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Bonnie Pollack and Michael Kwiatkowski Recently Obtained a Favorable Decision on Behalf of Secured Lender in Chapter 11 Bankruptcy Case

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Partner Bonnie Pollack and associate Michael Kwiatkowski recently obtained a favorable decision on behalf of a secured lender in a chapter 11 bankruptcy case pending before Judge Robert E. Grossman in the Eastern District of New York.

In the case, the individual chapter 11 debtor owns real property which is the debtor's residence and is also used by the debtor to operate a bed and breakfast. Prior to the chapter 11 filing, the firm's client, holder of a first mortgage on the property, obtained a judgment of foreclosure and sale in state court. The parties filed competing chapter 11 plans and disclosure statements in the case. Lender filed a liquidating chapter 11 plan which proposed selling the subject property. The debtor's chapter 11 plan sought to modify the mortgage by taking lender's mortgage claim of approximately $1.6 million and reducing it to principal amount of $1,050,000 with proposed payment of $100,000 down payment and balance to be paid over a 30-year period with 4.25% interest rate. The debtor's plan presented a myriad of issues that formed the basis for the lender's robust objection to the approval of the disclosure statement and eventual confirmation of the chapter 11 plan. After a hearing on the parties' chapter 11 plans and related disclosure statements, Judge Grossman approved lender's disclosure statement for its plan and found that the debtor's plan was not confirmable.

A full analysis of the legal issues raised by debtor's chapter 11 plan is beyond the scope of this alert. However, two issues addressed by Judge Grossman during the court hearing provide important lessons for lenders, their representatives, and bankruptcy practitioners in general.

Initially, the apparent basis for the debtor's proposed modification of lender's mortgage was an alleged settlement that the debtor argued the parties reached based on email correspondence between the parties' counsel. Although the lender never agreed to any settlement, debtor's counsel submitted the parties' email communications in an attempt to argue that there was in fact a settlement. Judge Grossman agreed with the lender in finding that the parties did not in fact reach a settlement, partly because the lender noted that the settlement communications were conditioned on further review and comment.

Federal Rule of Evidence 408(a)(1) prohibits admission of settlement communications in order to "prove or disprove the validity or amount of a disputed claim or to impeach by a prior inconsistent statement or a

contradiction." Fed. R. Evid. 408(a)(1). Debtor counsel's submission of parties' settlement communications to the Court, while it may not have technically violated Rule 408(a)(1), is generally disfavored since such practice may have a chilling effect on parties' willingness to engage in future settlement discussions. *See for example*, *Winchester Packaging, Inc. v. Mobil Chemical Co.*, 14 F.3d 316, 320 (7th Cir. 1994) ("The settlement of legal disputes out of court would be discouraged if settlement offers and other documents in settlement negotiations were admissible in evidence."); *Fassett v. Sears Holdings Corp.*, 319 F.R.D. 143, 155 (M.D. Pa. 2017) ("I also remain wary of piercing the sanctity of settlement negotiations for fear that doing so would discourage extrajudicial resolution in future cases.").

To avoid potential disputes about whether a settlement was reached, parties should, in addition to including the standard disclaimer that any communication is protected by Rule 408 (*i.e.*, "Confidential Settlement Communication / Subject to Fed. R. Evid. 408"), expressly require that any settlement be "subject to parties' execution of a mutually agreed-upon formal written agreement" or words to that effect. Such an express requirement clearly indicates the party's reservation of right not to be bound without a formal written agreement and should prevent a potential argument that the parties reached a settlement unless a written agreement is actually executed by the parties. *See Winston v. Mediafore Entm't Corp.*, 777 F.2d 78, 80 (2d Cir. 1985) (while "[u]nder New York law, parties are free to enter into a binding contract without memorializing their agreement in a fully executed document," courts, in deciding whether parties intended to be bound in the absence of a written agreement, are to consider the following factors: "(1) whether there has been an express reservation of the right not to be bound in the absence of a writing; (2) whether there has been partial performance of the contract; (3) whether all of the terms of the alleged contract have been agreed upon; and (4) whether the agreement at issue is the type of contract that is usually committed to writing."). This may be particularly important for counsel representing corporate clients and financial institutions which may have specific internal requirements for settlement approvals.

The second, and more substantive, issue raised in the case involved debtor's attempt, in the proposed chapter 11 plan, to modify the lender's mortgage. This implicated the anti-modification provision of section 1123(b)(5) of the Bankruptcy Code. While it is well-recognized that a debtor cannot modify a mortgage on the debtor's principal residence where the mortgage lien is secured by some value in the debtor's principal residence, the subject property here was being used as the debtor's "principal residence" *and* had a commercial/business use (*i.e.*, debtor's bed and breakfast business).

Section 1123(b)(5) of the Bankruptcy Code allows a debtor to propose a chapter 11 plan that "modif[ies] the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence*, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claim." 11 U.S.C. § 1123(b)(5) (emphasis added). Section 1322(b)(2) of the Bankruptcy Code, applicable in chapter 13 cases, provides the same exact provision and courts have generally agreed that decisions interpreting either provision are persuasive in interpreting the other provision. *See In re Brooks*, 550 B.R. 19, 25 n.3 (Bankr. W.D.N.Y. 2016); *Lievsay v. Western Fin. Sav. Bank, F.S.B. (In re Lievsay)*, 199 B.R. 705, 708 (9th Cir. B.A.P. 1996).

While there is contradictory caselaw on the issue of whether sections 1123(b)(5) and 1322(b)(2) of the Bankruptcy Code apply to multi-use properties such as the debtor's property, we successfully argued that section 1123(b)(5) of the Bankruptcy Code applies to prevent the debtor from modifying the lender's mortgage. Key among the

decisions supporting this view was *In re Addams*, 564 B.R. 458 (Bankr. E.D.N.Y. 2017) issued by another Bankruptcy Judge in the Eastern District of New York, Judge Alan S. Trust, in a case involving section 1322(b)(2) of the Bankruptcy Code. There, Judge Trust held that although portion of the subject property was rented out by the debtor, section 1322(b)(2) of the Bankruptcy Code nevertheless prevented the debtor from modifying the mortgage and bifurcating the lender's claim into secured and unsecured portions. *In re Addams*, 564 B.R. at 466. *See also In re Brooks*, 550 B.R. 19, 26 (Bankr. W.D.N.Y. 2016) ("the anti-modification exception under 11 U.S.C. § 1322(b)(2) applies to any loan secured only by real property that the debtor uses as a principal residence, even if that real property also serves additional purposes."); *In re Macaluso*, 254 B.R. 799, 800 (Bankr. W.D.N.Y. 2000) (anti-modification exception under section 1322(b)(2) applies to any property that is used as the debtor's principal residence even if the property includes additional uses). *But see Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3d Cir. 2006); *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1 (1st Cir. 1996). Judge Grossman expressly agreed with Judge Trust's decision and ruled in favor of the lender, thus finding debtor's proposed chapter 11 plan unconfirmable. Our readers should note that this conclusion may change under the new Small Business Reorganization Act of 2019 which will permit individual small business debtors to modify their residential mortgages under certain instances. This will be the subject of its own client alert shortly.

Lenders are well aware that the way the borrower uses mortgaged property will impact lender's rights as a mortgage holder if the borrower defaults on the loan, both in bankruptcy and outside of it. Based on Judge Trust's decision *In re Addams* and Judge Grossman's ruling in favor of our client, lenders have a good argument that the anti-modification provisions of sections 1123(b)(5) and 1322(b)(2) of the Bankruptcy Code should protect them from debtors' attempts to modify mortgages on multi-use properties as long as one of the uses of the property is as the borrower's "principal residence."

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Bonnie Pollack or Michael Kwiatkowski at (516) 357-3700.

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