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The North Carolina Banking Institute Symposium on the Foreclosure Crisis: Mortgage Cramdown in Bankruptcy as a Necessary Incentive to Encourage Mortgage Modifications*

I. INTRODUCTION

In the years since the financial crisis began, holders of loans initiated nearly 6 million foreclosures in the United States.¹ Some estimates suggest that another 6.5 million homeowners, already behind on their mortgages face the same prospect.² Many experts agree that reducing the principal owed on such loans is the most effective way to minimize the number of homeowners who will ultimately lose their homes,³ and consequently also to reduce the huge costs associated with foreclosures.⁴ In spite of this, and of the incentives to modify that recent legislation has provided,⁵ the holders of these loans are largely unwilling to engage in principal modifications.⁶ One way that homeowners could exert pressure on loan holders to make these modifications is through the possibility of a cramdown in a Chapter 13 proceeding.⁷ In these proceedings, any principal above the current fair market value of home is treated as unsecured debt, leaving the home encumbered only by the amount it is currently worth.⁸ Today, however, the Bankruptcy Code (The Code) limits courts' ability to modify primary residence

* This Note is part of the North Carolina Banking Institute Symposium on Foreclosure Crisis.

1. *The Private Sector and Government Response to the Mortgage Foreclosure Crisis, Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 3 (2009) (statement of Julia Gordon, Senior Policy Counsel, Center for Responsible Lending) www.house.gov/apps/list/hearing/financialsvcs_dem/gordon.pdf.

2. *Id.*

3. *Id.* at 9.

4. Kathryn E. Johnson & Carolyn E. Waldrep, Note, *The North Carolina Banking Institute Symposium on the Foreclosure Crisis: Overview*, 14 N.C. Banking Inst. 198-200, (2010).

5. *Id.* at 203-12.

6. *Id.* at 201-02.

7. Steven Seidenberg, *Battle on the Home Front: A Proposal to Modify Mortgages in Bankruptcy Fails in Congress, But Proponents Say It's the Missing Weapon in Fighting Foreclosures*, A.B.A. J., Aug. 2009, at 55-56.

8. 11 U.S.C. §1322(b)(2) (2006).

mortgages, despite the fact that homeowners not in bankruptcy may attempt to renegotiate and modify their mortgages.⁹

Although the some of the legislation enacted since the beginning of the foreclosure crisis provides incentives to loan holders to renegotiate mortgages,¹⁰ they are insufficient without permitting a cramdown for primary residence mortgages in Chapter 13 Bankruptcy proceedings.¹¹ In order to examine this issue, this note first discusses the current state of bankruptcy law.¹² Part III then explores current efforts at similar modifications,¹³ and Part IV discusses the benefits that would be created by changing bankruptcy law to permit cramdowns, particularly the incentives for servicers to modify mortgages voluntarily.¹⁴

II. CHAPTER 13 BANKRUPTCY AND RECENT PROPOSALS FOR CHANGE

A. *Different Treatment under Chapter 13 for Primary Home Loans*

Chapter 13 of the Bankruptcy Code allows individual debtors who are unable to fully repay their debts to take part in a system of supervised repayments.¹⁵ Such payments are often manageable only because bankruptcy judges can reduce the

9. See Manuel Adelino et al., *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization 2* (Fed. Res. Bank of Boston, Policy Discussion Paper No. 09-4, 2009), available at www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf.

10. Johnson & Waldrep, *supra* note 4, at 203-12.

11. See *infra* pp. 276-278, notes 15-24.

12. See *infra* Part II, pp. 276-79, notes 15-35.

13. See *infra* Part III, pp. 279-85, notes 35-77.

14. See *infra* Part IV, pp. 285-86, notes 78-80.

15. This repayment system distinguishes Chapter 13 Bankruptcy from Chapter 7. This Note does not address Chapter 7 bankruptcy for several reasons. One is that, barring some "exempt" property, a debtors assets are liquidated in Chapter 7 bankruptcy and as such it does not serve the purpose, central to the Act, of keeping a homeowner in his home (section 522(d)(1) allows a debtor to retain a maximum of \$15,000 in real property that serves as the principal residence). 11 U.S.C. 522 (2006). The second is that states can currently choose to implement their own system of exemptions that differ from the U.S. Code, and as such the impact of Chapter 7 bankruptcies on the foreclosure crisis would be inconsistent depending on jurisdiction. *U.S. Courts Chapter 7, BANKRUPTCY BASICS*, <http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter7.html>.

principal on a debtor's secured debt in cases where the principal exceeds the actual value, often referred to as a cramdown.¹⁶ The excess, formerly secured, debt for which creditors had the right to claim a particular piece of property in case of default, is then treated as unsecured debt.¹⁷ Modifications like these are especially relevant in today's financial market, in which so many homeowners are faced with debt that far exceeds the actual value of their home. Since the Code's revision in 1978, however, Section 1322(b)(2) permits judges to modify only "secured claims other than a claim secured only by a security interest in real property that is the debtor's principal residence."¹⁸ Because this powerful cramdown provision does not apply to debts secured by homes, bankruptcy judges cannot restructure home mortgage principal and interest payments, and any such modification can only be achieved with the mortgage holder's agreement.¹⁹ Because efforts to encourage modifications have focused on renegotiations with loan holders, they have not been successful without the "stick" of a judicial cramdown to encourage loan holders and servicers to participate.²⁰

Bankruptcy relief has not historically been thought of as a tool for debtors to manage their troubled mortgages.²¹ Although bankruptcy provides a "safety net" for debtors, it precludes mortgage modification.²² In the wake of the financial meltdown,

16. 11 U.S.C §1322(b)(2)(2006); Principal reductions are frequently referred to as either "cramdowns" or "strip downs." Adam J. Levitin & Joshua Goodman, *Mortgage Market Sensitivity to Bankruptcy Modification*, 4 (3rd Annual Conference on Empirical Legal Studies Papers) Apr. 2008, available at <http://ssrn.com/abstract=1121054>.

17. 11 U.S.C §1322(b)(2) (2006) (addressing shift from secured to unsecured debt); *Glossary*, BANKRUPTCY BASICS, <http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/glossary.html> (on distinction between secured and unsecured debt).

18. 11 U.S.C §1322(b)(2) (2006); Katherine Porter, et al., *The Home Ownership Burdens of Bankrupts*, 2009 No. 7 NORTON BANKR. L. ADVISER 1, 5 (July 2009); see also Melissa B. Jacoby, *Bankruptcy Reform and the Financial Crisis*, 13 N.C. BANK. INST. 115, 116 (2009) (explaining the reasons for changes to bankruptcy law).

19. See Jacoby, *supra* note 18, at 116.

20. See Seidenberg, *supra* note 7, at 55-56.

21. See Jacoby, *supra* note 18, at 116.

22. H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009," and H.R. 225, the "Emergency Homeownership and Equity Protection Act": *Hearing Before the H. Comm. on the Judiciary*, 111th Cong., Jan. 22, 2009 (Statement of Associate Professor Adam J. Levitin, Geo. U. L. Center) [hereinafter *Hearings*], WL154355.

however, policy makers and legislators have begun considering the role bankruptcy policy could play in preventing home foreclosures and lessening the impact on neighborhoods blighted by multiple foreclosures.²³ This shift in thinking about the role bankruptcy law should play in stabilizing the economy has resulted in the recent introduction of several bills aimed at broadening the scope of bankruptcy judges' power to modify home mortgage loans.²⁴

B. The Push for Cramdown Legislation and Its Subsequent Failure

The Obama Administration was a vocal supporter of these attempts to eliminate the Section 1322(b)(2) exemption of home mortgages from the cramdown provision.²⁵ Rhetoric about the exemption was a feature in the President's stump speeches as he supported the stimulus plan early in 2009.²⁶ These proposals faced opposition, however, from parties concerned that the changes would chill mortgage lending.²⁷ Opponents such as the Mortgage Bankers' Association, pointed to how cramdowns of mortgage

23. See Jacoby, *supra* note 18, at 116.

24. See Jacoby, *supra* note 18, at 115; see generally Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 200, 111th Cong. § 4 (2009) (permitting modification of some mortgages secured by primary home residences); Emergency Homeownership and Equity Protection Act, H.R. 225, 111th Cong. § 3 (2009) (amending the Code to permit the modification of certain mortgages secured by primary home residences); Homeowners' Protection Act of 2008, H.R. 7328, 110th Cong. (2008) (amending the Code to permit the modification of certain mortgages secured by primary home residences); Helping Families Save Their Homes in Bankruptcy Act of 2008, S. 2136, 110th Cong. (2008) (permitting bankruptcy judges to modify the terms of some nontraditional and subprime mortgages secured by primary home residences); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. (2007) (permitting the modification of some mortgages secured by primary home residences).

25. See Edmund L. Andrews, *Obama Plan On Housing Said to Push On Lenders*, N.Y. TIMES, Feb. 17, 2009, at B1, available at 2009 WLNR 3066879.

26. *Id.* ("It turns out you can't modify that mortgage if you're in bankruptcy," the president told residents. "Now that makes no sense. What that's doing is, it's forcing a lot of people into foreclosure who potentially would be better off, and the bank would be better off and the community would be better off, if they're at least making some payments.").

27. See, e.g., Seidenberg, *supra* note 7, at 61; John C. Murray & Baxter Dunaway, *Mortgage Modification: Voluntary and Involuntary*, 1 L. DISTRESSED REAL EST. ch.3A, 28, (2008), available at <http://www.firstam.com/ncs/resources/doc/05-Article%201.pdf>.

loan principal might affect loan holders, and by extension, the availability of credit.²⁸ Allowing bankruptcy judges to change the principal amount of home loans, they argued, would create such uncertainty about the value of the loans themselves that loan holders would be more reluctant to issue new loans.²⁹ To compensate, the Mortgage Bankers' Association estimates that interest rates would rise and that lenders would increase the required down payment and closing costs as insurance against the possible loss should a bankruptcy judge reduce a borrower's required mortgage payments.³⁰

Supporters of modifications say that the proposed change would bring fairness to bankruptcy law, which currently allows cramdowns on most secured debt outside of primary residence mortgages.³¹ Cramdowns are even permissible for second homes.³² Additionally, supporters argue that loan holders should not be comparing the value of collateral after a bankruptcy proceeding to the value of collateral that has suffered no losses.³³ Rather, the accurate comparison is post-bankruptcy value to post-foreclosure value.³⁴ Considered this way, the value investors are likely to recoup is already uncertain, and it is very likely that they would be better off with a mortgage modification in bankruptcy rather than in foreclosure.³⁵

III. BENEFITS OF CHANGING BANKRUPTCY LAW TO PERMIT MORTGAGE CRAMDOWNS

A. *Importance of Principal Modifications for Homeowners*

The current legislation has not been sufficient to promote renegotiation for homeowners in need, and as it stands the Code

28. See, e.g., Seidenberg, *supra* note 7, at 61.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. See Adam Levitin, *Is Redefault Risk Preventing Mortgage Loan Mods?*, Credit Slips (July 16 2009, 2:03pm) <http://www.creditslips.org/creditslips/2009/07/is-redefault-risk-preventing-mortgage-loan-mods-.html>.

34. *Id.*

35. *Id.*

cannot serve as the necessary “stick” to encourage loan holders to come to the table with homeowners.³⁶ To remedy this situation and create that important incentive, Congress needs to modify the Code. According to a study comparing housing affordability to income, homeowners facing foreclosure who are candidates for Chapter 13 bankruptcy are substantially less likely to be able to afford their payments than homeowners overall.³⁷ Of homeowners in Chapter 13 Bankruptcy, seven out of ten live in housing that is considered “unaffordable” or “severely unaffordable.”³⁸ With such a large proportion of these homeowners trapped in payment plans that demand huge portions of their income,³⁹ the likelihood of avoiding foreclosure is very low.⁴⁰ A June 2009 study of a pool of Wells Fargo mortgage trusts showed that fewer than 60 percent of homeowners who renegotiated with their loan holders actually saw a reduction in their payments, and those reductions that did occur averaged less than \$175 each month; larger results are rare and have generally been the result of litigation.⁴¹ Homeowners have very few options available that actually make a substantial difference in their ability to make payments towards keeping their homes, and many will still ultimately face foreclosure.⁴² Reductions to principal, however, in the rare cases that they occur,⁴³ bring home costs in line with their current value and make it feasible for homeowners to make their payments.⁴⁴

36. Ruth Simon, *Rescue Includes Steps to Help Borrowers Keep Homes*, WALL ST. J., Sept. 29, 2008, at A8, available at <http://online.wsj.com/article/SB122265697254684627.html> (predicting that forty percent of mortgages will exceed the value of the homes by the time the market stabilizes).

37. Porter, *supra* note 18, at 5.

38. *Id.* at 2 (stating also that HUD Families in bankruptcy were 2.5 times more likely than the general population to own homes that are “unaffordable” or “severely unaffordable”); see also DAVID A. VANDENBROUCKE, DEP’T HOUS. AND URBAN DEV., HOUSING AFFORDABILITY DATA SYSTEM 11 (2007), http://www.huduser.org/Datasets/hads/HADS_doc.pdf (explaining the HUD benchmarks for affordability).

39. Porter, *supra* note 18, at 1 (explaining that HUD designates borrowers whose mortgage costs 30-50% of their income as living in unaffordable housing, those paying greater than 50% as living in severely unaffordable housing.)

40. *Id.*

41. See Gretchen Morgenson, *So Many Foreclosures, So Little Logic*, N.Y. TIMES, July 5, 2009, at BU1, available at 2009 WLNR 12800460; Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modification from 2007 and 2008, Remittance Reports*, 36 FORDHAM URB. L. J. 509, 526 (April, 2009).

42. *Id.*

43. *Id.* (stating that 17.2% of loans modified in June of 2009 had reductions in

B. Changes to the Bankruptcy Code Would Facilitate Principal Reductions

Changes to Chapter 13 bankruptcy provisions, particularly to the 1322(b)(2) exemption, could potentially change the outlook for borrowers hoping to modify their home loans by significantly changing the incentive structure for loan holders and servicers.⁴⁵ While opponents of this kind of change argue that this would harm lenders by making it harder to rely on the value of homes as collateral,⁴⁶ it seems that the losses loan holders often suffer in foreclosures have the same effect.

1. Cramdown Options in Chapter 13 Would Increase Principal Reductions

A change to Chapter 13 permitting bankruptcy judges to apply the cramdown to home mortgages and reduce the principal owed on home loans in bankruptcy would provide leverage for borrowers in distress, even for those who do not themselves enter bankruptcy.⁴⁷ A 2009 report from Credit Suisse predicts that this change to the Bankruptcy Code would reduce the number of foreclosures by twenty percent.⁴⁸ Under this proposal, mortgages would be “crammed down” to the current market value of the property securing the loan, rather than being valued at their origination amount.⁴⁹ In the subsequent three to five years of structured repayment, the value of the reduction would be treated as a claim with equal priority to other unsecured claims.⁵⁰ Thus, loan holders would have a chance to recover some portion of the

principal, interest, or fees).

44. *Id.*

45. Porter, *supra* note 18, at 7.

46. See Seidenberg, *supra* note 7, at 56.

47. *Id.* at 55-56.

48. ROD DUBITSKY ET. AL., BANKRUPTCY LAW REFORM - A NEW TOOL FOR FORECLOSURE AVOIDANCE 1 (2009), http://www.bankruptcylawnetwork.com/wp-content/uploads/2009/01/credit_suisse_bankruptcy_law_reform.pdf (noting that this provision was not included in the version of the stimulus package that passed).

49. *Id.*

50. *Id.* (though it is noted that the amount which a borrower would be able to pay back over a five year period is substantially less than had that same amount been paid back over the 30 years typical of a mortgage).

difference between the original loan and the value of the property securing it at the time of the borrower's bankruptcy.⁵¹

Proponents of this change point out that because so many homeowners have negative equity in their homes, those who might have been able to refinance in a better economy or have their loans otherwise modified, are facing foreclosure proceedings.⁵² Recognition of the need to reduce balances of these "underwater" loans is not limited to consumer protection groups. Federal Reserve Chairman Ben Bernanke commented in 2008 that if servicers would accept principal reductions significant enough to allow homeowners to modify in the current market it would "remove the downside risk to investors of additional writedowns or a re-default."⁵³

2. Renegotiation Would Take Place in the Shadow of Bankruptcy

The knowledge that a borrower could enter Chapter 13 bankruptcy and have their principal reduced through a cramdown would play an important role in encouraging servicers to renegotiate outside of bankruptcy.⁵⁴ Renegotiating would allow them to make modifications on their own terms, rather than being subject to terms decided on by a bankruptcy court.⁵⁵ The president of the National Association of Consumer Bankruptcy Attorneys referred to this incentive as a "sword of Damocles" that homeowners could "hold over the lenders' heads" and as a "bargaining chip" that could give homeowners leverage in their dealings with servicers and loan holders.⁵⁶ The result is that distressed homeowners would have increased options in two

51. *Id.*

52. Seidenberg, *supra* note 7, at 52; Levitin, *supra* note 33.

53. CENTER FOR RESPONSIBLE LENDING, SOLUTION TO HOUSING CRISIS REQUIRES ADJUSTING LOANS TO FAIR MARKET VALUE THROUGH COURT-SUPERVISED MODIFICATIONS 1 (April 2008) <http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/court-supervised-modifications-would-make-large-scale-foreclosure-prevention-possible.pdf>.

54. Seidenberg, *supra* note 7, at 55.

55. *Id.*

56. *Id.* at 56. The "sword of Damocles" is a figure from Greek legend, which is often referenced to illustrate a constant threat. *The Sword of Damocles*, Ackland Art Museum, <http://www.ackland.org/tours/westall.html>.

directions. First, the servicer would have more incentive to modify outside of bankruptcy,⁵⁷ and second, for those homeowners for whom it was ultimately necessary for the consumer to enter bankruptcy, the bankruptcy court would have the ability to modify their home loan in a cramdown.⁵⁸ This incentive for servicers to modify voluntarily would be a very positive effect of changes to the Bankruptcy Code.

C. *Objections to This Provision are not Persuasive*

1. Concern about the Chilling of Mortgage Lending

The primary objection to this provision, as well as to previous attempts to modify the Code, is that allowing cramdowns would have a chilling effect on mortgage lending. This objection is less relevant, however, to those provisions that apply only retroactively.⁵⁹ By extending the relief of cramdowns to mortgages that have already been made, this change would prevent many foreclosures without the risk of preventing future mortgage lending.⁶⁰ Even where that is not the case, however, studies suggest that because losses in foreclosure are greater than those in bankruptcy, the market will not respond to a change in bankruptcy law by increasing the cost of credit.⁶¹ One study looked at the effect that cramdowns had on the mortgage market in the 1980's and 90's, before the case *Nobleman v. American Savings Bank*⁶² resolved the circuit split which had permitted cramdowns on primary residences in some areas.⁶³ The study found that when

57. Seidenberg, *supra* note 7, at 55-56.

58. *Hearings, supra* note 22, at 19 (noting that this group is unlikely to be large, as for most filers bankruptcy is a last choice rather than a strategic option).

59. See DAVID H. CARPENTER, THE PRIMARY RESIDENCE EXCEPTION: LEGISLATIVE PROPOSALS IN THE 111TH CONGRESS TO AMEND THE BANKRUPTCY CODE TO ALLOW THE STRIP DOWN OF CERTAIN HOME MORTGAGES CONGRESSIONAL RESEARCH SERVICE REPORT RL34301 6. (2009).

60. *Id.*

61. See Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 565.

62. *Nobleman v. Am. Sav. Bank*, 508 U.S. 324, 327 (1993).

63. Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets*, 1 (Georgetown Univ. Law Ctr. Bus., Econ. and Regulatory Policy Working Paper No. 1087816, 2008), available at <http://works.bepress.com/>

cramdowns were permitted, they did not affect either the origination rates or the number of bankruptcies filed.⁶⁴ It also found very small effects in the costs of loans, suggesting that contrary to the concerns of those who argue cramdowns would deter lending, the lending market is actually fairly insensitive to cramdowns.⁶⁵ The study suggests that this finding is another result of the fact that loan holders tend to suffer very limited losses, both in “scope and magnitude.”⁶⁶

2. Concern about Spreading Losses to Other Sectors

Another objection is that this change to bankruptcy law would also have repercussions for holders of other kinds of loans, such as credit card companies and automobile lenders.⁶⁷ Under current law, these loans are repaid in part while homeowners default on their mortgages, which cannot be modified.⁶⁸ If the law is changed, these other loan holders with both secured and unsecured debt may suffer additional losses as some part of the pool of money which would otherwise go to them must go to make payments on the debtors’ home loan.⁶⁹ This would in effect distribute losses naturally borne by the holders of mortgages as a result of underwriting standards to other industries which have not seen the abuses present in the mortgage lending industry, which some believe would cause rates to rise in those other areas.⁷⁰ One argument against this is that both the credit and auto loan industries have seen changes to the relevant parts of the Bankruptcy Code in the past without significant impact on their rates.⁷¹ Tightening standards in 2005 did not cause a corresponding drop in rates, and so some critics argue that it is

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64. *Id.*

65. *Id.*

66. *Id.* (suggesting that there are not huge increases in bankruptcy filings nor do lenders lose large amounts in cramdowns compared to foreclosures).

67. Dubitsky, *supra* note 48, at 2 (noting that this provision was not included in the version of the stimulus package that passed).

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 13.

unrealistic to assume that a change in the opposite direction would cause rates to rise.⁷² Regardless of the effect on other industries, however, effective relief for homeowners and stabilization of the housing market requires legislation which makes clear that “housing and broader economic policy objectives” must be the focus of Chapter 13 bankruptcy relief, even at the cost of borrowers repaying less of their unsecured debt in other areas.⁷³

3. Concern about Excessive Chapter 13 Filings to Take Advantage of Cramdowns

Another concern critics of this proposed change to the Code have voiced is that it would create “a cottage industry within consumer bankruptcy” encouraging any homeowners who had underwater mortgages and qualified for bankruptcy to file in order to take advantage of reducing their mortgage with a cramdown.⁷⁴ This concern, however, is not realistic. Chapter 13 Bankruptcy has significant repercussions for debtors’ credit scores that last for years following a bankruptcy filing.⁷⁵ The primary function of the cramdown option in Chapter 13 Bankruptcy would not be in its actual use, but in the servicers’ awareness of the option.⁷⁶ The knowledge that homeowners could file for Chapter 13, which would transfer discretion over how the debt was handled from the servicer to a judge, would work to encourage servicers to engage in productive renegotiations to prevent that.⁷⁷

IV. CONCLUSION

Revising the Bankruptcy Code to allow modification of mortgages secured by primary residences in Chapter 13 would create convincing incentives for servicers by making them aware of

72. *Id.* at 13.

73. *See* Jacoby, *supra* note 18, at 118.

74. *The Worsening Foreclosure Crisis: Is it Time to Reconsider Bankruptcy Reform?: Hearing Before the Subcomm. on Administrative Oversight & the Courts of the Comm. on the Judiciary*, 11th Cong. 1 (2009) (statement of Richard Genirberg).

75. Dubitsky, *supra* note 48, at 13.

76. Seidenberg, *supra* note 7, at 56.

77. *See id.* at 56.

the fact that homeowners have the option of a cramdown.⁷⁸ While the option would likely be used only rarely, in “isolated and strategic” instances,⁷⁹ especially in better economic times when the value of homes trends upwards rather than downwards, it would still work to keep homeowners in their homes and help stabilize the market by preventing foreclosures and increasing the number of renegotiations.⁸⁰

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78. *Id.* at 55-56.

79. *Hearings, supra* note 22, at 19.

80. Seidenberg, *supra* note 7, at 55.