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Questions and Answers about the Mortgage Modification Bankruptcy Bills (H.R. 200 and S. 61)

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1. What is the status of the bills?

Several bills currently pending in Congress would repeal the Bankruptcy Code provision which prohibits modification of home secured loans. Although the Bankruptcy Code generally permits secured claims to be modified, section 1322(b)(2) singles out most home mortgage claims and shields them from modification, other than through a plan which cures a mortgage default. This provision prevents consumers from proposing to change the interest rate, amortization, or term of mortgage loans in a chapter 13 plan. The decision in *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993) also makes clear that mortgage claims are not subject to cramdown to the value of the collateral.

The following bills would permit cramdown and loan term modifications on home mortgages:

- The House bill is H.R. 200 (‘‘Helping Families Save Their Homes in Bankruptcy Act of 2009’’). Following several subcommittee hearings on this bill and on an earlier bill from the 110th Congress (H.R. 3609 - ‘‘Emergency Home Ownership and Mortgage Equity Protection Act of 2007’’), H.R. 200 (as amended by substitute bill) was voted favorably out of the Judiciary Committee on January 27, 2009 on a 21-15 vote.

- The Senate bill is S. 61 (‘‘Helping Families Save Their Homes in Bankruptcy Act of 2009’’). S. 61 was referred to the Judiciary Committee on January 6, 2009. An earlier bill from the 110th Congress, S.2136, was

voted favorably out of the Judiciary Committee on March 6, 2008 on a 10-9 vote.

2. What is the most significant feature of the bills which would make modification for home mortgages different than under current law for other loans?

A secured claim which is subject to cramdown (bifurcation of the holder's claim into an allowed secured claim and an unsecured claim pursuant to Code section 506) and modification of its terms normally must be paid in full within the three to five year duration of the chapter 13 plan. While this may be feasible for claims secured by personal property, few debtors are able to pay a secured claim of $100-500,000 during the plan. The bills provide a solution which is borrowed from chapter 12 farmer cases. Similar to Code section 1222(b)(5), the bills allow payment of the modified mortgage claim, regardless of the original amortization, over a period beyond the life of the chapter 13 plan. By eliminating the need to make additional payments on prepetition arrearages as under a cure plan, and by combining the term extension with interest rate and principal reduction, many debtors facing a home foreclosure would be able to propose feasible and affordable plans if this change is enacted. (The last question below provides a comparison between a cure plan under current law and a modification under the bills).

Both bills (Sec. 4) provide that the repayment period of the holder's secured claim can be extended for a period that is no longer than 1) 40 years (reduced by the period for which such loan has been outstanding) or 2) the remaining term of the loan (beginning on the petition date). The repayment term and other modification provisions in the bills amend the Code by creating a new section 1322(b)(11)(current section 1322(b)(11) is redesignated as (b)(12), which applies to claims secured by a security interest in the debtor's principal residence.

3. Can the debtor freeze or reduce the interest rate on the loan?

The bills explicitly provide that the plan may modify the interest rate due under the mortgage. If the debtor has an adjustable rate mortgage (ARM), the bills (Sec. 4) provide that the loan's interest rate may be modified by "prohibiting, reducing, or delaying adjustments to such rate of interest...." Significantly, this would permit the debtor to stop adjustments on an "exploding" ARM by freezing the current rate, convert an ARM into a fixed rate loan, or reduce the rate on a high-cost subprime loan.

A separate provision which would be included in new section 1322(b)(1) permits the debtor to modify the terms of the loan by providing for payment of interest at a "fixed" annual rate. In *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004), the Supreme Court held that in modifying the interest rate on a car claim being paid under a chapter 13 plan, the bankruptcy court should use the prime rate, adjusted to reflect potential risk, taking into account "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."

The bills contain almost identical language on determining the appropriate interest rate. The interest rate is calculated based on conventional mortgage rates, rather than the prime rate. [1] Sec. 4 of S. 61 states that the plan may provide for payment of interest on the mortgage claim at an annual percentage rate based on the Federal Reserve Board's "annual yield for conventional mortgages." Sec. 4 of H.R. 200 uses a different index for determining the conventional rate: the "average prime offer rate" as published by the Federal Financial Institutions Examination Council.

Both bills also provide that the applicable rate shall include a "reasonable premium for risk." Debtors will generally argue that the added risk premium need not be large and should in most cases be smaller than that added for personal property which depreciates rapidly, such as motor vehicles. In some cases, such as where the debtor has significant equity, a risk premium set at zero may be appropriate.

4. How will the cramdown amount be determined?

Neither bill provides any specific additional guidance or limitations on how courts would determine the amount of permitted cramdown. Thus, a mortgage creditor's allowed secured claim will be determined in the customary manner by applying Code section 506. Since the debtor will be proposing to retain the home, valuation generally will be based on the home's fair market value (rather than its foreclosure or liquidation value) as of the effective date of the plan.

5. Are there any other limitations on the cramdown, such as an equity appreciation sharing or "clawback" requirement?

The House bill in Sec. 4 provides that if the debtor sells the home before receiving a discharge in the chapter 13 case, the claim may be reduced under new section 1322(b)(11) only if the debtor agrees to pay the mortgage creditor a portion of the net sale proceeds, as reduced by costs of sale and improvements made to the property. The Senate bill does not presently contain a similar provision.

The "clawback" formula set out in the House bill for determining the equity sharing depends upon the timing of the sale within a five year period following plan confirmation. If the home is sold in the first year of the plan, the mortgage creditor is to receive 80 percent of the difference between the sales price and the amount of the creditor's claim (plus costs of sale and improvements). If the residence is sold in the second year, then the applicable percentage is 60 percent. If the residence is sold in the third year, then the applicable percentage is 40 percent. If the residence is sold in the

[1] It has generally varied over time as to which of these two indexes have been lower. For example, the annual contract interest rate for conventional fixed-rate first mortgages in 2007 was 6.34%, while the annual prime rate for that year was 8.05%. In 2004, the annual conventional fixed-rate first mortgage rate was 5.84% and the annual prime rate was 4.34%. *See* http://federalreserve.gov/releases/h15/data.htm.

fourth year, then the applicable percentage is 20 percent. In all cases, the payment to the creditor under this provision shall not exceed the amount of the allowed secured claim determined as if such claim had not been reduced under new section 1322(b)(11).

6. Are there any pre-filing conditions the debtor must satisfy before proposing a chapter 13 plan which seeks to modify a home mortgage?

The House bill in Sec. 4 provides that the debtor may propose a modification under new section 1322(b)(11) only if the debtor certifies that he or she attempted to contact the mortgage creditor "regarding modification of the loan" not less than 15 days before filing bankruptcy. This requirement does not apply if a foreclosure sale is scheduled to occur within 30 days of the date the debtor files bankruptcy.

If the debtor has a chapter 13 case pending when the Act becomes effective, the debtor must certify that he or she attempted to contact the mortgage creditor regarding modification of the mortgage before either: 1) filing a plan that seeks modification under new section 1322(b)(11); or (2) moving to modify a plan to include a modification under new section 1322(b)(11).

7. Are all mortgages covered by the bills?

The House bill (Sec. 4) provides that mortgage loans covered by new section 1322(b)(11) must have been originated before the effective date of the bill. The Senate bill as introduced does not have a similar limitation. However, based on negotiations between Senate sponsors of S.61 and Citigroup Inc. for its support of the bill, a provision limiting application to loans originated before the bill's enactment will likely be added to the Senate bill.

Both bills also provide that the mortgage must be the "subject of a notice that a foreclosure may be commenced." In most cases, this will be notice of the right to cure a default before acceleration typically sent by the mortgage holder in accordance with the uniform mortgage instruments.

Finally, the House bill in Sec. 8 provides that nothing in the Act is intended modify any obligation of the Federal Housing Administration, the Veterans Administration, and the Department of Agriculture under mortgage insurance or guarantee contracts related to loans secured by a principal residence.

8. Can the debtor modify a subordinate mortgage?

One of the major impediments to voluntary mortgage modifications has been mortgage servicers' inability to deal with subordinate mortgages on the property. Given the large number of 80/20 mortgages currently in or soon to be in foreclosure, this is a

huge problem which has not been addressed in any meaningful way by the voluntary loan modification programs. New section 1322(b)(11) applies to all claims secured by a security interest in the debtor's principal residence, which would include subordinate mortgages. The House bill in Sec. 4 makes this abundantly clear by providing in new section 1322(b)(11) that the debtor may modify the rights of the holder of a claim secured by a security interest in the debtor's principal residence and "the rights of the holder of any claim secured by a subordinate security interest in such residence."

9. Are debtors in pending chapter 13 cases eligible to seek a modification?

Both bills (Sec. 9 of H.R. 200 and Sec. 8 of S.61) provide that the amendments take effect on the date of enactment. In addition, the bills provide that the amendments apply to cases commenced "before, on, or after the date of the enactment of this Act." Debtors in pending chapter 13 cases would be permitted to seek modification of their plans to obtain the relief provided under the Act.

10. Are there any specific plan confirmation requirements?

Both bills in Sec. 6 provide that if the plan proposes to modify a home secured loan, the modification must be proposed in good faith. An amendment to the House bill approved when the bill was voted out of the House Judiciary committee provides that the debtor must not have obtained the home mortgage by the "debtor's material misrepresentation, false pretenses, or actual fraud. No similar provision is found in the Senate bill.

The bills also require that a plan seeking a mortgage modification provide that the claim holder retain its lien until the later of: 1) when the claim as modified is paid or 2) the debtor obtains a discharge under section 1328. Unlike the treatment of other allowed secured claims under section 1325(a)(5), this provision recognizes that a modified mortgage claim will continue to be paid even after the debtor has completed a chapter 13 plan and the holder's unsecured claim has been discharged.

11. Do the bills provide relief for debtors who are currently ineligible for chapter 13 based on the debt limitations?

Debtors in states with high housing costs have increasingly found that they are ineligible to file a case under chapter 13. Without an amendment to section 109(e), many homeowners in such states would not be permitted to seek loan modifications in chapter 13. For example, a debtor couple may owe $780,000 on a first mortgage and $135,000 on a second mortgage secured by their primary residence, and the value of their home is now $630,000. The debtors also have $65,000 in unsecured medical debt and credit card bills. The secured portion of their mortgage debt would be $630,000, and the unsecured portion would be $285,000. The other unsecured debt amount of $65,000, plus the

$285,000 unsecured portion of the home debt, totals $350,000. The debtors would be ineligible for chapter 13 since their unsecured debt total of $350,000 is above the current section 109(e) limit of $336,900. This is true even though the debt secured by their home value would be under the section 109(e) secured debt limit of $1,010,650.

Both bills have provisions in Sec. 2 which amend section 109(e) to provide that in certain circumstances the debt computation does not include the secured or unsecured portions of debts secured by the debtor's principal residence. The exception applies if the current value of the debtor's principal residence is less than the secured debt limit. This change would make the debtors in the above example eligible for chapter 13. Alternatively, the exception applies if the debtor's principal residence was sold in foreclosure or the debtor surrendered the residence and the current value of such residence is less than the secured debt limit.

12. Do the bills address problems with excessive and undisclosed creditor fees in chapter 13 cases?

An enormous problem for many debtors who attempt to save homes from foreclosure in chapter 13 is that mortgage creditors often misapply payments and add unauthorized or excessive fees to the mortgage accounts while the case is pending. These debtors emerge from bankruptcy after three to five years of struggling to cure an arrearage only to have the creditor begin foreclosure anew based on claims of unpaid fees for such items as attorney's fees, property inspections, broker price opinions, and other charges allegedly incurred during the case. These fees and charges are added to mortgage accounts without notice to the borrower, trustee or bankruptcy court.

Both bills include a provision to remedy this problem. Sec. 5 in both bills provides that a fee, cost, or charge incurred during the pendency of a chapter 13 case may be charged to the debtor or added to the account only if:

- the mortgage creditor discloses the fee, cost, or charge in a notice filed with the court within 1 year after the fee or charge is incurred, or 60 days before the case closing;
- the fee, cost, or charge is lawful under applicable nonbankruptcy law, reasonable, and provided for in the agreement; and
- the value of the secured property is greater than the claim, including such fee, cost, or charge.

The bills specify that the failure of the mortgage creditor to provide the required notice would amount to a waiver of the subject fee or charge and that any attempt to collect the fee or charge would be a violation of the automatic stay or the discharge injunction.

The bills also include provisions in these sections which state that a plan may provide for the waiver of any prepayment penalty on a mortgage claim.

13. Do the bills repeal any of the changes made by the 2005 Act?

None of the BAPCPA changes are repealed. The bills do, however, address the requirement of a prebankruptcy credit counseling briefing added by BAPCPA, which has caused problems for some borrowers facing foreclosure. Both bills in Sec. 2 state that the debtor does not need to obtain the briefing if the debtor certifies that he or she has received a notice that the mortgage creditor may "commence a foreclosure on the debtor's principal residence." This provision would effectively overrule court decisions which have held that a pending foreclosure is not a sufficient "exigent circumstance" which would merit a deferral of the counseling under the procedure Congress adopted in the 2005 law presumably to deal with emergencies such as foreclosures.

14. Are there any tax consequences for debtors resulting from a mortgage modification?

To the extent that the modification provided in the debtor's plan includes a cramdown, the mortgage claim is bifurcated and the unsecured portion of the creditor's claim would be discharged upon successful completion of the plan. The debtor's plan would also provide for continuing payments on the reamortized mortgage after the case is closed. Both bills (Sec. 7) clarify through an amendment to Code section 1328 that the remaining balance owed on the reamortized mortgage (the unpaid portion of the allowed secured claim) is not discharged at the conclusion of the case.

Importantly, the amount of the mortgage cramdown representing the mortgage holder's unsecured claim, like all other debt discharged in bankruptcy, is not treated as discharge of indebtedness income for tax purposes.[2] Given the limitations of the recently enacted Mortgage Forgiveness Debt Relief Act of 2007 (Pub. L. No. 110-142) in regard to home equity debt,[3] a mortgage modification in bankruptcy under these bills would avoid tax consequences for the debtor that might exist if the modification were made outside of bankruptcy.

15. Do the bills address any other issues?

Both bills (Sec. 3) contain a provision which would reinforce that certain consumer protection claims may be asserted in the claim allowance process in bankruptcy, notwithstanding the prior entry of a foreclosure judgment. The provision would overrule bankruptcy court decisions which have held that the Rooker/Feldman and other claim preclusion doctrines prevent a debtor from asserting a Truth in Lending Act

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[2] 26 U.S.C. § 108.

[3] *See* NCLC Reports, Bankruptcy and Foreclosures Edition, "How Congress Did (or Did Not) Save Your Clients from Foreclosure: The Mortgage Forgiveness Debt Relief Act of 2007" (Nov.-Dec. 2007).

rescission claim (or other consumer protection law claims) as an objection to a proof of claim filed by a creditor if a prepetition foreclosure judgment was entered against the debtor.

16. Do the bills make permanent changes to the Bankruptcy Code?

Both bills currently do not include a sunset provision. However, as mentioned, the amendments creating new section 1322(b)(11) apply only to existing mortgages.

17. Can you provide a comparison between a cure plan under current law and a mortgage modification under the proposed bills?

Assume that the borrowers have a subprime 2/28 ARM mortgage with an initial teaser interest rate of 8.63%. Their monthly principal and interest payment is $1,748 ($1,973 with taxes & ins.) for the first 24 months. The borrowers are unable to afford even the teaser rate payment and fall behind. They file chapter 13 bankruptcy in the eighteenth month to stop a foreclosure sale. The principal owing at the time of filing is $225,000, with a total arrearage of $14,000, and their home is now valued at $200,000. To cure the arrears and maintain current payments with rate adjustments, they would need to make the following payments, assuming rate adjustments based on a LIBOR index plus a margin of 6, with applicable rate caps and using historical rates for the period 2004-2007. This also assumes that taxes and insurance remain constant during the plan.

Chapter 13 Plan to Cure Default on ARM under Current Law:

$ 389 payment on arrears (assuming cure over 36 mos.)
$ 46 interest on arrears payment each month (assuming required by mortgage documents)
$ 44 trustee's fee each month (assuming plan permits regular payments to be made directly to servicer and not considering administrative costs, such as attorney's fees, or other payments under plan)

$ 2,227 monthly to keep current and cure arrears for first six months of plan (including taxes and insurance)
$ 2,364 monthly to keep current and cure arrears for months 7-12 of plan
$ 2,522 monthly to keep current and cure arrears for months 13 - 18 of plan
$ 2,651 monthly to keep current and cure arrears for months 19 - 24 of plan
$ 2,656 monthly to keep current and cure arrears for months 25 - 30 of plan
$ 2,664 monthly to keep current and cure arrears for months 31 - 36 of plan

If the Code changes made by the bills were enacted, the borrowers could propose to 1) extend the mortgage term, so that it would have another 342 months to run (360 original term less 18 months loan has been outstanding), 2) reduce the interest rate going

forward at a fixed rate of 7.25%, and 3) reduce the current loan balance to $200,000 based on the fair market value of the property.

Proposed Chapter 13 Plan with Mortgage Modification:

$200,000	current loan balance
342	month term
7.25%	interest

$ 1,643	ongoing monthly mortgage payment (including taxes and insurance of $225/month)
$ 66	trustee's fee each month (assuming mortgage payments are made by the trustee under the plan and based on a reduced commission of 4%)
$ 1,709	monthly to keep current for 3 year duration of plan
$ 1,643	monthly to keep current for remaining 25 1/2 years of mortgage term (subject to adjustment only for taxes and insurance)