Testimony of

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Before the Senate Committee on the Judiciary
Hearing on
"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"
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Mr. Chairman and members of the Committee, I am Mark S. Scarberry, Professor of Law at Pepperdine University School of Law and currently the Robert M. Zinman Resident Scholar at the American Bankruptcy Institute (ABI). I am pleased to appear today to speak about pending legislation that would amend the Bankruptcy Code (the "Code") to help homeowners avoid foreclosure.

Founded on Capitol Hill in 1982, the ABI is a non-partisan, non-profit association of over 11,000 professionals involved in bankruptcy and insolvency, representing both debtors and creditors in consumer and business cases. ABI is not an advocacy group and does not take lobbying positions on legislation before Congress or advocate any particular result in matters pending before the courts. Rather, the ABI is a neutral source for information about the bankruptcy system (such as how courts are interpreting provisions of the Bankruptcy Code) and a resource for members of Congress and their staff considering changes to the Code. As an academic, and as the ABI resident scholar, I am permitted to give my views on legislation, but those views should not be taken as the views of the ABI.

At Pepperdine, I teach and write primarily in the area of bankruptcy law, including both business and consumer bankruptcy. My C.V. is attachment 1 to this written statement, but let me briefly say that after graduating from UCLA Law School and working for four years in Los Angeles for the law firm of Jones, Day, Reavis & Pogue, I joined the faculty of Pepperdine University School of Law, where I have taught for the past twenty-five years. This semester I have served as the Scholar in Residence at the ABI in Alexandria, Virginia. I am the lead author of a chapter 11 business bankruptcy casebook published by Thomson/West. I have written training materials for a pro bono consumer bankruptcy program in Los Angeles, the Los Angeles County Bar Ass'n/Public Counsel "Debtor Assistance Project," and taught in its training programs, preparing lawyers to provide pro bono consumer bankruptcy services. I recently finished a law review article for the ABI Law Review on the Supreme Court's decision earlier this year in Travelers Casualty & Insurance Co. of America v. Pacific Gas & Electric Co.,1 a decision with both business and consumer bankruptcy implications. Today's subject is not new to me; fourteen years ago I published an article2 on the topic of home mortgage strip down just as the Supreme Court was deciding Nobelman v. American Savings Bank,3 which held that the Code prohibited strip down of home mortgages in chapter 13.

As the Resident Scholar at the ABI, I have studied the pending legislation introduced in both the Senate and House dealing with the mortgage crisis, including the four bills that would, to one extent or another, permit modification of home mortgages in chapter 13. I prepared a chart comparing the four bills. The chart, which I think has been widely consulted, is available on the ABI webpage, www.abiworld.org, and appears as attachment 2 to this written statement.

My testimony today will focus on the two Senate bills, S. 2133 and S. 2136. A key difference of course is that Senator Durbin's bill, S. 2136, allows a chapter 13 plan in some cases to reduce the amount of an undersecured mortgage to the value of the home without the consent of the mortgage holder, a result that is called "strip down." (Sometimes it is called "cramdown," but it is best to reserve that term for confirmation of a chapter 11 plan over the dissent of a class of claims or interests). Senator Specter's bill, S. 2133, would require consent of the mortgage holder before a chapter 13 plan could reduce the amount of the mortgage.

Thus I will begin by discussing the concept of home mortgage strip down and how the provisions of the Code presently do not permit it in cases under chapters 7, 11, or 13. Then I will explain why allowing home mortgage strip down in chapter 13, under the approach in S. 2136, would not simply treat home mortgage holders the same as other secured creditors but in fact much less favorably. Next I will explain why I prefer S. 2133's approach, allowing reduction of the amount of the mortgage only if the mortgage holder--or possibly the mortgage servicer--consents. A key reason is that strip down deprives the mortgage holder of the possibility of benefiting from a recovery in the real estate market and thus substantially changes the risk characteristics of the debt instrument.

Then I will suggest ways in which the bills might be improved. Substantive suggestions include targeting relief more precisely and also providing a clear benchmark for the setting of interest rates (so that costly, repetitive hearings with subjective outcomes can be avoided). On the technical side I will suggest that the bills address discharge issues and other issues dealt with by Representative Miller's bill, H.R. 3609.

Before getting into those areas of my testimony in detail, I would like to suggest the possibility that Congress could use its power to enact bankruptcy laws to help Treasury Secretary Paulson succeed in his attempt to provide more of a "wholesale" solution to the mortgage crisis, as compared to the one-case-at-a-time "retail" solution that might be provided by the bills before the Committee today. To the extent that mortgage servicers may lack authority to modify mortgages on a "wholesale" basis, under the process suggested by Secretary Paulson, such modifications may be unenforceable or may leave the servicers vulnerable to lawsuits filed by beneficial owners of the mortgages. Congress may wish to consider legislation that would validate such agreements when entered into under guidelines set by the Department of the Treasury and that would immunize servicers from liability for entering into such agreements.4 It is not clear that the bankruptcy courts could handle enough chapter 13 cases quickly enough to deal effectively with the current problems and those on the near horizon, even if one of the bills before the Committee were to be enacted quickly. A "wholesale" solution may be necessary if any effective legislative action is to be taken. To the extent that a "wholesale" solution may require modification of the rights of the beneficial holders of mortgages, the bankruptcy power may be a particularly appropriate basis for legislation.

Home Mortgage Strip Down Under the Bankruptcy Code

When the value of a secured creditor's collateral is less than the amount of the debt secured by the collateral, section 506(a) of the Code usually divides the secured creditor's claim into a secured claim for the value of the collateral and an unsecured claim for the excess. Under non-bankruptcy law, the secured creditor has a lien on the collateral for the entire amount of the debt (even though the value is less than the debt), and the debtor generally has no right to eliminate the lien simply by paying the value of the collateral. In some cases, bankruptcy law allows the lien on the collateral to be reduced to the value of the collateral. When that occurs, it is called a "strip down" of the lien. If the lien at issue is a mortgage on the debtor's home, we would use the term home mortgage strip down.

At about the time Congress enacted the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in 1989, circuit courts began holding for the first time that home mortgages could be stripped down in chapter 13.5 In 1992 a chapter 7 liquidation bankruptcy mortgage strip down case (not involving a home mortgage) reached the Supreme Court, followed the next year by a chapter 13 home mortgage strip down case. By that time, as I noted in my 1993 article, "strip down [was] becoming so widely used that it threaten[ed] to further damage the already weak home lending industry."6 In the 1992 case, Dewsnup v. Timm,7 the Supreme Court held that section 506(d) of the Code--a provision applicable to bankruptcy cases under all chapters of the Code (other than the new chapter 15) did not authorize strip down of liens. And in the 1993 case, Nobelman v. American Savings Bank,8 the Supreme Court held that section 1322(b)(2) prohibited home mortgage strip down in chapter 13.

The Supreme Court decided Nobelman on June 1, 1993. Two months later Congress extended the sunset date for the chapter 12 family farmer bankruptcy provisions--originally enacted in 1986--by five years, to October 1, 1998. (Subsequently, the sunset date was extended multiple times, with only a brief lapse, until chapter 12 was made permanent in 2005.) Although, as noted below, farm home mortgage strip down is permitted under chapter 12, the extension of its sunset date does not seem to have signaled disapproval of Nobelman; the next year, in 1994, Congress amended section 1123(b) to ensure that home mortgage holders received the same protection in chapter 11 cases that they received under Nobelman in chapter 13 cases.

Why Allowing Home Mortgage Strip Down in Chapter 13 Under S. 2136 Would Treat Mortgage Holders Less Favorably Than Other Secured Creditors

It is often said that allowing home mortgage strip down in chapter 13, under an approach like that in S. 2136, would simply treat holders of home mortgages the same as other secured creditors, such as holders of mortgages on vacation homes. That is not, however, the case.

If a secured creditor's lien is stripped down under the current provisions of chapter 13, the stripped down amount must be paid off during the chapter 13 plan with interest--a period of no more than five years.9 Thus, as a practical matter, a debtor cannot strip down a first mortgage on a vacation home, because the payments needed to pay off even the stripped-down amount over five years will be too large. The rare debtor who could afford such large payments does not deserve bankruptcy relief.

Under S. 2136, however, a debtor could pay off a stripped-down home mortgage over a period that could be as much as nearly thirty years. Not only would strip down thus become feasible only for home mortgages, but the interest rate to which the holder of the home mortgage would be entitled for up to nearly thirty years would be set by the court rather than by the contract, and the home mortgage holder would have to wait for that very long time to receive full payment even of the stripped down amount. By contrast, other secured creditors whose liens are stripped down in chapter 13 are subject to a court-determined interest rate for no more than five years and cannot be required to wait longer to be paid.

Finally, many secured creditors other than home mortgage holders no longer are subject to strip down in chapter 13 after the 2005 amendments to the Code. Purchase money automobile lenders are subject to strip down only if the loan was made more than two and a half years (910 days) before the petition filing date.10 Home mortgages thus would be treated worse than the most common debt secured by personal property, even though Congress historically has recognized the importance of protecting real property secured lenders, and particularly home mortgage lenders.11

Why the Code Should Not Be Amended To Provide for Home Mortgage Strip Down in Chapter 13

I believe home mortgage strip down should not be permitted in chapter 13. Permitting home mortgage strip down would likely cause difficulties in the secondary mortgage market that is so important to the availability and affordability of home mortgages. In addition, permitting home mortgage strip down would cause unjustified harm to the holders of home mortgages and home mortgage related securities, with a negative effect on investors, including investors of modest means. These views are based mainly on two conclusions. First, as noted above, home mortgages would move from being protected to being treated less favorably than most other secured consumer debts. Second, home mortgage strip down would substantially change the risk characteristics of home mortgages, largely because of the likelihood that strip down would occur during a real estate market downturn when prices are depressed.12

Under the approach in S. 2136, home mortgage holders would not benefit from the upturn in the real estate market that ordinarily follows a downturn. Congress attempted, wisely in my view, to prevent such consequences in chapter 11 cases with regard to all kinds of collateral, by repealing former section 1124(3) (which permitted cashing out of a mortgage at a depressed market value) and by creating the section 1111(b)(2) election (which permits an under-secured creditor to elect to be treated as fully secured, though perhaps without much of the protective effect that Congress intended). At least some financially-distressed debtors who could, perhaps with difficult belt-tightening, afford to make their mortgage payments, will instead opt to strip down the mortgage in chapter 13. The later upturn then will provide equity for the debtor rather than a restoration of value to the mortgage. Under current law, after foreclosure the mortgage holder has the option hold the property and wait for it to appreciate. Home mortgage strip down eliminates that upside potential.

In addition, it seems likely that private mortgage insurance would not compensate home mortgage holders if the debtor strips down the mortgage in chapter 13 and avoids foreclosure. At least in the short run, strip down would deprive home mortgage holders of the benefit of the credit enhancement they bargained to receive, by way of private mortgage insurance.

Changing the risk characteristics of home mortgages retroactively in this way not only would likely depress further the value of the existing home mortgages. Increased risk would mean increased interest rates to compensate for the risk, and denial of mortgage credit to some who presently would qualify under appropriate underwriting standards. There also would be a shadow cast on the trustworthiness of American mortgage-backed securities. The implications are disturbing given that such securities are held worldwide by investors who count on the protection of property and contract rights under American law. Note that inclusion of a sunset provision might provide little comfort; the main lesson to be learned from inclusion of farm home mortgage strip-down in chapter 1213 is that provisions thought to be temporary often turn out to be permanent.

Substantive Suggestions with Regard to S. 2133 and S. 2136

Whether a mortgage modification bill is needed at all depends on whether the market will handle this crisis without Congressional intervention and on whether the homeowners who may lose their homes should be protected even at the risk of causing other harm (such as making it more difficult and more expensive for future would-be homeowners to obtain mortgages).

Should Congress decide to move forward with a bill, my substantive suggestions would be:

(1) not to include home mortgage strip down;

(2) to target relief carefully under clear and objective standards, such as the income standards in S. 2136, standards that do not require subjective, fact-intensive considerations (such as whether the debtor has sufficient current income per S. 2136);

(3) not to allow extension of the term of a home mortgage;

(4) to provide clear standards for the interest rate to be applied, in the event the contract rate is modified, which should probably be something like 2% over an appropriate national thirty-year conventional prime mortgage rate (rather than allowance of an appropriate risk premium, which would lead to subjective results after costly and repetitive hearings, and rather than locking in existing teaser rates);

(5) to provide both clear mortgage origination dates for eligibility for mortgage modification (e.g., mortgages originated between January 1, 2003 and September 26, 2007) and a firm sunset date (preferably one much shorter than the seven years provided for in S. 2133); and

(6) to delete the provision of S. 2136 providing for forfeiture of the mortgage lien and debt for various violations of law.

Technical Suggestions with Regard to S. 2133 and S. 2136

Allow me to refer the Committee to the chart that is Attachment 1 to this written statement for a discussion of some of the technical aspects of the bills. Technical provisions similar to those in H.R. 3609 should be included. They would make clear (1) that the mortgage holder's lien is retained despite the provisions of section 1325(a)(5)(B)(I)(bb), (2) that any personal liability on the mortgage is not discharged, and (3) that the debtor's discharge of other debts need not await completion of all payments on the modified mortgage. I would also suggest that some mechanism other than fraudulent transfer law be used if it is desirable to allow recovery of excessive interest. Finally, it should be made clear that the $75,000 homestead exemption provided by S. 2136 is a floor amount rather than an amount to be added to existing state law exemptions.

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Thank you again for the opportunity to appear today. Please do not hesitate to call upon me or the ABI if we can be of further assistance on this or any other bankruptcy policy issue.

1 127 S. Ct. 1199 (2007)

2 Mark S. Scarberry & Scott M. Reddie, Home Mortgage Strip Down in Chapter 13 Bankruptcy: A Contextual Approach, 20 PEPPERDINE L. REV. 425 (1993).

3 508 U.S. 324 (1993).

4 This approach would go further than Representative Castle's bill, H.R. 4178, which would provide immunity for services but apparently would not expand their authority to enter into agreements that would bind beneficial owners of mortgages.

5 See Scarberry & Reddie, supra note 2, at 432-48. Note, however, that most of the courts that allowed strip down nevertheless required debtors to maintain their payments at the originally required level. See id. at 486. Thus the effect was not to help debtors who were unable to make their payments, but rather to allow them to pay off their stripped down mortgages years earlier than they otherwise would have. This strange approach also had the effect of maintaining the level of cash flowing to holders of mortgages for years; the full effect of strip down thus would not have been seen until years down the road. Of course the Court intervened in Nobelman and stopped the practice soon after it had become widespread.

6 See Scarberry & Reddie, supra note 2, at 494.

7 502 U.S. 410 (1992).

8 508 U.S. 324 (1993).

9 See 11 U.S.C. § 1325(a)(5)(B); Enewally v. Wash. Mut. Bank (In re Enewally), 368 F.3d 1165 (9th Cir. 2004); Scarberry & Reddie, supra note 2, at 468-73; Helping Families Save Their Homes in Bankruptcy Act: Section by Section Summary, page 1 (Dec. 4, 2007 version); cf. Ann E. O'Donnell, Modification of Secured Claims: How to Reconcile Apparent Conflicts Within the Plain Language of § 1322, CHAPTER 13 ANALYSIS, ABI 12th Annual Northeast Bankruptcy Conference, available on Westlaw at 071405 ABI-CLE 13 (2005) (discussing Enewally and several district court and bankruptcy court decisions that split on the issue whether payments must be completed within the five years permitted for a plan). In my view, the Code is clear on this point; Enewally was correctly decided.

10 See 11 U.S.C. § 1325(a) (final sentence--the "hanging paragraph"--added in 2005).

11 In addition to the protection of home mortgages in chapters 11 and 13, consider section 722, which permits redemption of certain property from liens by payment of amount of the debt or the value of the property, whichever is less, but which excludes real property from its operation.

12 Valuation issues also would create much litigation under the approach in S. 2136, not only because of the difficulties in valuing real property but also because the approach to be taken to valuation--foreclosure sale value vs. what it would cost the debtor to buy a similar home--may be contested. The latter type of valuation would seem to be required by Assocs. Comm'l Corp. v. Rash, 520 U.S. 953 (1997), but that might be questioned, and footnote 6 in Rash creates ambiguity.

13 The impact of chapter 12 farm home mortgage stripdown on that specialized market, even if it were researched, likely would tell us little about the impact of chapter 13 home mortgage stripdown on the much larger home mortgage market that is so dependent on the secondary market.