

Senate Defeats Legislation Permitting Judges to “Cramdown” Mortgage Modifications on Primary Residences

By Anting J. Wang

On April 30, 2009, the Senate defeated an amendment intended to grant bankruptcy judges limited power to “rewrite” mortgages on primary residences. The amendment would have allowed bankruptcy judges to lower interest rates and extend the duration of mortgages originated before January 1, 2009, with values less than \$729,000. Furthermore, judges would have been permitted to “cramdown” principal amounts to the fair market value of the home, thereby assisting homeowners whose outstanding principal amounts exceeded the fair market value of their homes.[1]

The number of additional bankruptcy filings that would have occurred had the amendment been passed is uncertain. For a similar version of the legislation passed by U.S. House of Representatives in March 2009, the Congressional Budget Office (CBO) estimated that approximately 350,000 additional households would file for bankruptcy over the 2009–2019 period and that about two-thirds of those filings would occur within the first three years after enactment. The CBO could not, however, estimate the number of additional bankruptcy filings that would occur under the amendment, as several factors remained uncertain, such as the supply of experienced bankruptcy lawyers who could handle additional filings and how bankruptcy courts might respond to their new authority.[2]

The defeat in the Senate stymied President Obama’s plan to provide relief via bankruptcy channels to homeowners facing foreclosure. However, a different housing bill entitled “Helping Families Save Their Homes Act of 2009” (S. 896) easily passed.[3]

Existing Law

The Bankruptcy Code (the Code) allows for loans to be modified as a part of a Chapter 13 personal bankruptcy reorganization plan. Section 1123(a)(5) of the Code reads, “[A] plan of reorganization shall . . . provide adequate means for the plan’s implementation, such as . . . modification of any lien; . . . extension of a maturity date or a change in an interest rate or other term of outstanding securities.” 11 U.S.C. § 1123 (1984). However, the Code specifically withholds this power with respect to personal homeowner mortgages on primary residences. “[T]he 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 principal residence . . .” 11 U.S.C. § 1322(b) (1984). Thus, bankruptcy judges may modify many types of loans as a part of a Chapter 13 work out—but not a mortgage on a debtor’s primary residence. The only type of debt that a consumer cannot modify in bankruptcy is debt on a single-family principal residence. Modification of mortgages on investment properties, vacation homes, and multifamily properties, including cooperatives and condominiums, is permitted.

Policy Considerations

The special protection for single-family principal residences stemmed from Congressional belief that if lenders were shielded from a potential retool of mortgages in bankruptcy court, they would pass on these gains to consumers in the form of lower mortgage costs, thereby promoting homeownership. However, pundits have argued that the assumptions behind this special protection are incorrect. In fact, bankruptcy modification risk has not been reflected in primary mortgage pricing, secondary mortgage pricing, or in private mortgage insurance pricing. Nor have homeownership rates increased as a result of the shield. Instead, markets appear indifferent to bankruptcy modification risk because the cost of foreclosure for lenders often outweighs the cost of a potential bankruptcy court restructuring. As a result, lenders price against the greater foreclosure risk, and not the lesser cost of a mortgage modification.[4] In part due to these policy concerns, calls for the elimination of the shield intensified.

Overview of the Amendment

The legislation took the form of an amendment to Senate Bill No. 896. Section 503 of Senate Amendment No. 1014 allowed a plan to modify a mortgage on a primary residence if the loan:

- (1) originated before January 1, 2009;
- (2) had an unpaid principal balance not greater than \$729,000 (the maximum loan amount provided for in the guidelines of the Homeowner Affordability and Stability Plan); and
- (3) was at least 60 days delinquent.

In the case of a principal residence that was subject to a written notice that a foreclosure may be commenced, a modification plan could:

- (a) provide for payment of the amount of the allowed secured claim, thereby “cramming down” the principal value of the loan;[5]
- (b) modify the terms and conditions of the loan by extending the repayment period and resetting the interest rate at a fixed rate based on the current prime rate plus a reasonable premium for risk; and
- (c) provide for payment of the loan directly to a creditor, and not to a trustee.

Furthermore, modification was limited only to those debtors who certified that they had sought a qualified loan modification offer or a qualified loan refinancing offer, and could not be used by debtors whose income at the time of petition was equal to or greater than 80 percent of the area median income as defined by the Department of Housing and Urban Development.

A qualified loan modification offer is defined within the amendment as a loan modification offer that (i) requires no fees or charges to be paid by the debtor; (ii) permits the debtor to continue to make payments under the modification agreement; (iii) is offered in good faith to the debtor in writing; (iv) is presented to the debtor as a firm written offer; (v) is offered with respect to a loan for which no foreclosure sale is scheduled; and (vi) is not revoked by the servicer of such loan for reasons within the control of the debtor.

A qualified loan refinancing offer is defined within the amendment as a loan offered in accordance with the HOPE for Homeowners program (a program that refinances mortgages for borrowers who have difficulty making their payment but can afford a new loan insured by the Department of Housing and Urban Development’s (HUD) Federal Housing Administration (FHA)), which (A) refinances a loan secured by the senior security interest in the principal residence of the debtor, and which is eligible to be refinanced under the Hope for Homeowners program; (B) permits the debtor to continue making payments under the loan, and (C) where the debtor has received written notice that the loan was approved by HUD to serve as a mortgagee.

Opposition to the Amendment

The amendment faced criticism from various groups, particularly the financial services industry. Supporters of the amendment scored a victory earlier in 2009 when Citigroup, a recipient of federal aid, backed the House measure. But no other banks followed its lead. As a result, two Democratic leaders championing the legislation, Senators Richard J. Durbin (D-IL) and Charles E. Schumer (D-NY), narrowed the scope of the bill in an effort to garner bipartisan support. The amendment was revised to restrict modification to existing loans only (those issued prior to January 1, 2009) and loans with a balance due of less than \$729,000. Additionally, eligibility was limited to homeowners already in foreclosure who had solicited an offer from their original lender.

These adjustments only partially quelled opposition. Foes argued that permitting bankruptcy judges to modify mortgages would cause a spike in interest rates, which “is exactly the wrong solution for jobs, homeowners, and the economy,” according to Senate Republican Leader Mitch McConnell (KY).[6] The amendment would also assertedly raise costs for everyone by diverting capital from the mortgage debt market, introducing additional uncertainty for investors, and flooding bankruptcy courts with homeowners seeking judicial relief.[7]

Most troubling for those opposed to the amendment, however, was the perceived “moral hazard” involved in readjusting mortgages for the benefit of troubled homeowners. Such relief was said to create the impression among lenders and homeowners that the government would bail them out of the consequences of irresponsible contracts.[8] Potential loan adjustments would allegedly benefit three groups, which arguably did not deserve such assistance: (1) defaulted homeowners, some of whom borrowed irresponsibly or even fraudulently; (2) investors who stood to lose more in a workable loan modification than in foreclosure; and (3) loan servicers, who because of their fiduciary obligations, should be agreeing to modifications anyway.

Defeat in the Senate

The amendment was defeated in the Senate by a vote of 45–51. New York Democratic Senators Schumer and Kirsten Gillibrand voted for the measure.

The amendment’s proponents placed blame for its defeat on a number of factors. President Obama allegedly had long backed the amendment, and referred to it while lobbying for his \$700 billion Troubled Asset Relief Program (TARP). But facing stiff opposition from banks, the President did little to lean on

lawmakers who worried it might spike interest rates. Nor did the amendment receive more than tepid endorsement from Treasury Secretary Timothy Geithner, who appears to favor the creation of a government-sponsored program relying on private investors to buy risky mortgage-backed securities.

Finally, backers of the bill attributed its defeat to the ardent opposition of financial institutions. "There was a lot of fear-mongering," said Andrew Jakobovics, associate director for housing and economics at the Center for American Progress in Washington. "The banks put on a good show, saying 'Hey, if you force us to take more losses, we're going to go out of business.'"[9]

Consequences of the Amendment's Defeat

The consequences of the amendment's defeat have been described as "potentially catastrophic": U.S. foreclosure filings spiked by more than 81 percent in 2008, and were up 225 percent compared with 2006. Foreclosures also affect home prices by placing many homeowners "underwater" on their mortgages, meaning that they owe more than their homes are worth. These homeowners are more likely to default, and the additional supply of foreclosed homes adds to the spiral of declining home prices. As a result, "if home prices keep plunging, the foreclosure scourge will likely continue." [10]

Going forward, some measure of intervention is needed. "Clearly, the foreclosure prevention programs implemented to date have not had any real success in slowing down this foreclosure tsunami," according to James Saccacio, CEO of RealtyTrac.[11] Other mortgage foreclosure programs are sure to be considered to address the tide of rising foreclosures and their adverse impact on the U.S. economy.

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FOOTNOTES

1. Chapter 13 "cramdown" is not to be confused with the eponymous Chapter 11 "cramdown," where a plan of reorganization may be confirmed over the objections of dissenting creditors via 11 U.S.C. § 1129(b) (2005).
2. Dennis P. Lockhart, President & Chief Executive Officer, Federal Reserve Bank of Atlanta, Panel Discussion at the Atlanta Commerce Club: The Subprime Crisis: Is It Contagious?, Feb. 29, 2008.
3. The mortgage modification plan discussed in this article was proposed as an amendment to the Helping Families Save Their Homes Act, which encourages, but does not require, lenders to cut homeowners' monthly payments and refinance loans for individuals whose home's market value has sunk below what they owe. This act remains silent as to the bankruptcy court's power to modify mortgages.
4. Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 Harv. L. & Pol'y Rev. 1, 6, 7 (Online) (Jan. 19, 2009), www.hlpronline.com/Levitin_HLPR_011909.pdf.
5. "In determining the value of the holder's secured claim under section 506(a)(1) for purposes of subsection (b)(11)(A), the value of the debtor's principal residence shall be the fair market value of such residence on the date of the determination of the value of the allowed secured claim" S.A. 1014, 111th Cong. § 503 (2009).
6. *Mortgage Bankruptcy Bill Fails in the Senate*, Associated Press, Apr. 30, 2009, available at www.msnbc.com/id/30503750/.
7. Renae Merle, *Bankruptcy Filings Would Rise Under Mortgage Bill, CBO Says*, Wash. Post, Feb. 25, 2009 at D6.
8. David Leonhardt, *The Trouble With a Homeowner Bailout*, N.Y. Times, Oct. 22, 2008, available at www.nytimes.com/2008/10/22/business/economy/22leonhardt.html?_r=1&ref=patrick.net&oref=slugin.
9. *Mortgage Bankruptcy*, *supra* note 6.
10. Les Christie, *Foreclosures Up a Record 81% in 2008*, CNNMoney.com, Jan. 15, 2009, available at http://money.cnn.com/2009/01/15/real_estate/millions_in_foreclosure/index.htm.
11. *Mortgage Bankruptcy*, *supra* note 6.

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