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The Primary Residence Exception: Legislative Proposals in the 110th Congress to Amend Section 1322(b)(2) of the Bankruptcy Code

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Summary

Bankruptcy provides an avenue by which debtors may get relief from their debts. There are two types of bankruptcies: liquidation and reorganization. Chapter 13 of the Bankruptcy Code governs reorganizations for individuals. The Code provides the court some leeway to adjust the value of certain liens. For many secured debts, the court has "cram down" authority, that is, the power to lower, over the creditor's objections, the debt's value to as low as the collateral's fair market value. However, § 1322(b)(2) prohibits the modification of debts "secured only by a security interest ... that is the debtor's primary residence."

The recent downturn in the housing market has likely played a role in the rise of late mortgage payments and foreclosures occurring across the country. Some in Congress expect it will lead to increased filings for bankruptcy. As a result, at least five bills seeking to amend § 1322 of the Bankruptcy Code have been introduced in the 110th Congress. These bills are H.R. 3609 (the Emergency Home Ownership and Mortgage Equity Protection Act), which was ordered to be reported favorably by the House Judiciary Committee; S. 2133 and H.R. 3778 (the Home Owners Mortgage and Equity Savings Act, or HOMES Act); S. 2136 (the Helping Families Save Their Homes in Bankruptcy Act of 2007); and S. 2636 (the Foreclosure Prevention Act of 2008).

This report provides an overview of the general Chapter 13 process and analyzes how these five bills seek to amend certain sections of Chapter 13.

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Mortgage Market Backdrop

Subprime mortgages are loans extended to borrowers who have no credit history, a blemished credit history, and/or a weak debt-service-to-income ratio. The subprime mortgage market began to flourish in the 1990s. Prior to this time, many borrowers with less than perfect credit profiles were generally not extended credit. The expansion of the subprime market improved access to credit for these borrowers. As such, the subprime mortgage market has likely played a large role in the increase of homeownership in the country.[1] According to the U.S. Census Bureau, the national homeownership rate increased from 64.1% in 1993 to 68.9% in 2005.[2] This increase was even more dramatic for minority groups, who saw an increase of nearly 10% during that same time frame.[3] This period of time also happened to coincide with a strong overall housing market, when many homes increased in value.

The housing market began to slow down near the beginning of 2006. This downturn has likely played a role in the rise of late mortgage payments and foreclosures occurring across the country.[4] Some in Congress are concerned that the problems with the housing market will lead to increased filings for bankruptcy.[5] As a result, a number of legislative proposals have been introduced in the 110th Congress

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[1] For more information regarding the subprime mortgage market, *see* CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by Edward Vincent Murphy.

[2] *Id.* at 3-4.

[3] *Id*. (homeownership rate of minorities increased from 42.4% in 1993 to 51.3% in 2005).

[4] *See* CRS Report RL33930, *supra* note 1, and CRS Report RS22511, *Preliminary Observations on the Impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8)*, by Brian Cashnell, Mark Jickling, and Heather D. Negley.

[5] *See* CRS Report RS22511, *supra* note 4 (while the overall bankruptcy rate for the year 2006 is below the rate in 2005, it is likely that this reduction has more to do with a dramatic increase in filings prior to the implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8), which was widely viewed as more onerous to debtors than the law in place before the act, than a decreased need for bankruptcy protection during this period).

that are directed at the subprime mortgage market, including at least five bills seeking to amend § 1322 of Chapter 13 of the Bankruptcy Code (Chapter 13).[6]

This report provides an overview of the general Chapter 13 process and summarizes how the five bills mentioned above seek to amend Chapter 13. As these bills, in some cases, deal with matters beyond the scope of this report, the analysis of them is limited to proposed effects on when the modification of mortgages secured by the debtor's primary residence would be allowed; when prepayment penalties on these loans could be waived; whether and to what extent repayment of these loans would be allowed; whether and to what degree interest rates and annual percentage rates (APRs) on these loans could be modified; and whether and in what circumstances the credit counseling requirement could be waived or otherwise adjusted.

Overview of Chapter 13

Bankruptcy provides an avenue by which debtors may get relief from their debts. There are two types of bankruptcies: liquidation and reorganization. Chapter 13 governs reorganizations for individuals. This chapter also provides a framework for debtor-creditor negotiations of repayment prior to a petition for bankruptcy by serving as a baseline, which provides leverage for each side during these negotiations. Outside of bankruptcy, debtors and creditors may consensually modify the terms of their contractual obligations with the understanding that where they cannot agree, the terms are to be modified in accordance with the parameters of the Code if the debtor files and qualifies[7] for bankruptcy. Subject to limited exceptions, a debtor must receive credit counseling prior to filing for bankruptcy under Chapter 13.[8]

When a qualified debtor cannot negotiate revised payments with his or her creditors, as is usually the case,[9] the debtor may file a petition for an individual

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[6] *See*, H.R. 3609, S. 2133, H.R. 3778, S. 2136.

[7] For instance, 11 U.S.C. § 109(e) requires a Chapter 13 petitioner to have a regular income and limited amount of secured and unsecured debt.

[8] For more information regarding the Bankruptcy Code's credit counseling requirements, *see* CRS Report RL33737, *Credit Counseling Requirements Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and the Pension Protection Act of 2006*, by Jennifer Staman.

[9] *See*, U.S. Senate, Committee on the Judiciary, Statement of Henry J. Sommer, President of the National Association of Consumer Bankruptcy Attorneys, Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes," December 5, 2007. ("If cramdown is not permitted for debtors who cannot pay their mortgages, debtors and creditors have several other alternatives, none of which is more favorable to the mortgage creditor: ... (4) Voluntary modification, *which lenders rarely agree to*, in which an arrangement similar to cramdown results.") (emphasis added) ("But the truth is that voluntary modifications are not being made in any significant numbers ... In a dramatic example, it was recently reported that when state housing finance agencies sought to help borrowers by asking lenders to modify loans so the agencies could then refinance them, they (continued...)

reorganization. Under Chapter 13, the debtor is required to file a reorganization plan with the court.[10] Chapter 13 is a streamlined process, so the plan is generally submitted at the same time as the petition for bankruptcy.[11] Sec. 1322(a) states the requirements that all plans must meet. Sec. 1322(b) states additional parameters that a plan must meet, if applicable. If the plan meets the Code's requirements, including the guidelines of § 1322, the court may confirm the plan in accordance with § 1325.[12]

The Code provides the court some leeway to adjust the value of certain liens. For many secured debts, the court has "cram down" authority, that is, the power to lower, over the creditor's objections, the debt's value to as low as the collateral's fair market value.[13]

Among the secured debts that the court does not have authority to modify under the current Chapter 13 are those that are secured by the debtor's principal residence.[14] Section 1322(b)(2) states in relevant part, "the plan may ... modify 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 primary residence." By virtue of this provision, a court may modify the debt of a mortgage secured by a debtor's *vacation* home, for instance, but may not cram down the debt on a mortgage secured by the same debtor's *primary* residence. The purpose of the exception, at least based on analysis

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[9] (...continued)
had no success because lenders would not make the modifications. If mortgage companies will not modify loans even when they will receive an immediate payoff through refinancing, they certainly will not modify them in cases where they will be paid over a long period of time."). *But see*, "The Hope Now Alliance," a voluntary agreement brokered by Treasury Secretary Henry Paulson between lenders, servicers, and investors. The plan would provide a five-year freeze on mortgage interest rates for certain subprime mortgage borrowers. The plan is designed to buy time for both homeowners and lenders so that borrowers can refinance into more affordable fixed-rate loans in order to limit the number of mortgages going into default and reduce the number of homes for sale in an already saturated market. To qualify, six conditions must be met: (1) borrowers must reside in the residences covered by the mortgage; (2) borrowers must be current with their mortgage payments; (3) the loans must have been taken out between January 1, 2005 and July 31, 2007; (4) the loans must have an adjustable interest rate that will reset between January 1, 2008, and July 31, 2010; (5) payments would increase by more than 10% after the reset; and (6) borrowers must have credit scores below 660 and less than 10% higher than their scores at the time of origination.

[10] 11 U.S.C. § 1321.

[11] Bankruptcy Rule 1007(c) allows the debtor to file a reorganization plan within 15 days of petition.

[12] 11 U.S.C. § 1325 provides the standards by which a bankruptcy court may confirm a reorganization plan.

[13] 11 U.S.C. § 1322(b)(2). To determine the fair market value of a collateral for the purpose of exercising its cram down authority, the court generally holds a hearing during which the parties submit evidence to support a value. After this hearing, the court determines the appropriate fair market value, and that amount is used to set the reduced debt value, which is plugged into the debtor's reorganization plan.

[14] *Id.*

of its legislative history as expressed in a concurring opinion by Justice Stevens, was to "encourage the flow of capital into the home lending market."[15]

Some legislators have questioned the equity of this exception. In the chairwoman's opening statement of the Subcommittee on Commercial and Administrative Law's markup of H.R. 3609 (discussed below), Representative Linda Sánchez stated: "The current law is unfair and needs to be changed. That's why I'm proud to be behind this bill [H.R. 3609], which will restore fairness to hardworking American families struggling to save their homes from foreclosure in bankruptcy."[16] Similarly, Representative Brad Miller, sponsor of H.R. 3609, argued that the disparate treatment of debts secured by the debtor's primary residence under the Code in relation to other secured debts is an indication that the Bankruptcy Code favors businesses but not average homeowners.[17] Others believe allowing modifications of these mortgages in bankruptcy will cause more harm than good. For instance, Professor Mark S. Scarberry, a Resident Scholar at the American

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[15] Nobelman v. Am. Sav. Bank, 508 U.S. 324, 332 (1992) (*citing* Grubbs v. Houston First Am. Sav. Ass'n., 730 F. 2d 236, 245-46 (5th Cir. 1984). Despite Justice Stevens's statement, it is unclear whether encouraging capital into the mortgage lending market was the only, or even primary, legislative purpose of 11 U.S.C. § 1322(b)(2). The language of § 1322(b)(2) was the result of a compromise between the House and Senate versions of the Bankruptcy Reform Act of 1978 (P.L. 95-598). However, there was no conference report for this bill, and our research of the legislative history of § 1322(b)(2) yielded no report language or recorded debate to explain the purpose behind the exception for debts secured by the debtor's primary residence. *Grubbs*'s conclusion, which was relied upon by Justice Stevens, appeared to be based on witness testimony during hearings on the act, which were conducted in the 94th and 95th Congresses. Some of the more relevant testimony cited was given by Edward J. Kulik during the hearings from the 95th Congress. Mr. Kulik, representing the Real Estate Division of the Massachusetts Mutual Life Insurance Company, expressed concern about provisions of the bills that would allow modification of secured debts. He stated "[t]hese provisions may cause residential mortgage lenders to be extraordinarily cautious in making loans in cases where the general financial resources of the individual borrower are not particularly strong." Mr. Kulik continued: "[s]erious consideration should be given to modifying both bills so that, at the least ... a mortgage on real property other than investment property may not be modified...." *See* Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. of Improvements in Judicial Machinery of the Sen. Comm. on the Judiciary, 95th Cong., 1st Sess., 707, 714-15 (1977).

[16] *Linda Sanchez and Brad Miller Introduce Legislation to Relieve Homeowners From Sub-Prime Mortgage Crisis*, Press Release (September 27, 2007), [http://www.lindasanchez.house.gov/news.cfm/article/348].

[17] *Miller speaks out on behalf of middle class homeowners in a House Committee on Financial Services hearing on "Possible Responses to Rising Mortgage Foreclosures."* Press Release (April 17, 2007), [http://www.house.gov/bradmiller/prpr20070417a.html] (*stating:* "Bankruptcy laws have long been intended to help give people a fresh start ... [high net worth individuals and businesses] can go into bankruptcy, they can shirk their obligations ... And, usually after they come out of bankruptcy, the top executives all pat themselves on the back for their good work by giving themselves a nice bonus. But, for the American homeowner, they can't get a mortgage obligation rewritten in bankruptcy ... American homeowners, the American middle class needs someone on their side. American business has someone on their side. The American homeowners need someone on their side. They need Congress on their side and I hope we will be.").

Bankruptcy Institute, believes allowing cram down of primary residence mortgages would "cause problems in the secondary mortgage market" and would "substantially change the risk characteristics of home mortgages...."[18]

Another issue that is addressed by the five bills analyzed in this report is the credit counseling requirement. Because, in most cases, debtors must receive credit counseling before filing a Chapter 13 petition, this requirement can delay bankruptcy filings. Such a delay can be detrimental to debtors seeking to save their homes from foreclosure through a Chapter 13 reorganization. For this reason, the bills provide exceptions to or time extensions for the completion of the credit counseling requirement in certain circumstances.

Bill Comparisons

H.R. 3609. H.R. 3609 (the Emergency Home Ownership and Mortgage Equity Protection Act) was ordered to be reported favorably by the House Committee on the Judiciary on December 12, 2007 by a vote of 17 to 15. H.R. 3609, as passed the House Judiciary Committee, would eliminate the exception from judicial modification of certain debts secured by the debtor's primary residence but only if a number of conditions are met. Modification would be allowed only for "nontraditional mortgages" and "subprime mortgages," as they are defined by the bill, that (1) were originated between January 1, 2000 and the effective date of the bill; (2) have been subjected to a foreclosure notice; and (3) were part of a Chapter 13 bankruptcy petition filed within seven years of the bill's enactment.[19] "Nontraditional mortgages" are loans secured by the debtor's primary residence, except reverse mortgages and secondary home equity lines of credit, that provide payment schedules that either only cover the interest accrued or do not fully cover accrued interest.[20] These loans are commonly referred to as "interest only" or "negatively amortized" loans. "Subprime loans" are loans secured by the debtor's primary residence with APRs that exceed, by 3% for first mortgages or 5% for secondary mortgages, the prevailing rate based on Treasury securities.[21] If a debtor's mortgage meets one of the two definitions and all three conditions listed above, then the debtor's Chapter 13 reorganization plan may modify the terms of the mortgage debt by: (a) cramming down the value of the lien to the fair market value of the property; (b) waiving prepayment penalties that are provided for in the loan document; (c) "prohibiting, reducing, or delaying adjustments" of variable interest rates to the prevailing rates at the time of and subsequent to filing a bankruptcy petition; and (d) allowing for payment of the debt for 30 years less the number of years the loan has been outstanding (or the remaining payment term if it is more than 30 years) and provide a fixed interest rate based on the prevailing rate as published

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[18] U.S. Senate, Committee on the Judiciary, Statement of Mark S. Scarberry, Professor of Law and Robert M. Zinman Resident Scholar at the American Bankruptcy Institute, Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes," December 5, 2007.

[19] H.R. 3609, § 4.

[20] H.R. 3609, § 2.

[21] *Id.*

by the Board of Governors for the Federal Reserve System, plus a reasonable yield for risk.[22] Additionally, H.R. 3609 would provide debtors who file a Chapter 13 petition within seven years of the bill's effective date and who have had a foreclosure notice issued on their primary residence an extension of 30 days (or 45 days if a bankruptcy court finds cause) after the date of petition to meet the Code's credit counseling requirement.[23]

S. 2133. S. 2133 (the Home Owners Mortgage and Equity Savings Act, or HOMES Act), as it was introduced in the Senate, would allow judicial modification of a debt secured by the debtor's primary residence only if the debtor meets specified income-level thresholds,[24] and then only if both the creditor and debtor agree to the adjustment in writing.[25] Because of the written agreement requirement, this provision of the bill does not seem as if it would substantively change what is already allowed outside of bankruptcy.[26]

Currently, a debtor and creditor, if they so agree, could modify debt secured by the debtor's primary residence outside of bankruptcy.[27] The provision from S. 2133 would basically reach this same end, just in a slightly different way. Instead of the debtor and creditor agreeing outside of bankruptcy to a repayment plan that includes a modification of the debt secured by the debtor's primary residence, S. 2133 would require a written statement of agreement to modify, followed by a reorganization plan that included the modification that would then be approved by the court. The only real difference between the two is that S. 2133 would require a written agreement in bankruptcy that is otherwise implicit to such an agreement outside of bankruptcy. Since a creditor's agreement to modify a debt secured by the debtor's primary residence is presumably unlikely, a proposal that does not provide a court some authority to modify these debts in absence of creditor approval does not substantively change what is currently allowed.

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[22] H.R. 3609, § 4. The holder of the claim that is modified pursuant to § 4 of the bill would continue to have a lien on the property until the debt is fully paid under the plan or until the debt is discharged in accordance with 11 U.S.C. § 1328, which ever comes later. H.R. 3609, § 5.

[23] H.R. 3609, § 3.

[24] This means test is based on the state's median family income as well as the size of the debtor's family.

[25] S. 2133, § 2 (It is unclear how long the holder of the claim would continue to hold the lien on the property for the discharged portion of the debt under the bill.).

[26] This interpretation seems to be shared by the bill's sponsor. Senator Specter, on October 5, 2007, stated on the Senate floor that S. 2133 "does not give bankruptcy judges the latitude to reduce the principal on a mortgage.... My bill would only allow the reduction of principal if the lender and the homeowner agree." *See Specter Speaks on Mortgage Crisis*, Press Release (October 5, 2007), [http://specter.senate.gov/public/index.cfm?FuseAction=NewsRoom.ArlenSpecterSpeaks&ContentRecord_id=70319d9c-1321-0e36-bac8-2d8f6d5de585&Region_id=&Issue_id=].

[27] Such voluntary modifications are not the norm. *See*, *supra* fn. 8.

S. 2133 would also allow for a waiver of prepayment penalties and for certain modifications of interest rates of some adjustable rate mortgages (without the need for creditor approval), but only if the debtor meets the specified income-level thresholds provided in the bill.[28] The bill would additionally allow for a delay in the credit counseling requirement until after filing for bankruptcy if a foreclosure has been initiated against the debtor's primary residence.[29] S. 2133 would not provide an extension of repayment beyond what is currently allowed under the Code. Finally, the bill would sunset seven years after enactment.[30]

H.R. 3778. H.R. 3778 (the Home Owners Mortgage and Equity Savings Act, or HOMES Act), as it was introduced in the House, is nearly identical to S. 2133, with the major exception that it would not require written agreement by the parties before a court could cram down a debt secured by the debtor's primary residence.

S. 2136. S. 2136 (the Helping Families Save Their Homes in Bankruptcy Act of 2007), as the bill was introduced in the Senate, would allow judicial modification of a debt secured by the debtor's primary residence but only if the debtor meets an income means test.[31] More specifically, a cram down would be allowed if

> after deduction from the debtor's monthly income of the expenses permitted for debtors described in section 1325(b)(3) (other than amounts contractually due to creditors holding such allowed secured claims and additional payments necessary to maintain possession of the residence), the debtor has insufficient remaining income to retain possession of the residence by curing a default and maintaining payments while the case is pending....[32]

If the debtor meets the means test, S. 2136 would allow payment to extend for thirty years less the number of years that the mortgage has been outstanding.[33] The bill would also allow adjustment of the interest rate for repayment at a fixed annual percentage rate equal to "the most recently published annual yield for conventional mortgages" by the Federal Reserve's Board of Governors "plus a reasonable

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[28] S. 2133, § 2 (if the debtor meets the bill's means test, a court may modify an adjustable rate mortgage "by prohibiting or delaying adjustments to the rate of interest applicable to the debt on and after the date of filing of the plan or voiding any such adjustments that occurred during the 2-year period preceding that date of filing....").

[29] S. 2133, § 4. In most cases, a debtor must receive credit counseling prior to filing for bankruptcy under Chapter 13. For more information regarding the Bankruptcy Code's credit counseling requirements, *see* CRS Report RL33737, *Credit Counseling Requirements Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and the Pension Protection Act of 2006*, by Jennifer Staman.

[30] S. 2133, § 6.

[31] This means test is different from the one in S. 2133 and H.R. 3778. It is unclear how the bill would affect the creditor's lien on the portion discharged.

[32] S. 2136, § 101.

[33] *Id.*

premium for risk," if the debtor meets the means test.[34] In addition, the bill would allow the court to waive any prepayment penalty provided in a mortgage secured by the debtor's primary residence, without regard to the means test.[35] Finally, the bill would eliminate the credit counseling requirement if a foreclosure sale has been scheduled, without regard to the chapter of the Bankruptcy Code under which the debtor has filed.[36]

S. 2636. Title IV of S. 2636 (the Foreclosure Prevention Act of 2008), as it was introduced in the Senate, incorporates, in its entirety, the language of S. 2136 as that bill was introduced in the Senate. The other titles of S. 2636 are unrelated to bankruptcy.

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[34] *Id.*

[35] S. 2136, § 201.

[36] S. 2136, § 102.