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In re Francis J. and Janet S. GENNETTE, Debtors.

95-10066.

United States Bankruptcy Court. D. Vermont

Sept. 15, 1995.

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J.J. Kennelly, of Carroll, George & Pratt, Rutland, VT, for Vermont National Bank (Bank).

J.M. Sensenich, White River Junction, VT, Chapter 13 Trustee, pro se (trustee).

MEMORANDUM OF DECISION ON CONFIRMATION OBJECTION

FRANCIS G. CONRAD, Bankruptcy Judge.

***1** We sustain [FN1] Vermont National Bank's objection to confirmation of Debtors' Chapter 13 [FN2] Plan of Reorganization because Debtors do not appropriately provide for bank's claim.

Debtors own an undivided one-half interest in commercial property on Route 4 in Mendon, Vermont, where they formerly operated an upscale doll store. Bank has one first mortgage on the entire property that secures two separate loans. One loan is to Debtors who owe Bank about $225,000. The other is to a husband and wife who own the remaining undivided one-half interest in the property (co- owners).

The co-owners, who owe Bank about $185,000, have unaccountably not appeared in this Chapter 13 case, despite the fact that they have significant financial interests at stake. Although the co-owners are reputedly not in default, the mortgage defines both couples collectively as "Borrower," and provides:

[U]pon BORROWER'S breach of any covenant or agreements of BORROWER in this Mortgage, including the covenants to pay when due any sums or obligations secured by this Mortgage, LENDER ... [after notice] may declare all of the sums secured by this Mortgage to be

accelerated and immediately due and payable ... and may invoke any and all remedies permitted by applicable law.

See, Commercial Mortgage appended to Bank's Proof of Claim filed March 22, 1995, ¶ 16. Thus, Debtors' default gives Bank the right to accelerate the co- owners' balance and to foreclose their interest in the property, even though the co-owners might be fully in compliance with the terms of their own loan.

Debtors concede that Bank has a secured claim, but the parties dispute the amount of that claim, with Debtor arguing that Bank is fully secured, and Bank demurring. To win confirmation, a Chapter 13 Plan must treat a secured claim under one of the three alternatives provided by 11 U.S.C. § 1325(a)(5). Debtors here, however, do not identify which of the three alternative provisions of the statute they rely on.

Bank asserts, in support of its objection, that the entire mortgaged property is worth $375,000. Debtors counter that its value is $475,000, and that their undivided one-half interest is worth half of that figure or $237,500. Thus, Debtors contend, turning over their interest in the property to Bank pays off Bank in full. Bank counters that the value of Debtors' one-half interest must be discounted substantially, to take account of "the generally accepted principle that the value of an undivided, fractional interest in property may be less than a proportionate share of the fair market value of the whole due to the attendant problems of divided control and ownership." In re Sprecher, 65 B.R. 598, 601 (Bkrtcy.C.D.Ill.1986). Accordingly, Bank has bifurcated its claim into a secured claim of $85,000 and a general unsecured claim for the balance, about $140,000. Debtors did not bifurcate Bank's claim in their Plan, but treated it as fully secured.

***2** The Bankruptcy Code, 11 U.S.C. § 1325, requires that a Chapter 13 Plan provide for a secured claim in one of three ways:

(a) Except as provided in subsection (b), the court shall confirm a plan if--

* * *

(5) with respect to each allowed secured claim provided for by the plan--

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder....

Bank has not accepted the Plan, so only § 1325(a)(5)(B) and (C) are available here. Debtors' Chapter 13 Plan provides that "Bank shall be paid in full by the conveyance" of Debtor's interest in the property, and makes no provision for treatment of any deficiency.

This characterization of what is to happen appears to contemplate a distribution under § 1325 (a)(5)(B), which requires that the property distributed be worth at least as much as the secured claim. Although we have not yet had a valuation hearing, it is clear from the undisputed facts before us that the value of the property at issue--Debtors' undivided one-half interest--is less than the full amount of Bank's claim.

We assume for the sake of argument that the fair market value of the entire property is the $475,000 contended for by Debtors, and not Bank's lesser value of $375,000. Debtors make two arguments. They argue, first that their one- half interest in the whole is worth one-half of the whole or $237,500, which is greater than Bank's claim. Accordingly, Bank will be paid in full by conveyance of Debtor's interest in the property. Next, Debtors argue that it doesn't matter if their one-half interest in the property is actually worth less than Bank's claim because Bank "has a mortgage on 100% of the property to secure a default on only one of the notes." If "the interest of Debtors alone isn't sufficient," Debtors argued at the hearing on this matter, Bank is "still out there ... able to foreclose a hundred percent of the property to get the full value."

They may get hit with a lawsuit from the [co-owners] for some kind of lender liability but that's separate and apart. That's a totally independent claim by the co-owners that may be brought, may not be brought, may be successful, may not be. [It's a] sort of pie in the sky kind of situation....

Record at 12.

We reject both arguments.

On the facts of this case, it is clear that Debtors cannot pay Bank's claim in full by conveying their interest in the property to Bank. We must determine the property's value "in light of the purpose of the valuation and of the proposed disposition or use of such property." 11 U.S.C. § 506(a). "Very different considerations come into play depending upon whether the property is to be disposed of or whether it is to be retained by the debtor." Sprecher, supra, 65 B.R. at 601.

***3** [F]ractional interests typically sell at a discount and appraisers often apply a discount in assessing the fair market value of such a fractional interest. Factors relevant to a determination of what discount, if any, is applicable include the type of property, the size of

the divided interest owned and the number and relationship of other owners. Where the ownership is scattered amongst various unrelated parties, the value might properly be discounted. On the other hand, where the relationship between the various undivided owners is so close that it is likely that the property in question would be sold as a whole unit rather than by a sale of the separate undivided interests, application of a discount factor might not be appropriate.

Id. The mortgaged property is a single building on a single parcel, owned by two unrelated couples. Debtors do not propose to retain their interest, but to convey it to Bank, which must then dispose of it in what even Debtors concede, as noted above, promises to be a complicated and contentious undertaking. In these circumstances, it is patently obvious that an undivided half-interest isn't worth half the value of the whole.

Shared ownership means shared decision-making; it necessitates compromising one's own desires to accommodate the desires of one's co-owners. Shared ownership also brings with it a significant risk of unforeseen events, as Debtors' co-owners now know all too well. Moreover, shared ownership subjects the parties and the property to the strictures of a state-law regulatory background. 12 V.S.A. §§ 5161 et seq. For example, Vermont property law gives each owner the right to force a division of the undivided interests. "A person having or holding real estate with others, as joint tenants, tenants in common or coparceners, may have partition thereof." 12 V.S.A. § 5161. The right to partition "is a right incident to common ownership which a co-owner may demand absolutely." Coolidge v. Coolidge, 130 Vt. 132, 134, 287 A.2d 566 (1972). The commissioners appointed to partition the property may physically divide the parcel among common owners, 12 V.S.A. § 5171, assign the entire parcel to one party "provided he pays to the other party such sum ... as the commissioners judge equitable," 12 V.S.A. § 5174, or sell the entire parcel and divide the proceeds. 12 V.S. A. §§ 5175-77. As a matter of practical business reality, the inherent uncertainty of shared ownership makes an undivided half-interest less valuable than one half of the value of the whole. Moreover, the Supreme Court has directed us to "assume the validity of this state-law regulatory background and take due account of its effect." BFP v. Resolution Trust Corp., 511 U.S. ----, ----, 114 S.Ct. 1757, 1762, 128 L.Ed.2d 556, 569 (1994). Property that is subject to such "strictures is simply worth less." Id.

Debtors' claim that their half-interest in the property is worth $237,500 is also undermined from another perspective.

***4** We note that our statutory purpose here is not to determine market value, but to value the Bank's "interest in the estate's interest in such property." 11 U.S.C. § 506. See generally, Queenan, Standards for Valuation of Security Interests in Chapter 11, 92 Com.L.J. 18, 31 (1985) ("largely ignored [is] the fact that it is the creditor's security interest in the collateral that is to be valued")..... "[M]arket value" in substance [is] the price that would be agreed to between a willing buyer and willing seller after a reasonable period of exposure in a competitive market, with each party fully informed and acting prudently in its own self

interest.... A secured creditor, however, is not in the position of a willing seller, but must incur the costs of fighting through an unwilling debtor, and then dispose of the property under somewhat less than ideal conditions. Thus, the value of the secured creditor's interest is invariably less than the market value of the property.

In re Carmania N.V., 156 B.R. 119, 121 n. 1 (Bkrtcy.S.D.N.Y.1993). Absent a valuation hearing, we are not prepared to agree with Bank that Debtors' undivided half-interest is worth only $85,000. We do find, however, that it is certainly worth less than $225,000, the full amount of Bank's claim. Thus Debtors are unable to comply with § 1325(a)(5)(B).

We also reject Debtors' argument that Bank must look to the property of their nondebtor co-owners to satisfy its claim against them. The debtors in In re Beach, 169 B.R. 201, 203 (D. Kan.1994) also argued that "the value of the ... secured claim is measured by the entire value of the [collateral], not just the ... undivided interest owned by the debtor." The Court there rejected that argument, holding, that it

fails to explain how the bankruptcy estate can have an interest in the ... undivided portion of the [property] the debtors do not own. The Bankruptcy Code does not contemplate the inclusion of the interest of nondebtors into the bankruptcy estate. Rather, the bankruptcy estate is limited to property in which the debtor has a legal or equitable interest. 11 U.S.C. § 541(a). The court can find nothing in the language of § 506(a) to suggest that Congress intended the valuation approach suggested by the debtors.

Id. at 203-04. We agree. We have no authority to value Bank's secured claim based on the fact that its mortgage covers the undivided half-interest of Debtors' co-owners. Given the fact that the value of Debtors' undivided half- interest in the property is worth less than the amount of Bank's claim against them, Bank is undersecured, regardless of the fact that Bank's mortgage extends to the fractional interests of Debtors' nondebtor co-owners. Debtors must provide for the deficiency themselves, to the extent of the legally available assets in their own estate; they may not preserve their own assets by squandering those of nondebtors.

Debtors may treat the secured portion of Bank's claim under § 1325(a)(5)(C), by surrendering their one-half undivided interest. But, to be confirmed, Debtors must provide for the unsecured portion of Bank's claim. They have not. Accordingly, we deny confirmation.

***5** One last matter needs to be addressed. Were this an adversary proceeding, and not just a contested matter, Fed.R.Bkrtcy.P. 7019 and Fed.R.Civ.P. 19 would apply. Rule 19 requires the joinder of any person who

claims an interest relating to the subject of the action and is so situated that the disposition of the action in the person's absence may (i) as a practical matter impair or impede the

person's ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of the claimed interest.

It appears from the record that Debtors' co-owners are persons who ought to be joined in this proceeding. Their interests are so intertwined with those of Bank and Debtors that whatever we do in the future will affect them, and may leave one or both of the parties liable to them. Fed.R.Bkrtcy.P. 9014 authorizes us "at any stage in a particular matter [to] direct that one or more of the rules" governing adversary proceedings apply. Accordingly, Debtors are directed to join the co-owners in any future proceedings.

Counsel for Bank shall settle an Order consistent with the terms of this Memorandum of Decision upon five days' notice to Debtors.

FN1. Our subject matter jurisdiction over this controversy arises under 28 U.S.C. § 1334 (b) and the General Reference to this Court under Part V of the Local District Court Rules for the District of Vermont. This is a core matter under 28 U.S.C. §§ 157(b)(2) (A), (B), (K), and (O). This Memorandum of Decision constitutes findings of fact and conclusions of law under F.R.Civ.P. 52, as made applicable by F.R.Bkrtcy.P. 7052.

FN2. Debtors filed for protection under the Bankruptcy Code, 11 U.S.C. § 101 et seq., on Feb. 1, 1995.

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