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Mortgages & Mentoring: My Career with Judge Barry S. Schermer

Cynthia Kern Woolverton*

Most people think of Judge Schermer as the judge they have been appearing in front of for years — smart, consistent, and expeditious. He is all of those things and many more. He is a father, a grandfather, a brother, a friend and an amazing teacher. Each of us who knows Judge Schermer, or who has dealt with him in any capacity, has a story to tell about how he has taught each of us.

My first exchange with Judge Schermer was nearly twenty years ago.

"Good Morning, Your Honor. Cynthia Woolverton on behalf of [fill in the blank creditor]."

"Ms. Woolverton, where did you go to law school?" asked the Judge.

"St. Louis University, Your Honor."

"Hmmm…maybe you will grow into your position," responded the Judge.

From that exact moment Judge Schermer began teaching me. Although I understood that a law degree and a job did not mean I had made it or that I had "arrived," he helped me understand that I needed to work every day to be the best. Since that time he has encouraged me to be a better attorney by demanding a full understanding of the issues presented, including preparation and planning, so as to never have to respond, "Judge, I don't know the answer to that."

During the last six years I have had the unique opportunity to teach alongside Judge Schermer here at Washington University School of Law in the Fundamentals of Bankruptcy class. This class begins with an introduction into state law collection and then explores the most common chapters of bankruptcy: Chapter 7 on liquidation, Chapter 13 on repayment plans, and Chapter 11 on reorganization. For many students, this class is extremely difficult because of the amount of material we cover and the complexity of many of the issues. This class requires analysis and

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independent thought because the reading material is the responsibility of the student. Developing that material through current cases and real life fact patterns is our responsibility as instructors. You can read cases in the text about property of the estate, but never will you fully understand the scope of this Code section until the Judge asks you if your pet parakeet named Lulu is property of the estate (or the baby parakeets she gives birth to just two weeks after the filing of your bankruptcy case). An automatic stay violation seems like a simple concept when described as a collection effort until the Judge asks you about the prosecution of a bad check. Is that a criminal proceeding that is not stayed by section 362,[1] or is it an attempt to collect a debt? Judge Schermer has an uncanny ability to remember what we could not have known when we started down this path in our careers. He is capable of breaking down the most difficult of concepts to allow students to grasp them and build on the knowledge each day. Whether guiding students through a Supreme Court case to demonstrate that many people disagreed about the meaning of the words in the Code, or creating drawings on the board to illustrate a concept, he is constantly looking for ways to make the pages of the book come alive. I have marveled at the Judge's ability to engage our students, encouraging a level of excitement that matches our own — even at 7:30 in the morning. We have all been that student sitting in the lecture hall just hoping to get through another day, another semester. But each year, we have students taking the practice more seriously and considering a future in the field to which Judge Schermer has devoted a lifetime. This is no mistake. He makes this happen each day.

One of my favorite subjects to teach with Judge Schermer is secured claims in a Chapter 13 case. At this point in the semester the students have learned that bankruptcy has some unanticipated results. They have learned to expect the unexpected. No subject teaches this more poignantly, however, than secured claims, particularly concerning home mortgages.

We begin with the elements of an acceptable plan under section 1325,[2] which sets out the standards for confirmation of a Chapter 13 plan. The general rule for secured claims is that, if the debtor desires to retain the

1. 11 U.S.C. § 362 (2010).
2. 11 U.S.C. § 1325 (2010).

collateral securing a claim, the plan must propose that the secured claim holder will receive at least the value of the collateral. This standard begs for a discussion about how the students would determine this value. There is always a debate about whether the amount should be what the debtor could sell the property for versus what he would have to pay to buy a new one. Like many of the concepts of Chapter 13, the United States Supreme Court has already given us an answer. For this particular issue, the Supreme Court's answer is in *Associates Commercial Corp. v. Rash*.[3] Before reaching the Supreme Court, six of the circuits had split at least three ways on the definition of value — liquidation, replacement and splitting the difference between liquidation and replacement.[4]

The Rashes had purchased a truck for freighthauling.[5] When they filed their Chapter 13 bankruptcy case, they still owed $41,000 which represented approximately fifty-five percent of the purchase price.[6] Estimating the amount that the truck would sell for at a liquidation sale, the Rashes' Chapter 13 plan proposed to force the lender down to $28,500, which would be paid over the fifty-eight months of the plan.[7] Associates Commercial Corp. objected, indicating that if the Rashes were required to replace the vehicle with a similar truck, the amount necessary to purchase that vehicle would be $41,000, which should be considered the value of the vehicle for purposes of satisfying the standards of section 1325.[8]

With an eight-to-one decision, Justice Ginsburg's majority opinion focused on the language of section 506(a), seemingly forgotten by the Fifth Circuit in the case on appeal. The provision requires that the valuation be determined ''in light of the purpose of the valuation and of the proposed disposition or use of such property.''[9] In this case, the Rashes' plan had proposed to retain the truck; therefore, Justice Ginsberg

3. 520 U.S. 953 (1997).

4. *See* Taffi v. United States (*In re* Taffi), 96 F.3d 1190, 1191-92 (9th Cir. 1996) (en banc); Winthrop Old Farm Nurseries v. New Bedford Inst. Or Sav. (*In re* Winthrop Old Farm Nurseries), 50 F.3d 72 (5th Cir. 1995); Metrobank v. Trimble (*In re* Trimble), 50 F.3d 530, 531-32 (8th Cir. 1995); *In re* Hoskins, 102 F.3d 311, 316 (7th Cir. 1996); *cf.* GMAC v. Valenti (*In re* Valenti), 105 F.3d 55, 62 (2nd Cir. 1997).

5. *Associates Commercial*, 520 U.S. at 956.

6. *Id.*

7. *Id*. at 957.

8. *Id*.

9. *Id.* at 961 (quoting 11 U.S.C. § 506(a)).

found that the proper value for the purposes of the Chapter 13 plan was the cost of an equivalent truck.[10]

Congress specifically addressed this issue in the amendments to the Code in 2005 known as the Bankruptcy Abuse Prevention and Consumer Protection Act.[11] A new paragraph was added to section 506(a), which states:

> (2) If the debtor is an individual in a case under [C]hapter 7 or 13, such value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.[12]

A basic financial concept is that money today is worth more than money a year from now due to inflation and opportunity costs. Therefore, if the secured creditor is expected to wait for payment over the next several years and the Code requires the creditor to receive both a lien securing the claim and a promise of payment for the total value as of the date the plan is approved by the court that is "not less than the allowed amount," then interest is a necessary component to a secured claim in bankruptcy.[13]

Next, the students must determine the appropriate interest to be charged — contract rate, prime rate, or something else? Having resolved the issue of the value, the United States Supreme Court tackled the issue of the appropriate interest rate in *Till v. SCS Credit Corporation*.[14] In choosing the "prime plus" rate, the Court determined that the approach would satisfy the Code's intentions and provide an objective rather than a subjective inquiry for each case. The adjustment from the prime rate to

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10. *Id.* at 965.

11. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 199 Stat. 23 (codified as amended at 11 U.S.C. § 506(a) (2005)).

12. 11 U.S.C. § 506(a) (2005).

13. 11 U.S.C. § 1325(a)(5)(B)(ii) (2010).

14. 541 U.S. 465 (2004).

the prime plus rate would account for the riskiness of a bankruptcy debtor. The Court, however, did not go far enough as to tell the courts what the plus number ought to be.[15]

In class, we then turn our focus to the remaining words of section 1322(b)(2). The clause "except a claim secured by the debtor's principal residence" limits the general concept that secured claims can be modified. A mortgage or deed of trust is the instrument that secures an interest in the debtor's property and, along with the original promissory note, allows for the claim of a lender in the Chapter 13 bankruptcy case.

Understanding mortgages and their significance in our economy requires a review of the real estate market and borrowing/lending practices in the last several decades. The 1990s saw a steady housing market with modest increases in values. Because of this steady growth, when the stock market crashed in 2000, people began looking for more stable investments and real estate was the answer. With many more people entering the housing market, the need for financing increased; with that need came innovative ideas in lending such as adjustable rate loans, interest only loans and zero down loans. With no money invested by the homeowner into the transaction, everyone wanted in. Home prices were on the rise and real estate, from the homeowner's viewpoint, was a secure asset.

The lending industry was happy to participate as well. For lenders, a mortgage loan is an income stream. Depending on the borrower and his creditworthiness, there are different types of loans from federally insured or guaranteed loans. These include federally insured loans issued by the Federal Housing Administration (FHA), or guaranteed loans from the U.S. Department of Veterans Affairs (VA) given by the government agency Ginnie Mae, conforming loans[16] given by Fannie Mae and Freddie Mac (government-sponsored enterprises), and non-conforming loans such as jumbo loans or Alt-A loans. The private sector became very active in the non-conforming mortgage industry as the need for lending increased.

These developments began changing lending drastically. Years ago, if you got a mortgage from a bank, it was very likely that the bank would keep the loan on its balance sheet until the loan was repaid. But, the need

15. *Id*. at 484.

16. Conforming loans are those that meet certain borrower quality characteristics and loan-to-value ratios and are smaller than the conforming loan size limit.

for new money and the risk of default created a new way of lending. "New money" refers to the fact that when the bank loans $100,000.00, it has to wait for repayment terms to recover those amounts unless it sells the loan to someone else who agrees to await the repayment terms. The payment for the loan allows the bank to lend again to a different borrower which in turn increases available credit for homeowners. As for decreasing the risk of default, the options available to a lender are to lend to only those individuals whom you know can repay or to spread the risk through the process of securitization.

Put simply, securitization is the process of taking many mortgage loans, bundling them and selling them to investors. A mortgage is the perfect instrument for securitization. It has a steady cash flow, a low default rate, is easily diversified by geography and is readily transferable. This process begins with the formation of a special purpose vehicle which can be a corporation, trust, or any other legally separate entity. The special purpose vehicle issues asset-backed securities into the market, and investors in turn purchase the securities to receive a return on their investment. The special purpose vehicle uses the proceeds of the security sale to purchase the pool of assets from the originator. The securities are structured so that interest payments on the mortgages are at least sufficient to cover the interest payments due on the bonds, while principal payments on the mortgages are used to pay down the principal on the bonds.[17]

But this was not enough; so, along came resecuritization. Resecuritization involves selling bonds that are themselves backed by pools of bonds which are referred to as collateralized debt obligations. The collateralized debt obligations can look like mortgage-backed securities, except that the assets are made up of other kinds of securities.[18]

In normal circumstances, diversification reduces risk — having mortgages from different geographical areas means, if there is a housing slump in one area of the country, there is likely a boom in another part of the country that offsets the slump. This idea carried through in the resecuritization process. However, these transactions became so complex

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17. Jason Cox, et al., *Why Did the Credit Crisis Spread to Global Markets?* 6 (2010) (unpublished article) (on file with the author).

18. *Id*. at 7.

that often times it was impossible to know what the underlying actual assets were, which resulted in many inaccurate credit ratings.[19]

But what did all of this have to do with the individual borrower? Adjustable-rate mortgages and the other creative mortgage products appealed to those who wanted the lowest possible interest rates and expected to be able to either sell their homes or refinance them before the mortgages reset. However, after the real-estate market crash, many did not have enough equity to refinance and houses began to sit on the market as prices went into a free fall.

Defaults skyrocketed and, with mortgage-backed securities in every investment portfolio, the crash started. Eventually, rating agencies had to downgrade the mortgage-backed securities. These toxic assets could not be sold. Yet, there was no longer any place for these to go. The banks had to begin writing down the assets. These write-downs hurt banks even when they were not planning to sell the assets. A bank's balance sheet lists all of a bank's assets and liabilities. A bank's capital is determined by subtracting its liabilities from its assets. Therefore, when commercial banks took write-downs, decreasing the value of their assets, capital also decreased. Regulators watched poorly capitalized banks more closely and restricted their operations. Lending froze.[20]

It has taken a long time for the industry to rebound. In many parts of the country, the housing market is just starting to recover with more people entering the buying market.[21] Homes remain the largest asset most Americans will ever have.[22] Our country's history teaches us that home ownership is part of the American dream. This dynamic explains the major protections afforded to those companies willing to exist in the lending market.

If a debtor in a bankruptcy case is unable to modify the rights of the creditor with a secured claim in his principal residence, it would seem that his hands are tied and he is left in the same situation he was in prior to filing the bankruptcy case. However, section 1322(b)(5) helps to save the

19. *Id*. at 16.
20. *Id*. at 20.
21. Samantha Sharf, *Housing Outlook 2017: Eight Predictions from the Experts*, FORBES (Jan. 3, 2017), https://www.forbes.com/sites/samanthasharf/2017/01/03/housing-outlook-2017-eight-predictions-from-the-experts/#65b0f7d7fa09.
22. *Id.*

day.[23] This provision allows the debtor to cure the default within a reasonable time and maintain his payments when the secured claim has a last payment due after the date of the final plan payment.[24] As most mortgages are thirty-year mortgages, a debtor often has this opportunity. "Curing" refers to bringing those amounts due and owing at the time of the filing current. For example, a borrower who has missed five mortgage payments in the amount of $500.00 each is also likely to have had additional fees assessed to his account such as late charges, inspection fees and possibly attorney fees if the account has moved into a foreclosure status. The amount due at the time of the filing of the case, the "arrearange amount," includes all of these amounts. The debtor is obligated to maintain his ongoing payments as they come due.

Many loans in bankruptcy are adjustable rate mortgages, which are often times associated with a balloon payment and mature within three to five years of origination. Section 1322(c)(2) provides that this loan, even on the principal residence, can be modified so long as the loan matures during the life of the plan.[25] If the facts are present, section 1322(c)(2) directs us back to section 1325(a)(5) requiring the claim to be paid its value and adequate protection.[26]

Trying to make these concepts work together, we present students with the following facts. A husband and wife filed for bankruptcy after falling behind on their mortgage payments. The original amount of the loan was $68,250.00. After the filing of the bankruptcy case, the lender filed a proof of claim for $71,335.00 representing the unpaid principal balance, interest as well as fees and costs. Section 506(a) of the Bankruptcy Code provides that an allowed claim secured by a lien on the debtor's property is a secured claim to the extent of the value of the creditor's interest in the property and is an unsecured claim to the extent the claim exceeds the value of the creditor's interest in the property. Relying on this section, the debtors (1) valued the residence at $23,500 in their Chapter 13 plan and proposed to make payments pursuant to the mortgage contract up to only

23. 11 U.S.C. § 1322(b)(5) (2010).
24. *Id.*
25. *See* 11 U.S.C. § 1322(c)(2) (2010); *and* American Gen. Fin., Inc. v. Paschen (*In re* Paschen), 296 F.3d 1203 (11th Cir. 2002); *and In re* Eubanks, 219 B.R. 468 (B.A.P. 6th Cir. 1998).
26. 11 U.S.C. § 1322(c)(2).

that amount plus prepetition arrearages; and (2) proposed to treat the remainder of the bank's claim as unsecured.[27] Under the debtors' proposed plan, unsecured creditors were to receive nothing. The bank, objecting to the plan, argued that the debtors' proposed bifurcation of the bank's claim into a secured claim for $23,500 and an effectively worthless unsecured claim modified the bank's rights as a homestead mortgagee in violation of 11 U.S.C. § 1322(b)(2), which provides 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." [28]

Which legal theory wins? This is a famous case in the mortgage industry heard by the United States Supreme Court in the case of *Nobelman v. American Savings Bank*.[29] In a unanimous decision, the Court sided with the mortgage lender and found that a Chapter 13 debtor cannot reduce the amount owed to a mortgage lender on the debtor's principal residence to the value of the collateral because of the language of section 1322(b)(2).[30] While section 506(a) is the appropriate place to begin to determine if a creditor is a secured creditor, section 1322(b)(2) uses the words "the *rights* of holders of secured claims."[31] The Court found that it would be impossible to reduce the lender's secured claim to $23,500.00 without modifying its contractual rights to interest, monthly payment amounts or repayment terms.[32] This case is still a leading case in the mortgage industry for the protection of rights for those businesses whose funding provides for the American dream.

We continue to develop the concepts in class and take the students to a situation in which many debtors find themselves in today's economic climate. We add to the hypothetical a first lien against the property in the amount of $155,000.00 and a second lien in the amount of $40,000.00. The appraised value of the home is $140,000.00. Does the Supreme Court's decision in *Nobelman* mandate the same treatment for both liens? Can the debtor propose a plan that alters the rights of either of these

27. 11 U.S.C. § 506(a) (2005).
28. 11 U.S.C. §1322(b)(2) (2010).
29. 508 U.S. 324 (1993).
30. *Id.* at 332.
31. *Id.* at 327 (emphasis added).
32. *Id.* at 328.

creditors? The Supreme Court did not find fault with the Nobelmans' reliance on section 506(a)[33] to determine the secured status of the claim.[34] In fact, the section is the correct starting point. The first lien on this property is fully secured because the value of the property secures at least a portion of the claim. However, the same cannot be said of the junior lien. Applying section 506 to this claim, there is no equity to support the claim, and therefore, there is no portion of the claim that is secured.[35] Because there is no portion that is secured, the language of section 1322(b)(2) is inapplicable in this situation.[36] The junior lien is wholly unsecured and can be modified by the debtor's plan.[37]

Exploring these concepts with the guidance and expertise of Judge Schermer makes teaching enjoyable and gives the students the tools necessary to expand their knowledge of bankruptcy and secured transactions. Throughout my career I have had the good fortune to learn from and be guided by the man we honor in this edition. And for this reason, there is no question I am a better attorney, a better teacher and even a better person. I am honored to have been a part of this celebration and to personally thank you, Judge, for everything you have done for me and the practice of law. Congratulations for thirty impressive years on the bench.

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33. 11 U.S.C. §506 (2005).

34. *Nobelman*, 508 U.S. at 328.

35. *See, e.g.*, *In re* Fisette, 455 B.R. 177, 182 (B.A.P. 8th Cir. 2011); *and* 11 U.S.C. §506 (2005).

36. *In re* Fisette, 455 B.R. at 182; *and* 11 U.S.C. § 1322(b)(2) (2010).

37. *See* Minnesota Hous. Fin. Agency v. Schmidt (*In re* Schmidt), 765 F.3d 877, 878 (8th Cir. 2014); Branigan v. Davis (*In re* Davis), 716 F.3d 331, 334–39 (4th Cir. 2013); Zimmer v. PSB Lending Corp. (*In re* Zimmer), 313 F.3d 1220, 1222–27 (9th Cir. 2002); Lane v. W. Interstate Bancorp (*In re* Lane), 280 F.3d 663, 665–69 (6th Cir. 2002); Pond v. Farm Specialist Realty (*In re* Pond), 252 F.3d 122, 124–27 (2d Cir. 2001); Tanner v. FirstPlus Fin. (*In re* Tanner), 217 F.3d 1357, 1358–60 (11th Cir. 2000); Bartee v. Tara Colony Homeowners Ass'n (*In re* Bartee), 212 F.3d 277, 284–95 (5th Cir. 2000); McDonald v. Master Fin. (*In re* McDonald), 205 F.3d 606, 609–15 (3d Cir. 2000).