# The Primary Residence Exception: Legislative Proposals in the 111th Congress to Amend the Bankruptcy Code to Allow the Strip Down of Certain Home Mortgages

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# Summary

The U.S. housing market began to slow in early 2006 and has led to what many economists believe is the worst housing finance environment since the Great Depression of the 1930s. As a result, there has been a significant rise in late mortgage payments, foreclosures, and bankruptcies nationwide. High unemployment has exacerbated these problems.

Mortgage market participants may voluntarily agree to adjust mortgage terms in order to help troubled borrowers continue to stay in their homes. However, there are a number of obstacles that may discourage mortgage servicers and creditors from performing loan modifications in advance of a petition for bankruptcy, even in situations in which a modification would be the most economically beneficial outcome for the majority of interested parties. There are many barriers to a successful loan modification. One notable obstacle is the way in which mortgage servicers are paid. Servicers often receive more in compensation through a foreclosure than they do through loss mitigation or loan modification. This is especially true where a servicer goes through the time and effort of offering a borrower a modification only to have the borrower redefault in the near future.

Bankruptcy provides an avenue by which debtors may get relief from their debts. Chapter 13 of the U.S. Bankruptcy Code governs reorganizations for most individuals. The Code provides courts some leeway to adjust the value of certain debts. For many secured debts, the court has "strip down"—also, commonly referred to as "cram down"—authority. Strip down is the power to lower, over the creditor's objections, the secured claim to as low as the collateral's fair market value and treat the balance of the debt as an unsecured claim. However, Section 1322(b)(2) of the Code prohibits the strip down of debts secured by the debtor's primary residence.

At least four bills that would amend Section 1322 of the Bankruptcy Code have been introduced in the 111th Congress. These bills are S. 61 and H.R. 200 (the Helping Families Save Their Homes in Bankruptcy Act of 2009), H.R. 1106 (the Helping Families Save Their Homes Act of 2009), and H.R. 225 (the Emergency Home Ownership and Mortgage Equity Protection Act). Additionally, an amendment, S.Amdt. 1014, to S. 896 (the Helping Families Save Their Homes Act of 2009; Senate companion bill to H.R. 1106) would allow for the judicial modification of certain mortgages in bankruptcy but was voted down 45-51 and withdrawn on April 30, 2009. S. 896 was signed into law on May 20, 2009, as P.L. 111-22 without making any changes to the Bankruptcy Code. More recently, during floor consideration of H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, the House voted down an amendment that would have allowed strip down of certain mortgages in bankruptcy. H.Amdt. 534 (Amdt. 018 as printed in H.Rept. 111-370) failed by a vote of 188-241.

This report provides an overview of the general Chapter 13 process and analyzes how these pieces of legislation would amend certain sections of Chapter 13.

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# Mortgage Market Backdrop

The U.S. housing market began to slow in early 2006 and has led to what many economists believe is the worst housing finance environment since the Great Depression of the 1930s.[1] As a result, there has been a significant rise of late mortgage payments, foreclosures, and bankruptcies nationwide.[2] High unemployment has exacerbated these problems. Many believe the market will get worse in the absence of changes in laws and/or regulations. For instance, Mark Zandi, the chief economist of Moody's Economy.com, estimates that 4.9 million foreclosures will occur between 2009 and 2011.[3]

In an attempt to stem the tide of foreclosures and bankruptcies, a number of voluntary loan modification programs have been initiated, including the Obama Administration's Making Home Affordable Program.[4] These programs seek to make mortgage payments more affordable to homeowners who are having, or likely will have difficulty meeting their mortgage obligations, while also avoiding the costs for both debtors and creditors associated with a foreclosure or bankruptcy. However, there are a number of obstacles that have operated to discourage mortgage servicers and creditors from performing loan modifications in advance of foreclosure or a petition for bankruptcy, even in situations in which a modification would be the most economically beneficial outcome for most interested parties. There are many barriers to a successful loan modification. One notable obstacle is the way in which mortgage servicers are paid.[5]

Servicers often do not hold an ownership interest in the underlying mortgage. Instead, they process and distribute borrowers' principal and interest payments for those who do own the mortgage. Mortgage servicers' primary source of revenue is through a fixed percentage of a borrower's regular monthly mortgage payments.[6]

When borrowers become delinquent or default on their monthly payments, servicers also may engage in loss mitigation and initiate foreclosure proceedings on behalf of mortgage holders. In fact, these actions usually are performed simultaneously. Foreclosure proceedings generally are more streamlined than loss mitigation efforts, which are more tailored to the individual characteristics of borrowers and their underlying homes. As a result, engaging in loss mitigation

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[1] *See, e.g.*, Jon Hilsenrather, Serena Ng, and Damian Paletta, *Worst Crisis Since the '30s, With No End Yet in Sight*, Wall Street Journal, Sept. 18, 2008, available at http://online.wsj.com/article/SB122169431617549947.html ("'This has been the worst financial crisis since the Great Depression. There is no question about it,' said Mark Gertler, a New York University economist who worked with fellow academic Ben Bernanke, now the Federal Reserve chairman, to explain how financial turmoil can infect the overall economy.").

[2] *See* CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by (name reda cted). Chapter 13 filings in FY2008 were up 14% from the same period a year before, according to a Dec. 15, 2008 press release by the U.S. Courts available at http://www.uscourts.gov/Press_Releases/2008/BankruptcyFilingsDec2008.cfm. It is unclear how much of this increase was directly related to mortgage debt.

[3] *Housing Market Meltdown Not Over: Zandi*, Reuters, Dec. 2, 2009, available at http://www.cnbc.com/id/34242187.

[4] *See, e.g.*, CRS Report R40210, *Preserving Homeownership: Foreclosure Prevention Initiatives*, by (name redacted).

[5] Other potential obstacles include: the existence of junior liens, fractured ownership interest inherent in securitized mortgages, contractual limitations and potential contractual liability, tax standards, accounting standards, default recidivism, servicers' man-power and organizational limitations, and underwater mortgages (i.e., when debts owed on a mortgage exceed the underlying home's value).

[6] Larry Cordell, *et al.*, *The Incentives of Mortgage Servicing: Myths and Realities*, Finance and Economics Discussion Series, Federal Reserve Board, Sept. 8, 2008, available at http://www.federalreserve.gov/PUBS/FEDS/2008/200846/200846pap.pdf.

efforts usually is more expensive and time consuming for servicers than initiating foreclosure. In absence of a structured loss mitigation or loan modification program, such as the Making Home Affordable Program, that offers incentive payments for participation, servicers often do not receive any compensation for the time and energy they spend engaging in loss mitigation. On top of these costs, servicers, under some circumstances, are contractually obligated to advance principal and interest payments to secondary market participants when the borrower is delinquent. Servicers only begin receiving payment when delinquent borrowers resume monthly payments, and because servicers usually get paid a set percentage, their compensation decreases when borrowers' monthly payments are reduced.[7]

On the other hand, servicers are able to recoup certain fees assessed during the foreclosure process. These fees can be significant.[8] Thus, servicers often receive more in compensation through a foreclosure than they do through loss mitigation or loan modification. This is especially true where a servicer goes through the time and effort of offering a borrower a modification only to have the borrower redefault in the near future.[9]

Some argue that voluntary modification programs have not been effective enough. In a letter sent to Speaker of the House Nancy Pelosi and House Minority Leader John Boehner, the Attorneys General of 22 states and the District of Columbia stated:

> In recent months, State Attorneys General have especially focused on urging mortgage servicers to avoid unnecessary foreclosures by modifying unaffordable loans in a manner that serves holders, servicers, homeowners, and the public. Through the multi-state Foreclosure Prevention Working Group, we collected data which demonstrates that voluntary loan modification measures have failed.... Because most troubled mortgages are securitized, multiple stakeholders may be involved in the decision to modify mortgage loans, causing a continued paralysis. Although some major lenders have recently embarked on loan modifications on a wide scale, many servicers and secondary market investors remain unwilling or unable to act, even when their own economic interests dictate otherwise.[10]

Proponents of amending the Bankruptcy Code believe allowing strip down of primary residences would have two important results. First, it would encourage the voluntary modification of mortgages before default or delinquency that may drive borrowers into bankruptcy. Second, they believe that where voluntary workouts prior to bankruptcy could not be achieved, strip down would adjust the mortgage terms such that the costs and benefits are efficiently spread among debtors and creditors, while allowing debtors to remain in the home after bankruptcy. Senator Durbin, before the Senate Committee on the Judiciary, stated:

> As we heard at last year's hearing, the benefits of this proposal [to allow the modification of certain mortgage debts in bankruptcy] are clear. We heard testimony that:

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[7] *Id.*

[8] Written Testimony of Adam J. Levitin, Associate Professor of Law, Georgetown Law Center, *Helping Families Save their Homes: the Role of Bankruptcy Law*, U.S. Senate, Committee on the Judiciary, Nov. 19, 2008, available at http://judiciary.senate.gov/hearings/testimony.cfm?id=3598&wit_id=7542 (internal citations omitted).

[9] Roberto G. Quercia, *et. al*, *Loan Modifications and Redefault Risk: An Examination of Short-term Impact*, Center for Community Capital, University of North Carolina at Chapel Hill, Working Paper, Mar. 2009, available at [http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf.

[10] Letter to Speaker of the House Nancy Pelosi and House Minority Leader John Boehner, Jan. 6, 2009, available at http://www.mass.gov/Cago/docs/press/2009_01_06_bankruptcy_code_attachment1.pdf.

> •My legislation would significantly reduce the number of foreclosures and help hundreds of thousands of families stay in their homes.
>
> •Mortgage modification in bankruptcy benefits everyone - the homeowner, the lender, the neighboring homeowners and the economy - far more than foreclosure.
>
> •My proposal would give lenders, servicers and investors a real incentive to voluntarily rework mortgages....[11]

Professor Adam Levitin, at the same Senate Judiciary Committee hearing, explained:

> In a perfectly functioning market without agency and transaction costs, lenders would be engaged in large-scale modification of defaulted or distressed mortgage loans, as the lenders would prefer a smaller loss from modification than a larger loss from foreclosure. Voluntary modification, however, has not been happening on a large-scale, for a variety of reasons, most notably contractual impediments, agency costs, practical impediments, and other transaction costs.
>
> If all distressed mortgages could be modified in bankruptcy, it would provide a method for bypassing the various contractual, agency, and other transactional inefficiencies. Permitting bankruptcy modification would give homeowners the option to force a workout of the mortgage, subject to the limitations provided by the Bankruptcy Code. Moreover, the possibility of a bankruptcy modification would encourage voluntary modifications, as mortgage lenders would prefer to exercise more control over the shape of the modification. An involuntary public system of mortgage modification would actually help foster voluntary, private solutions to the mortgage crisis....
>
> Allowing bankruptcy to serve as a forum for distressed homeowners to restructure their mortgage debts is both the most moderate and the best method for resolving the foreclosure crisis and stabilizing mortgage markets. Unlike any other proposed response, bankruptcy modification offers immediate relief, solves the market problems created by securitization, addresses both problems of payment reset shock and negative equity, screens out speculators, spreads burdens between borrowers and lenders, and avoids both the costs and moral hazard of a government bailout.[12]

Others argue that amending the Bankruptcy Code alone would not promote voluntary modifications outside of bankruptcy because such legislation would not directly address the payment, tax, accounting, and litigation concerns that are the main deterrent to voluntary modifications.[13] For instance, a group of Columbia University professors argue that

> [P]roposals to change the [Bankruptcy] Code could dramatically increase bankruptcy-filing rates. Servicers will prefer mortgage modification in bankruptcy because their expenses are reimbursed in bankruptcy, not outside it. Thus, proposed reforms could push millions of borrowers into bankruptcy, delaying the resolution of the current crisis for years.

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[11] Statement of Senator Richard Durbin, *Helping Families Save their Homes: the Role of Bankruptcy Law*, U.S. Senate, Committee on the Judiciary, Nov. 19, 2008, available at http://judiciary.senate.gov/hearings/testimony.cfm?id=3598&wit_id=747.

[12] Written Testimony of Adam J. Levitin, Associate Professor of Law, Georgetown Law Center, *Helping Families Save their Homes: the Role of Bankruptcy Law*, U.S. Senate, Committee on the Judiciary, Nov. 19, 2008, available at http://judiciary.senate.gov/hearings/testimony.cfm?id=3598&wit_id=7542 (internal citations omitted).

[13] *See, e.g.*, Christopher Mayer, Edward Morrison, and Tomasz Piskorski, *A New Proposal for Loan Modifications*, Jan. 7, 2009, available at http://www4.gsb.columbia.edu/realestate/research/housingcrisis/mortgagemarket.

Still others believe allowing modifications of these mortgages in bankruptcy will reduce market stability. For instance, Professor Mark S. Scarberry, a Resident Scholar at the American Bankruptcy Institute, believes allowing strip down of primary residence mortgages would "cause problems in the secondary mortgage market" and would "substantially change the risk characteristics of home mortgages...."[14] Additionally, David G. Kittle, Chairman of the Mortgage Bankers Association, has testified:

> One of the greatest potential destabilizing initiatives is the topic of discussion today - allowing bankruptcy "cramdown" for home mortgages.... We understand the well intentioned goal of such legislation is to provide a back stop against the large numbers of foreclosures. However, the unintended result would be large numbers of bankruptcies, higher losses to servicers, lenders and investors, and reduced ability by the financial industry to extend affordable credit. Such bankruptcy reform will have a negative impact on individual borrowers, a housing recovery and the economy as a whole.[15]

At least four bills that would amend Section 1322 of the U.S. Bankruptcy Code[16] have been introduced in the 111th Congress. These bills are S. 61 and its House companion, H.R. 200 (the Helping Families Save Their Homes in Bankruptcy Act of 2009); H.R. 1106 (the Helping Families Save Their Homes Act of 2009); and H.R. 225 (the Emergency Home Ownership and Mortgage Equity Protection Act). Additionally, an amendment, S.Amdt. 1014, to S. 896 (the Helping Families Save Their Homes Act of 2009; Senate companion bill to H.R. 1106) would allow for the judicial modification of certain mortgages in bankruptcy but was voted down 45-51 and withdrawn on April 30, 2009. S. 896 was signed into law on May 20, 2009 as P.L. 111-22 without making any changes to the Bankruptcy Code. More recently, during floor consideration of H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, the House voted down an amendment that would have allowed strip down of certain mortgages in bankruptcy. H.Amdt. 534 (Amdt. 018 as printed in H.Rept. 111-370) failed by a vote of 188-241.

This report provides an overview of the general Chapter 13 process and analyzes how these pieces of legislation seek to amend Chapter 13. As they, 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.

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

[15] Statement of David G. Kittle, Chairman of the Mortgage Bankers Association, *Helping Families Save their Homes: the Role of Bankruptcy Law*, U.S. Senate, Committee on the Judiciary, Nov. 19, 2008, available at http://judiciary.senate.gov/hearings/testimony.cfm?id=3598&wit_id=7541.

[16] 11 U.S.C. § 101, *et seq*.

# Overview of Chapter 13

Bankruptcy provides an avenue by which debtors may get relief from their debts. Chapter 13 governs reorganizations for most individuals. A reorganization generally means that debts are paid from the debtors' future income. Outside of bankruptcy, debtors and creditors may attempt to consensually modify the terms of their contractual obligations. If the parties attempt to reach a voluntary workout outside of bankruptcy, the Chapter 13 framework may serve as a baseline for negotiations with the parties understanding that if they cannot agree, the terms may be modified in accordance with the parameters of the Code if the debtor files and qualifies[17] for bankruptcy.

When a qualified debtor cannot meet outstanding obligations or negotiate revised payments with his or her creditors,[18] the debtor may file a petition for an individual reorganization. In most cases, debtors must receive credit counseling before filing a Chapter 13 petition.[19] Under Chapter 13, the debtor is required to file a proposed reorganization plan with the court.[20] The proposed Chapter 13 plan generally is submitted at the same time as the petition for bankruptcy.[21] Section 1322(a) states the requirements for all plans. Section 1322(b) states additional parameters that a plan may meet, if applicable. If the plan meets the Code's requirements, including the guidelines of Section 1322, the court may confirm the plan in accordance with Section 1325.[22] Chapter 13 plan disputes among debtors and creditors are settled by the bankruptcy judge.[23]

The Code provides courts some leeway to adjust the value of certain debts. Many unsecured debts may be reduced or discharged. For many secured debts, the court has "strip down"—also, commonly referred to as "cram down"—authority. Strip down is the power to lower, over the

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[17] 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.

[18] Voluntary mortgage modifications were relatively rare prior to 2008. *See* Statement of Henry J. Sommer, President of the National Association of Consumer Bankruptcy Attorneys, *The Looming Foreclosure Crisis: How To Help Families Save Their Homes*, U.S. Senate, Committee on the Judiciary, Dec. 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 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.").

However, voluntary modifications are becoming more and more common as the housing market has continued to lag and market participants have devised ways to perform modifications. *See, e.g.*, CRS Report RL34372, *The HOPE NOW Alliance/American Securitization Forum (ASF) Plan to Freeze Certain Mortgage Interest Rates*, by (name redacted) and (name redacted); Federal Deposit Insurance Corporation Press Release, *FDIC Announces Availability of IndyMac Loan Modification Model*, Nov. 20, 2008, available at http://www.fdic.gov/news/news/press/2008/pr08121.html; Federal Housing Finance Agency Press Release, *FHFA Announces Implementation Plans for Streamlined Loan Modification Program*, Dec. 18, 2008, available at http://www.fhfa.gov/webfiles/267/SMPimplementation121808.pdf.

[19] This requirement can delay bankruptcy filings. Such a delay may be detrimental to debtors seeking to save their homes from foreclosure through a Chapter 13 reorganization.

[20] 11 U.S.C. § 1321.

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

[22] 11 U.S.C. § 1325 provides the standards by which a bankruptcy court may confirm a reorganization plan.

[23] 11 U.S.C. §§ 502 and 1325.

creditor's objections, the amount the debtor must pay the creditor for the secured claim to as low as the collateral's fair market value. Amounts in excess of fair market value are treated as unsecured debt and may be discharged.[24]

Among the secured debts that the court may not strip down under the current Chapter 13 are those that are secured by the debtor's principal residence.[25] 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."

Other real property liens, however, are commonly modified in bankruptcy reorganizations. As a general rule, a real property lien is only protected as a nondischargeable secured debt up to the market value of the collateral. Indebtedness under a mortgage or security interest is treated as unsecured—and therefore modifiable or potentially dischargeable to the extent that the amount of indebtedness exceeds the value of the collateral.[26] The Code allows a court to modify a mortgage secured by the debtor's *vacation* home, *investment* home, and family farm,[27] for instance, but by virtue of § 1322(b)(2)—and a parallel provision in Chapter 11[28]—a court may not strip down the claim on a mortgage secured by the same individual's *primary* residence.

Even after this provision was enacted by the Bankruptcy Reform Act of 1978, some courts interpreted the Code as allowing strip down of primary residences until they were overruled by a 1992 U.S. Supreme Court decision.[29] Hence, the Code's prohibition on the modification of liens that secure a primary residence is arguably the exception, not the rule. The purpose of the exception, at least based on analysis of its legislative history as expressed in a concurring Supreme Court opinion by Justice Stevens, was to "encourage the flow of capital into the home lending market."[30]

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[24] 11 U.S.C. §§ 1322(b)(2). To determine the fair market value of a collateral for the purpose of exercising its strip 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.

[25] 11 U.S.C. § 1322(b)(2). An exception to this rule is provided for primary residence mortgages in which the final payment under the original terms would be due during the reorganization plan. 11 U.S.C. § 1322(c)(2); *see* In re Paschen, 296 F.3d 1203 (11th Cir. 2002). While modification generally is not allowed, a debtor may be able to cure defaults and otherwise reinstate the terms of a debt secured by the debtor's primary residence pursuant to 11 U.S.C. § 1322(b)(5). *See* 8 Collier on Bankr., (15th Ed. 2008), p. 1322.09.

[26] 11 U.S.C. § 506.

[27] 11 U.S.C. § 1222(b)(2).

[28] 11 U.S.C. § 1123(b)(5). Individuals who do not qualify for Chapter 13 may be able to file for a reorganization in Chapter 11 in spite of the fact that Chapter 11 is generally for commercial debtors. 11 U.S.C. § 109; *see also*, Toibb v. Radloff, 501 U.S. 157 (1991). A Chapter 13 petitioner, for instance, must have secured and unsecured debts that fall below certain thresholds. 11 U.S.C. § 109(e).

[29] Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1992).

[30] *Id.* at 332 (*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 CRS research of the recorded legislative history of § 1322(b)(2) yielded little 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 (continued...)

The prohibition on strip down of primary residence mortgages limits debtors' ability to protect their homes from creditors through bankruptcy. When debtors file for chapter 13 protection, foreclosure proceedings on their primary residence can be stopped (as a result of the automatic stay). Additionally, the Code allows debtors to pay arrearages on the mortgage (and potentially other debts) over three to five years as part of their chapter 13 reorganization plan. However, these payments would be in addition to their normal monthly mortgage payments. As a result, two types of debtors are most likely to be able to save their home through a chapter 13 petition. The first group consists of those debtors who have high levels of unsecured debts, which can be reduced under the Code. Debtors in this category are able to allocate more of their income to pay off the mortgage arrearages while continuing their regular mortgage payments because of the reduced burden from their unsecured debts. The second group consists of those who defaulted on debts because of a temporary loss of income, for example, as a result of job loss or a medical condition. Debtors in this category could be able to meet their normal mortgage obligations while also repaying arrearages if they are able to find a new job or otherwise regain steady income.[31] Thus, homeowners generally must

> have incomes at the time of their bankruptcy filings that are sufficient to permit them to meet their future mortgage payments and other living expenses. To receive a bankruptcy discharge and to cure defaults on their mortgage loans, families need to stay current on their ongoing mortgage obligations. A family's success in saving its home in bankruptcy may turn in large part on the relationship between its current income and its housing costs.[32]

Allowing primary residence mortgages to be stripped down in bankruptcy may increase the number of homeowners who benefit from a bankruptcy filing, but as discussed above, it also could be detrimental to others.

# Bill Comparisons

## S. 61

S. 61 (the Helping Families Save Their Homes in Bankruptcy Act of 2009), as introduced, would allow for certain modifications of debts secured by the debtor's primary residence "that is the subject of a notice that a foreclosure may be commenced." The foreclosure process varies by state. In some states, the process can start and finish in a matter of days. Requiring a foreclosure notice before a debtor may take advantage of the strip down in bankruptcy may limit the law's effectiveness because it could force a debtor to file a bankruptcy petition within a short period of time. Making the decision to file for bankruptcy may be difficult to do quickly because potential

(...continued)

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*, U.S. Senate, Subcommittee of Improvements in Judicial Machinery of the Committee on the Judiciary, 95th Cong., 1st Sess., 707, 714-15 (1977).

[31] John Eggum, Katherine Porter, and Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 3 Utah Law Rev. 1123, 1126 (2008).

[32] *Id.* at 1127.

debtors may desire to compare bankruptcy to other options based on the effect a reorganization is likely to have on their ability to retain certain property, their credit worthiness, their future income, etc. Potential debtors may need to discuss their situation with a bankruptcy attorney in order to make a knowledgeable decision.

If a qualified debtor's mortgage meets the above requirements, then the debtor's Chapter 13 reorganization plan may modify the terms of the mortgage debt in several different ways.[33] First, the secured claim may be stripped down to the fair market value of the property, and the remaining balance would be treated as an unsecured claim.[34]

Second, the plan may prohibit, reduce, or delay changes in variable interest rates.[35] This provision would address, in part, mortgages that started with relatively low fixed rates, but subsequently adjusted to a significantly higher variable rate. These low, initial rates are often referred to as teaser rates. Borrowers who could meet the payments at the introductory rate may not be able to afford the higher, adjusted rate.

Third, the plan may allow for payment of the qualifying mortgage debt for 40 years less the number of years the loan has been outstanding or for the remaining payment term, whichever is longer.[36] This provision would not adjust the payment of other debts beyond the normal three- to five-year term of repayment plans. In other words, the bill would allow for repayment of modified primary residence debts over 40 or more years, but the repayment period of all other debts would not be changed by the bill. Requiring debtors to pay off a potentially large debt, like a primary residence mortgage, in five years or less could be prohibitively difficult and could undermine the effectiveness of the law. This provision of S. 61 is important because most courts interpret the current Code as requiring debtors to pay off the entire secured claim of non-primary residence mortgages that are modified in accordance with § 1322(b)(2) during the three- to five-year plan.[37]

Fourth, plans may provide a fixed interest rate based on the prevailing rate as published by the Board of Governors for the Federal Reserve System, plus a reasonable yield for risk.[38] This provision would allow the reduction of fixed interest rates to levels consistent with current market conditions for comparable mortgages.

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[33] Unlike H.R. 200, as ordered to be reported by the Judiciary Committee, S. 61 does not expressly state that these modifications may be made to subordinate debts secured by the debtor's primary residence.

[34] S. 61 § 4. The holder of the claim that is modified pursuant to § 4 of this bill would continue to have a lien on the property until the secured claim is fully paid under the plan or until the claim is discharged in accordance with 11 U.S.C. § 1328, whichever comes later. S. 61 § 6.

[35] S. 61 § 4.

[36] S. 61 § 4.

[37] *See, e.g.*, In re Enewally, 368 F.3d 1165, 1172 (9th Cir. 2004) ("Therefore, a debtor may not use § 506(a) in combination with § 1322(b)(5) to reduce the secured claim and repay it over a period longer than the plan term."); In re Kinney, LEXIS 22313, 18 (Conn. 2000) ("If the [mortgage] payments are changed, sections 1322(c) and 1325(a)(5) both require that they be completed over the life of the plan, which cannot exceed five years...." (*quoting* In re MacGregor, 172 B.R. 718, 721 (Mass. 1994) (internal citations omitted)); In re Pruett, 178 B.R. 7 (N.D.Ala. 1995); In re Brown, 175 B.R. 129 (Mass. 1994); In re Murphy, 175 B.R. 134 (Mass. 1994). There is some disagreement among the courts as to what adjustments to mortgage terms constitute a "modification" pursuant to § 1322(b)(2). *Compare* In re Koper, 284 B.R. 747, 752 (Conn. 2002) with In re Pruett, 178 B.R. at 9.

[38] S. 61 § 4.

Fifth, plans may waive prepayment penalties that are provided for in the loan document.[39] Prepayment penalties are intended to cover the mortgage holder for lost interest payments incurred due to early payment. These fees were especially common in subprime mortgages.

Finally, the bill would allow for the elimination of the Code's credit counseling requirement if the debtor certifies to a court that a foreclosure sale has been scheduled on the debtor's principal residence.[40] This waiver would remove a procedural hurdle that could slow the debtor's ability to file a bankruptcy petition, which may be important in light of the streamlined foreclosure process, as discussed above.

## H.R. 200

H.R. 200 (the Helping Families Save Their Homes in Bankruptcy Act of 2009) was reported (H.Rept. 111-19) by the House Judiciary Committee on February 24, 2009. This bill was a mirror image of S. 61 when it was introduced, but markup of the bill by the House Judiciary Committee resulted in several substantive changes relevant to this report. First, modifications could only be made to qualifying debts that were entered into prior to the bill's enactment date.[41] Proponents argue that limiting strip down to existing debts would reduce the likelihood that the bankruptcy changes would increase overall mortgage rates.

Second, the bill makes clear that the ability to modify debts secured by a debtor's primary residence applies to subordinate debts in addition to primary debts.[42] Many homeowners have more than one mortgage on their home, for instance from financing a "piggy-back" loan to cover some or all of the 20% of the sales price traditionally required as a downpayment to purchase a home.

Third, the bill would change the way in which fixed rates would be calculated for modified mortgages. Rather than relying on an index based on Treasury securities, H.R. 200 would be based upon an index of average prime rates that is published by the Federal Financial Institutions Examination Council (FFIEC). A premium for risk would still be added to the FFEIC average rate.[43] The Federal Reserve Board and many mortgage industry groups believe an index based on average prime offer rates is a more accurate and consistent way to establish mortgage rates than reliance on Treasury securities.[44]

Fourth, H.R. 200 includes a profit sharing provision that would require debtors who have their mortgages modified in bankruptcy and sell the home within four years of the modification to share the net proceeds of the sale with their creditors. The amount that would have to be shared would decrease each year after the modification. The debtor would have to pay the creditor 80% of the net proceeds of a sale within the first year of modification; 60% for a sale in the second year; 40% for a sale in the third year; and 20% for a sale in the fourth year. The net proceeds

39 S. 61 § 5.

40 S. 61 § 2.

41 H.R. 200 § 4.

42 H.R. 200 § 4.

43 H.R. 200 § 4.

44 *See* Federal Reserve System, Truth in Lending Final Rule, 73 Fed. Reg. 44534-44536 (July 30, 2008), available at http://edocket.access.gpo.gov/2008/pdf/E8-16500.pdf.

would be calculated by subtracting the amount of the modified secured claim, the sales costs, and the value of home improvements made from the sales price. The bill also appears to place a ceiling on the amount creditors may recoup through the profit sharing provision to the difference between the secured claim before the bankruptcy and the amount of the modified claim; however, the language of this portion of the provision is less than clear.[45] This profit sharing provision would limit the ability of debtors to quickly profit off of a stripped down mortgage and would allow both creditors and debtors to reap the benefits of a stabilized housing market. It is unclear if or to what extent holders of secondary mortgages would be able to share in the net proceeds based on this provision.

Fifth, debtors would not be able to modify debts secured by their primary residence without certifying that they attempted to discuss a loan modification with creditors before filing for bankruptcy or that a foreclosure sale is scheduled to take place within 30 days of the bankruptcy filing.[46] This provision would force most debtors to seek a voluntary loss mitigation effort before being able to take advantage of the change in the Bankruptcy Code. However, because no action is required by creditors, debtors would not be prevented from reaping the bill's benefits simply because creditors failed to respond to debtors' requests for voluntary relief or were unable or unwilling to grant such relief.

Sixth, modifications would not be available to debtors that received a refinance, an extension, or a renewal of mortgage credit based on "the debtor's material misrepresentation, false pretenses, or actual fraud."[47] This provision would bar debtors who arguably are less deserving of help from taking advantage of the bill.

Finally, H.R. 200 expressly states that the changes made by the bill would not in anyway change the mortgage insurance obligations of the Federal Housing Administration (FHA), the Department of Agriculture (USDA), or the Veterans Administration (VA).[48] Some have questioned how these federal mortgage insurance programs would be affected by changes to the Bankruptcy Code in absence of an explicit legislative statement on the issue.

## H.R. 1106

H.R. 1106 (the Helping Families Save Their Homes Act of 2009), as agreed to by the full House on Thursday, March 5, 2009, varies from H.R. 200 in several substantive ways that are relevant to this report.[49] First, H.R. 1106 clarifies that the profit sharing provision ceiling is in fact the

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[45] H.R. 200 § 4. A representative portion of the bill's profit sharing provision is:

> A claim may be reduced under subsection (b)(11)(A) only on the condition that if the debtor sells the principal residence securing such claim ... then the debtor agrees to pay to such holder, if such residence is sold in the 1st year occurring after the effective date of the plan, 8- percent of the amount of the different between the sales price and the amount of such claim (plus costs of sale and improvements), but not to exceed the amount of the allowed secured claim determined as if such claim had not been reduced under such subsection....

[46] H.R. 200 § 4.

[47] H.R. 200 § 6.

[48] H.R. 200 § 8.

[49] In addition to making a number of technical changes, the bill also includes a number of provisions outside of the scope of this report. For more information on some of these provisions, see CRS Report R40224, *Troubled Asset Relief Program and Foreclosures*, by (name redacted) et al. and CRS Report RL34730, *Troubled Asset Relief Program: Legislation and Treasury Implementation*, by (name redacted) and (name redacted).

difference between the secured claim before the bankruptcy and the amount of the modified claim. In other words, creditors could only share in the net proceeds up to "the unpaid amount of the allowed secured claim" had the debt not been modified.[50]

Second, the bill extends the profit sharing provision for an additional year and increases the amount of the net proceeds that must be shared to 90% in the first year, 70% in the second year, 50% in the third year, 30% in the fourth year, and 10% in the fifth year.[51]

Third, debtors would not be able to modify debts secured by their primary residence without certifying that: (a) they attempted to discuss a loan modification with creditors before filing for bankruptcy; (b) they provided their mortgage creditor information on their income, debts, and expenses; and (c) they considered any offered loan modification meeting the requirements of the Obama Administration's Homeowner Affordability and Stability Plan (Obama Plan). However, these certifications would not be required if a foreclosure sale is scheduled to take place within 30 days of the bankruptcy filing. This provision may encourage voluntary loan modifications outside of bankruptcy by incentivizing creditors to delay setting a foreclosure sale date until they have been able to assess a debtor's ability to meet modified loan terms.[52]

Fourth, H.R. 1106 would prohibit debtors "*convicted of* obtaining by actual fraud the extension, renewal, or refinancing" of a primary residence mortgage from taking advantage of a mortgage modification in bankruptcy. Additionally, before approving a reorganization plan that modifies a primary residence mortgage, the bankruptcy judge must find that "the modification is in good faith." According to the bill, a modification would *not* be in good faith if "the debtor can pay all of his or her debts [including any future scheduled payment increases] ... without difficulty for the foreseeable future...." The bankruptcy judge, in assessing if the proposed modification is in good faith, also should take into account any affordable voluntary loan modification offered by the creditor that meets the Obama Plan requirements without reducing the mortgage principal.[53]

Fifth, at the request of either the debtor or the creditor, a bankruptcy judge may approve a reorganization plan that reduces the interest rate so as to make a 30-year mortgage affordable to the debtor without reducing the mortgage principal. This provision would potentially allow the interest rate to be reduced below the average prime rate as long as the principal owed is not modified.[54]

Sixth, the bill makes clear that it would apply to any bankruptcy case that is initiated after enactment, that is pending on appeal, or is appealable at the time of enactment.[55]

Seventh, the bill would provide the FHA, VA, and USDA Secretaries the statutory authority to pay out claims on insured mortgages that are modified pursuant to the bill, under certain circumstances.[56]

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[50] H.R. 1106 § 103.

[51] H.R. 1106 § 103.

[52] H.R. 1106 § 103.

[53] H.R. 1106 § 105.

[54] H.R. 1106 § 105.

[55] H.R. 1106 § 108.

[56] H.R. 1106 §§ 121-123.

Finally, debtors that certify they have received a foreclosure notice on their principal residence would have to receive credit counseling within 30 days of filing a petition for bankruptcy.[57]

## H.Amdt. 534

H.Amdt. 534 to H.R. 4173 (the Wall Street Reform and Consumer Protection Act of 2009) failed by a vote of 188-241. Its substance is largely the same as H.R. 1106, as agreed to by the full House in March of 2009.

## S.Amdt. 1014 to S. 896

S.Amdt. 1014 to S. 896 (the Helping Families Save Their Homes Act of 2009; Senate companion bill to H.R. 1106) would allow for the judicial modification of certain mortgages in bankruptcy but was voted down 45-51 and withdrawn on April 30, 2009. S. 896 was signed into law on May 20, 2009, as P.L. 111-22 without making any changes to the Bankruptcy Code.

The language of S.Amdt. 1014 was similar to that of H.R. 1106. The most significant difference between the two is that S.Amdt. 1014 would allow for the modification of a smaller set of mortgages. The amendment sought to prohibit borrowers who exceed certain income levels and borrowers who received offers from their lenders to modify or refinance into affordable mortgages from qualifying for bankruptcy protection.

S.Amdt. 1014 would allow judicial modification of mortgages only when:

(a) the mortgage was originated before January 1, 2009;

(b) the mortgage had a principal balance of less than the maximum amount allowed under the Obama Plan (currently $729,750 for a single-unit home);

(c) the mortgage was at least 60 days delinquent;

(d) the mortgage was subject to a foreclosure notice, if it was the senior security interest; and

(e) the debtor *sought* a "qualified loan modification offer"[58] or a "qualified loan refinance offer"[59] before filing for bankruptcy.

Also, if the debtor's income was more than or equal to 80% of the area median income and the debtor *received* a "qualified loan modification offer" or a "qualified loan refinancing offer" or the debtor's monthly mortgage payment prior to modification resulted in a debt-to-income ratio (DTI) of less than 31%, the debtor would not qualify for a mortgage modification in bankruptcy. A debtor whose income was less than 80% of the area median income and who had *received* a

[57] H.R. 1106 § 101.

[58] A "qualified loan modification offer," among other things, would need to meet the guidelines of the Obama Plan or to modify the debtor's payment to a debt-to-income ratio (DTI) equal to or less than 31% for at least five years. S.Amdt. 1014 § 501.

[59] A "qualified loan refinancing offer," among other things, would need to meet the guidelines of the HOPE for Homeowners program as established by P.L. 110-289, the Housing and Economic Recovery Act of 2008. S.Amdt. 1014 § 501.

"qualified loan modification offer" or a "qualified loan refinancing offer" or whose monthly mortgage payment prior to modification was less than 31% DTI would not be authorized for a principal reduction under S.Amdt. 1014, but his or her mortgage could have been modified in the other ways allowed under the amendment (e.g., interest rate reduction).[60]

The profit sharing provision of S.Amdt. 1014 also varied from that of H.R. 1106. S.Amdt. 1014 would require debtors who had their mortgages modified in bankruptcy to share one-half of the net proceeds with the creditor if the home was sold anytime during the bankruptcy case.[61]

## H.R. 225

H.R. 225 (the Emergency Homeownership and Equity Protection Act), as introduced, is identical to S. 61 with regard to the terms discussed in this report, except that modifications could only be made to qualifying debts that were entered into prior to the bill's enactment date.[62]

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[60] S.Amdt. 1014 §§ 502-503.

[61] S.Amdt. 1014 § 503.

[62] H.R. 225 § 3.