In the United States Bankruptcy Court

for the Northern District of Iowa

NICHOLAS G. COREY and CAROL J. COREY *Debtor(s).*	Bankruptcy No. X88-01902S Chapter 11

MEMORANDUM OF DECISION AND ORDER RE: CONFIRMATION OF PROPOSED PLAN

Debtors seek confirmation of their proposed chapter 11 plan. The only objector is First Federal Savings & Loan Association of Sioux City (FIRST FEDERAL). A hearing on confirmation was held on April 26, 1990 in Sioux City, Iowa. The court now issues this memorandum of decision which includes findings of fact and conclusions of law as required by Bankr. R. 7052. This is a core proceeding under 28 U.S.C. § 157(b)(2)(L).

FINDINGS OF FACT

Nicholas G. Corey (COREY) is a 46-year old businessman who for the past 24 years has been buying and selling real estate for profit. For the past ten years, his real estate business has involved buying real properties from institutional lenders, rehabilitating the properties, and reselling them by contract for deed. For the most part, Corey has bought distressed properties which have been recovered by the lenders through foreclosures or deeds in lieu of foreclosures. Corey has also pursued other business ventures. Investments in a pizza business and a video store, not in real estate, led to his bankruptcy filing.

Coreys' proposed plan filed December 29, 1989 and modified April 26, 1990 includes nineteen classes. Classes I, II and XIX are respectively administrative claims, priority claims, and unsecured claims. The balance of the classes are secured claims which involve either real estate loans or executory contracts for the purchase or sale of real estate. Claims of First Federal are included in classes VIII, XI, XII, XIII, XVI, XVII, and XVIII.

First Federal's claim in class XII is represented by a note and mortgage. The promissory note has a 10-1/2% interest rate with the remaining term of 15.25 years. The proposed plan does not impair the claim.

First Federal's claim under class XIII is represented by a note and mortgage; the note bears a 9.75% per annum interest rate. The plan does not impair this claim.

Class XVII includes a First Federal claim represented by a note and mortgage with the note bearing an interest rate of 9% per annum and a remaining term of 17 or 18 years. The proposed plan does not impair the class XVII claim.

First Federal's claim under class XVIII also is embodied in a note and mortgage. A building on the mortgaged premises burned during the course of the chapter 11 case, and insurance coverage will enable Coreys to pay First Federal's claim in full, at once, and without impairment.

Coreys' plan proposes the impairment of three First Federal claims, those contained in classes VIII, XI, and XVI.

The First Federal class VIII claim is represented by a promissory note having a balance due as of April 1, 1990 of $17,056.44. Coreys signed the $24,000.00 promissory note to Home Federal Savings & Loan Association of Sioux City (HOME FEDERAL) on August 7, 1979. The note has a remaining term of 9.5 years and an interest rate of 11.25% per annum. Monthly payments on the note are $252.00. The plan proposes to extend the term of the payments to 13 years and to decrease the interest rate to 11%, thereby decreasing the monthly payment to $210.00. The plan proposes that First Federal, the successor-in-interest to Home Federal, would retain its mortgage in real property located at 1500 South Irene, Sioux City. That property is a two-story duplex which Coreys bought from a Home Federal borrower who was intending to deed the property back to the lender. Home Federal loaned Coreys sufficient monies to buy the property, without down payment, and to fix it up. Coreys purchased the property from Home Federal's borrower with the lender's understanding that Coreys would fix it up and sell it on contract. As of the date of the confirmation hearing, the property had a fair market value of $19,800.00 and a liquidation value of $18,810.00. Coreys' buyer agreed to paint the house, fix the roof, and clean up the yard, and these improvements have been made. The property is not occupied by Coreys' purchaser.

Coreys propose to impair First Federal's claim in class XI. This claim is represented by a promissory note secured by a real estate mortgage. The initial note was executed by Coreys on March 9, 1978 with an interest rate of 9% per annum. The interest rate was increased to 12-1/2% by an agreement dated July 13, 1981. The remaining term of the loan is 8.1 years, and Coreys' monthly payments to First Federal, the present holder of the note, are $499.00. The original loan was for $45,000.00. The note had a balance due of $30,244.41 as of April 1, 1990. Coreys propose to extend the term from 8.1 years to 13 years and to reduce the annual interest rate from 12-1/2% to 11%, thus reducing the monthly payments to $368.30. Under the plan, First Federal would retain its lien in two parcels of real estate. One is a residence at 515 South Helen, Sioux City which Coreys have sold on contract. The property has a fair market value of $16,500.00, and a liquidation value of $14,850.00. The contract buyer owes Coreys a remaining balance of $21,903.16. Coreys' buyer has sold this property by contract to a third buyer. The class XI claim is secured also by real estate located at 1708 South Irene, Sioux City. This property has a fair market value of $24,000.00 and a liquidation value of $21,600.00. Corey sold this property on contract in May of 1981; he is owed a remaining balance of $27,828.48. Both of the properties are owner occupied.

First Federal's claim under class XVI is based on a promissory note secured by a real estate mortgage. The original note in the amount of $42,000.00 was executed by Coreys to First Federal on May 10, 1979. It carried an interest rate of 10-3/4% per annum. Coreys executed an amended and substituted note on April 13, 1981 increasing the interest rate to 12% per annum. The note has a remaining balance of $30,306.91 and a remaining term of 9.1 years with monthly payments of $462.00. Coreys propose to extend the term of the loan to 13 years and reduce the interest rate to 11% per annum, thereby reducing the monthly payments to $368.30. The note is secured by a real estate mortgage on two properties. One is 714 South Cecelia, Sioux City which has a fair market value of $16,500.00 and a liquidation value of $14,850.00. Property at 3201-03 Marshall, Sioux City also secures this loan. This property has a fair market value of $23,000.00 and a liquidation value of $20,700.00. Coreys sold both properties on contract on May 4, 1981, and the purchaser presently owes Coreys $48,615.20. Neither of the properties are presently owner occupied.

Coreys' plan impairs First Federal's claims under classes VIII, XI, and XVI, as well as other creditors' secured claims under the plan. The principal reason for impairments was to create cash flow to pay unsecured creditors and administrative expenses. Without impairment of some secured claims, Coreys would be unable to generate sufficient cash flow to make payments to unsecured, administrative and priority claimants. At the time of the confirmation hearing, Coreys were current on all debts to First Federal.

The properties purchased by Coreys generally are located in areas of town that are deteriorating or are distressed, but some properties are in good areas. Coreys, in pursuing reorganization, have attempted to sell some of their better real estate contracts, but have been unable to sell any.

The First Federal claims, which Coreys seek to impair, all arose out of transactions in which Coreys borrowed money from Home Federal or First Federal in order to purchase and/or rehabilitate residential properties for rental or resale. Both lenders knew that Coreys would not occupy the properties and for the most part would attempt to resell them.

Thomas Kimmel was in charge of the real estate department at Home Federal for almost 17 years before he began working for First Federal and later for First National Bank in Sioux City. He regularly dealt with Coreys. Home Federal loans to Coreys usually involved the sale of property that Home Federal had taken back by foreclosure. Home Federal generally made loans to Coreys in order to unburden itself of reacquired properties and to make good mortgage loans. Kimmel testified that in 20 years of dealing with Corey he had never had a problem with him. Generally, Home Federal loaned money to Coreys at the market rate which existed at the time of the loan.

Sioux City loan rates secured by residential housing are generally based on a national market rate adjusted for risk. At the time of the confirmation hearing, the prevailing market rate for residential mortgage loans was 11% per annum. Lower rates can be purchased by paying "points." In the Sioux City market, a 13-year loan term on residential housing is neither long-term nor short-term.

First Federal's present loan policy is not to lend money with non owner-occupied housing as security. It believes such loans have a greater risk of default. Factors considered by First Federal in making loans are the credit worthiness of the borrower, the condition of the property, the length of the loan, and the prevailing market rate.

According to First Federal officer Nick Riser, an appropriate additional per annum interest factor for loans covering non-owner occupied housing would be %. First Federal made its loans to Coreys knowing that the purchase property would not be owner occupied. At least one of the properties covered by class XVI was a First Federal reacquired property sold to Coreys either by First Federal or a First Federal borrower.

As of Wednesday, April 25, 1990, the yield on U. S. government treasury bonds maturing April, 1993 was 8.99%.

DISCUSSION

First Federal objects to the treatment of its claims under class VIII, XI, and XVI. First Federal asserts three grounds for objection. First, it insists that the plan discriminates unfairly because it seeks to retain favorable First Federal loan rates on unimpaired classes, but to reduce loan rates unfavorable to Coreys. Second, First Federal contends that the plan is not fair and equitable because it does not provide First Federal with deferred cash payments having present values of its fully secured claims. It says the plan interest rate is insufficient at 11% per annum to provide the required treatment under 11 U.S.C. § 1129(b)(2)(A)(i)(II). Third, First Federal argues that the plan is not fair and equitable because it is inherently unfair to allow the debtor to use bankruptcy to obtain a better deal from the lender than he originally made. This is because debtor is retaining the benefits of his sale contracts, but reducing the benefits to the lender under the original contract of loan.

Coreys request that the plan be confirmed under the "cram down" provisions of 11 U.S. C. § 1129(b). They further ask that if the court concludes that the proposed treatments for classes VIII, XI and XVI do not provide fair and equitable rates under 11 U.S.C. § 1129(b)(2)(A)(i)(I), the court provide an interest rate, by which they will abide.

DISCUSSION

"Fair and Eguitable"

Classes VIII, XI, and XVI are the only dissenting classes. First Federal is the creditor in each class. In order to attain confirmation of the plan despite the plan's failure to meet the requirements of 11 U.S.C. § 1129(a)(8), Coreys must show that the plan meets the requirements of 11 U.S. C. § 1129(b). To meet such requirements, it must be shown that "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims . . . that is impaired under, and has not accepted, the plan." § 1129(b)(1).

The plan is "fair and equitable" with regard to a class of secured claims if the plan provides:

> "that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

11 U.S.C. S 1129(b)(2)(A)(i)(II). The plan must also provide for retention of the claimant's lien. Section 1129(b)(2)(A)(i)(I).

Thus in order to be fair and equitable, the plan must pay the total amount of the claims and afford First Federal the full present values of its fully secured claims in classes VIII, XI and XVI. First Federal argues it does not because the proposed interest rates of 11% per annum is less than the market rate.

In this circuit, the court must determine the appropriate discount rate to provide First Federal with present value of its allowed secured claim by considering the prevailing market rate for an equal term loan, the quality of security, and the risk of subsequent default. U.S. v. Doud, 869 F.2d 1144, 1146 (8th Cir. 1989); In re Monnier Bros., 755 F.2d 1336, 1339 (8th Cir. 1985); and U.S. v. Neal Pharmacal Co., 789 F.2d 1283 (8th Cir. 1986).

To arrive at the appropriate discount rate, this court may consider the yield on treasury bonds as a riskless rate, and adjust it for risks present in the case at hand. In re Doud, 869 F.2d at 1146. This methodology has heretofore been used in this district. In re Nog, 76 B.R. 675, 678 (Bankr. N.D. Iowa 1987).

First Federal does not object to the methodology but argues that a 2% risk factor is insufficient to protect it in light of the nature of the security and the likelihood of default. No one disputes that the treasury bond rate for a maturity equal to the proposed payout periods would be 8.99% per annum. A two percentage point risk factor, which is so often adopted in reorganization cases, would provide an annual interest rate of 10.99%, just below the proposed 11% for the three impaired First Federal classes.

The interest rate dispute between debtors and First Federal must be addressed by class.

CLASS VIII

The court agrees that the interest rate proposed to be paid on the claim contained in class VIII is not fair and equitable. Several factors lead to this determination. The property has a liquidation value of $18,810.00 which secures a debt of $17,056.00. This is a relatively small equity cushion. The property was only recently sold on contract (1989), and the contract balance is substantially in excess of the liquidation value of the property. There is no evidence as to the creditworthiness of the contract buyer nor as to the effect of his or her default on Coreys' ability to pay First Federal. The property is not owner occupied, and therefore the contract buyer's ability to pay Coreys may depend upon the buyer's ability to lease the property. Because of the slight equity cushion and the relatively recent nature of the contract sale, the court believes that an additional 1/2% per annum is necessary to fairly compensate First Federal for the risk of default with regard to this loan.

CLASS XI

The proposed rate of 11% to be paid under the plan over thirteen years is fair and equitable with regard to this class. The properties securing the note have a liquidation value of $36,450.00. The debt against these properties is $30,244.00, resulting in an equity cushion which is approximately 20% of the amount of debt. The original term on this loan was 20 years. It has remained current. There has been a principal reduction of nearly $15,000.00 since Coreys became obligated under the original loan. Coreys seek to extend the time period for payment by only 4.9 years. The property located at 1708 South Irene was sold by Coreys on contract in 1981. It would appear, therefore, that the contract buyer has an investment which he or she would desire to protect by remaining current on the contract. The properties securing the debt are both owner occupied.

CLASS XVI

The proposed 11% interest rate to be paid over thirteen years on the class XVI is appropriate. The properties securing the loan have a total liquidation value of $35,550.00. The remaining balance of the promissory note is $30,307.00, resulting in an equity cushion of more than $5,000.00 which is approximately 17% of the debt. The original term of this loan was 20 years, and debtors seek now to extend it for an additional 3.9. Coreys' obligation to the lender is current. The properties securing the debt, while not owner occupied, were sold to the contract buyer in 1981 and that contract is not in default. The contract buyer, therefore, would appear to have an investment in the property as an incentive to remain current on the contract payments.

UNFAIR DISCRIMINATION

First Federal objects to the plan on the ground that debtors seek to reduce the interest rates on the notes in classes VIII, XI and XVI, while retaining the lower-than-market interest rates on classes XII, XIII and XVII. These latter unimpaired classes have interest rates, respectively, of 10-1/2%, 9.75%

and 9%. First Federal argues, therefore, that the plan discriminates unfairly among classes of secured creditors. If the plan discriminates unfairly, it cannot be "crammed down" under 11 U.S.C. 1129(b).

At the outset, there is a question as to whether or for what classes First Federal may raise this objection. It is only dissenting classes which may raise the issue of whether they are being unfairly discriminated against. 11 U.S.C. § 1129(b)(1); Matter of Johns-Manville Corp.-, 68 B.R. 618, 636 (Bankr. S.D. N.Y. 1986), aff'd. 78 B.R. 407 (S.D. N.Y. 1986); In re Jones, 32 B.R. 951, 954 (Bankr. D. Utah 1983); In re Western Real Estate Fund, Inc., 75 B.R. 580, 586 (Bankr. W.D. Okla. 1987); Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am.Bankr.L.J. 133, 141 (1979). First Federal's claims under classes XII, XIII, XVII and XVIII are not impaired. First Federal, having unimpaired claims under these classes, is conclusively presumed to have accepted the plan as to those classes. 11 U.S.C. § 1126(f). The conclusive presumption of § 1126(f) prevents First Federal from obtaining the more favorable rate of interest which would apply if debtor were forced to rely on the cram down treatment of First Federal's claims under classes XII, XIII, and XVII.

Moreover, First Federal has filed ballots accepting the plan under classes XIII, XVII and XVIII. Presumably, it would have done so also under class XII, had its treatment been unimpaired. The debtors' amendment to the plan filed at confirmation changed the debtors' treatment of class XII from impaired to unimpaired. It is First Federal, as the claim holder in classes VIII, XI and XVI, which objects to its treatment as discriminatory. This can hardly be the case because First Federal under the latter classes is receiving higher interest rates than any other secured creditors.

Perhaps First Federal's objection regarding unfair discrimination is intended to be lodged under §§ 1123(a)(4) and 1122(a). The latter section permits a plan proponent to place a claim in a particular class "only if such claim . . . is substantially similar to the other claims . . . of such class." First Federal may be arguing that all of its secured claims should have been placed in one class and treated alike under § 112 3 (a) (4) -- with a market interest rate.

Section 1122(a) does not, however, prohibit placement of substantially similar claims in different classes. Hanson v. First Bank of South Dakota, N.A., 828 F.2d 1310, 1313 (8th Cir. 1987). The circuit court would preclude, however, classification of claims in such a way as to unfairly manipulate voting. Hanson at 1313.

The voting rationale of 5 1122(a) has been well explained as follows:

> Under chapter 11, questions of classification must be resolved specifically by reference to the issue that the vote of class members will decide: whether to waive the absolute priority rule and the rule against unfair discrimination. Only claims carrying similar interest in application of these rules should be classified together, so as to assure that a creditor may be outvoted only by other creditors with a similar interest in invoking or waiving these rules.

Cohn, Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code, 56 Am.Bankr. L.J. 293, 307 (1982).

Coreys' classification of First Federal's claims does not appear improperly motivated to manipulate voting. By placing certain of First Federal's claims in separate classes and leaving them unimpaired, Coreys prevent First Federal's dissenting vote on the plan as to those classes. This, however, is not improper vote manipulation. It is typical and often necessary for chapter 11 plans. Moreover, it is typical for individual secured claims to be placed in separate classes. In re Sullivan, 26 B.R. 677, 678 (Bankr. W.D. N.Y. 1982); In re Hollanger, 15 B.R. 35, 41 (Bankr. W.D. La. 1981); 5 Collier on Bankruptcy, 1 1122.03[6]1 1123-13 and I 1129.03[4][b] at 1129-72 (15th Ed. 1989).

First Federal has not cited to the court any authority for the proposition that First Federal's secured claims were improperly classified. The court concludes that the separate classification of First Federal's secured claims does not violate 1122(a) of the Code.

The court will assume for a moment that under Coreys' classification scheme the unfair discrimination standard of § 1129(b)(1) is applicable to unimpaired classes. The court will also assume, without deciding, that the unfair discrimination standard applies to classes of secured claims.(1)

What then does "unfair discrimination" mean? There are at least two schools of thought. In re Future Energy Corp., 83 B.R. 470, 492-493 (Bankr. S.D. Ohio 1988); Blair, Classification of Unsecured Claims in Chapter 11 Reorganization, 58 Am.Bankr. L.J. 197, 205-211 (1984). One points out that it is a standard of confirmation which Congress intended to apply to classes of subordinated or partially subordinated claims. Aceguia, Inc. v. Clinton (In re Aceguia, Inc.), 787 F.2d 1352, 1362 (9th Cir. 1986); Klee, All You Ever Wanted to Know About Cram Down 53 Am.Bankr. L.J. 133, 141 (1979).

Other courts, however, apply the standard more broadly to determine whether a plan classifies similar claims separately and unfairly proposes different treatment for these classes. In re Wilhelm, 101 B.R. 120, 122 (Bankr. W.D. Mo. 1989); Matter of Johns-Manville Corp., 68 B.R. at 636. The court will assume, without deciding, that the broader interpretation of the unfair discrimination standard applies. If it did not, First Federal could have no unfair discrimination argument.

A four-part test has been used to determine whether discrimination among classes is fair:

(1) whether the discrimination has a reasonable basis;

(2) whether the debtor can fulfill the plan without the discrimination;

(3) whether the discrimination is proposed in good faith; and

(4) whether the treatment of the class discriminated against is in proportion to the reason for the discrimination.

In re Buttonwood Partners, Ltd., 111 B.R. 57, 63 (Bankr. S.D. N.Y. 1990); Matter of Rochem, Ltd., 58 B.R. 641, 643 (Bankr. D. N.J. 1985); In re Ratiedge, 31 B.R. 897, 899 (Bankr. E.D. Tenn. 1983).

An alternative formulation is whether "the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class. . . ." Klee, All You Ever Wanted to Know About Cram Down . . ., 53 Am.Bankr. L.J. at 142.

Regardless of which formulation is applied in this case, Coreys' treatment of the secured claims of First Federal is not unfairly discriminatory. The First Federal claims are divided into separate classes. Each of the promissory notes representing the claims is secured by separate parcels of real property. Notes were executed at different times with different rates of interest. The quality of the security differs. This division of the First Federal claims into separate classes is typical. Coreys' treatment of the various claims has a rational basis. The straightforward reason is to create sufficient cash flow and to enable the debtors to pay all administrative expenses, and a dividend to unsecured creditors. The stream of payments to First Federal on the unimpaired claims is exceeded by Coreys' income from the mortgaged properties. The surplus is useable to make payments to other creditors under the plan. Coreys' reason for impairing other First Federal claims is to reduce the monthly payments to create additional cash flow. This is done by extending the payment date and reducing the interest rate from contract to market. Without impairing First Federal's claims under classes XII, XIII and XVII, the debtors could not consummate the plan. The court finds also that the degree of discrimination reasonably relates to the purpose of the discrimination. The term extension on the three classes is short and reasonable. First Federal will be receiving market interest rates on the three impaired loans. The court also finds that the treatment of the impaired classes was proposed in good faith.

Therefore, even if the unfair discrimination standard applied with regard to non-dissenting classes of secured claims, this court would find Coreys' treatment of First Federal's claims non-violative of the unfair discrimination standard of 1129(b)(1).

UNFAIRNESS

First Federal's remaining objection is that it is unfair to permit the debtors to use bankruptcy to obtain a better business deal than they originally made with the lender. First Federal argues that Coreys originally financed at market rate and resold the properties on contract. First Federal contends that Coreys now seek to retain the benefits of the contracts for deed while forcing the lender to reduce the interest rate on loans relating to the same properties.

Coreys, however, are doing exactly what the Code either requires or allows them to do. Contracts for deed are executory contracts which debtor must either accept or reject. Brown v. First Nat. Bank in Lennol, 844 F.2d 580, 581 (8th Cir. 1988), cert. dismissed, 487 U.S. 1260 (1988). There is no reason to expect that Coreys would reject beneficial sales contracts. The court has already discussed Coreys' ability to leave unimpaired certain of First Federal's claims and the limits of Coreys' treatment of First Federal where the claims are impaired. The court finds nothing in Coreys' treatment of First Federal that is unfair, and First Federal has cited no authority for its argument.

PLAN MODIFICATION

Debtors have asked the court to modify the plan with regard to the impaired First Federal classes by providing any interest rate the court finds to be appropriate. Normally the court would not involve itself in modifying plans which are found to be defective under the Code. The proposed plan provides an interest rate of 11% per annum for the class VIII claimant. The court has found 11-1/2% per annum to be the appropriate rate. The court believes the difference in monthly payments to be less than $6.00.

While debtors should not propose plans and then ask the court to rewrite them if they are found wanting, the court, in this instance, will permit confirmation of the plan as modified by the court. In this instance, to deny confirmation and require modification and further hearing merely to change the interest rate in the class VIII claim from 11% to 11-1/2%, would be burdensome on all concerned given the limited impact of the change.

CONCLUSIONS OF LAW

The court concludes that the Coreys' proposed plan or reorganization meets the requirements of 11 U.S.C. § 1123(a) and the requirements of 11 U.S.C. § 1129(a), subsections (1), (2), (3), (4), (5), (7), (9), (10), (11), and (12). The court concludes that § 1129(a)(5), (6), and (13) are not applicable. The plan meets the requirements for confirmation of 11 U.S.C. § 1129(b)(1) and (2)(A)(i).

ORDER

IT IS ORDERED that the reorganization plan filed December 29, 1989 and modified April 26, 1990 is confirmed with the modification that First Federal Savings & Loan Association of Sioux City as the class VIII creditor shall receive an interest rate on its claim of 11-1/2% per annum on the unpaid balance from and after confirmation of the plan of reorganization. Judgment shall enter accordingly.

SO ORDERED ON THIS 21st DAY OF MAY, 1990.

William L. Edmonds
Chief Bankruptcy Judge

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1. There are contrary views on this issue. Booth, The Cram Down of Secured Creditors: An Impetus Toward Settlement, 60 Am.Bankr. L.J. 69, 82-83 (1986).