Undersecured Claim

§ 506(a) bifurcates an undersecured claim into:

- "[A] secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and
- [A]n unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim."
  - "Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."

§ 506(b) grants post-petition interest only when an "allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim."

After-Acquired Property

§ 552 provides that property acquired by the estate after the petition date is not subject to any prior lien except when the security agreement extends to proceeds or profits of such property.

Cash Collateral and the Code

§ 363(a) defines cash collateral as "cash . . . or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest."

- This includes proceeds, rents, and other profits of property

§ 363(c) requires a trustee or debtor-in-possession to obtain creditor approval or court authorization to use cash collateral.

§ 363(e) requires a trustee or debtor-in-possession to provide adequate protection upon the request of a creditor whose property is used, sold, or leased.

Single Valuation

§ 506(a)'s "interest in property" does not take into account the lost use value, otherwise: "the proportions of the claim that are secured and unsecured would alter, as the stay continues -- since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time." *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988).

- "The phrase 'value of such creditor's interest' in § 506(a) means 'the value of the collateral.'" *Id.*

In re Reddington/Sunarrow Ltd. P'ship, 119 B.R. 809, 813 (Bankr. D.N.M. 1990): "If payments are made to an undersecured creditor, they must be allowed to reduce the allowed secured claim of the creditor. Otherwise the payments would be treated as interest payments or use value, in direct contravention of *Timbers*."

Single Valuation

- Bifurcation is made on petition date and remains unchanged throughout the process.

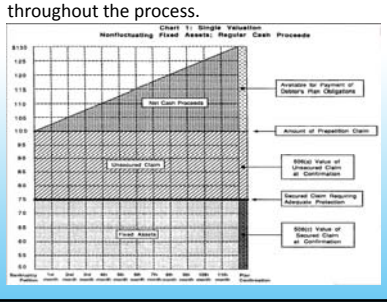


Chart from: *In re Addison Properties Ltd.*, 185 B.R. 766, 773 (Bankr. N.D. Ill. 1995).

Continuous Valuation

Dewsnup v. Timm, 502 U.S. 410, 417 (1992): "Any increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor, not to . . . the debtor and not to . . . unsecured creditors whose claims have been allowed and who had nothing to do with mortgagor-mortgagee bargain."

In re Union Meeting Partners, 178 B.R. 664, 675 (Bankr. E.D. Penn. 1995): "A broad reading of *Timbers* would prohibit all post-petition increases in a creditor's security, and could not be reconciled with § 552(b) and other Supreme Court cases."

- "It stands to reason . . . that an undersecured creditor's secured claim increases as 'proceeds, product, offspring, rents, [and] profits' accrue post-petition." *Id.*

Continuous Valuation

Bifurcation is made on petition date and income generated during the bankruptcy case increases the secured claim.

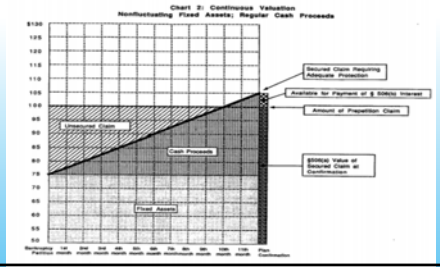
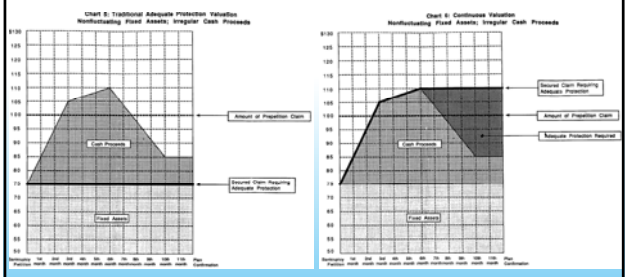


Chart from: *In re Addison Properties Ltd.*, 185 B.R. at 778.

Single v. Continuous Valuation



Charts from: *In re Addison Properties Ltd.*, 185 B.R. at 782-83.

Dual Valuation

- "Delinking adequate protection and confirmation valuations produces a system of dual valuation, like the one that many courts have employed in Chapter 13 cases." *In re Addison Properties Ltd.*, 185 B.R. at 784.
  - "This dual valuation approach is consistent with, if not required by, Section 506(a)." *Id.*

Dual Valuation

"For purposes of adequate protection, the claim of the secured creditor is fixed as of the date of filing." *Id.*

- "[I]f the underlying collateral is not declining in value or at risk of declining in value, the additional cash collateral may be used by the debtor to pay administrative expenses, as well as to maintain or improve the underlying collateral or to make payments on the creditor's claim." *Id.*

"At confirmation, the secured claim is revalued." *Id.*

- "The total claim is reduced by any payments made by the debtor" and "[a]ny proceeds under Section 552(b) that have not been expended by the debtor, and are not necessary . . . under Section 506(c), increase the amount of the secured claim." *Id.*

Dual Valuation

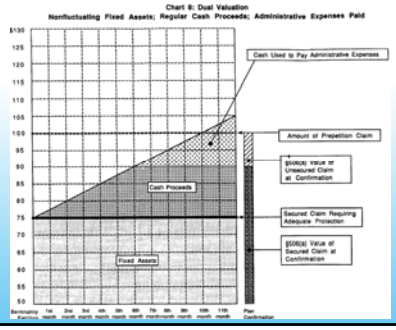


Chart from: *In re Addison Properties Ltd.*, 185 B.R. at 786.

Flexible Approach

Fin. Sec. Assur. v. T-H New Orleans Ltd. Pshp. (In re T-H New Orleans Ltd. Pshp.), 116 F.3d 790, 798 (5th Cir. 1997): "[F]or purposes of . . . whether a creditor is entitled to accrue interest under § 506(b) in the circumstance where the collateral's value is increasing and/or the creditor's allowed claim has been or is being reduced by cash collateral payments . . . valuation of the collateral and the creditor's claim should be flexible and not limited to a single point in time, such as the petition date or confirmation date."

- "This ruling recognizes the discretionary nature of bankruptcy courts as courts of equity." *Id.*

Prudential Ins. Co. of Am. v. SW Bos. Hotel Venture, LLC (In re SW Bos. Hotel Venture, LLC), 748 F.3d 393, 406 (1st Cir. 2014): "[A] bankruptcy court may, in its discretion, adopt a flexible approach."

Zachary & New Value

Absolute Priority Rule: For plan to be "fair and equitable" with respect to unsecured class, "holder of any claim or interest that is junior to the claims of such class will not . . . retain . . . any property." 11 U.S.C. § 1129(b)(2)(B)(ii).

Zachary v. Cal. Bank &Tr., 811 F.3d 1191 (9th Cir. 2016): Ninth Circuit joins other circuits that examined the issue and held that BAPCPA did not impliedly repeal the absolute priority rule, thus overruling *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012)

Zachary & New Value

The Exception in Individual Cases: property acquired post petition. *Id.*

Zachary Court: "an individual debtor may not cram down a plan that would permit the debtor to retain prepetition property . . . but may cram down a plan that permits the debtor to retain *only postpetition property*." 811 F.3d at 1196 (emphasis added).

Key Statutory Words: "holder of any claim or interest that is junior . . . will not receive or retain . . . *any property*." 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).

Zachary & New Value

New Value Corollary: The new value contribution must be new; substantial; in money or money's worth; necessary for a successful reorganization; and reasonably equivalent to the value or interest received. *In re Bonner Mall P'ship*, 2 F.3d 899, 908 (9th Cir. 1993).

The question: May individual Chapter 11 debtors retain exempt assets without violating Absolute Priority Rule?

Put another way: Must debtors contribute new value to the Chapter 11 plan that includes the value of exempt property?

Zachary & New Value

Minority View: To cramdown unsecured creditors & retain any prepetition property, individual debtor must contribute new value equaling all non-exempt and exempt property.

In re Gosman, 282 B.R. 45, 49 (Bankr. S.D. Fla. 2002):"'Any' means 'every' and 'all'. . . By having the word 'any' modify 'property,' there is no reason, or implication, whatsoever to support . . . that [the absolute priority rule] is limited to non-exempt assets.")

In re Yasparro, 100 B.R. 91, 95 (Bankr. M.D. Fla. 1989): Section 1129(b)(2)(B)(ii) "specifically provides to meet the absolute priority rule the Debtor may not retain 'any property' if the unsecured creditors are not to be paid in full [and] makes no distinction between exempt and non-exempt property."

Zachary & New Value

Majority View: Individual debtors may retain exempt property without violating the absolute priority rule.

In re Egan, 142 B.R. 730, 733 (Bankr. E.D. Pa. 1992): "[I]f debtors intend to retain only exempt property, then they are merely retaining that which is their absolute right to retain in any event, and they are not, properly speaking, receiving or retaining 'any interest that is junior to the interests' of any class of creditors."

Zachary & New Value

Majority View (cont.):

In re Henderson, 321 B.R. 550, 559 (Bankr. M.D. Fla. 2005): "Once the exemptions are allowed the properties are no longer part of the Debtor's estate, and the Debtor does not retain property on account of such interest because he retains it as a matter of right by virtue of recognition of his right to exemptions."), *aff'd, Van Buren Indust. Invs. v. Henderson (In re Henderson)*, 341 B.R. 783 (M.D. Fla. 2006).

In re Gerard, 495 B.R. 850, 856 (Bankr. E.D. Wis. 2013) "exempt property that has been removed from the estate prior to confirmation is not property that is received or retained 'under the plan' as required for application of the absolute priority rule.")

Zachary & New Value

Additional Implications: How to value "equity" in an individual case?

- *203 N. LaSalle*?
- Competitive bidding?
- Waive exclusivity?

Application of *Till* in Chapter 11

The problem: Choosing the appropriate cramdown interest rate in a Chapter 11 case.

The question: Should the "Formula Approach" adopted by the plurality of the Court in *Till v. SCS Credit Corp.*, 124 S. Ct. 1951 (2004) apply in Chapter 11?

The Approaches Considered

The Supreme Court considered four approaches:

Formula Approach: Augment the national prime rate to account for risk of nonpayment posed by borrowers in debtor's financial position. *Till* at 471. (also called "prime-plus").

Coerced/Forced Loan Approach: Rate creditor could have obtained if creditor had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk. *Id.* at 472.

The Approaches Considered

Four approaches continued:

Presumptive Contract Rate Approach: Original contract rate is presumptive cramdown rate, which either creditor or debtor could challenge. *Id.* at 473.

Cost of Funds Approach: Rate it would cost creditor to obtain the cash equivalent of the collateral from an alternative source. *Id.*

The Plurality Split

Plurality: Start with national prime rate and adjust for risk of non-payment (Court did not specify proper scale, but noted that courts have generally approved 1-3%. *Id.* at 479-80.

Dissent: Start with contract rate and adjust for risk of non-payment. *Id.* at 492.

Justice Thomas: National prime rate should suffice, but Congress did "not require a debtor-specific risk adjustment." *Id.* at 486-87.

The *Till* Factors

What is the appropriate size of the risk adjustment?

Plurality identified three factors:

- Circumstances of the estate
- Nature of the security
- Duration and feasibility of the plan

Id. at 479.

Till's Footnote 14

Plurality noted that Bankruptcy Code includes numerous provisions requiring courts to discount a stream of deferred payments to ensure creditor gets value of its claim, then stated: "We think it likely Congress intended bankruptcy judges . . . to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions." *Id.* at 474.

But what about footnote 14?

Till's Footnote 14

"Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession." *Id.* at 476 n.14.

Notable *Post-Till* Chapter 11 Cases

Bank of Montreal v. Official Comm. of Unsecured Creditors (In re Am. Homepatient, Inc.), 420 F.3d 559, 568 (6th Cir. 2005): "[W]e decline to blindly adopt Till's endorsement of the formula approach for Chapter 13 cases in the Chapter 11 context. Rather, we opt to take our cue from Footnote 14 of the opinion."

- Ask what rate efficient market would produce
- Court found no basis to reverse bankruptcy court, which carefully evaluated expert testimony as to appropriate market rate. *Id.* at 569.

Notable *Post-Till* Chapter 11 Cases

In re SW Bos. Hotel Venture, LLC, 460 B.R. 38, 54-55 (Bankr. D. Mass. 2011): "A market analysis by experts should be performed to ascertain whether the type of loan that the debtor is proposing in a plan can be obtained or whether an efficient market is lacking . . . . [w]here an efficient market . . . is absent, the overwhelming majority of courts applies the 'formula' approach."

Notable *Post-Till* Chapter 11 Cases

Wells Fargo Bank N.A. v. Tex. Grand. Prairie Hotel Realty, L.L.C. (In re Tex. Grand Prairie Hotel Realty, L.L.C.), 710 F.3d 324, 331 (5th Cir. 2013) (emphasis in original): Courts have applied the *Till* formula method in Chapter 11 "because they were persuaded by the plurality's reasoning, not because they considered *Till* binding . . . We will not tie bankruptcy courts to a specific methodology . . . rather, we continue to review a bankruptcy court's entire cramdown-rate analysis only for clear error."

Notable *Post-Till* Chapter 11 Cases

U.S. Bank N.A. v. Wilmington Sav. Fund Soc'y (In re MPM Silicones, LLC), 531 B.R. 321, 333 (S.D.N.Y. 2015) (internal quotations omitted): "The [appealing creditors] have provided no good reason why the cramdown interest rate should place Chapter 11 creditors—but not Chapter 13 creditors—in the same position they would have been in had they arranged a new loan . . . [or] why the cramdown interest rate should allow Chapter 11 creditors—but not Chapter 13 creditors—to 'receive more than the present value of their allowed claim.'"

- Court upheld bankruptcy court choosing 7-year treasury rate as base rate rather than risk-free rate, because it is "often used as a base rate for longer-term corporate debt. *Id.* at 334.