Cramdowns Now and New: Ins and Outs of Chapter 13 Mortgage Cramdowns

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MORTGAGE CRAMDOWNS-
WITH THE RAINBOW GONE, IS THE POT OF GOLD STILL ATTAINABLE?

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In the good old days of the early 1990s, debtors could effectively use the balloon payment plans ("the rainbow") as a means to own real estate free of a mortgage, (the "pot of gold"). It took a lot of work and sacrifice on the part of debtors but many cramdown plans went to completion and discharge. Is that still an attainable goal? Exploring cramdown plans post BAPCPA has proven how difficult, if not impossible, it is today to propose and complete a conforming cramdown plan.

Claims That Are Still Not Modifiable—As we literally go to press, first mortgages secured only by single family residences are still protected from modification. The Senate on April 30, 2009 defeated the attempt to amend §1322(b) to allow Bankruptcy judges to modify first mortgages on residential properties. It was proposed this time as an amendment to a housing bill and defeated by a 51-45 vote. The House had already passed its own version on March 5, 2009.

Senator Durbin and the other proponents of this amendment state that they will keep trying to get this done, citing the continuing mortgage crisis and the crisis facing thousands of homeowners. Opponents say that this modification would mean higher interest rates and increase the cost of home ownership. Clearly, for any such legislation to succeed, the large lending institutions and other mortgage industry giants would have to support it. A number of questions come to mind immediately should this eventually succeed: If the judges are to have this authority, how should it be structured? Should all mortgages be ripe for modification or only those labeled "subprime"? Or would there be a limit on the length of time the default

existed prior to bankruptcy filing or the amount of the default? How would the individual courts determine the new secured claim and the new interest rate? Would the creditors be able to recoup any money on their claims later if the value of the collateral increases prior to discharge? To be determined at a later date, possibly.

Claims which are not subject to § 1322(b)(2) but are *fully secured by the value of the collateral* cannot be modified. See In re Richard W. Briana, Jr. , 2008 WL 4833083 (Bkrtcy.D.Mass) wherein Judge Feeney ruled: "The Debtor's plan is unconfirmable as the Debtor cannot both cure arrears owed to LPP *and* **cramdown** its fully secured claims. There is no factual or legal justification for **cramdown** of a fully secured claim, citing 11 U.S.C. §§ 506, 1325(a)(5)."

Claims That Are Modifiable

Other than the above, those claims that can't be stripped off can be modified if the price is right, at least in theory. In practice, does it work?

Cramdowns in Chapter 13 cases have resurfaced recently after disappearing in the later 1990s when we last faced a plunging real estate market and related economic turmoil. During the early 1990s, it was relatively uncomplicated to file a chapter 13 cramdown plan. Property values were declining as they are today. The debtors typically filed §506(b) motions to determine the amount of the secured claim and after either agreement with the mortgagee or court determination, a secured value was set and an interest rate determined under the 'formula" method established by Judge Feeney. (*In re St. Cloud* 209 B.R. 801 Bkrtcy.D.Mass.,1997.) The debtors filed a balloon payment plan calling for sale or refinance of the property in the 60th month. If the debtor made all the payments under the confirmed plan, the big reward at the end of the plan was the super discharge and freedom from a mortgage payment. All of the payments were

paid to the trustee. If the debtors made all the payments, the plan worked because the economic conditions had improved considerably during the 60 months of the plan such that the debtors were able to take advantage of refinancing and/or a sale to complete their balloon payments—some at quite a financial coup. The mortgagees did not receive the benefit of the improved market conditions and were stuck having to accept a "payoff" pursuant to the terms of the confirmed plan.

With the Amendments of October, 2005 the ability to draft a feasible cramdown Chapter 13 plan has been significantly thwarted. Balloon payments on periodic payment plans are not allowed which effectively killed cramdown plans…or did it? In order to draft a feasible cramdown plan, the debtors have to either propose other than a periodic payment plan or a plan that calls for maintenance of payments to satisfy § 1322(b)(5) during the life of the plan.

The Appropriate Standard For Establishing Value

Replacement value or liquidation value? In this jurisdiction, holding with the majority, the appropriate standard for establishing value for both residential and commercial real estate is the *replacement value* as noted by Judge Kornreich, Chief Judge for the District of Maine, as set forth in the *Rash* decision. (See In re Young, 390 B.R. 480 Bkrtcy.D.Me.,2008):

> "The standard for determining value is set according to the purpose of the valuation and the proposed disposition or use of the property securing an allowed claim. *See Rash*, 520 U.S. at 961, 117 S.Ct. 1879. The purpose of the valuation in this case is the cram-down of Camelot's claim. After the cram-down, the property is to be retained by the debtors. With that purpose and that proposed use, replacement value is the proper standard. *Id.* at 965, 117 S.Ct. 1879.
>
> and,
>
> "The collateral in ***Rash*** was a commercial truck. The same standard applies to commercial and residential real estate. *See In re Winthrop Old Farm Nurseries,*

> 50 F.3d 72, 75 (1st Cir.1995)(commercial real estate)(cited favorably in *Rash,* 520 U.S. at 963, 117 S.Ct. 1879); *In re Taffi*, 96 F.3d 1190, 1192 (9th Cir.1996)(en banc)(residential real estate)(cited favorably in *Rash*, 520 U.S. at 959, n. 2, 117 S.Ct. 1879)."

The rationale is that the value of the property the debtor seeks to retain should equal the cost of acquiring a similar property for the same purpose.

Note: Particularly when dealing with investment and/or rental property, the appropriate replacement value may be best determined by using the rental income approach rather than the standard sales comparison approach in your appraisal.

The Appropriate Time To Establish Value

When should the value of the collateral be fixed? Some have argued it is the date the petition is filed. Others argue it is the date the plan is confirmed which can be considerably later than the petition date if value is disputed, which would favor the debtors in a declining real estate market. Continuing his opinion in the *Young* case, *supra*, Judge Kornreich went on to summarize the different dates that have been used to determine when the valuation of the real estate should occur, citing cases that have used the petition date, others that have used the date the plan was filed, and still others that have used the confirmation date or effective date of the plan:

> "Before BAPCPA, § 506(a) did not fix a precise moment in time for determining the value of property securing an allowed claim. That assignment was left to the courts. A range of opinions on timing was expressed before and after *Rash.* *Rash* itself is vague on the subject."

He ruled that the appropriate date to be used is the petition date:

> "The petition date is the appropriate time for determining the value of the real property securing Camelot's lien for two reasons. First, no one has pressed for a different point in time. Second, bifurcation requires knowledge of the extent of the creditor's interest in the estate's interest in property. The estate's interest in property (with exceptions not relevant here) is established upon the commencement of the bankruptcy case. *See* § 541(a)(1). Therefore, to learn the extent of Camelot's interest in the real property,

> we must know the value of each estate's interest in the real property on the petition date."

Effective Notice To Creditors

Unquestionably, plans that seek to modify creditor's rights have to give adequate notice to the creditor to satisfy due process requirements. Is simply sending the plan to the payment address provided by the debtor sufficient? Most likely not. The address is usually a lock box. Valid addresses for notice can usually be obtained by an internet search on the servicer's website. It's highly recommended that notice also be given to any local law office that may have been representing the lender in a foreclosure action relative to the property. Once you have the address down, you then also need to think of the terms of the proposed plan—are the terms set out clearly enough for a creditor to receive adequate notice of your intent to alter their contractual rights? New local Chapter 13 formats seek to provide clear notice of claims modification.

Acceptance by a creditor is one of the three ways to confirm a plan. Is silence by a creditor deemed acceptance? The B.A.P. would seem to believe so if proper notice **and** proper service have been given even if no response is filed:

> "We adopt the Third Circuit's view that acceptance may occur upon a secured creditor's failure to file a timely objection to a chapter 13 plan. In re Szostek, 886 F.2d at 1414 ("Otherwise, [the rules], which set a deadline for filing objections to a plan, would have no substance.")." In Re Flynn, BAP NO. MB 08-033, March, 2008.

Mortgage Cramdowns in Chapter 13

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The 2005 amendments to the Bankruptcy Code ("BAPCPA") created new difficulties for those seeking to modify mortgage claims in bankruptcy. While there has been an explosion in the elimination of junior mortgages in Chapter 13--due to sinking property values which have rendered many of these mortgages wholly unsecured--cramdowns of first mortgages were curtailed by the BAPCPA amendments. A mortgage can be "crammed down" when its balance is less than the value of the property securing it. The claim is bifurcated into secured and unsecured portions. The unsecured portion is treated in the same manner as other general, unsecured claims in Chapter 13, often receiving a small dividend through the plan. Treatment of the secured portion, however, is a matter of controversy.

It must first be emphasized that first mortgages secured only by a debtor's home cannot be crammed down at all. However, cramdowns are permissible when there is additional collateral for a mortgage besides the home, when a property is an investment or vacation home, or in cases of multi-family dwellings. In such cases, the mortgage claim can be bifurcated and the secured claim paid in one of the ways that the Code allows.

What are the options for dealing with a secured claim after cramdown? After fixing the value of the property, either through agreement with the lender or through litigation, a secured claim must generally be paid with interest during the life of the plan.[1] This creates a practical difficulty: secured claims are usually quite large and the duration of a Chapter 13 plan cannot

[1] What interest rate applies is governed by Till v. SCS Credit Corp., 541 U.S. 465 (2004) and its progeny: generally prime plus a risk factor of one to three percentage points.

exceed five years. A debtor will seldom have sufficient income to pay such a large claim in such a short time. One way that bankruptcy practitioners handled this problem prior to the BAPCPA amendments was to file a plan with a sale or refinancing provision. A debtor would propose to use sale or refinancing proceeds, often at the end of the plan term, to satisfy the secured claim with a balloon payment. However, the BAPCPA amendments imposed a new requirement on the treatment of secured claims, requiring that "if property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly amounts." 11 U.S.C. 1325(a)(5)(B)(iii). Although practitioners have proposed plans containing balloon payments since this amendment, these attempts have largely been unsuccessful. Recently, the First Circuit Bankruptcy Appellate Panel sharpened this point by affirming the denial of confirmation of a Chapter 13 plan because of a balloon payment provision. See Hamilton v. Wells Fargo Bank, 1st Cir. BAP NO. MB 08-046 (March 6, 2009). However, two viable, yet underutilized, possibilities remain when trying to achieve confirmation of a cramdown plan.

The first option is to avoid the statute's conditional prohibition on balloon payments by proposing a plan without periodic payments. Nothing in the subsection prohibits balloon payments *per se*: it only does so if the plan calls for periodic payments. Therefore, a plan could be proposed calling for only one payment to satisfy the secured claim and other claims, the funding for which could come from a sale or refinancing. However, such a plan, once filed, would immediately find itself in the crosshairs. First, counsel for the mortgage lender would likely object to confirmation (and move to lift the automatic stay) due to the lack of post-petition payments. A secured lender is entitled to receive adequate protection to insure against diminution in the value of its claim. Because any cramdown will necessarily involve a property

without equity value (a prerequisite to cramdown is that "negative equity" exists), a debtor will not be able to offer an equity cushion to protect the creditor. The lack of an equity cushion coupled with the lack of post-petition payments may be sufficient grounds to lift the automatic stay. A creditor would likely also object to confirmation of the plan on feasibility grounds. Whether a plan is feasible is largely on a matter of judicial discretion. There is no bright line. However, a plan that depends on a refinancing when a debtor has little or no dependable income would likely fail on account of feasibility, especially in the current credit environment. However, successful scenarios can be envisioned. For example, if a debtor's first mortgage on a two-family home was $410,000 and the value of the property had sunk to $275,000 (not uncommon in many areas), the debtor could propose a sale plan in, say, the sixth month to a family member, or a refinancing plan to be funded by loan to the debtor in the same time period. The key would be to come into bankruptcy with viable financing or sale options which could be consummated quickly. If these could be credibly shown to the Court, the debtor would have a fair chance of resisting the mortgage lender's initial onslaught and carrying out his plan. In our example, the benefit would be substantial: the reduction of $135,000 of a first mortgage obligation.

Another option for paying the secured portion of a crammed down mortgage is a so-called McGregor plan. These plans were first articulated by former Massachusetts Bankruptcy Judge Queenan in the case In re McGregor, 172 B.R. 718 (Bankr.D.Mass.1994), and adopted by Judge Feeney in the case of In Re Trenton Murphy, 175 B.R. 134 (Bankr.D.Mass. 1994. The key to such a plan is Section 1322(b)(5), which states that a debtor may "provide for the curing of any default within a reasonable time and maintenance of payments 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." This is the provision that allows for the commonplace Chapter 13 plan proposing to cure mortgage arrears while maintaining regular, post-petition mortgage payments in order to stave off a foreclosure and bring a mortgage back into good standing. It warrants mentioning that McGregor resulted in the denial of plan confirmation because the debtor proposed to change an aspect, such as the interest rate or payment amount, of the post-petition secured payments. However, the court held that it was only possible for a debtor to utilize Section 1322(b)(5) if he maintained normal contract payments on the secured claim (and cured any pre-petition arrears). Consequently, the only difference between a McGregor plan and a normal cure-and-maintain plan is that the amount of the secured claim will have changed. In a McGregor plan, a debtor cannot re-amortize the secured portion and avoid making normal post-petition mortgage payments as called for by the note; he will simply pay off the mortgage more quickly because the secured amount will have been reduced. However, these normal payments need only be maintained during the life of the plan, which might be as little as three years. After that, the debtor could resolve with the lender the amount of the outstanding secured claim (or seek a judicial declaration of this amount) and seek a refinancing of the new balance to reduce the ongoing mortgage payment.

These are two viable options for effectuating a successful cramdown of a mortgage claim. McGregor plans offer the most promise for debtors because one-payment balloon plans necessarily bring adequate protection into question. However, none of the options achieve what a debtor frequently wants--a reduction in the amount of a first mortgage payment to make his home more affordable.

Is there a Secret Formula? Determination of Interest Rate on Modified, Secured Claims Under 11 U.S.C. § 1325 (a)(5)(B)(ii)

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Once a secured claim in a Chapter 13 case is successfully bifurcated under 11 U.S.C. § 1322(b)(2), the claim can either be modified or cured within the plan pursuant to either U.S.C. § 1322(a)(5) or U.S.C. § 1322(b)(5) respectively. If the former is chosen, and the claim is to be modified, the entire amount of the secured portion of the bifurcated claim must be paid in full during the life of the plan pursuant to U.S.C. § 1322(a)(5) and § 1322(d). See also, In re Plourde, 2009 BNH 7 (2009); *In re* McDonald, 397 B.R. 175, 176 (Bankr. D. Me. 2007); *In re* Kheng, 202 B.R. 538, 539 (Bankr. D.R.I. 1996); Brown v. Shorewood Fin. Inc. (*In re* Brown), 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 (Bankr. D. Mass. 1994); *In re* DeMaggio, 175 B.R. 144 (Bankr. D. NH 1994); and *In re* Legowski, 167 B.R. 711, 716 (Bankr. D. Mass. 1994).

In *In re* Plourde, 2009 BNH 7 (2009), the Debtors argued unsuccessfully, citing Federal National Mortgage Assoc. v. Ferreira (*In re* Ferreira), 223 B.R. 258 (Bankr. D.R.I. 1998), that they could modify the bank's secured claim and then make payments on the modified claim over the remaining term of the underlying promissory note. Although Judge Vaughn agreed that payments on a secured, bifurcated claim could extend beyond the life of the plan, that could *only* occur if all of the provisions of 11 U.S.C. § 1322 (b)(5) were followed, e.g., all of the mortgage arrears were cured.

Once a secured claim is bifurcated, a Court must determine an appropriate interest rate so the claimant will be compensated properly for the present value of its secured claim under U.S.C. § 1322(a)(5)(B)(ii). In requiring that a chapter 13 plan provide for the payment of the present value of deferred payments to the holder of an allowed secured claim, Congress intended that debtors compensate the secured party for the decrease in value of its claim caused by delayed payment. *In re* St. Cloud, 209 B.R. 801, 806 (Bankr. D. Mass. 1997) quoting in part, *In re* Clark, 168 B.R. 280 (Bankr. W.D.N.Y.1994). See also, Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997). In order to achieve confirmation of a plan treating long-term secured debt that is bifurcated under section 506 (a), the Debtors must either pay the allowed amount of the secured claim in full within the plan term, see In re Legowski, 167 B.R. 711, 716 (Bankr. D. Mass. 1994) or cure the mortgage default, maintain regular mortgage payments during the plan term and, thereafter, pay the secured portion of the claim during such further period as is necessary to retire the secured debt. See, In re McGregor 172 B.R. 718 (Bankr. D. Mass. 1994). So, it seems that under the *McGregor* and *Brown* rationales, bifurcation and long-term treatment are not mutually exclusive.

Courts have traditionally used the so-called "Formula Approach" set forth by the United States Supreme Court in Till v. SCS Credit Corp., 541 U.S. 465 (2004). See also *In re* St. Cloud, 209 B.R. 801 (Bankr. D. Mass. 1997)[2]. The *Till* Court analyzed several interest rate calculation methods (the formula rate, the coerced loan rate, the presumptive contract rate and the cost of funds rate) and determined that the formula rate approach yielded the result most consistent with 11 U.S.C. § 1325 (a)(5)(B)(ii). In deciding upon this approach, the Court was guided by two

[2] See also and generally, In re Ibarra, 235, B.R. 204, 213 (Bankr. D. P.R. 1999) and In re River Village Associates,161 B.R. 127, 135-36 (Bankr.E.D.Pa.1993) for a brief discussion of various other interest rate calculation methods, e.g., cost of funds employed in General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 69

primary concepts. First, an appropriate rate should compensate creditors for deferred payments on the value of their present claims. Rake v. Wade, 508 U.S. 464, 472, (1993). Second, the Court, "should aim to treat similarly situated creditors similarly and to ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default." Id. at 477, 478.

The Court rejected the coerced loan, presumptive contract rate, and cost of funds approaches stating that those approaches were overly complicated, imposed significant evidentiary costs and aimed, incorrectly in the Court's view, to make each individual creditor whole, rather than to ensure the debtor's payments have the required present value[3].

The *Till* Court reasoned that the Formula approach was best because it employed ordinary and traditional institutional lending practices that started with the national prime rate and then put the Bankruptcy Court in a position to weigh case specific evidence in order to establish an additional interest rate. The appropriate size of that risk adjustment would depend on such factors as the circumstances of the estate, the nature of the security, the type and value of the collateral, the terms of the plan, the debtor's financial history and prospects, the lender's risk factors and lost opportunity costs and the duration and feasibility of the reorganization plan.

The dissent (Justices Scalia, O'Connor and Kennedy) believed that the formula approach's starting point, the national prime rate, was too low; and the typical, additional risk adjustment of 1% to 3% wouldn't properly provide a creditor with present value. According to the dissent, the proper way to determine the applicable interest rate was to take the existent

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(3rd Cir.1993), risk free rate, original contract rate, IRS judgment rate, statutory interest rate and Treasury bill risk free rate.

[3] The Code does not include profit within the value of a secured creditor's allowed claim. See, *In re* Smith,178 B.R. 946, 951 (Bankr.D.Vt.1995).

interest rate on the promissory note or contract and to allow parties to motion the bankruptcy court to modify the rate, upward or downward.

With the present prime rate presently below 4%[4], Chapter 13 cram-downs seemingly on the rise and the Till's plural, non-binding decision, litigation surrounding the determination of the appropriate interest rate under 11 U.S.C. § 1325 (a)(5)(B)(ii) is likely to continue.

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THE PANEL'S CONCLUSION

Understanding that a debtor has a loan that may be modified does not mean that the debtor will be able to draft a plan that can be confirmed even if he reaches an agreement on the secured claim amount and interest rate. Most debtors will not have the means to pay the cramdown claim within the life of the plan or, if they chose the *McGregor* route, repaying the claim pursuant to the original loan documents to the amount of the new secured claim. Other than periodic payment plans present often insurmountable obstacles. Alternate non-bankruptcy approaches may provide relief for debtors, such as voluntary loan modifications which typically take the claim out of Chapter 13 by rewriting it to eliminate the arrearages. There are also the standard forbearance agreements which spread out the arrearages over a shorter period of time than a five year plan but may also temporarily reduce the payments and the interest rate. Any voluntary modifications have to be done directly with the servicer but in the end may better provide the permanent relief the debtor seeks in order to save his residence.

[4] Prime rate as of 4-29-09 was 3.25%. See, http://www.bankrate.com/rates/interest-rates/prime-rate.aspx