United States Bankruptcy Court
Western District of Wisconsin

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James E. Cleasby and Delores M. Cleasby, Debtors
Bankruptcy Case No. 90-03191-11

United States Bankruptcy Court
W.D. Wisconsin, Eau Claire Division

July 22, 1991

Peter E. Grosskopf, for the debtors.
Christa Reisterer, for United States of America, Farmers Home Administration.

Thomas S. Utschig, United States Bankruptcy Judge.

MEMORANDUM OPINION, FINDINGS OF FACT, AND CONCLUSIONS OF LAW

The matter before the Court is the confirmation hearing of the debtors' Chapter 11 plan. The United States of America, Farmers Home Administration (hereinafter USA-FmHA) has objected to confirmation of the plan. The debtors are James E. and Delores M. Cleasby and they are represented by Peter E. Grosskopf. The USA-FmHA is represented by Christa Reisterer.

The relevant facts can be briefly stated. The debtors filed a Chapter 7 bankruptcy on March 2, 1983, and received a discharge in that year. One of their creditors was the USA-FmHA, which had a mortgage on the debtors' real estate -- three parcels comprising 377 acres in Trempealeau County. The Chapter 7 discharge eliminated the debtors' in personam liability on the USA-FmHA's secured debt, while the in rem liability of the property held as security remained unaffected.

The USA-FmHA initiated a foreclosure action against the debtors' real estate on August 22, 1989. As part of their defense, the debtors asserted that they were eligible for the 1987 Farm Credit Act. This federal legislation mandated that the USA-FmHA offer or provide restructuring to its homeowners rather than foreclose. The legislation established various programs for that purpose. The USA-FmHA successfully contested the debtors' eligibility for the Farm Credit Act before the Honorable Barbara B. Crabb of the United States District Court for the Western District of Wisconsin. In an order dated July 31, 1990, Judge Crabb held that since the debtors have no personal liability to the FmHA, they are not "borrowers" under the Act and could therefore not use its debt restructuring programs to avoid foreclosure. A judgment of foreclosure and sale was then entered on August 24, 1990, in the amount of $397,261. The debtors appealed Judge Crabb's decision and the foreclosure judgment to the Seventh Circuit. Their motion to stay the foreclosure pending appeal was denied by Judge Crabb on November 5, 1990. A foreclosure sale was scheduled for November 16, 1990. On November 14, 1990, the debtors filed a Chapter 11 bankruptcy.

As part of their Chapter 11 case, the debtors brought a motion under 11 U.S.C. § 506 to determine the value of the real estate and the amount of the secured claim of USA-FmHA. At a hearing on February 13, 1991, this Court determined the value of the real estate to be $97,000. Because of a first lien for real estate taxes of $21,301.61, the amount of the USA-FmHA's secured claim was determined to be $75,698.39.

The debtors filed their Chapter 11 plan with this court on February 19, 1991. In it they propose to pay the "allowed secured claim of the FmHA in the amount of $75,698.39 -- in cash in full, within a reasonable time after confirmation of the plan." See Debtors' Chapter 11 Plan at 3.

The USA-FmHA in its objection originally asserted that the debtors' plan could not be confirmed where it improperly scheduled a debt previously discharged. The USA-FmHA asserted that it no longer held a "claim against the debtors, but only a lien against the debtors' property." It cited Home State Bank of Lewis v. Johnson (In re Johnson), 904 F.2d 563 (10th Cir. 1990) in support of this assertion. This case was recently reversed by the U.S. Supreme Court. See Johnson v. Home State Bank, 111 S. Ct. 2150 (1991). In Johnson, the U.S. Supreme Court ruled that a mortgage lien that secures an obligation for which a debtor's personal liability has been discharged in a Chapter 7 liquidation is a claim subject to inclusion in an approved Chapter 13 reorganization plan. See id. The fact that the present case involves a Chapter 11 reorganization does not diminish the applicability of the Johnson holding here. This argument of the USA-FmHA must thus fail. The FmHA does therefore have a "claim" which can be included in the debtors' Chapter 11 plan.

In its brief opposing confirmation, the USA-FmHA next asserted that, should this Court find that it does indeed have a claim, then the USA-FmHA makes an election under 11 U.S.C. § 1111(b). That section provides:

> (b)(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless--
>
> (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or
>
> (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (B) A class of claims may not elect application of paragraph (2) of this subsection if--
>
> (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
>
> (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

11 U.S.C. § 1111(b) (West 1991). On April 17, 1991, the USA-FmHA filed a notice of

§ 1111(b) election with this court. The core of the objection to confirmation currently before the Court involves the effect of this election. The debtors allege that their prior Chapter 7 bankruptcy reduced the amount of the USA-FmHA's claim against them to an amount equal to the value of the real estate, citing Lindsey v. Federal Bank of St. Louis (In re Lindsey), 823 F.2d 189 (7th Cir. 1987) for support. They further allege that, regardless of the USA-FmHA's § 1111(b) election, the only amount owed by them to the USA-FmHA is $75,698.39. In support of this assertion, the debtors cite the language "[s]uch claim is a secured claim to the extent that such claim is allowed" from § 1111(b). See 11 U.S.C. § 1111(b) (West 1991) (emphasis added). As noted, the debtors have arranged tentative third-party financing to pay the FmHA's claim " [o]f $75,698.39 -- in cash in full." See Debtors' Chapter 11 Plan at 3.

After examining the relevant statutes, case law, commentaries, and the arguments of the parties, the Court finds that the debtors have erred in their interpretation of 11 U.S.C. § 1111(b).

Initially, the Court notes that § 1111(b) is regarded as "[o]ne of the most difficult sections of the [Bankruptcy] Code." See In re 222 Liberty Associates, 108 B.R. 971 (Bankr. E.D. Pa. 1990). See also Pusateri, Swartz, and Shaiken, Section 1111(b) of the Bankruptcy Code: How Much Does the Debtor Have to Pay and When Should the Creditor Elect?, 58 Am. Bankr. L. J. 129, n. 4 (1984). The confusion surrounding this section stems in part from the language of § 1111(b) itself. The debtors rely on the language cited earlier in support of their interpretation of it. The USA-FmHA cites the language "[n]otwithstanding section 506(a) of this title" in support of its contention that its entire claim of $397,261 plus interest became fully secured as a result of its § 1111(b) election. The Court notes from this that § 1111(b) is not a model of statutory clarity.

Judicial precedent, legal commentators, and the legislative history of § 1111(b) do serve to illuminate this provision, however, and support the USA-FmHA's interpretation. "If the § 1111(b)(2) election is made, an allowed claim is a secured claim to the extent that the claim is allowed, notwithstanding the value of the collateral as determined under § 506(a)." In re 222 Liberty Assocs., 108 B.R. 971, 977 (Bankr. E.D. Pa. 1990), citing with approval In re Tampa Bay Assocs., Ltd., 864 F.2d 47 (5th Cir. 1989); In re California Hancock, Inc., 88 B.R. 226 (Bankr. 9th Cir. 1988); In re Western Real Estate Fund, Inc., 75 B.R. 580 (Bankr. W.D. Okla. 1987). Numerous other courts under similar facts have issued decisions which support the USA-FmHA's contention that its entire claim of $397,261 is to be treated as fully secured. See, e.g., In re Cook, 126 B.R. 575, 581 (Bankr. D. S.D. 1991); In re Broad Assocs. Ltd. Partnership, 125 B.R. 707, 712-13 (Bankr. D. Conn. 1991); In re Whitemont Assocs. Ltd. Partnership, 125 B.R. 354, 357-58 (Bankr. D. Conn. 1991). The debtors have cited no cases which support their interpretation of the effect of the § 1111(b) election. In fact, one court explicitly states that § 1111(b) was added to the Code to prevent the very thing which the debtors are proposing to do here regarding the USA-FmHA's claim. See In re Broad Assocs. Ltd. Partnership, 125 B.R. at 711-12 ("Section 1111(b) was added to the Bankruptcy Code . . . so that nonrecourse secured creditors . . . would not be 'cashed out' by a payment equal to the value of the collateral.").

The debtors assert, however, that their case is unique because it involves a prior discharge under Chapter 7. Here too, the debtors are in error. The prior Chapter 7 discharge served merely to discharge the personal liability of the debtors to FmHA; it did nothing to reduce the in rem liability of the debtors to FmHA. The amount of this liability was determined to be $397,261 in the judgment of foreclosure of August 24, 1990. The subsequent valuation under § 506 of the property did not by any means

reinstate or affect the discharged personal liability of the debtors. That valuation determined that the FmHA had a secured claim of $75,698.39 and thus an unsecured claim of $321,562.61. Nor does the FmHA's § 1111(b) election reinstate the personal liability of the debtors. It served to convert the entire USA-FmHA's claim to a secured claim for purposes of its treatment under the debtors' Chapter 11 plan.

The § 1111(b) election did not convert the USA-FmHA's nonrecourse claim into a recourse claim, as the debtors assert. The plain language of § 1111(b) states that "[a] claim secured by a lien on property of the estate shall be allowed or disallowed . . . the same as if the holder of such claim had recourse against the debtor . . . unless . . . the class of which such claim is a part elects . . . application of [§ 1111(b)(2)]." 11 U.S.C. § 1111(b) (West 1991) (emphasis added). The USA-FmHA did elect under § 1111(b)(2) and therefore the "unless" language clearly serves to remove its claim from the provision specifying treatment as a recourse claim. See In re Broad Assocs. Ltd. Partnership, 125 B.R. 707, 712 (Bankr. D. Conn. 1991). The USA-FmHA has in effect a fully secured nonrecourse claim. See In re Cook, 126 B.R. at 581.

In addition to judicial precedent, the legislative history also clearly supports the USA-FmHA's position here.

> If section 1111(b)(2) applies then the "electing" class is entitled to have the entire allowed amount of the debt related to such property secured by a lien even if the value of the collateral is less than the amount of the debt. In addition, the plan must provide for the holder to receive, on account of the allowed secured claims, payments, either present or deferred, of a principal face amount equal to the amount of the debt and of a present value equal to the value of the collateral.
> For example, if a creditor loaned $15 million to a debtor secured by real property worth $18 million and the value of the real property had dropped to $12 million by the date when the debtor commenced a proceeding under chapter 11, the plan could be confirmed notwithstanding the dissent of the creditor as long as the lien remains on the collateral to secure a $15 million debt, the face amount of present or extended payments to be made to the creditor under the plan is at least $15 million, and the present value of the present or deferred payments is not less than $12 million.

124 Cong. Rec. H11,104 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,421 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

Lastly, numerous commentators who have addressed this issue have reached conclusions consistent with the USA-FmHA's position here. See, e.g., 5 Collier on Bankruptcy para. 1129.03 at 1129-74 (15th ed. 1990); Pusateri, Swartz, and Shaiken, Section 1111(b) of the Bankruptcy Code: How Much Does the Debtor Have to Pay and When Should the Creditor Elect?, 58 Am. Bankr. L. J. 129, 131, 136 (1984); Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, 152-161 (1979).

It is thus clear that the debtors' assertion that a cash payment of $75,698.39 would fully satisfy the USA-FmHA's claim in spite of the § 1111(b) election is in error.

In order to comply with the Code, therefore, the debtors must provide the USA-FmHA with deferred cash payments equalling the greater of: 1) the present value of USA-FmHA's interest in the collateral ($75,698.39) or 2) the total claim ($397,261 plus interest to the date of filing). See 11 U.S.C. § 1129(b)(2)(A)(i)(II) (West 1991); see also In re Whitemont Assocs. Ltd. Partnership, 125 B.R. at 358; Pusateri, Swartz

and Shaiken, supra pp. 136-141. Since the debtors' plan does not comply with this provision, it is not confirmable in its present form.

Accordingly, confirmation of the debtors' Chapter 11 plan is denied.

This decision shall constitute findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052 and Rule 52 of the Federal Rules of Civil Procedure.