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Underwater Homeowner to Uncooperative Mortgage Lender: Take My Home, Please! Does Dirt for Debt Work in Chapter 13?

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Underwater Homeowner to Uncooperative Mortgage Lender: Take My Home, Please! Does Dirt for Debt Work in Chapter 13?

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Consider this situation: A couple with only moderate income has had to relocate, and the mortgage on their vacated home is underwater, with a balance greater than the home's value. The homeowners can't sell the home unless their mortgage lender agrees, and the mortgage lender won't agree to a sale and chooses not to foreclose the mortgage. So the homeowners still have the obligation to make mortgage payments on the vacated home—and insure it, and maintain it, and pay its property taxes, and (if it's a condo) pay their homeowners' assessments—but now they also have whatever costs are incurred in their new living space. They don't have enough income to cover all of these expenses. A bankruptcy could help them by discharging their personal liability for the mortgage payments, but could it also remove the other obligations of ownership? Specifically, can a bankruptcy filing require their lender to assume the ownership obligations by taking the home in payment of its secured claim?

This method of treating a secured claim, known colloquially as making the creditor take "dirt for debt," is recognized in Chapter 11 cases, but the cost of proceeding in that chapter makes it impractical for most homeowners. For most homeowners, the dirt for debt option would only be viable in Chapter 13. Its availability under that chapter, though, is debatable, with a set of conflicting decisions on the question,[1] and at least two cases now pending at the circuit level.[2]

This *Law Letter* takes a closer look at dirt for debt in Chapter 13, first outlining the settled law in Chapter 7 and 11 and then examining the arguments made in the Chapter 13 decisions.[3] The conclusion is that Chapter 13 does offer the same dirt-for-debt option that Chapter 11 does.

Paying Claims with Estate Property Outside of Chapter 13

Chapter 7

In Chapter 7 there is no provision for payment of claims other

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than in cash. The trustee's duty under Code § 704(a)(1) is to "reduce to money" the property of the debtor's estate and then, under § 726, to pay creditors in the specified priority from the liquidated estate.[4] To reduce the estate property to money, of course, the trustee often has to sell the property, including property subject to liens, but underwater property will probably be sold only with the mortgage holder's consent.[5] Most important for underwater homeowners, the trustee is given no authority to transfer property to a lienholder rather than selling it. The almost universal treatment of underwater property in Chapter 7, then, is abandonment by the trustee under Code § 554(c), leaving the debtor as the owner of the property,[6] with

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personal liability for whatever ownership expenses are not discharged.[7] So Chapter 7 offers only limited relief to a debtor holding underwater property—and certainly does not offer a live possibility of requiring the mortgage holder to take dirt for debt.

Chapter 11

The situation in Chapter 11 is different. Code § 1123, titled "Contents of plan," sets out, in subsection (a), a number of provisions that a plan must include for dealing with creditor claims and, in subsection (b), a number of optional provisions. Among the mandatory provisions, § 1123(a)(5) requires that each Chapter 11 plan "provide adequate means for the plan's implementation," and in a list of possible means for implementation, it includes subparagraph (D): "sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate."[8] *In re Sandy Ridge Dev. Corp.*, the leading case on dirt-for-debt plans in Chapter 11, the Fifth Circuit reads subparagraph (D) as plainly allowing such plans.[9] It points out that the subparagraph makes a sale of estate assets, as would take place in Chapter 7, only the first of two alternatives—emphasizing the word "or"—with the second alternative being a direct "distribution" of estate property to secured creditors. *Sandy Ridge* concludes, then, that "a plan may include a 'give-back' " to creditors.[10]

Sandy Ridge also recognizes the major limitation on dirt-for-debt plans in Chapter 11. In addition to § 1123, governing the content of a plan, § 1129 sets out requirements for plan confirmation. If the holders of secured claims do not accept the plan, § 1129(b)(1) requires that the plan treat their claims fairly and equitably. Requirements for fair and equitable treatment are in turn set out in § 1129(b)(2). For secured claims, under § 1129(b)(2)(A), that treatment must include satisfaction of the claims in one of three ways: (i) cash payments with the debtor retaining the collateral subject to the creditors' liens, (ii) sale of the collateral with liens to attach to the proceeds, or (iii) "the realization by such holders of the indubitable equivalent of such claims."[11] Since dirt-for-debt

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