

**Politics, Practicality and People: The Impact of the
Mortgage Meltdown in Bankruptcy,
Including Mortgage Modification Legislation**

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Legislative Update

H.R. 1106 - House Passed Bill

The following are selected sections of H.R. 1106 that were under the jurisdiction of the House Judiciary Committee. H.R. 1106 passed the House on March 5, 2009, by a vote of 234 - 191.

Sec. 101: This section modifies the eligibility requirements for Chapter 13 relief.

Section 109(e) of the Bankruptcy Code, the Chapter 13 eligibility provision, is amended to exclude the secured or unsecured portions of a debt secured by a debtor's principal residence, when:

- 1) The value of the residence is less than the applicable maximum amount of the secured debt limit set forth in §109(e), or when
- 2) The value of the residence is less than the applicable maximum amount of the secured debt limit set forth in §109(e) if the debtor's residence was sold at foreclosure or surrendered to the creditor.

What does this mean? This prevents the unsecured deficiency claim, which is a part of the total mortgage debt, from being included with other unsecured debts to defeat the debtor's Chapter 13 eligibility.

Pre-petition credit counseling could be extended 30 days post-petition if debtor has received notice that the creditor may commence a foreclosure proceeding. No 5 day pre-petition unavailability requirement. The debtor must certify this fact to the court.

Sec. 102 This section focuses on §502(b) of the Bankruptcy Code.

Section 502(b) of the Bankruptcy Code presently enumerates various claims of creditors that are not entitled to payment in a bankruptcy case, subject to certain exceptions. The House bill amends §502(b) to provide that a claim, secured by debtor's principal residence, is not entitled to payment in a bankruptcy case to the extent that the claim is subject to a remedy for rescission under the Truth in Lending Act, notwithstanding the prior entry of a foreclosure judgment. What does this mean? This provision prevents a claim preclusion or Rooker-Feldman defense being raised to bar the Truth in Lending Act rescission remedy because of the foreclosure judgment.

Sec. 103 Scope of application, certifications, and procedural requirements.

Section 1322(b)(2), which now prevents the modification of a claim secured exclusively by the debtor's principal residence, contains limited exceptions:

- 1) The new ability to "cramdown" or modify a home loan mortgage to value will apply only to mortgages originated before the effective date of the House bill.
(The new modification statute will not apply to mortgages entered into after the date of enactment. This was a major negotiating point urged by Citigroup. Consequently, lending that occurs after the enactment will not be impacted.)
- 2) The mortgage must be subject to a notice that a foreclosure may be or has been commenced with respect to the mortgage.
- 3) The House bill clearly pertains to both primary and subordinate mortgages that encumber a debtor's primary residence.

New §1322(h) contains certifications that the debtor must undertake:

- 1) Debtor must certify that he or she has contacted the mortgagee or servicer not less than 30 days before the bankruptcy filing regarding a possible modification of the mortgage.
- 2) Debtor must also certify that the mortgagee or servicer was provided a written statement of current income and expenses, as well as, existing debt in a format that substantially conforms with §521 of the Bankruptcy Code.
- 3) The debtor must provide a certification that includes a statement that the debtor considered any "qualified loan modification" offered to the debtor by the mortgagee or servicer, if one was actually offered.
(This does not apply if the foreclosure sale is scheduled to occur within 30 days of the bankruptcy filing.)

[A "qualified loan modification" is defined in Sec. 100 of the House bill as an agreement made according to the guidelines of the Obama Administration's Homeowner Affordability and Stability Plan. Essentially the loan payment plus all charges and assessments is reduced to a percentage of the debtor's income in accordance with the guidelines. A percentage frequently mentioned is 31% of the debtors' gross income.]

- 4) If the Chapter 13 case is already pending, the debtor must certify that the mortgagee or servicer was contacted before the Chapter 13 plan was filed and was advised of the proposed modification terms, or, if the filed plan is being modified, the debtor must certify that the mortgagee or servicer was advised of the proposed modification terms.

The modifications terms are set forth in new §1322(b)(11):

- 1) The amount of the secured claim is the fair market value of the property as of the date of the valuation. If value is contested, the appraisal rules used by the Federal Housing Administration shall apply.
- 2) An adjustable interest rate may be reduced or delayed.
- 3) The repayment period may be extended for a period that is not longer than 40 years, reduced by the period that the mortgage has already been outstanding.
- 4) The plan may provide for the payment of interest at a fixed annual rate, equal to the current applicable average prime offer rate as of the date of the order for relief, plus a reasonable premium for risk. This particular prime offer rate is published by the Federal Financial Institutions Examination Council and, when the risk premium is added, would be similar to a Till interest rate.
- 5) The payment of the mortgage, as modified, at the discretion of the court, may be made directly to the holder of the claim or through the Chapter 13 trustee.

In exercising its discretion, the court is to take into consideration the debtor's ability to pay the trustee's fees on payments disbursed through the trustee.

New §1322(g), the "clawback" section, provides that the claim may be reduced under §1322(b)(11) only on the condition that the debtor shall pay the mortgagee a stated portion of the sales proceeds should the residence be sold before all payments under the plan are completed or before the debtor receives a discharge.

If the residence is sold during the:

Mortgagee receives:

1st year after effective date of plan

90% of the difference in the sales price and the adjusted amount of claim plus the costs of sale and any improvements made by the debtor

2 nd year	70%
3 rd year	50%
4 th year	30%
5 th year	10%

If a sale does occur, the court would take into account, before making the percentage allocation, the amount of the creditor's claim before it was modified, as well as, whether payments were made on the unsecured portion of the creditor's claim. In other words, the creditor would not be able to receive more than was originally owed.

Sec. 104 Post-petition/post-confirmation fees, costs, and charges.

Section 1322(c) is amended to require a creditor with a claim against the debtor's residence to give notice to the debtor, the debtor's attorney, and the Chapter 13 trustee of any fees, costs, or charges that arise during the pendency of the case. The notice must be given before the earlier of one year when the fee was incurred or 60 days before the case is closed. At the court's discretion, these notices could be more frequent.

The fees must be reasonable, lawful under non-bankruptcy law, and provided for in the security agreement.

To be allowable, the value of the debtor's residence must exceed the total claim amount including the fees and charges.

If the notice is not given, the fees will be considered waived. Collection efforts would be precluded by either the automatic stay or the discharge injunction, whichever would be applicable.

Sec. 104 also provides that a Chapter 13 plan may waive any prepayment penalty on a claim secured by the debtor's residence.

Sec. 105 Plan confirmation standards remain substantially the same.

Debtor cannot have been convicted of fraud in obtaining the renewal, extension, or refinancing of the credit that gave rise to the modified claim.

The modification must be in good faith. A lack of good faith exists if the debtor has no need for the modification relief because he or she could pay all of the scheduled debts in the foreseeable future without difficulty.

In determining good faith, the court must consider whether the creditor offered the debtor a “qualified loan modification” that would have enabled the debtor to pay the debt without reducing the principal amount of the mortgage.

There is also a consent procedure when the debtor and the claim holder agree to an interest rate reduction lower than that specified in new §1322(b)(11) with no reduction of the mortgage principal. If this procedure is found to be affordable, it should not be rejected by the court.

Sec. 106 Discharge exception.

At discharge, the unpaid portion of the modified claim is not discharged which is similar to the current long term debt discharge exception. However, a deficiency claim is not created where it would otherwise not exist.

Sec. 107 Trustee compensation.

The Chapter 13 trustee’s compensation on the payments disbursed on a claim modified pursuant to new §1322(b)(11) is capped at 4%. The court can waive these fees if the debtor has income less than 150% of the official poverty line applicable to the size of the debtor’s family and the payment of the fees would render the debtor’s plan unfeasible.

Sec. 108 Effective date.

Effective date is the date of enactment.

Sec. 109 Potential “Sunset Clause.”

GAO study to be completed within 2 years of the date of enactment which would include a recommendation as to whether a “Sunset Clause” should be enacted.

Ongoing Senate Negotiations:

The Senate also has been considering the home loan modification legislation. Senator Richard Durbin (D-Ill.), the Democratic Majority Whip, is the primary proponent of S.61, the Senate version of the legislation. In the past several days, Senator Durbin has been engaged in serious negotiations with lobbyists representing the Credit Union National Association, JP Morgan Chase, Wells Fargo, Bank of America, and with consumer

groups led by the Center for Responsible Lending. Final details of the proposal are still undecided, but the following are some major issues of contention that I have been able to extract from news services:

- 1) The legislation would apply only to mortgages that were in existence prior to January 1, 2009, not those that were originated thereafter.
- 2) The loan amount must be equal to or less than \$729,750.00.
- 3) If, through a government program, there was an offer to modify a loan, that mortgage would only qualify for “cramdown” if the borrower were still at risk of defaulting after the modification. Then, the bankruptcy judge would only have the power to change the interest rate or the mortgage terms, not the principle amount of the loan. Alternatively, the “cramdown” provision would not be available to a debtor if the lender offered to modify the mortgage through the Treasury Department’s new foreclosure mitigation program.
- 4) Another alternative proposal would limit “cramdown” to only 90% of the amount of the mortgage indebtedness.
- 5) If the primary residence appreciated in value after “cramdown” and was sold, the debtor and the lender would divide the appreciated profit equally, presumably throughout the life of the plan.
- 6) The provisions of the legislation would sunset in 2014.

In an effort to generate support for the legislation, Senator Durbin has discussed making permanent the temporary increase in deposits insured by the Federal Deposit Insurance Corporation to \$250,000.00 from \$100,000.00. In addition, there was a proposal to increase the F.D.I.C.’s credit line with the federal government from \$30 billion to \$100 billion, thus enabling regulators to reduce a proposed special premium that banks would owe the F.D.I.C. later this year by more than 50% - a \$7.7 billion savings.

According to Senate Democratic Conference Vice-Chairman, Senator Charles Schumer (D-NY), the Senate might consider a contentious credit card bill and the bankruptcy home loan modification bill as amendments to a broader banking measure. The credit card bill protects card holders from arbitrary interest rate spikes. This is the same banking legislation, mentioned earlier, which includes the provision that permanently gives the F.D.I.C. the power to insure bank deposits up to \$250,000.00. Senator Schumer also said that Democrats involved in the negotiations think that there will be a floor vote on the bankruptcy bill regardless of the outcome of the negotiations.

The National Association of Federal Credit Unions (NAFCU) indicated that it would oppose the home loan modification legislation. NAFCU would like to limit “cramdown” to sub-prime and non-traditional loans, a proposal similar to a measure approved by the House Judiciary Committee in 2007 that later stalled. Both Senator Schumer and Senator Durbin have said that they would not accept such limitations because the housing crisis has affected prime mortgages, as well as, the “at risk” mortgages.

Later, the news services reported that the credit unions’ objection may be withdrawn. Apparently, because of their precarious financial circumstances, many credit unions may need “bailout” funds which may not be forthcoming if their opposition to “cramdown” is not retracted.