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Saving Your Home Through Chapter 13 Bankruptcy: The Impact of *Rake v. Wade*

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by Berton J. Maley

I. INTRODUCTION

For years, part of the American Dream has been to own a home. To do so without a home mortgage would be a pipe dream for most Americans. Even with such financing, the dream is not easily realized. In difficult economic times, when a mortgagor falls behind on her monthly payments and has nowhere else to turn, bankruptcy relief under Chapter 13 has been a traditional recourse.[1]

In a Chapter 13 bankruptcy, unlike the more common Chapter 7, an attempt is made to allow the debtor to save her home. Pursuant to a court-approved plan, the Chapter 13 debtor surrenders a portion of her income each month toward the payment of debt. While creditors wait for their money, the bankruptcy court prevents them from proceeding with other remedies such as repossession, garnishment, or foreclosure.

The fresh start envisioned by Congress in the Bankruptcy Code, however, does create some hardships. Debtors seeking relief under Chapter 13 must propose a repayment plan that meets strict criteria, and Congress and the bankruptcy courts have been especially protective of the rights of mortgage holders.

A debtor who has fallen behind on her home mortgage payments can seek relief through Chapter 13. Pursuant to Section 1322(b)(5), one of the provisions of Chapter 13, the debtor can pay off the arrearage through a repayment plan while continuing to make current payments.[2] The effect of Chapter 13 is to split the mortgage into two separate debts: a pre-petition debt and a post-petition debt. The pre-petition debt consists of those payments, advances, fees, and charges that came due prior to the filing of the bankruptcy petition; the post-petition debt is treated like a current mortgage and consists of those payments which come due after the bankruptcy petition is filed.[3]

Pursuant to a court-approved plan, the Chapter 13 debtor surrenders a portion of her income each month toward the payment of debt. While creditors wait for their money, the bankruptcy court prevents them from proceeding with other remedies such as repossession, garnishment, or foreclosure.

However, the courts limit the right to cure arrearages while maintaining current payments. The court only approves the Chapter 13 plans that offer a reasonable cure for the mortgagee's pre-petition arrearage claim.[4] Under such a plan, the person must completely pay off the pre-petition debt within a reasonable time, usually between twenty-four and thirty-six months. Under no circumstances can the Chapter 13 plan extend the life of the mortgage beyond the original maturity date.[5] Finally, a Chapter 13 plan cannot modify the contractual rights of a mortgage holder on the debtor's principal residence.[6]

The Supreme Court recently construed this last protection in *Nobelman*

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v. American Savings Bank.[7] In pertinent part, Section 1322(b)(2) states that a Chapter 13 plan may "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."[8] In *Nobelman*, the Supreme Court interpreted this section to mean that lending institutions' rights are determined by state law based on the underlying mortgage agreement.[9] These rights include all those rights bargained for by the parties to the contract. The only modification permitted by Section 1322(b)(2) was the Section 1322(b)(5) "cure" discussed above, the split of the mortgage debt into pre- and post-petition obligations.[10]

Creditors have argued for some time that to cure a claim properly would require debtors to make a stream of payments that equals the present value of the arrearage claim. This would necessitate payment of interest to compensate the creditor for the time value of the money, a position which the bankruptcy code supports. Creditors making this argument relied principally on Section 506(b)[11] and Section 1325(a)(5).[12] Under Section 506(b), secured creditors are entitled to interest on their claims and other fees, costs, and charges provided for by the underlying security documents **to the extent of their security**. In other words, if the mortgage agreement provided for payment of interest and other charges, these charges are recoverable at least to the extent that the total claim does not exceed the value of the house securing the mortgage.[13] Additionally, Section 1325(a)(5) provides that a plan can be confirmed only if the holder of each allowed secured claim provided for by the plan retains the lien securing its claim and if "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim."[14]

The basic argument of creditors has been that if debtors were to surrender their home, creditors would immediately receive the value of their secured claim. Therefore, if debtors are to cure the arrearage claim over two to three years, creditors are entitled to payments plus interest so that the creditors receive the same value as they would have received through an immediate surrender. A failure to provide for the interest of the arrearage claim is a failure to cure the claim and a modification of creditors' rights.[15]

Debtors seeking relief under Chapter 13 must propose a repayment plan that meets strict criteria, and Congress and the bankruptcy courts have been especially protective of the rights of mortgage holders.

II. *RAKE V. WADE*

In its recently decided case of *Rake v. Wade*, the Supreme Court took its ruling in *Nobelman* one step further.[16] The Supreme Court considered three cases out of the Northern District of Oklahoma. In each of these three cases, debtors proposed Chapter 13 plans that attempted a Section 1322(b)(5) cure. The plans provided for mortgage arrearage claims to be paid off through the Chapter 13 plan while debtors maintained current, post-petition payments. In each case, the mortgage obligations were oversecured; the value of the residence owned by each pair of debtors exceeded the outstanding balance on the corresponding notes.

The holder of the notes objected to each of the three plans, arguing that he was entitled to attorneys' fees and interest on the arrearages. Both the bankruptcy court and the district court ruled against the holder of the notes and decided that allowing interest on an arrearage claim would be improper unless the underlying mortgage note provided for such interest. The Court of Appeals for the Tenth Circuit reversed those decisions, however, stating that Section 506(b) entitles oversecured claimants to interest on arrearages and other charges even if the debt instruments are silent on the subject. Since the circuits were split on this issue, the Supreme Court granted certiorari to resolve the conflict.[17]

The Supreme Court considered the provisions of Sections 1322(b)(2), 1322(b)(5), 1325(a)(5), and 506(b), and held that oversecured creditors are entitled to interest on arrearages paid off under mortgagors' Chapter 13 plans, even if mortgage instruments are silent on the subject and applicable state law would not have required the payment of interest.[18]

III. UNANSWERED QUESTIONS

Although the Supreme Court made it clear that oversecured mortgage claimants are entitled to interest, several questions remain unanswered. First, does the debtor, the creditor, or the trustee calculate the interest?

In some districts, the standing trustees in bankruptcy began to calculate interest on oversecured claims almost immediately. In other jurisdictions, creditors began to calculate interest on their own claims and include this interest on their claims as filed with the bankruptcy court. In still other cases, debtors have attempted to pro-

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vide for certain amounts of interest in their Chapter 13 plans.[19] Any of these methods might work if all parties could agree on the rate of interest to be charged.

The second and most important question left open by the Supreme Court is: to what rate of interest is the claimant entitled? The Supreme Court expressly declined to address this issue in footnote eight to its decision. "Because the issue is not presented in this case, we express no view on the appropriate rate of interest that debtors must pay on arrearages cured pursuant to § 1322(b)(5)."[20] Since most mortgage agreements provide for acceleration of debt upon default, they are generally silent as to the interest rate applicable to the curing of defaults. Significant disagreement has arisen over appropriate rate of this interest.

IV. METHODS OF CALCULATION

Several different methods of calculation have been suggested and argued among debtors, creditors, and the standing trustees. These include application of the contractual rate of interest, the judgment rate of interest, and the market rate of interest.

A. Contractual Rate of Interest

Although few mortgage agreements make any provision for payment of interest in bankruptcy, all mortgage agreements provide for payment of interest on the outstanding principal loaned. Generally, these interest rates are higher than the judgment or market rate would be and are highly advantageous to creditors if applied to arrearages. On a large arrearage claim, the difference between a 9 percent judgment rate and a 12.5 percent contractual interest rate may be well worth the cost of litigation. Indeed, good arguments support payment of interest at the contractual rate.

The United States Bankruptcy Court for the Southern District of Texas applied one such argument in *In re Sauls*.[21] In *Sauls*, the debtors proposed to cure their mortgage arrearage while maintaining current payments. In light of the Supreme Court's recent decision in *Rake v. Wade*, the Sauls proposed to pay interest on the arrearage claim at the rate of 8 percent. Mellon Mortgage Company, holder of the claim, objected, claiming it was entitled to the 10.5 percent rate of interest provided for in the note and mortgage. Mellon relied on Section 1322(b)(2), which prohibits modification of the rights of the mortgage holder on the debtor's principal residence. The trustee in the case argued that the creditor was only entitled to the present value of the claim and opposed the objection.[22]

The Supreme Court considered the provisions of Sections 1322(b)(2), 1322(b)(5), 1325(a)(5), and 506(b), and held that oversecured creditors are entitled to interest on arrearages paid off under mortgagors' Chapter 13 plans, even if mortgage instruments are silent on the subject and applicable state law would not have required the payment of interest.

The bankruptcy court sustained the objection of the mortgage company and denied confirmation of the debtors' Chapter 13 plan. The bankruptcy judge held that while the market rate of interest suggested by the debtors would provide creditors with the present value of their claim, the courts inquiry into the non-modifiable rights of creditors pursuant to Section 1322(b)(2) are not necessarily satisfied by that rate.[23] In other words, the interest rate bargained for by mortgagor and mortgagee at the time the mortgage was executed is one of the rights protected by 11 U.S.C. 1322(b)(2). Accordingly, the court concluded "that the appropriate rate of interest to be paid on a mortgagee's arrearages under a Chapter 13 plan is the non-default contract rate."[24]

B. Judgment Rate of Interest

After a foreclosure proceeding in state court goes to judgment, but before a sheriff's sale takes place, mortgage holders are generally entitled to interest on the judgment at a rate determined by state law. State law sets a rate of interest that is applicable to all judgments. Many have argued that it is this judgment rate of interest that ought to apply to mortgage claims.

Recently, the United States Bankruptcy Court for the Western District of New York considered the appropriate rate of interest issue. The court in *In re Callahan* was presented with several cases in which Chapter 13 plans were proposed prior to the Supreme Court's decision in *Rake v. Wade.* [25] None of these plans proposed the payment of interest on the arrearage claims, and the creditors objected. The parties then argued about the appropriate rate of interest to be applied under the *Rake v. Wade* decision.

In *Callahan*, the bankruptcy court held that the state judgment rate was the best rate to apply for several reasons: (1) it is the rate that debtors would be required to pay on the arrearages if a judgment for foreclosure and sale was entered in a state court proceeding; (2) although the

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debtors might benefit from application of a market rate at any given time, the respective benefits would even out over time; (3) application of the state judgment rate would reduce conflict in resolving the issue prior to confirmation; and (4) application of this set rate would make Chapter 13 less costly to confirm and complete, making it easier for debtors to save their homes.[26]

C. Market Rate of Interest

The final approach considered here is the market rate approach. Since mortgage agreements do not generally provide an interest rate for arrearage cures, many argue that the rate should be based on the amount it would cost to finance the cure. Three techniques can be used in determining this rate: (1) the creditor's cost of funds approach; (2) the forced loan approach; and (3) the treasury bill rate.

The Eighth and Ninth Circuits have applied the creditor's cost of funds approach to calculate the appropriate interest rate.[27] The calculation of this rate is generally a function of the prime lending rate. The argument for applying this rate is that the appropriate discount is the rate at which the creditor would be required to pay interest if it were borrowing the claim amount. For example, if the creditor is owed $5,000 in arrearages and must wait three years to receive the value of its claim, the interest rate should be what the creditor would have to pay another lender to get that $5,000.

Some might argue that a forced loan approach is more applicable to the circumstances of a Chapter 13 bankruptcy. This approach acknowledges the fact that in some circumstances, where high risk or urgent need is involved, the cost of financing commitments is often higher than the normal lending rate. Therefore, this rate should apply in bankruptcy because greater risk is involved than in normal financing obligations. In general, however, bankruptcy courts have not responded well to this approach, preferring instead to add a risk factor of one or two percent to the prime lending rate.[28]

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The third market value approach is application of the treasury bill rate, or what the government pays to borrow money. This approach would be the most beneficial to debtors as the government pays less to borrow than any other entity. However, even the largest financial institutions borrow money at a rate higher than the government, and courts which apply the treasury rate tend to try equitable adjustment of the rate by adding a risk factor. Thus, even those courts which use the treasury bill approach generally end up with something very similar to the creditor's cost of funds approach discussed above.[29]

Most adherents to the various market rate approaches argue that the best calculation is one which applies the prevailing market rate of interest on similar loans at the date of filing of the bankruptcy petition. Some parties argue further that the absolute maximum rate, even using this calculation, should be the contract rate in the mortgage itself.

Although calculation methods appear to have been established in some districts, the question is far from settled in most jurisdictions. A uniform method of calculating interest under *Rake v. Wade* still seems far off.

V. NECESSITY OF OVERSECURITY

Rake v. Wade also raised the question of whether the mortgage holder must be oversecured in order to be entitled to interest. The Supreme Court findings were limited to loans that were oversecured.[30]

However, if one applies the rationale by which the *Rake* court determined interest was appropriate, the value of the mortgage holders' security seems somewhat less important than the definition of a cure. Several courts, including bankruptcy courts for the Western District of New York and for the District of New Jersey, have now held that claimants for mortgage arrearages are entitled to interest whether or not their claims are fully secured.[31] The District Court of New Jersey held that a home mortgage is always deemed fully secured for the purposes of Section 1322(b)(2). Therefore, all mortgages on debtors' principal residences must be treated as if they were fully secured for purposes of determining whether the mortgage holders are entitled to interest under *Rake v. Wade.*[32]

The United State Bankruptcy Court for the Western District of New York reached a similar conclusion for different reasons in *In re Callahan.*[33] The court acknowledged the debtors' argument that it would be inconsistent with "the scheme of the Bankruptcy Code" for fully secured and under secured claims to be treated in the same fashion, but approached the issue from a different perspective. The *Callahan* court determined that the

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focus of its consideration should not be the secured or unsecured nature of the arrearage claim, but the conceptual requirements for a meaningful and equitable cure under Section 1322(b)(5). The court took its definition of a cure from the Second Circuit Court of Appeals, which stated that: "Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of 'cure' used throughout the Bankruptcy Code."[34] The *Callahan* court, applying this definition of cure, held that allowing debtors to pay an arrearage claim over time without interest would be an inequitable and unrealistic interpretation of the concept of cure because a cure requires a meaningful return to pre-default conditions. Therefore, when the proposed cure is not immediate but is to be accomplished over time, some sort of interest **must** be added.[35]

The issue of undersecured claimants' entitlement to interest has yet to be determined in most jurisdictions, and the issue is unlikely to be settled in a uniform fashion for quite some time.

VI. CONCLUSION: THE IMPACT OF *RAKE V. WADE*

Indisputably, the Supreme Court's decision in *Rake v. Wade* will have a profound impact on Chapter 13 bankruptcy. Chapter 13 bankruptcy is the traditional recourse for homeowners anxious to save their homes in time of economic hardship, and the decision of *Rake v. Wade* will necessarily adversely impact the chance of success in that endeavor.

Regardless of the method of calculating interest that becomes the norm, the bottom line is the same. The cost to Chapter 13 debtors of curing their mortgage defaults and reinstating their loans will increase dramatically. As a result of the interest, arrearage claims will be higher and more difficult to cure in a reasonable time as required by the Bankruptcy Code.

Debtors who lose their homes as a result of this change in the bankruptcy law have good cause to complain. Where mortgage agreements provide for interest on the principal balance over the life of the loan, a debtor could very well argue that the interest required by *Rake v. Wade* is interest on top of interest, and is extremely unequitable. The mortgage lenders, on the other hand, are confused by the holding and generally have not even determined how to apply these funds if they are received.

As if the mere payment of this interest were not burdensome enough to the debtor, the confusion as to methods of calculation will likely cause an increase in litigation. Generally, the debtor's attorneys fees are paid through the Chapter 13 plan over the life of the case. Additionally, most mortgage agreements provide for the debtor to pay the attorney's fees and costs of the mortgage holder. The debtor, already facing hard times, is required to pay the litigation costs of both sides in any dispute over the appropriate rate of interest or the application of interest. Where the courts conflict, a determination of this rate may require a lengthy and costly appellate process that will seriously jeopardize the typical debtor's chances of ever successfully completing the Chapter 13 process.

In short, the impact of *Rake v. Wade* is likely to be an increase in litigation and contested confirmation hearings, and a decrease in the success rate of Chapter 13 bankruptcies. ❖

ENDNOTES

1 11 U.S.C. §§ 1301-1330 (1988).
2 11 U.S.C. § 1322(b)(5) (1988).
3 *Id.*
4 *Id.*
5 *Id.*
6 11 U.S.C. § 1322(b)(2) (1988).
7 Nobelman v. American Savings Bank, 113 S.Ct. 2106 (1993).
8 11 U.S.C. § 1322(b)(2) (1988).
9 113 S.Ct. at 2110.
10 *Id.*
11 11 U.S.C. § 506(b) (1988).
12 11 U.S.C. § 1325(a)(5) (1988).
13 11 U.S.C. § 506(b) (1988).
14 11 U.S.C. § 1325(a)(5) (1988).
15 In re Callahan, 158 B.R. 898, 904 (Bankr. W.D. N.Y. 1993).
16 Rake v. Wade, 113 S.Ct. 2187 (1993).
17 *Id.* at 2189.
18 *Id.* at 2193.
19 The jurisdictional differences in who calculates the interest are based on my own experience in practice. For example, in the Northern District of Illinois, Eastern Division, we have been calculating the interest and including this calculation in proofs of claims. In the Southern and Central Districts, however, the trustees calculate the interest.
20 *Id.* at 2192.
21 In re Sauls, 161 B.R. 794 (Bankr. S.D. Tex. 1993).
22 *Id.* at 795.
23 *Id.* at 796.
24 *Id.*
25 In re Callahan, 158 B.R. at 898.
26 *Id.* at 902-03.
27 United States v. Doud, 869 F.2d 1144, 1146 (8th Cir. 1989); In re Fowler, 903 F.2d 694, 697-98 (9th Cir. 1990).
28 In re Fowler, 903 F.2d at 698. A district court decision based on the forced loan approach was overturned in favor of the creditor's cost of funds approach.
29 *Id.* at 697; In re Wichmann, 77 B.R. 718, 721 (Bankr. D. Neb. 1987); In re Bergbower, 81 B.R. 15, 16 (Bankr. S.D. Ill. 1987).
30 113 S.Ct. at 2189.
31 In re Callahan, 158 B.R. at 904; In re Brycki, 161 B.R. 915, 917 (Bankr. D. N.J. 1993).
32 *See* 161 B.R. at 917.
33 158 B.R. at 904.
34 In re Taddeo, 685 F.2d 24, 27 (2d Cir. 1982).
35 158 B.R. at 904.