



## Bulletin

# Reconsidering Mortgage Cram-down in Bankruptcy

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**O**n May 19, 2009, President Obama signed into law the Helping Families Save Their Homes Act, which is also known as the Mortgage Reform Act. Representing the federal government's first major effort to help homeowners avoid foreclosures as a result of the economic crisis, the act has significantly affected how the mortgage lending industry operates.

The law amended the federal Truth in Lending Act to create a safe harbor from liability for servicers and other parties in connection with entering loan modifications and other loss mitigation plans. It also instituted new foreclosure prevention initiatives for the Federal Housing Administration's (FHA's) single-family loan program and new protections from foreclosure for bona fide tenants.

Despite these and other new protections provided by the Mortgage Reform Act, the law is just as noteworthy for what it does not do. Indeed, the version of the bill that first emerged from the House of Representatives included a provision that would have empowered bankruptcy judges to "cram-down" on mortgage lenders by lengthening the terms of mortgages, cutting interest rates, and reducing the mortgage balances of bankrupt homeowners to reflect the reduced value of their homes in the aftermath of the housing crisis.

This measure, which was considered by many as an essential element of any serious effort to stave off the wave of foreclosures sweeping the country, was vigorously opposed by the banking industry. Ultimately, the mortgage cram-down provision was voted down by

the Senate on a 45-51 vote and did not make its way into the final version of the law.

A year after the passage of the Mortgage Reform Act, it is clear that the measures enacted by Congress have not gone far enough to forestall the rising tide of foreclosures. Foreclosure notices jumped 19 percent in March 2010 from the previous month and ended the first quarter of this year 7 percent higher than the last quarter of 2009.

In light of these troubling developments, the Obama administration recently announced a plan that would allow homeowners who owe more on their mortgages than their homes are worth to obtain new loans backed by the FHA. The program would be funded by \$14 billion from the administration's existing \$75 billion foreclosure prevention program.

While this new program undoubtedly will bolster the government's ongoing effort to keep families affected by the financial crisis in their homes, it is becoming increasingly clear that simply throwing additional federal dollars at this problem will not be enough. The time has come for Congress to reconsider the role that bankruptcy judges can play given the rising tide of foreclosures.

### Bankruptcy Unkind to Struggling Homeowners

Historically, the bankruptcy process has not been kind to struggling homeowners. While bankruptcy judges have broad authority to reduce and eliminate creditor claims under both Chapter 7 and Chapter 13 of the U.S.

Bankruptcy Code, they are powerless to do so when the debt is secured by a debtor's primary residence. This anomaly is a result of the Supreme Court's 1996 *Nobleman* decision, which held that if a homeowner declares bankruptcy, then a judge has no right to modify the mortgage. As a result of this Supreme Court decision, lenders have been inclined to resist any efforts to modify the terms of a loan outside of bankruptcy.

Because mortgage lenders don't have to worry that a debtor will be able to reduce or discharge a mortgage through a bankruptcy proceeding, they have no reason to work voluntarily with homeowners impacted by the financial crisis to avoid foreclosure. The result is that homeowners who fall behind on their mortgages are between the proverbial rock and a hard place. The lenders' stance is a bit surprising because homes sold at foreclosure often sell for much less money than they would through a non-foreclosure sale.

Further complicating matters is the fact that many homes are subject to more than one mortgage. If the terms of a mortgage are changed through an agreement between the primary lender and the homeowner, the secondary mortgage could be wiped out, leaving the second lien holder with nothing. In these instances, second lien lenders are likely to fight any loan modification that does not spread the loss among the first and second mortgage holders and ensure some return to the second lien holder.

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First and second lien lenders are currently clashing over how voluntary mortgage modifications should take shape, which, in conjunction with banks' general disincentive to modify mortgage terms, has rendered the federal government's mortgage relief efforts to halt foreclosures ineffective.

The result has been a steady stream of mortgage defaults and foreclosures that shows no sign of slowing down, notwithstanding the start of a recovery in other parts of the economy. This is strong evidence that relying solely on the Mortgage Reform Act and the recent additional measures enacted by Congress and the Obama administration to solve the problem will not work.

Unless bankruptcy judges are empowered to amend existing mortgages to reflect the present value of a debtor's home, then the intransigence of and internecine conflict between mortgage providers will preclude cooperative loan modifications from occurring on the scale necessary to end the foreclosure crisis. Moreover, if homeowners are forced to declare bankruptcy because of an inability to pay other debts, then under the current scheme they will lose their home in most states.<sup>1</sup> Accordingly, maintaining the status quo means more foreclosures are in the offing.

### A Softening in Attitudes

In the face of the recent dismal foreclosure statistics and in light of the current enmity toward the banking industry, certain major mortgage lenders are beginning to soften their stance with respect to the addition of a loan modification provision to the Bankruptcy Code.

Barbara J. Desoer, president of Bank of America Home Loans, testified before the House Financial Services Committee on April 14 that her bank now supports a change to the bankruptcy law to allow for the modification of mortgages by bankruptcy judges. She said that "for a segment of borrowers that is the appropriate alternative," provided that such borrowers had already gone through the Home Affordable Modification Program, the Obama administration's main foreclosure prevention program.<sup>2</sup> Bank of America Home Loans accounts for about 20 percent of the U.S. mortgage origination market.

In addition, Citibank reportedly favors empowering bankruptcy judges to modify mortgage loans, so long as homeowners are required to seek a voluntary modification first.<sup>3</sup>

However, even with certain major players changing their tune, enactment of a mortgage cram-down provision will not be easy, as opposition persists from other prominent lenders. At the April 14 Congressional hearings, representatives from JP Morgan and Wells Fargo reiterated their resistance to such a change.

"I think you'd have to ask yourself whether a change in bankruptcy law is really the best way — and the fastest way — to achieve assistance for homeowners...I think there's other alternatives," said Mike Heid, co-president of Wells Fargo Home Mortgage.

David Lowman, CEO of Chase's home lending group, argued that allowing modifications of home loans after the fact would decrease lenders' willingness to lend in the first place. Lowman asked the panel rhetorically, "If we rewrite the mortgage contract retroactively to restore equity to any mortgage borrower because the value of his or her home declined, what responsible lender will take the equity risk of financing mortgages in the future?"

Notwithstanding Chase's evocation of the "parade of horrors" that will befall the mortgage market if a cram-down provision is added to the Bankruptcy Code, the tide appears to be turning. As the increasing number of foreclosures continues unabated, it has become clear that adding a mortgage cram-down provision to the Bankruptcy Code is necessary to give lenders the incentive they need to modify underwater mortgages on a voluntary basis outside of bankruptcy.

Moreover, such a provision will have other benefits, as it will enable homeowners who may need to file bankruptcy for other reasons to avail themselves of the process without fear of losing their homes. Reconsideration of this once-controversial proposal will likely provide the crucial missing piece of the regulatory scheme originally contemplated by Mortgage Relief Act, leading to a reduction of residential foreclosures and further spurring the economic recovery. ■

<sup>1</sup> In five states, Texas, Florida, Iowa, Kansas, and South Dakota, debtors are authorized to protect an unlimited amount of home equity from the claims of creditors in bankruptcy. In the other 45 states, homestead exemptions impose some form of dollar limitation upon the debtor's exemption.

<sup>2</sup> See House Committee on Financial Services Full Committee Hearing: Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program, webcast available at [www.house.gov/apps/list/hearing/financialsvcs\\_dem/hr\\_040510.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr_040510.shtml).

<sup>3</sup> See Reich, Robert, "Why Citi Turned Around on Mortgage Cram-downs," [www.laprogressive.com/economic-equality](http://www.laprogressive.com/economic-equality)

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