Joint Memo for Proposed Bankruptcy Law Reform:

Solutions to Preserve Homeownership

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The Center for Responsible Lending, Consumer Federation of America, National Association of Consumer Advocates, National Association of Consumer Bankruptcy Attorneys and National Consumer Law Center jointly provide the following analysis of needed reforms. In the face of rising subprime mortgage foreclosures, we have been working to find a way to save the homes of borrowers who are stranded in loans that have exploding interest rates and monthly payments and are now widely recognized as improper. We have developed a proposal for modifying the Bankruptcy Code to provide urgently needed relief; our proposal and its necessity are explained below.

The Problem

As 2006 drew to a close, 2.2 million households in the subprime market had either lost their homes to foreclosure or held subprime mortgages that likely will fail over the next several years absent intervention. These foreclosures will cost these families their homes, along with up to $164 billion in lost wealth.[1]

Borrowers currently in a 2/28 hybrid adjustable rate mortgage loan typically face a 30% or greater payment increase during the third year of the loan, even if interest rates in the economy stay exactly the same. Most will be unable to afford an increase of this magnitude. These borrowers were put into loans they cannot afford, often having been steered away from the sustainable loans for which they would have qualified.[2] The current options of these victims of predatory lending are limited to the following:

(1) Continue to make payments on the loan at the higher rate. Few can successfully continue in their loans because the debt- to-income ratios were unsustainably high even at the introductory "teaser" rates – often 50% to 55% of monthly income. As a result, the prospect of paying an additional 30% or more on their mortgage is not viable; for many borrowers, the increased payment will approach or exceed their total net monthly income after the interest rate adjustment.

(2) Sell the house. For many borrowers selling their house is not a solution because the loans were underwritten with such high loan-to-value ratios that with the slow-down (or reversal) of home price appreciation, possible appraisal fraud, and the equity-stripping common to these

loans, the sale would not net sufficient proceeds to cover the outstanding debt and any applicable prepayment penalties, which are included in over two-thirds of subprime loans.

(3) Refinance into another loan. The refinancing option is now largely unavailable, both because many borrowers lack sufficient equity to support a refinancing, and because many of the lenders that extended these loans are themselves filing for bankruptcy.[3]

(4) Negotiate with the lender for a loan modification, workout or loss-mitigation program. Working with their present servicer is often difficult to achieve because the loans are now held in trusts by many investors, presenting impediments, both legal and economic, to such agreements. In the bankruptcy context, reducing the outstanding balance of an unaffordable subprime home loan has the additional benefit of creating no taxable income event for the homeowner. In general, a creditor's write-down of a borrower's loan balance as part of a loss mitigation or loan restructuring is considered "income" under the tax code. Hence, a borrower who benefits from a loan modification of this sort may face the uncertainty of a potential tax assessment a year or so later, once again putting the home in jeopardy. The tax code has a specific income exclusion for loan reductions in a bankruptcy action.[4]

(5) Foreclosure. For increasing numbers of borrowers, foreclosure is the only option available. Center for Responsible Lending research projects that 20% of subprime loans originated in 2006 will end in foreclosure.[5] Lehman Brothers Equity Research puts the number at 30%.[6]

The first four options are unavailable to many borrowers, and the last entails financial disaster, and for some number of borrowers, loss of all family wealth and even homelessness.

The only chance many of these borrowers have is through declaring bankruptcy. The problem is that as currently enacted, the Bankruptcy Code favors home mortgage lenders over all other secured and unsecured creditors.[7] The amendment disfavoring protection of the debtor's principal residence was added at a time – 1978 – when home mortgages were nearly all fixed-interest rate instruments with low loan-to-value ratios and were rarely themselves the source of a family's financial distress. As a result, bankruptcy law singled out the home mortgage loan as the major debt for which the bankruptcy court is powerless to provide relief. Since that time, the mortgage market has shifted considerably. Subprime lending practices of the last six years, which have relied on property appreciation, and in many cases appraisal fraud, have left many borrowers with mortgages larger than the value of their homes. If the borrowers cannot restructure these debts, then they cannot get back on their feet financially.

We are not alone in pointing to the problems associated with current bankruptcy rules harming the ability of families to retain their homes. Credit Suisse issued a report stating that there would be an increase in foreclosure filings (and corresponding investor losses) as the new law barred any realistic option of filing for bankruptcy. Credit Suisse concluded that: "the bottom line is that new bankruptcy law appears to be harming mortgage borrowers, and for investors, this should result in rising losses."[8] These problems have prompted our proposal to modify Chapter 13.

Brief Summary of Relevant Bankruptcy Provisions

Bankruptcy enables troubled debtors to seek relief from their debts. Typically, a debtor files for bankruptcy in order to forestall foreclosure, repossession or debt collection litigation. Consumer bankruptcy functions as a form of social safety net, providing an equitable distribution of resources among creditors, and enabling debtors to get a fresh start. Generally, individual debtors can choose between filing under Chapter 7 and Chapter 13. Chapter 7 contemplates the liquidation of the debtor's non-exempt assets for the benefit of creditors, and the release of the debtor from further liability on most unsecured debts. In Chapter 13, the debtor establishes a plan for repaying a portion of her debts out of future earnings over a three to five year period, after which, most unsecured debts are discharged.

The problem with Chapter 7 is that, absent the lender's acquiescence, it does not permit the borrower to keep the house if there has been a default before the case is filed. Moreover, the 2005 amendments to the Bankruptcy Code make it more difficult for borrowers to file Chapter 7 cases, so many are forced into Chapter 13. This brings us to the problem with Chapter 13.

As currently drafted, Chapter 13 singles out home mortgage lenders for special protection that makes the home mortgage virtually the only debt that the court cannot modify and therefore the home the only asset it cannot protect. As the home is typically the largest and most important asset a family has, and the home mortgage loan is the family's largest single debt, the exclusion of the principal residence from modification prevents bankruptcy protection from reaching where it is needed most. In light of this fact, it is not surprising that most Chapter 13 plans fail.

The way Chapter 13 works is that the secured and unsecured debts are divided into two separate classes, and within each class, all creditors are treated the same. Most secured debts (e.g., cars, furniture) are preferred over unsecured debts (credit cards, installment debt), and are paid in full to the extent of the value of the collateral. For example, if a borrower owns an older car valued at $2,000, and the car secures a $4,000 loan, the first $2,000 of the debt is secured, and the rest is put into the class of unsecured debts, and paid pro rata along with the unsecured creditors.

The relevant provision is found at 11 USC §1322(b)(2), which empowers the court to "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of unsecured claims…" (emphasis supplied). "Modification" can entail reducing part of the principal balance, reducing the interest rate, or extending or altering the repayment schedule. The ability to modify the debt is possible for virtually every type of debt except for the mortgage on the borrower's primary residence. One might expect that the home would be the most protected asset because it is the most fundamental, as reflected in the policy considerations that have led to state homestead exemptions, but the opposite is the case in the current federal bankruptcy law.

For years, bankruptcy courts found ways around the provision's harsh result by finding exceptions to the blanket prohibition on modifying home mortgage loans – by, for example, finding that the exemption applies only to extent that the outstanding loan balance does not exceed of the value of the home, or, because the rationale for the home mortgage exception was the need to incent home mortgage lending to facilitate home purchases, finding that it only

applies to purchase money lending and not refinances. These "fixes" ended with the 1993 Supreme Court case of *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993), in which the Court held that bankruptcy courts must apply section 1322(b) according to its express, literal terms. The practical effect of the current bankruptcy law is that borrowers stuck in unaffordable home loans must repay the loans according to their terms or lose their homes. No other creditor—in personal bankruptcy or business bankruptcy—can leave a borrower in such a position.

Not only is this policy unwise; it is unjust. Because the home mortgage exemption applies only to primary residences, borrowers wealthy enough to own two homes can obtain relief from the mortgage on their second home, thereby retaining at least one shelter for their family. Nor does the exemption apply to the homes of family farmers, who file under Chapter 12, or to commercial real estate owned by businesses filing under Chapter 11.[9] The law thus deprives mostly low-wealth and middle class families from protections available to all other debtors.

Proposed Fixes to the Bankruptcy Code

A. Addressing the Code's special treatment of home mortgage loans

In order to address problems resulting from the Code's disempowerment of bankruptcy judges to modify home mortgage debt, Congress should eliminate the exception, putting home mortgage loans in parity with other secured debt:[10]

1322 Contents of plan

. . . .

(b) Subject to subsections (a) and (c) of this section, the plan may –

(2) modify the rights of holders of secured claims, ~~other than a claim secured only by a security interest in real property that is the debtor's principal residence,~~ or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

There are strong policy reasons for protecting all home loan borrowers, as opposed to just a subset of homeowners, such as those with subprime loans.[11] It is important to recognize that making all home loans subject to modification will have no effect on most prime mortgages. The bankruptcy provisions have their bite only when the loan-to-value ratio exceeds 100%. When the lender has been more careful, then a debtor's bankruptcy will have no effect. Only when a lender has extended debt that is both secured and unsecured, would the change in the law have any effect.

Some prime lenders might welcome the change because it would corral second and third mortgages and home equity lines of credit added after the initial mortgage was granted. A prime lender typically prefers to see a homeowner remain in a home and continue making payments on the original terms. To the extent a second mortgage or home equity line of credit puts the home in jeopardy, the changes in bankruptcy law would facilitate the strip down of the subsequent mortgage, leaving the first mortgage intact.

Giving mortgage protection to all families is good policy. A family that finally makes it out of the subprime market into prime should not be <u>more</u> at risk for losing the home than before. Nor is it desirable to deny this fundamental protection to prime borrowers who are barely holding onto the middle class. Finally, as the law currently provides opportunities for the rich to retain their vacation homes, it is difficult to see why everyone should not get the chance to hold onto at least one home.

B. Removing obstacles to entering Chapter 13

As a result of the 2005 amendments to the Bankruptcy Code, there are now several hurdles a debtor must clear in order to file for Chapter 13 bankruptcy, as Credit Suisse notes in its analysis of the impact of the 2005 amendments on subprime borrowers and the subprime market.[12] For example, as a result of the 2005 amendments, an individual cannot even meet the definition of a "debtor" (and so cannot file for bankruptcy) without first receiving credit counseling from an approved credit-counseling agency either in an individual or group briefing. Requirements like these cost precious time, which a borrower facing foreclosure cannot afford to lose, and were clearly not designed for dealing with an immediate crisis regarding the borrower's home.

There have also been serious problems with the provision in the 2005 Act that was intended to permit a deferral of the pre-bankruptcy counseling in "exigent circumstances." To be eligible under § 109(h)(3) for a deferral of the pre-petition credit counseling briefing requirement, each of the following three requirements must be satisfied: (1) the debtor's certification must describe exigent circumstances that merit a waiver; (2) the certification must state that the debtor requested credit counseling services from an approved agency, but was unable to obtain the services during the five-day period beginning on the date on which the debtor made the request; and (3) the certification must be satisfactory to the court. Some courts have denied the deferral requests and found that no exigent circumstances exist based on the view that the consumer received sufficient advance notice of a pending foreclosure and should have taken action sooner. *In re* Dixon, 338 B.R. 383 (8th Cir.BAP 2006). This ignores the fact that consumers are often making their best efforts to resolve a foreclosure with some kind of workout option right up until the foreclosure and delays may be caused by the lender's failure to promptly respond.

The remedy to the counseling requirement is simply to exclude it for debtors facing foreclosure:

Section 109 – Who may be a debtor

. . .

(h)(1) Subject to paragraphs (2), (3), (4) and (5), and notwithstanding any other provision of this section, an individual may not be a debtor under this title unless such individual has during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.

. . .

(5) The requirements of paragraph (1) shall not apply with respect to a debtor who submits to the court a certification that the holder of a claim secured by the debtor's principal residence has initiated a judicial or nonjudicial foreclosure on the debtor's principal residence.

The procedure for requesting a waiver as set out in the proposed change is consistent with the existing waiver provisions in § 109(h).[13] The proposal provides for a waiver of the pre-bankruptcy counseling requirement for borrowers facing foreclosure rather than a deferral of the requirement until after the bankruptcy is filed.[14]

C. Payment amounts under chapter 13 plans

Another problem with the 2005 amendments to the Bankruptcy Code is a provision that requires payments to secured creditors under a consumer's chapter 13 plan be made in "equal monthly payments." 11 U.S.C. § 1325(a)(5)(B)(iii). Some courts have construed this language to prohibit a plan that would permit the debtor to pay off the claim of a home secured lender by making a final balloon payment for the balance owed on the claim at the end of the plan with the proceeds of a refinancing. Even if the stripped down mortgage can be reamortized as we propose, an amendment to the equal monthly payments provision will help some consumers get the benefit of the mortgage strip down during the chapter 13 process.

Requiring equal monthly payments to all secured creditors, including homeowners, makes it harder to save a home because it reduces plan flexibility. The solution is to limit the application of the equal monthly payments provision to secured claims on personal property, thereby exempting homeowners from the provision:

§ 1325. Confirmation of plan

. . .

(iii) if the holder of the claim is secured by personal property --

(I) property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly amounts; and

(II) ~~the holder of the claim is secured by personal property,~~ the amount of such payments shall not be less than an amount sufficient to provide to the holder of such claim adequate protection during the period of the plan;

D. Possible amendments to chapter 7

One problem facing debtors who are trapped in high cost loans is the inability to refinance out of those loans. So, for example, a debtor who owes 125% LTV on a home must come up with a lender who will finance a 125% LTV mortgage—leaving the debtor in much the same difficulty. The inability to strip down a high loan to value mortgage gives the first lender a stranglehold over the debtor, as payments and fees rise and the debtor's only option is to give up the home.

Chapter 7 (the "Liquidation" route) has long had a provision to deal with such creditor leverage. The law currently provides borrowers with an opportunity for "redemption" of tangible personal property (*see* 11 USC § 722). Redemption entails paying the secured creditor an amount equal to the current value of the property (i.e., giving the creditor what it could obtain by selling it—100% of its current liquidation value). Currently redemption applies only to "personal " property (e.g. furniture, cars), but not to real property, like the home.

Set out below is a proposal to amend section 722 to permit all home loans to be redeemed. This proposal would allow the borrower to remain in the home, and be released from the debt, upon paying the creditor 100% of the liquidation value for the home. Redemption will not be a solution for every family because of the difficulty of coming up with the money to refinance the home. But for those borrowers who could arrange financing (for which the new lender would be fully secured), redemption would provide a way out. There would be little basis for the initial lender to complain: after all, that lender would be paid in full the secured amount of its loan, the same amount that it would have received had it gone through with foreclosure, with no need to complete the foreclosure. The remaining unsecured portion of the debt would be treated like any other debt in chapter 7, which means that it would be discharged or paid a pro-rata portion from the debtor's other assets.

The proposed modification is reflected in the underlined text below:

722 - Redemption

An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem the debtor's principal residence or tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 of this title or has been abandoned under section 554 of this title, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien or the liquidation value of such property, whichever is less, in full at the time of redemption.[15]

E. Clarification of the bankruptcy court's loan modification authority

If the Code is amended to empower the court to modify home loans, as it can almost all other secured loans, there will remain room for debate about what a reasonable modification would be.

Interest rate and term modification

The Code does not specify the interest rate a bankruptcy court should use. In *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004), the Supreme Court held that in modifying the interest rate payable on an outstanding car loan, the bankruptcy court should use the prime rate, adjusted upward to reflect the risk associated with lending to the bankrupt borrower, 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". Since the prime rate is used for car loans but not home loans, we would propose to using an index referring to the Freddie Mac average interest rate on 30-year fixed rate mortgages, plus half of one percent as a risk premium.

Under existing chapter 13 law, secured creditors must be paid the value of their allowed secured claim within the three to five year duration of the plan. However, chapter 12 of the Code allows a family farmer to extend repayment of secured debt, regardless of the original amortization, over a period beyond the life of the chapter 12 plan. Thus, the proposal to permit modification of home secured loans in chapter 13 will not benefit most consumer debtors unless there is a change made similar to the provisions in chapter 12 that permit reamortization. This is because most

consumer debtors, unless they obtain a new loan during the chapter 13 plan, cannot pay the full mortgage indebtedness of as much as several hundred thousand dollars during the plan. An amendment that tracks currently existing authority for chapter 12 family farmer bankruptcy debtors to modify loans, and includes the interest rate modification, would provide:

Add new section 1322(b)(11) (and renumbering 1322(b)(11) as (b)(12)):

(11) provide for payment of allowed claims secured by the debtor's principal residence consistent with section 1325(a)(5) of this title, over a period of up to 30 years from the date of the petition, except that payment of interest accruing after the date of filing of the petition on such claims shall be in an amount equal to half of one percentage point greater than the most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as published in statistical release H.15 or any publication that may supersede it, as of the applicable time set forth in 12 C.F.R. 226.32(a)(1)(i).; and

In addition, add at the beginning of section 1325(a)(5): except as otherwise provided by section 1322(b) of this title.

Excessive fees during bankruptcy

Another necessary change is a provision to control the enormous problem of mortgage companies adding unauthorized or excessive fees to the accounts of debtors who are in chapter 13. Many of these debtors emerge from a chapter 13 case after three to five years of struggling to cure an arrearage only to have the lender assert that they are several months behind on their payments due to fees for such items as attorney's fees, broker price opinions, and other charges allegedly incurred during the chapter 13 case, and which they were never informed of before. Many bankruptcy courts have decried these abuses, but usually they go unremedied because the bankruptcy case is over and the debtor has no money to litigate about them. Sometimes, the fees are not even revealed to the debtor until the debtor pays off the mortgage balance upon selling the home or refinancing.

A provision to remedy the problem of excessive fees could provide that all fees and charges based upon occurrences during the pendency of a chapter 13 case must be approved by the court:

A new section 1322(c)(3) would provide:

No fees, expenses, or charges shall be added during or after the bankruptcy case to any secured debt provided for by the plan based upon any occurrence during the bankruptcy case unless such fees or charges are approved, as reasonable, lawful, and provided for by the underlying contract, by the bankruptcy court after notice and a hearing. Such fees, expenses or charges shall only be added to the secured debt to the extent that the secured debt is secured by property the value of which is greater than the amount of such claim. The failure of a party to obtain such approval shall be deemed a waiver of any claim for such fees, expenses or charges for all purposes, and any attempt to collect them shall be deemed a violation of section 524(i) of this title.

F. Other possible amendments

Debtor's legal claims
Legal claims against third parties are property of the debtor that is frequently overlooked in bankruptcy cases. Failure to identify and list these claims on the bankruptcy schedules can have significant consequences. The debtor may be deprived of standing to pursue the claim either during or after the bankruptcy, or the doctrine of judicial estoppel may be invoked to prevent the debtor from pursuing the claim after the bankruptcy case is closed. See *Ajaka v. Brooks America Mortgage*, 453 F.3d 1339 (11th Cir. 2006). In some cases, this has prevented consumers from pursuing court actions against predatory lenders even when the consumers did not know they had such claims at the time the bankruptcy was filed. This amendment will prevent predatory lenders from escaping liability for their unlawful acts by allowing the debtor to proceed with the court action if the trustee does not move to be joined or substituted as a party in interest in the action.

§ 554. Abandonment of property of the estate

(a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

(b) On request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

(c) Unless the court orders otherwise, any property scheduled under section 521(1) of this title not otherwise administered at the time of the closing of a case is abandoned to the debtor and administered for purposes of section 350 of this title.

(d) Unless the court orders otherwise, property of the estate that is not abandoned under this section and that is not administered in the case remains property of the estate.

(e) In any action in State or Federal court with respect to a claim or defense asserted by an individual debtor in such action that was not scheduled as property under section 521(a)(1), the trustee shall be allowed a reasonable time to request joinder or substitution as the real party in interest. If the trustee does not request joinder or substitution in such action, the debtor may proceed as the real party in interest and no such action shall be dismissed on the ground that it is not prosecuted in the name of the real party in interest or on the ground that the debtor's claims were not properly scheduled in a case under this title.

Arbitration clauses
Mandatory arbitration clauses are found in many consumer contracts, including home mortgages. These clauses force consumers to submit their claims to an arbitrator who issues a final, binding ruling on the merits, with virtually no opportunity for judicial review. The enforcement of these arbitration agreements under the Federal Arbitration Act is often in direct conflict with the goal of bankruptcy jurisdiction to have one centralized forum for the prompt resolution of disputes affecting the bankruptcy estate. This conflict between the Bankruptcy Code and the Federal Arbitration Act has led most courts to hold that, at least as to core proceedings such as claims

and defenses raised as objections to a creditor's proof of claim, a bankruptcy judge may refuse to enforce an arbitration agreement and may stay any pending arbitration proceedings. In order to protect homeowners, both Fannie Mae and Freddie Mac have prohibited the use of arbitration clauses in home loans they purchase.

In order to prohibit the enforcement of arbitration clauses found in consumer contracts in bankruptcy proceedings, we recommend the following changes:

28 U.C.C. § 1334, Bankruptcy cases and proceedings

No written agreement for arbitration subject to the Federal Arbitration Act, 9 U.S.C. § 1 *et seq*., shall be enforceable in any civil proceeding arising under title 11, or arising in or related to a case under title 11, in a case filed by an individual debtor whose debts are primarily consumer debts.[16]

Homestead exemptions
A significant number of debtors facing foreclosure are elderly and have nonexempt equity in their properties because of low homestead exemptions in some states, either due to recent appreciation or the fact that their predatory mortgages were for less than the value of their properties. These debtors cannot save their homes by refinancing because they cannot afford the monthly payments that would be required, and cannot file chapter 13 cases to save their homes because current law would require paying the value of their nonexempt equity to unsecured creditors. They cannot even get chapter 7 relief because chapter 7 would cause them to lose their homes. The solution to this problem is a homestead floor for the elderly.

Statutory language would amend 11 U.S.C. § 522 to add a new 522(b)(3)(D) and amend 522(d)(1) as follows:

522(b)(3)(D): If the debtor, as of the date of the filing of the petition, is 55 years old or older, the debtor's aggregate interest, not to exceed $ 75,000 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence.

Section 522(d)(1) would be amended to read:

The debtor's aggregate interest, not to exceed $ 20,200 in value or, if the debtor is 55 years of age or older $75,000 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence, or in a burial plot for the debtor or a dependent of the debtor.

Home loans transferred by bankrupt lenders
The Code was amended in 2005 to protect consumers from the loss of their claims due to bankruptcy court sales of loan portfolios "free and clear" of those claims to third party purchasers. However, the new provision, section 363(o), may not extend to transfers of

portfolios pursuant to a chapter 11 plan. Language added as a new section 1129(a)(16) would prevent the evasion of the intent of section 363(o) through this device:

1129(a)(17): If the plan results in the transfer to a person of any interest in a consumer credit transaction that is subject to the Truth in Lending Act or any interest in a consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time) then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale under applicable nonbankruptcy law.

Consumer protection violations

A final possible amendment would be Senator Durbin's amendment that obtained significant support in the debate on the 2005 Act, disallowing claims in which lenders had violated consumer protection laws.

> Section 502(b) of title 11, United States Code, is amended--
>
> (1) in paragraph (8), by striking ``or'' at the end:
> (2) in paragraph (9), by striking the period at the end and inserting ";or" and
> (3) by adding at the end the following:
> "(10) the claim is based on a secured debt, if the creditor has failed to comply with any applicable requirement under section (c), (d), (e), (f), (g), (h), or (i) of section 129 of the Truth in Lending Act (15 U.S.C. §1639), sections 226.32 and 226.34 of Regulation Z (12 C.F.R. §§ 226.32 and 226.34) or any applicable state constitution, law or regulation that was in force at the time such debt was incurred".

Conclusion

Help is urgently needed for hundreds of thousands of American families at risk of losing their homes due to abusive home loans. For most of these families, bankruptcy is the only viable option to save their home, and this option will be available only if the Bankruptcy Code is revised to eliminate or limit the provisions that exclude home loans from bankruptcy protection. This current exclusion is contrary to sound policy, and operates to disadvantage low wealth and middle income borrowers as compared with family farmers, corporations, and debtors with sufficient wealth to own more than one home. If not changed immediately, up to two million borrowers will lose their homes, which usually constitute their life savings, through foreclosure.

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[1] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* ("*Losing Ground*") (Dec. 2006) at 3, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189

[2] A Freddie Mac researcher reports one out of five subprime borrowers could qualify for prime loans, (*see* Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005)), and a lending industry association recently acknowledged that many borrowers

placed into 2/28 mortgages could have qualified for thiry-year, fixed rate loans for a rate typically just 50 to 80 basis points (i.e., .5 or.8 of a percent) higher than the teaser rate on the loan they received. (*see* February 5, 2007 letter from CRL to Senators Dodd, Allard, Schumer, Reed and Bunning, attached as an exhibit to the Testimony of Martin Eakes before the U.S. Senate Committee on Banking, Housing and Urban Affairs, at p. 7 (responding to claims made by the Coalition for Fair and Responsible Lending (CFAL)), available at http://www.responsiblelending.org/pdfs/martin-testimony.pdf).

[3] S*ee e.g*., Gretchen Morgenson, *Crisis Looms in Market for Mortgages* , The New York Times (Mar. 11, 2007).

[4] Section 108 of the Tax Code sets forth the tax consequences of a discharge of indebtedness. It contains two key exclusions: A debt forgiveness/discharge is not income if it occurs in a Title 11 case (ie a bankruptcy case), or when the borrower is insolvent (see 26 USC sec. 108(a)(1)). Subsection108(d)(3) defines insolvent as where "the excess of liabilities over the fair market value of assets."

[5] *Losing Ground*, at 11.

[6] Lehman Brothers, *Mortgage Finance Industry Overview* (Dec. 22, 2006) at 1.

[7] In 2005 bankruptcy law was amended to treat purchase money loans for automobiles in the same fashion, but the dollar figures for such loans pale in comparison to the amount of a home loan and, depending on fair market value, the amount of equity associated with the residence. Moreover, such loans can still be modified with respect to interest rate and payment amounts.

[8] Credit Suisse, *Subprime HEAT Update* (March 8, 2007) at 12, 9.

[9] The family farm Chapter 12 corollary to section 1322(b)(2), found at 11 USC § 1222(b)(2), provides the bankruptcy court with power to "modify the rights of holders of secured claims, or of holders of unsecured claims…" Similarly, the corresponding provision of Chapter 11, found at 11 U.S.C. § 1123(b)(5), contains language identical to that in section 1322(b)(2), reaffirming the exemption for loans secured by the debtor's primary residence, but imposing no corresponding exemption for a company's principle place of business or any other property.

[10] In 2005 bankruptcy law was amended to treat purchase money loans for automobiles in the same fashion, but the dollar figures for such loans pale in comparison to the amount of a home loan and, depending on fair market value, the amount of equity associated with the residence. Moreover, such loans can still be modified with respect to interest rate and payment amounts.

[11] A narrower change would be to attempt to limit the modification to subprime, higher interest rate loans. In order to do that, it would remove "rate-spread" loans from the existing home mortgage exception. Rate spread loans are those that must be reported under the Home Mortgage Disclosure Act. This captures most, though not all, subprime loans.

This option would revise section 1322(b)(2) as follows:
1322 Contents of plan- . . .
(b) Subject to subsections (a) and (c) of this section, the plan may – . . . .
(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence that is not a loan for which the difference between the APR and the yield on Treasury securities having comparable periods of maturity is equal to or greater than 3 percentage points for first lien dwelling-secured loans, or equal to or greater than 5 percentage points for junior lien dwelling-secured loans, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

For the purposes of this section, "Comparable periods of maturity" shall mean the period equal to the shortest interest rate change date as defined by the loan agreement.

Note that the definition of comparable periods of maturity holds that if, for example, an adjustable rate mortgage loan has an initial interest rate change date (or reset period) after year two and then subsequent change dates every six months, then the comparable period of maturity would be the six month Treasury rate, as it is the shortest reset period as defined by the loan agreement. This definition deals with the problem of when lenders determine that a quickly adjusting ARM with an extremely short average life has a comparable maturity to a 30 year or 15 year Treasury note; depending on the shape of the yield curve, such a definition will not adequately capture loans that are high cost.

[12] See generally *Subprime HEAT Update*.

[13] This option provides relief for all home loans but could be limited in scope to subprime loans by inserting the following language: "a loan for which the difference between the APR and the yield on Treasury securities having

comparable periods of maturity is equal to or greater than 3 percentage points for first lien dwelling-secured loans, or equal to or greater than 5 percentage points for junior lien dwelling-secured loans. For the purposes of this section, "Comparable periods of maturity" shall mean the period equal to the shortest interest rate change date as defined by the loan agreement."

[14] To provide that a foreclosure filing by the creditor extends the borrower's deadline for receiving credit counseling until 60 days after the borrower has filed for bankruptcy, rather than gets rid of the requirement altogether, the following language could be used:

Section 109 – Who may be a debtor . . .
(h)(1) Subject to paragraphs (2) ~~and~~ ,(3)~~,~~ and (5), and notwithstanding any other provision of this section, an individual may not be a debtor under this title unless such individual has (a) during the 180-day period preceding the date of filing of the petition by such individual, or (b) if the holder of a loan initiated a judicial or nonjudicial foreclosure on the debtor's principal residence, during the 60-day period after the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.

To limit the scope even further to subprime loans, the following language could be used:
Section 109 – Who may be a debtor . . .
(h)(1) Subject to paragraphs (2) ~~and~~ ,(3)~~,~~ and (5), and notwithstanding any other provision of this section, an individual may not be a debtor under this title unless such individual has (a) during the 180-day period preceding the date of filing of the petition by such individual, or (b) if the holder of a loan for which the difference between the APR and the yield on Treasury securities having comparable periods of maturity is equal to or greater than 3 percentage points for first lien dwelling-secured loans, or equal to or greater than 5 percentage points for junior lien dwelling-secured loans initiated a judicial or nonjudicial foreclosure on the debtor's principal residence, during the 60-day period after the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.

For the purposes of this section, "Comparable periods of maturity" shall mean the period equal to the shortest interest rate change date as defined by the loan agreement.

[15] Our proposed language covers all home loans, not just subprime; this could be revised to cover just rate-spread home loans, if the decision is made to protect borrowers only in these loans.

[16] In the alternative, the clause could be limited to home loans by stating: "No written agreement for arbitration in connection with a loan or security agreement secured by the debtor's principal residence shall be enforceable in any civil proceeding arising under title 11, or arising in or related to a case under title 11, in a case filed by an individual debtor whose debts are primarily consumer debts."