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Several Proposed Amendments to the Bankruptcy Code Seek To Permit Mortgage Loan Modifications

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Several members of Congress have introduced competing bills to amend the Bankruptcy Code, and allow judges to modify certain mortgages in a Chapter 13 bankruptcy. The four bills share one essential feature: each would allow a bankruptcy judge to "strip down" a mortgage loan on a primary residence to the home's current value, if the property is worth less than the total outstanding amount of the debt.

Generally speaking, the total allowable claim of a secured creditor can be modified in bankruptcy to the value of the property securing the claim, with any remainder being "stripped down" to the priority of an unsecured claim.[1] For example, a claim of $100,000 secured by property with a current value of $75,000 is to be treated as a secured claim for $75,000 and an unsecured claim for $25,000. However, under §1322(b)(2) of the Bankruptcy Code, a bankruptcy judge cannot "modify the rights of holders of secured claims … secured only by a security interest in real property that is the debtor's principal residence …." Thus, if our example above applied to a secured claim by a mortgage lender on a debtor's principal residence, under §1322(b)(2), the allowed secured claim would be $100,000, even if the home was now worth only $75,000. All four bills would alter or eliminate § 1322(b)(2), but to differing degrees.

THE DURBIN PLAN

Two of the pending bills, Senate Bill S. 2136, sponsored by Sen. Richard Durbin, D-Ill. (the 'Durbin Plan"), and the similar House Bill H.R. 3609, sponsored by Rep. Brad Miller, D-N.C., contain provisions that threaten to significantly affect the claims of secured mortgage lenders in a Chapter 13 bankruptcy. Under the Durbin and Miller proposals, the § 1322(b)(2) prohibition would be eliminated entirely. The Durbin Plan gives the court the further power to determine which interest rate will apply on the modified mortgage, and to modify the life of the loan beyond the duration of the Chapter 13 plan, even beyond the original term of the mortgage note. Moreover, the debtor or U.S. Trustee could bring claims against a secured lender, and the entire secured claim can be disallowed if the mortgage lender violated any provisions of the Truth in Lending Act or any other state or federal consumer protection law.

THE SPECTER PLAN

The other two bills, Senate Bill S. 2133, sponsored by Sen. Arlen Specter, R-Pa., and the nearly identical House Bill H.R. 3778, by Rep. Steve Chabot, R-Ohio

1 *See* 11 U.S.C. § 506(a)(1).

(collectively the "Spector Plan"), would permit the § 1322(b)(2) prohibition to be enforced under certain circumstances, for example, if the debtor meets certain monthly income requirements, or if there is an enforceable agreement in writing between debtor and the mortgage lender. Moreover, under the Specter Plan, it would be the Chapter 13 plan, and not the bankruptcy court, that would have the power to modify home-mortgage interest rates, and only to a limited degree. Unlike the Durbin Plan, the Specter Plan would not allow mortgage payments to be extended beyond the term of the mortgage note.

ALL FOUR PLANS MAY HAVE A SIGNIFICANT IMPACT ON MORTGAGE BACKED SECURITIZATIONS

By allowing courts to retroactively modify mortgage loans, all four proposals threaten to have a significant impact on the MBS market, and to increase the risk of litigation. For example, in securitizations involving GSE's, such as Ginnie Mae, servicers are required to repurchase modified loans at par (e.g., the amount of the principal balance), and to avoid losses on those loans, servicers typically re-securitize modified loans, since voluntary modifications bring the loan current.[2] It is doubtful that mortgages modified in bankruptcy could be re-securitized, and, as a result, servicers will likely be forced to place such modified loans on their own books and bear the principal loss. (*Id.*) Moreover, because pooling and servicing agreements in private securitizations typically contain restrictions on modifications, as well as minimum standards for a loan's stated value, interest rate and term, there is a risk that judges could modify loans in a manner that conflicts with these terms, increasing the risk of an event of default and creating uncertainty on who should bear the loss on such loans. Similarly, the risk that a judge could modify loan variables such as interest rate and term may affect the modeling and performance assumptions made by investors, ratings agencies and investment advisors, which could call that modeling into question. As a result, all four proposals could result in additional downgrades of securities, and increase the risk of financial loss and litigation. (*Id.*)

2 *See* Statement of David G. Kittle, Chairman-Elect, Mortgage Bankers Association, Before the Subcommittee on Commercial and Administrative Law Committee on Judiciary, United States House of Representatives (October 30, 2007).

If you have any questions about the issues raised in this article or would like more information, please contact your Arnold & Porter attorney or:

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