United States Bankruptcy Court
Western District of Wisconsin

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In re William J. Lyrek and Lorena C. Lyrek, Debtors
Bankruptcy Case No. 94-11572-12

In re James E. Lyrek, Debtor
Bankruptcy Case No. 94-11573-12

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

October 31, 1994

Terrence J. Byrne, for the debtors.
Randi L. Osberg, for the People's State Bank of Bloomer.

Thomas S. Utschig, United States Bankruptcy Judge.

MEMORANDUM OPINION, FINDINGS OF FACT, AND CONCLUSIONS OF LAW

The objecting party in these cases, the People's State Bank of Bloomer, argues that it should not be forced to participate in these bankruptcy proceedings as it did not lend the debtors money and probably would have run from the opportunity had it been presented. Essentially, the bank seems to wish it could click the heels of a pair of ruby slippers together and, like Dorothy, escape from this land of Oz.

In the absence of such miraculous intervention, the dispute presently before the Court in these cases is whether People's State Bank of Bloomer is a "creditor" of the debtors within the meaning of the Bankruptcy Code. The debtors claim an interest in certain property upon which the bank holds a first mortgage. This mortgage was granted to the bank by the debtors' predecessor in interest; the debtors have no personal liability upon this obligation. However, the debtors want to value the real property, establish that amount as the bank's secured claim in this proceeding, and ultimately confirm a plan which permits them to retain the property. The bank strenuously opposes such treatment, and contends that as no debtor-creditor relationship exists between the parties, the debtors may not modify its rights to the property. The debtors are represented by Terrence J. Byrne, and the bank is represented by Randi L. Osberg.

The facts seem relatively straightforward. William and James Lyrek apparently formally acquired joint interests in the property commonly referred to as the "Clemmens Farm" at some time in March of 1993 by virtue of a quit claim deed from James Hartmon. The debtors claim that they had actually been in possession of the property for some time prior to this transfer of title as a result of an "unrecorded agreement" with Mr. Hartmon. Although such an unrecorded instrument is of dubious legal effect, even the bank's statement of facts indicates that the debtors claimed some interest in the property prior to March of 1993. Whether the exact nature of the

debtors' claim to the property was known to the bank prior to early 1993 is disputed by the parties.

Regardless, the quit claim deed purporting to transfer title to the debtors was not recorded until March 1, 1993. This was approximately one (1) week after the bank had initiated foreclosure proceedings against James and Carol Hartmon on a first mortgage on the farm. Mr. Hartmon had acquired the property in 1989[(1)] and mortgaged the property to the bank at that time to secure an indebtedness of approximately $55,000.00. The foreclosure action initiated by the bank in February of 1993 listed the debtors as additional defendants, and sought to remove them from the premises. Although the debtors argue that this indicates the bank knew of their claim to the property, the foreclosure pleadings merely listed them as "possible tenants in possession," and did not indicate that the bank believed they claimed an ownership interest in the property.

A judgment was entered in the state court foreclosure action on or about July 1, 1993. The judgment specified that a sale would not take place for twelve (12) months following the date of judgment, and this twelve (12) month period constituted the time in which the Hartmons could redeem the property. Notwithstanding the entry of this judgment, when the debtors filed these Chapter 12 proceedings, they listed the Clemmens farm as an asset and the bank as a secured creditor. Subsequently, the debtors filed motions to value the property and determine the amount of the bank's secured claim. The bank objected to this treatment, arguing that it is not a "creditor" within the meaning of the Bankruptcy Code. The parties submitted briefs on the issue, and a hearing was held on the matter on October 17, 1994.[(2)]

The debtors submit that they have an interest in the Clemmens farm under 11 U.S.C. § 541. As recognized by the debtors, interests in property are determined by state law, and the applicable state law in this case appears to permit the assignment of rights to real property even after a foreclosure suit has been initiated. See Wis. Stat. § 846.13 (permitting mortgagee or assigns to redeem property upon foreclosure). The bank appears to recognize this fact, admitting as it does that Wisconsin adheres to the "lien theory" of mortgages, whereby legal title remains in the mortgagor until confirmation of the sheriff's sale. See Bank of Commerce v. Waukesha County, 89 Wis.2d 715, 723-24, 279 N.W.2d 237 (1979); Mutual Fed. Savings & Loan Assoc. v. Wisconsin Wire Works, 58 Wis.2d 99, 104, 205 N.W.2d 764 (1972).

Given the fact that Hartmon, the mortgagor, possessed legal title to the property, it appears that it was possible for him to transfer some interest, of whatever nature, to the debtors. This appears to have been what happened in this case. The bank seeks to characterize this interest as "merely" a right of redemption, upon which the bank has no lien. However, at the time of the transfer, the debtors received more than merely a right of redemption, as the foreclosure judgment had not yet been rendered. They acquired the property, subject to the mortgage which was subsequently foreclosed. As assignees of Mr. Hartmon, the debtors possessed an interest in the property when they filed bankruptcy.[(3)]

The bank contends that as the debtors are not personally liable on the mortgage, there is no "debtor-creditor" relationship between the parties. According to the bank, the lack of such a relationship makes it impossible for the debtors to modify its rights in bankruptcy. In support of this argument, the bank stresses that it has no "claim," in a monetary sense, against the debtors. The debtors respond by pointing to the broad definition of "claim" under the Code, and further emphasize that the phrase "claim

against the debtor" includes a claim against the "property of the debtor." See 11 U.S.C. § 101(2).

There appears to be a split of authority regarding whether a debtor who is not personally liable upon a mortgage obligation may utilize a reorganization plan in an attempt to restructure debts against property in which the debtor claims an interest. The court in In re Kelly, 87 B.R. 508 (Bankr. S.D. Miss. 1986), was confronted with a situation similar to the one before this Court. The debtor had acquired title to a tract of real property through a quit claim deed from her brother. She never assumed the mortgage debt, and apparently never sought the lender's consent to the transfer. She filed bankruptcy and proposed a Chapter 13 plan which contemplated that she would cure the defaults on the mortgage debt and retain the property.

The Kelly court examined the situation and concluded that the bankrupt debtor was not personally in default on the indebtedness. The court looked at § 101(9)(A) of the Code, which defines a "creditor" as an entity with a claim against the debtor. Under § 101(4)(A), a "claim" is defined, in part, as a right to payment. The court reasoned that the creditor did not have a "right to payment" from the debtor; accordingly, there was no "debtor-creditor" relationship between the parties, and the debtor could not modify the lender's rights. Id. at 513-14.

Similarly, in In re Everhart, 87 B.R. 35 (Bankr. N.D. Ohio 1988), the court found that a lender was not a "creditor" of a debtor where no legal obligation or liability flowed between the debtor and the lender. The debtor was the daughter of the mortgagors, and claimed to have purchased the property from her parents. The debtor never assumed liability upon the mortgage debt but sought to retain the property under her bankruptcy plan. The court stated:

> Generally, without an attendant liability on a mortgage note, there can be no cure of a default by a third party who has unilaterally made payments thereon without an assumption of the debt. Id. at 37.

Again, the court stated that if the debtor had no personal liability to the creditor, there was no debt. However, as the debtor in Everhart had made payments upon the property for almost eight years and the lender knew of her interest in the property, the court refused to permit the lender to avoid the relationship it had ratified.[(4)] Id.

Finally, in In re Jones, 98 B.R. 757 (Bankr. N.D. Ohio 1989), the court was quite concerned with the fact that the mortgage debt had not been assumed. Because there was no assumption of the mortgage debt, the court found that the debtor could not use its plan to cure the default under the mortgage. The court stated:

> Because [the] debtor is not liable on the mortgage, there exists no debt owing to the bank; the bank has no claim against the debtor; and there exists no creditor-debtor relationship . . . [b]ecause there is no debtor-creditor relationship, debtor's plan may not provide for the curing of a default . . . .

Id. at 758-59; See also In re Wilkinson, 99 B.R. 366 (Bankr. N.D. Ohio 1989); In re Green, 42 B.R. 308 (Bankr. D.N.H. 1984).

Other courts, however, have taken the opposite view of the situation. In In re Marshall, 108 B.R. 195 (Bankr. C.D. Ill. 1989), a Chapter 12 debtor received a tract of land from his parents. The tract of land had been pledged by the parents to a creditor. In the debtor's bankruptcy plan, he proposed to pay the creditor the value of the property and retain the land. The creditor objected to this treatment, contending

that there was no debtor-creditor relationship.

The court in Marshall rejected the argument that the creditor did not hold a "claim" against the property. The court held that the lender's right to proceed against the "property" of the debtors qualified as a right of payment or a right to an equitable remedy which constituted a claim, even though the debtors were not personally liable for a deficiency. This was especially true in light of the language of 11 U.S.C. § 102(2), which provides that a claim against the debtor includes a claim against the property of the debtor. Id. at 198. The lender had a right to demand payment from the debtor, and absent such payment, possessed a right to the equitable remedy of foreclosure. Accordingly, the lender was a creditor within the meaning of the Code. Id. This rationale was also adopted by the court in In re Cox, 162 B.R. 191 (Bankr. C.D. Ill. 1993) (creditor had a claim because it had a claim against the debtor's property, if not the debtor personally).

In another recent decision on the issue, the court in In the Matter of Lumpkin, 144 B.R. 240 (Bankr. D. Conn. 1992) held that the contrary line of authority has been abrogated by the Supreme Court's holding in Johnson v. Home State Bank, 501 U.S. 78, 111 S.Ct. 2150, 115 L. Ed. 2d 66 (1991). In Johnson, the Supreme Court dealt with a debtor's attempt to classify a mortgage as a claim in his Chapter 13 plan even though his personal liability upon the mortgage had been discharged in a prior Chapter 7 proceeding (the so-called "Chapter 20" bankruptcy). The lender argued that as the debtor had no personal liability upon the mortgage debt, the mortgage was not a "claim" within the meaning of the Code.

The Supreme Court started with the basic premise that Congress intended that the definition of "claim" in the Code have the broadest available scope. A "claim" is a right to payment, and a "right to payment" means nothing more or less than an enforceable obligation. Johnson, 115 L. Ed. 2d at 74. Thus, held the unanimous court,

> Even after the debtor's personal obligations have been extinguished, the mortgage holder still retains a "right to payment" in the form of its right to the proceeds from the sale of the debtor's property. Alternatively, the creditor's surviving right to foreclose on the mortgage can be viewed as a "right to an equitable remedy" for the debtor's default on the underlying obligation. Either way, there can be no doubt that the surviving mortgage interest corresponds to an "enforceable obligation" of the debtor. Id. at 75.

Given its finding that the right to the proceeds of any foreclosure sale constituted a right to payment, the Supreme Court found the lack of personal liability irrelevant. Further, the Court found that a "fair reading" of § 102(2) of the Code is that a creditor who has a claim (or right to payment) enforceable only against the debtor's property nonetheless has a "claim" against the debtor for bankruptcy purposes. Id.

This Court, like the court in Lumpkin, finds that the broad interpretation of "claim" which the Supreme Court reiterated in Johnson compels the conclusion that the bank in the present case does in fact have a "claim" against the debtors. The bank possesses the right to the proceeds of any foreclosure sale, whether this right is characterized as a right to payment or a right to an equitable remedy. Lumpkin, 144 B.R. at 242; Marshall, 108 B.R. at 198; Cox, 162 B.R. at 198. The fact that the debtors have no personal liability to the bank, or that the bank did not voluntarily initiate its current relationship with the debtors, is irrelevant. A bankruptcy plan may restructure a claim where there is no personal liability no matter what circumstances surround that lack of personal liability. Lumpkin, 144 B.R. at 242. The contrary

authority cited by the bank were all decided prior to Johnson, and are of little, if any, precedential effect. Id.

The bank's final argument is that to permit the debtors to modify its rights in bankruptcy would somehow constitute impermissible "abuse" of the bankruptcy system. The bank argues that holding in favor of the debtors would create a "market" for assignments of property on the eve of foreclosure, a market which would severely harm lenders. However, it is unclear what harm this purported "market" would in fact cause, given that the original owners of the property could have themselves filed bankruptcy and treated the bank's claim in exactly the same fashion as the debtors now propose. Further, the bank retains its right to pursue those prior owners for any sums not paid by the debtors. In any event, as the Supreme Court stated in Johnson when responding to a similar fear, this Court does not believe that "Congress intended the bankruptcy courts to use the Code's definition of `claim' to police the [bankruptcy] process for abuse." Johnson, 115 L. Ed. 2d at 775; Lumpkin, 144 B.R. at 242.

Finally, though the bank may consider this treatment unfair, and still wish for its own pair of ruby slippers, any treatment of its claim in this case must provide that its secured claim be paid in accordance with the terms of the Bankruptcy Code. It will seemingly retain the right to pursue its original borrowers, the Hartmons, for any deficiency, as they are personally liable upon the mortgage. Given these facts, the bank would appear to be fairly and adequately protected, despite its claims to the contrary.

Accordingly, the bank's objection to the debtor's motion to value the Clemmens farm is overruled, as the bank does in fact possess a claim against the debtors within the meaning of the Bankruptcy Code.

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.

END NOTES:

1. There was some dispute regarding the date Mr. Hartmon acquired the property. The debtors produced testimony indicating the date of purchase was October of 1988. The bank, however, produced a title report and deed reflecting that Mr. Hartmon's purchase of the property was in the fall of 1989. For the purposes of this decision, this dispute is irrelevant.

2. Numerous other matters were also before the Court during the October 17, 1994 hearing, not only in these cases but in the related cases of debtors Raymond, Joan, and Kenneth Lyrek. The other matters have been disposed of by separate orders; however, it should be noted that the Clemmens farm, the property at issue, was valued by the Court at $44,000.00.

3. The bank seems to concede that if Mr. Hartmon had filed bankruptcy rather than transfer the property to the debtors, Mr. Hartmon could have restructured the mortgage debt.

4. The bank in this case submits that the debtors in this case do not qualify for such "equitable" treatment, as it submits it was not aware of the debtors' claim, did not accept payments from the debtors for a long period of time, and took no other action which could be deemed the ratification of the transfer of title to the debtors. As a result of the determination below, the Court finds it unnecessary to address these contentions.