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UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA

In re  
CAPITAL WEST INVESTORS, a California  
Limited Partnership,  
Debtor.

Case No. 93-53365-MM  
Chapter 11

**MEMORANDUM DECISION AND  
ORDER THEREON**

Employer's Tax Identification No. 77-0060385

**INTRODUCTION**

Capital West Investors, a California Limited Partnership, seeks confirmation of its Chapter 11 plan over the objection of impaired creditor Reilly Mortgage Group, Inc., the servicing agent on the first deed of trust. The court concludes that, with respect to Reilly, the plan satisfies the requirements governing plan confirmation in that it is fair and equitable, does not unfairly discriminate, and is not proposed by any means forbidden by law.

**FACTS**

Capital West owns and operates The Woods, an apartment complex in Fremont, California, which has been appraised at \$7 to \$9 million. Capital West acquired the property from Lincoln Park & Associates, Ltd. in 1985, assuming a note and first deed of trust held by Transamerican Investors Service Company. Transamerican's loan is now held by The Riggs National Bank of Washington, D.C. Riggs holds the note as part of a Federal Housing Act Project Loan Certificates Series Pool in which private individuals own and trade interests. Reilly is the servicing agent. The balance remaining on the loan is

1 approximately \$2,630,000.

2 The loan is insured by the Department of Housing and Urban Development ("HUD"). HUD  
3 operates the Federal Housing Act Home Loan Mortgage Insurance Program which insures against the  
4 lender's loss in the event of default by the borrower. This program enables lenders to provide low down  
5 payment loans. The terms of the mortgage insurance payment require HUD to pay 99 percent of the  
6 loan balance and take an assignment of the note in the event of default. When the loan originated in  
7 1978, Lincoln Park & Associates Ltd. executed HUD's Regulatory Agreement which contains  
8 requirements conditioning the loan. Capital West became bound by this agreement when it assumed the  
9 loan.

10 Relevant to the issues in this confirmation hearing, the agreement requires payment of monthly  
11 mortgage insurance premiums to HUD. The payment for June, 1994 is \$1,070.13; payments will  
12 continue to decline each month for the term of the loan. The agreement also contains "surplus cash"  
13 provisions which condition placement of any junior financing upon HUD's approval. HUD's stated  
14 policy requires that a borrower commit to pay the HUD loan and operational expenses before any junior  
15 financing and commit to fund an escrow account for additional items such as tenant security deposits.

16 HUD approved placement of a second deed of trust, held by Trilex Financial Services, which is  
17 presently in the amount of \$3,435,315 and becomes due in 1997. HUD also approved a third deed of  
18 trust, held by Woodson and McLarry, which is presently in the amount of \$1,334,871 and is due upon  
19 demand. Before Capital West filed this case, Woodson and McLarry paid \$351,610 to Trilex to cure  
20 outstanding defaults.

21 The proposed plan modifies Reilly's promissory note by eliminating both the mortgage insurance  
22 requirement and the "surplus cash" provisions in the Regulatory Agreement. Reilly claims that the  
23 modifications are unfair since the new note deprives Reilly of the value of its claim and discriminates  
24 against Reilly in comparison to other creditors. Reilly also argues that eliminating the mortgage  
25 insurance contravenes the policies of the National Housing Act. The Mortgage Bankers Association of  
26 America ("MBAA"), as amicus curiae, supports Reilly's objection, asserting that the case has national  
27 implications. MBAA argues that the ramifications of this plan will be to frustrate the purpose of the  
28 National Housing Act, to increase the amount of down payments which will be required to obtain home

1 loans, to deplete the funds HUD reserves to pay lenders and to debilitate the secondary mortgage market.

2 Capital West responds that Reilly is not entitled to the insurance payments under any provision  
3 of § 1129, that Reilly is treated as well as the other creditors and that the plan actually promotes the  
4 purposes of the National Housing Act. Additionally, Capital West submits that allowing borrowers to  
5 stop paying mortgage insurance will not impair the home loan market since the provisions of the  
6 Bankruptcy Code already adequately protect lenders, and that predictions of chaos in the secondary  
7 mortgage market are unjustified.

8  
9 **ISSUES**

10 1. Whether the plan provides Reilly with the full value of its secured claim as required by §  
11 506(b).

12 2. Whether the plan provides "at least the allowed amount of [Reilly's] claim" defined as "at least  
13 the value of [Reilly's] interest in the estate's interest" in the real property as required by §  
14 1129(b)(2)(A)(i), or alternatively, the indubitable equivalent of Reilly's claim as required by §  
15 1129(b)(2)(A)(iii).

16 3. Whether Reilly's treatment under the plan is consistent with treatment afforded other classes.

17 4. Whether the modifications to Reilly's note conflict with the requirements of the National  
18 Housing Act in violation of § 1129(a)(3).

19  
20 **DISCUSSION**

21 **1. Capital West's Plan Is Confirmable Since It Provides Reilly With The Full Value Of Its**  
22 **Claim.**

23 The first issue the court must resolve is whether the value of Reilly's secured claim includes the  
24 cost of insurance required by the original note. Reilly contends that it is entitled to, "any reasonable fees,  
25 costs, or charges provided for under the agreement under which such claim arose." 11 U.S.C. § 506(b).  
26 Reilly argues that since the insurance payments are charges described in the loan documents themselves,  
27 the payments are part of Reilly's secured claim. Reilly and MBAA complain that if the note does not  
28 maintain the benefit of mortgage insurance, the note becomes less valuable in the secondary mortgage

1 market.

2 Capital West concedes that any charge for mortgage insurance accrued to the date of confirmation  
3 is a valid claim but that thereafter, the plan modifies the note to eliminate the requirement for mortgage  
4 insurance. There is no disagreement that for purposes of the reorganization plan, the value of the  
5 collateral is determined at the time the plan is confirmed. In re Ahlers, 794 F.2d 388, 398 (1986), rev'd  
6 on other grounds, Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 108 S.Ct. 963 (1988).

7 The United States Court of Appeals for the Ninth Circuit has held that the value of an  
8 undersecured creditor's claim does not include mortgage insurance, resolving this issue. Lomas Mortg.  
9 USA v. Wiese, 980 F.2d 1279, 1283 (9th Cir. 1992), overruled on other grounds, Nobelman v.  
10 American Sav. Bank, 113 S.Ct. 2106 (1993). In Lomas, the debtor obtained a loan from Federal  
11 National Mortgage Association ("FNMA") secured by both a deed of trust and private mortgage  
12 insurance. Confirming the debtor's Chapter 13 plan, the Court held that the value of FNMA's claim under  
13 § 506(a) did not include mortgage insurance payments. Although Lomas considered the value of the  
14 claim of an undersecured creditor, the Court specifically noted that it "is not required to afford protection  
15 with respect to the creditor's contractual rights against third parties. Lomas, 980 F.2d at 1283 (quoting  
16 In re Fischer, 136 B.R. 819, 828 (Bankr. D. Alaska 1992)("Agreements between the creditor and third  
17 parties should not affect the valuation of the subject property.")). See also In re Lopez, 75 B.R. 961  
18 (Bankr. E.D. Pa. 1987), aff'd, 82 B.R. 712 (Bankr. E.D. Pa. 1988)(proper valuation did not include  
19 consideration of mortgage insurance); Grubbs v. Nat'l Bank of South Carolina, 114 B.R. 450, 452  
20 (D.S.C. 1990)("The availability. . . of recourse against third parties with respect to the claim should not  
21 affect the value attributed to the property.").

22 The reasoning of Lomas remains equally viable vis a vis the claim of an oversecured creditor.  
23 Reilly's contractual rights as a third party beneficiary of HUD's agreement with Capital West are not  
24 protected by the Bankruptcy Code. The result is that the value of Reilly's claim is determined as of the  
25 date of confirmation without taking into account any enhancement to value provided by the mortgage  
26 insurance.

27  
28 **2. The Plan Is Confirmable Under Fair And Equitable Standards**



1 Reilly's loan thus remains fully secured without mortgage insurance.

2 Similarly, the Bankruptcy Appellate Panel for the Ninth Circuit Court of Appeals has held that  
3 the indubitable equivalent exists where it is unlikely that a claim would ever become even partially  
4 unsecured, where the plan was not speculative and provided safeguards and fair interest rates. In re Pine  
5 Mountain, Ltd., 80 B.R. 171, 174-175 (Bankr. 9th Cir. 1987). Capital West's plan provides Reilly with  
6 the "indubitable equivalent" of its claim since it is unlikely Reilly's oversecured claim will ever lack  
7 security.

8  
9 **3. The Plan Does Not Unfairly Discriminate Against Reilly.**

10 Reilly contends that Capital West's plan unfairly discriminates in two ways. First, Reilly claims  
11 that unsecured creditors have recourse against Capital West's general partner while Reilly will no longer  
12 have recourse against HUD. This argument, however, must fail because the unsecured creditors have  
13 recourse under state partnership law. State law gives a lender the choice of pursuing the real property  
14 under the deed of trust or seeking a judicial foreclosure by waiving the collateral and pursuing the note.

15 Second, Reilly argues that the plan unfairly discriminates since it modifies notes for the second  
16 and third trust deeds but does not impair those lienholders to the same extent. The prohibition against  
17 unfair discrimination in § 1129(b)(1) ensures that a class receive "treatment which allocates value to the  
18 class in a manner consistent with the treatment afforded to other classes with similar legal claims against  
19 the Debtor." 5 Collier on Bankruptcy §1129.03 [3][b] (15th Ed. 1979). No other creditor has legal  
20 claims similar to those of Reilly, because only Reilly stands in first position. Undoubtedly both Trilex and  
21 Woodson and McLarry, the second and the third deeds of trust, would be pleased to accept Reilly's  
22 treatment if they could also exchange positions.

23 No unfair discrimination in treatment exists.

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25 **4. Plan Confirmation Is In Accord With The Goals  
26 Of Both Chapter 11 And The Federal Housing Act.**

27 **A. The Plan May Be Confirmed Even Though It Eliminates  
28 Payments To A Government Agency.**

Reilly argues that the court may not confirm Capital West's plan since the plan eliminates

1 insurance payments to a government agency. However, courts have held that government agencies  
2 assume the status of private creditors under the Bankruptcy Code. In re Buttonwood Partners, Ltd., 111  
3 B.R. 57 (Bankr. S.D.N.Y. 1990) (confirming the debtor's plan despite the possible violation of the  
4 Financial Institutions Reform, Recovery and Enforcement Act); In re Water Gap Village, 59 B.R. 23  
5 (Bankr. D.N.J. 1985) (HUD was subject to "cram down").

6 Before confirming the plan, the court, confronted with two governing statutes, is challenged to  
7 harmonize the policies and goals of each. National Labor Relations Board v. Bildisco & Bildisco, 465  
8 U.S. 513, 104 S.Ct. 1188 (1984). In order to assess whether Chapter 11 of the Bankruptcy Code  
9 conflicts with the National Housing Act, the court must review the goals and functions of each statute.

10  
11 **B. The Goal Of Chapter 11 Of The Bankruptcy Code**  
12 **Is To Increase Return To Creditors By Enabling Debtors To Reorganize.**

13 The Supreme Court has recognized that Chapter 11 has two major objectives. First, it permits  
14 the successful rehabilitation of the debtor. Bildisco, 465 U.S. at 527, 104 S.Ct. at 1196 (1984). In doing  
15 so, Chapter 11 allows the debtor to "continue to provide jobs, to satisfy creditors' claims, and to produce  
16 a return for its owners." United States v. Whiting Pools, Inc., 462 U.S. 198, 203, 103 S.Ct. 2309, 2312  
17 (1983). Secondly, "Chapter 11 also embodies the general Code policy of maximizing the value of the  
18 bankruptcy estate." Toibb v. Radloff, 501 U.S. 157, 163, 111 S.Ct. 2197, 2201 (1991).

19  
20 **C. The National Housing Act Provides Affordable Housing**  
21 **Not Only by Insuring Lenders But Also by Finding Alternate**  
22 **Methods of Financing to Prevent Foreclosure.**

23 Congress' purpose in enacting the National Housing Act is to provide a "decent home and suitable  
24 living environment for every American family." Beck Park Apartments v. U.S. Department of Housing,  
25 695 F.2d 366, 368 (9th Cir. 1982). To accomplish this goal, Congress provides programs designed, "to  
26 assist private industry in providing housing for low and moderate income families and displaced families."  
27 Id.

28 One way in which HUD accomplishes Congress' goal is by motivating lenders to loan money.  
HUD motivates lenders by both insuring that the loan will be repaid if the debtor defaults and by

1 restricting the borrower's activities in ways that protect the lender. Superficially, it may appear that  
2 Congress' purposes would be frustrated by allowing a debtor to stop paying mortgage insurance  
3 premiums after filing Chapter 11 Bankruptcy. However, Congress also furthers its goal of providing  
4 affordable housing by requiring HUD to assist private industry avoid foreclosure.

5 HUD is under statutory obligation to consider alternate methods of financing in cases where  
6 insisting on the original payment plan increases the debtor's risk of foreclosure. U.S. v. American Nat'l  
7 Bank, 443 F. Supp. 167 (N.D. Ill. 1977). HUD "has a statutory obligation to take action to prevent  
8 foreclosures by applying alternative methods of financing in appropriate cases." Id. at 175. Russell v.  
9 Landrieu, 621 F.2d 1037, 1041-1042 (1980) (In foreclosing property HUD could not act only to obtain  
10 maximum financial return but had to consider and implement alternatives to foreclosure which would  
11 effectuate the policy objectives of the National Housing Act); Kent Farms Co. v. Hills, 417 F. Supp. 297,  
12 301 (D.D.C. 1976) (Before HUD forecloses on a project "it must consider national housing policy and  
13 decide what further steps authorized by Congress it will take to assure continuity of the decent, safe,  
14 sanitary, low-cost housing then being provided.") Alternatives authorized by HUD regulations include  
15 modification, extension or refinancing of a mortgage. American Nat'l Bank, 443 F. Supp. at 175. See  
16 also C.F.R. §§ 203.340, 203.342 and 207.256(b).

17 MBAA also argues that the proposed plan undermines Congress's purpose in establishing a federal  
18 housing insurance program. HUD deposits all mortgage insurance premiums into a General Insurance  
19 Fund, out of which all lenders' claims are paid. MBAA contends that if borrowers were allowed to stop  
20 contributing to the Fund, it will be depleted. This argument fails, however, since, "[n]othing in the  
21 [Federal Housing] Act suggests that Congress intended HUD to consider factors such as determining the  
22 subsidy of federal credit programs. . . ." Walker v. Pierce, 665 F. Supp. 831, 839 (N.D. Cal. 1987).

23  
24 **D. Plan Confirmation Preserves The Concerns Of Both**  
25 **Chapter 11 And The Federal Housing Act.**

26 Chapter 11 of the Bankruptcy Code is fundamentally concerned with enabling debtors to  
27 reorganize; the Federal Housing Act's main goal is providing affordable housing. When attempting to  
28 harmonize the policies and goals of two competing statutes, the court must respect the fundamental

1 concerns of each.

2 By confirming Capital West's plan, the court preserves the concerns of both Chapter 11 and the  
3 Federal Housing Act. Plan confirmation will enable Capital West to forestall foreclosure by refinancing  
4 the third deed of trust rather than paying insurance on Reilly's note. Elimination of the surplus cash  
5 requirements will enable Capital West to restructure repayment without the burden of meeting other  
6 obligations first. By allowing Capital West the best possible chance to succeed, the court furthers the  
7 Federal Housing Act's purpose by enabling Capital West to continue to provide affordable housing to at  
8 least 160 individuals.

9 Congress, in enacting the Federal Housing Act, could not have intended to compromise the  
10 purpose of Chapter 11 of the Bankruptcy Code. Though Congress has carved out exceptions to the  
11 Code in order to protect various national policies in many areas, it has not done so here. The court can  
12 not interpret Congress' silence to mean that Congress intended to deny those debtors who are attempting  
13 to provide affordable housing the full protection Chapter 11 provides. If Capital West were to suffer  
14 foreclosure, the purposes of both Chapter 11 and the Federal Housing Act would be frustrated.

15  
16 **CONCLUSION**

17 Capital West's plan satisfies the requirements for confirmation in that it is fair and equitable, it  
18 does not unfairly discriminate, and it does not conflict with the National Housing Act in violation of §  
19 1129(a)(3).  
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