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Debtors Cannot Reduce Mortgage To Fair Market Value

In *Nobelman v. American Savings Bank*, 113 S.Ct. 2106 (1993), the United States Supreme Court held that a bankruptcy debtor could not reduce an undersecured homestead mortgage to its fair market value by dividing the mortgage into its secured and unsecured parts.

The Modified Repayment Plan

In 1984, American Savings Bank (American) loaned Leonard and Harriet Nobelman \$68,250 for the purchase of a condominium in Dallas, Texas. In return, the bank received an adjustable rate note which was secured by a deed on the residence. In 1990, the Nobelmans fell behind in their mortgage payments and sought relief under Chapter 13 of the Bankruptcy Code.

During the bankruptcy proceedings, American filed a proof of claim for \$71,335. This amount included the principal, interest, and fees the Nobelmans owed on their note. The Nobelmans, on the other hand, proposed to make payments on the mortgage contract only up to its fair market value of \$23,500 plus any arrearages incurred prior to the date they filed their petition.

Relying on Section 506(a) of the Bankruptcy Code, the Nobelmans classified the fair market value amount and the arrearages as the secured portion of their loan. They then stated that the remainder of the bank loan, approximately \$47,000, constituted the unsecured portion of the mortgage. Under the Nobelmans' modified Chapter 13 plan, unsecured creditors would receive nothing.

Section 506(a) of the Bankruptcy Code defines a secured claim as "an allowed claim of a creditor secured by a lien on property in which the estate [in this case, the Nobelmans] has an interest." However, a secured claim only extends to the value of the creditors

interest in the estate's interest in the property. Under the Nobelman's proposal, this value is the fair market value of the mortgage, totalling \$23,500 plus arrearages.

Furthermore, Section 506(a) defines as unsecured claim as "[t]he extent of the value of the creditor's interest ... less the amount of the entire claim." Under the circumstances in *Nobelman*, American claimed \$71,335 as the debt. The Nobelmans proposed \$23,500 plus arrearages as the amount of the secured claim in their mortgage. Thus the unsecured portion of the Nobelman's mortgage would total approximately \$47,000, or \$71,335 (American's total claim) minus \$23,500 plus arrearages (secured claim).

Dispute Over Secured and Unsecured Claims

Section 1322(b)(2) of the Bankruptcy Code allows debtors to adjust their indebtedness through a flexible repayment plan approved by a bankruptcy court. Under the plan, the debtor must submit a portion of future earnings and income to a trustee who will make payments to creditors for a period of not more than five years. Section 1322(b)(2) also allows modification of the rights of creditors holding secured claims. Nevertheless, Section 1322(b)(2) disallows modification in specific instances where (1) a creditor's only security interest is that of the debtor's principal residence; (2) creditors hold unsecured claims; or (3) creditors' rights of any class of claims is unaffected.

The Nobelmans, American, and the Chapter 13 trustee agreed that Section 1322(b)(2) prohibited modification of a homestead lender's rights. However, the parties argued whether dividing American's claim into a secured claim for \$23,500 and a worthless unsecured claim would modify the American's rights as a homestead lender in violation of Section 1322(b)(2) of the Bankruptcy Code.

The Nobelmans asserted that their Chapter 13 plan did not modify

American's rights because Section 1322(b)(2) only applied to the extent that the lender held a secured claim in the debtor's residence. The Nobelmans contended that the bank held a secured claim of only \$23,500, the value of the property. Section 506(a) states that a claim secured by a lien on the debtor's property was a secured claim only to the extent of the value of the property and an unsecured claim to the extent that it exceeded that value. The Nobelmans claimed that the plan fell within the limits of Section 1322(b)(2) because it only modified the bank's leftover unsecured claim.

Creditors Rights Protected

In rejecting the Nobelmans' plan, the Supreme Court examined the language of Section 1322(b)(2) because it focuses on creditors' rights, not on claims. The Court agreed with the Nobelmans that the portion of the bank's claim which exceeded \$23,000 was an unsecured claim. However, the Court concluded that the rights of the bank as a lender under Section 1322(b)(2) were not limited by the valuation of its secured claim.

Because the Bankruptcy Code does not define creditors rights, the Court looked to Texas law and the relevant mortgage instruments enforceable under state law. Creditors' rights under Texas law included: (1) the right to repay the principal in monthly installments over a fixed term at specified adjustable interest rates; (2) the right to retain the lien until the debt was repaid; (3) the right to accelerate the loan upon default and to foreclose on the residence by public sale; and (4) the right to bring an action to recover any deficiency remaining after foreclosure. After reviewing Texas' interpretation of creditors' rights, the Court held that although the contractual rights of a home mortgage lender were affected by the borrower's Chapter 13 bankruptcy, the rights bargained for by the borrower and the lender were protected from modification by Section 1322(b)(2).

The Supreme Court refused to follow the decisions of some appeals courts

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which had interpreted Section 1322(b)(2) as protecting only secured claims. Nonetheless, the Court acknowledged that such an interpretation was reasonable. The Court stated that Congress chose to use the phrase "claim secured by" in Section 1322(b)(2), instead of repeating the term of art "secured claim." The Court reasoned that the word "claim" was broadly defined in the Code as "any right to payment," whether secured or unsecured. In addition, the Court referred to Section 506(a) which used the phrase "claim secured by a lien" to encompass both the secured and unsecured portions of an undersecured claim. Following this analysis, the Court concluded that the phrase "a claim secured by only a lien on the debtor's home" referred to the entire claim, including both the secured and the unsecured portions of the claim.

The Supreme Court stated that this interpretation was the most reasonable because Section 1322(b)(2) would be impossible to administer using the approach suggested by the Nobelmans. The Nobelmans could not modify the terms of the unsecured portion of their loan without also modifying the secured portion. Preserving the interest rate and the monthly payments specified in the note after reducing the principal to \$23,500 would dramatically reduce the term of the note. In addition, the Court held that since the loan was an adjustable rate mortgage, this fact alone indicated that Section 1322(b)(2) could not operate with Section 506(a) in the manner suggested by the Nobelmans. Neither the mortgage contract nor the Bankruptcy Code suggested any basis for recalculating the amortization schedule of adjustable rate mortgages.

As a result, the Supreme Court determined that dividing the undersecured homestead lender's claim into its secured and unsecured parts would modify the rights of the creditor whose claim was secured only by a lien on the debtor's home. In the Nobelman's case, American's interest was only secured by a lien on the Nobelman's home. Thus, the Supreme Court could not allow the Nobelmans to divide their mort-

gage into secured and unsecured parts because such a bifurcation would clearly violate Section 1322(b)(2) of the Bankruptcy Code. ♦

Kathie Yoo

Title Company Must Sustain Loss Caused By Closing Attorney's Theft of Mortgage Money

In *Sears Mortgage Corp. v. Rose*, 1993 WL 283309 (N.J.), the New Jersey Supreme Court found that a closing attorney retained by the purchaser in a real estate transaction was the agent of the title insurance company in its dealings with the purchaser in effectuating title insurance. Accordingly, the court held that the title insurance company was liable for the closing attorney's theft of money earmarked for the payment and satisfaction of an existing first mortgage on the property. The court also held that the title insurance company breached its duty of good faith and fair dealing by failing to make its insured aware that there was an insurable risk of attorney defalcation (the failure of one entrusted with money to pay over when it is due to another) and also by failing to expressly provide or offer insurance coverage for that risk.

One Party Must Ultimately Bear the Loss

In August 1987, Emery Kaiser contracted to buy Michael Rose's condominium. Kaiser provided the money to buy the condominium by selling his house. Kaiser retained Joseph Gillen, a real-estate attorney, to represent him in both transactions. Gillen wrote to Commonwealth Land Title Insurance Company (Commonwealth) requesting a title insurance policy for Kaiser. Gillen also wrote to Sears Mortgage Corporation (Sears) requesting a mortgage payoff statement on Rose's condominium. Commonwealth conducted a title search and sent Gillen its title insurance com-

mitment which listed Gillen as an "applicant" and Kaiser as the "proposed insured." The commitment stated that the policy would be subject to certain requirements. Those requirements were: payment of the purchase price to the seller, payment of the premium for the policy, proper signing of a proposed deed from Rose to Kaiser, and that the mortgage from Rose to Sears be "paid and cancelled of record." Commonwealth only sent the policy to Gillen despite the policy's language specifically directing it to the insured.

On October 17, 1987, on a form provided by Commonwealth, Gillen informed the insurance company that the closing had taken place and asked it to perform its final search and issue a fee policy. Instead of sending Sears funds to pay off Rose's mortgage, Gillen misappropriated the closing funds from the Rose-Kaiser transaction as well as the closing funds from Kaiser's other transactions. Gillen absconded with the money and was later criminally convicted, imprisoned, and disbarred.

The trial court held that Commonwealth was liable to Kaiser for breach of its duty of good faith, fair dealing, and full disclosure. The court also found that Gillen had been Commonwealth's agent in its dealings with Kaiser and thus Commonwealth would be liable for Gillen's misconduct under the law of agency. The court ordered Commonwealth to pay off the Sears' mortgage and to issue Kaiser an owner's title-insurance policy free of the Sears' mortgage encumbrance.

The appellate division reversed the trial court's judgment. The appellate division refused to impose liability on Commonwealth because Kaiser's insurance policy did not include a provision protecting him from the risk of attorney misappropriation of funds. The Appellate Division also found that Gillen was Kaiser's, not Commonwealth's agent.

The Supreme Court of New Jersey reversed and reinstated the trial court's judgment against Commonwealth. The case turned on the specific relationships between the parties and their roles