

**PREPARED STATEMENT OF
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CHIEF BANKRUPTCY JUDGE FOR THE WESTERN DISTRICT OF TENNESSEE**

Before

**The United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law**

Regarding

**A FIELD BRIEFING ON HOME FORECLOSURES
IN MEMPHIS, TENNESSEE AND
RELATED MATTERS**

JULY 19, 2010

Introduction:*

Mr. Chairman and Members of the Subcommittee on Commercial and Administrative Law:

My name is David S. Kennedy. I am the Chief Bankruptcy Judge for the Western District of Tennessee and have been a bankruptcy judge for approximately 29 years. I am honored to be here to discuss home foreclosures in Memphis, Tennessee and related matters.

The desire to own a home has driven many Americans to take on substantial debt burdens in hopes of providing shelter for their families and obtaining equity in their homes; however, the economic climate of the last few years has left many homeowners cash-strapped and financially struggling to service their debts, including their home loans. Home values have dramatically dropped by nearly a third, increasing the number of so-called “underwater” home mortgages, where outstanding debt on the homes is greater than the current market values of the homes. Correspondingly, home equity continues to decline along with the hope for many individuals to stay current on their debt obligations and avoid home foreclosures. Some homeowners unsuccessfully attempt to save their homes from foreclosure while others just walk away (the so-called “Jingles Rule”). For whatever reason(s), undersecured home mortgagees (*e.g.*, banks) find dealing with first mortgage modifications and collecting on the deficiency portions difficult, as no equity exists in these homes. Likewise, many wholly underwater junior home mortgagees are charging off and subsequently selling debts to buyers, who may aggressively try to collect from homeowners via collection judgments, wage garnishments, and bank attachments.

The United States homeownership rate currently hovers at close to 70%,¹ but the recent financial crisis has caused a significant increase in home foreclosures. Home foreclosures in

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America are currently at a record high, having increased 35% between the first quarter of 2009 and the first quarter of 2010.² Approximately one in every 138 homes in the United States faces the grim prospect of foreclosure.³ Some estimates indicate that if no action is taken, close to 16% of all mortgaged homes will be in foreclosure by 2012.⁴ Western Tennessee, especially Memphis, has been hit particularly hard. In Shelby County alone, there were 1,420 foreclosures in May 2010.⁵

Home foreclosures impose significant costs on borrowers and their family units, lenders, securities markets, local city and county taxing authorities, and society in general. Foreclosures force borrowers to surrender and vacate their homes along with bearing the costs of relocation. Lenders typically collect only a portion of the foreclosed outstanding loans—historically recouping only 50-60% of the loan value.⁶ Security markets face uncertainty and volatility, as they attempt to price exposure to home foreclosure losses and attendant externalities associated with foreclosures. Third parties also are adversely affected, as foreclosures depress housing prices throughout neighborhoods and erode local tax bases. Simply put, the costs imposed by home foreclosures are substantial and far-reaching.

The nation's bankruptcy courts currently provide assistance to many individuals who find themselves in financial distress. Some of the limitations expressly provided in Title 11 of the United States Code, commonly referred to as the Bankruptcy Code, have hobbled the bankruptcy

¹ U.S. Census Bureau, *Homeownership Rates for the U.S. and Regions: 1965 to Present* (2010), available at <http://www.census.gov/hhes/www/housing/hvs/historic/files/histtab14.xls>.

² Associated Press, *Foreclosure Rates Jump 35%*, CBSNews.com, April 15, 2010, <http://www.cbsnews.com/stories/2010/04/15/business/main6398303.shtml>.

³ *Id.*

⁴ Al Yoon, *U.S. Judges See Red Herring in Mortgage Cramdown Fear*, Thomson Reuters, March 6, 2009, <http://www.reuters.com/article/idUSTRE5247PZ20090306>.

⁵ RealtyTrac, *Tennessee Foreclosure Rate and Foreclosure Activity Information*, May 2010, <http://www.realtytrac.com/trendcenter/tn-trend.html>.

⁶ Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 Wis. L. Rev. 565, 568 (2009).

courts' abilities to fully and effectively assist Chapter 13 debtors struggling to maintain and preserve their principal residences. More than half of the Chapter 13 cases where the debtor's principal residence is secured with a subprime mortgage ultimately are dismissed for various reasons.⁷ Currently, under 11 U.S.C. § 1322(b),⁸ debtors' Chapter 13 plans may not modify home mortgagees' interests, when secured solely by the debtors' principal residences. This leaves many financially distressed individual debtors little opportunity to cure their home loan economic defaults and save the home from foreclosure. Without a statutorily permissible modification of home loans, debtors may not receive the full potential of the bankruptcy system's protection for honest but unfortunate debtors. If the "antimodification provision" of § 1322(b) of the Bankruptcy Code were amended, the modification of "underwater" home loans in appropriate cases could allow the avoidance of many foreclosures, increase the success of more Chapter 13 plans, and concomitantly help the stabilization of the financial markets, tax bases, and family units.

At least four bills have been introduced in the First and Second Sessions of the 111th Congress that propose to amend 11 U.S.C. § 1322(b)(2). These amendments would statutorily allow bankruptcy judges on a case-by-case basis to allow Chapter 13 debtors an opportunity to modify mortgages secured only by the debtor/homeowner's principal residence.⁹

Summary of Chapter 13 Cases:

Broadly speaking, Chapter 13 of the Bankruptcy Code allows for the adjustment of debts of an individual debtor with regular income. Successful completion of a Chapter 13 plan signals

⁷ Rod Dubitsky et al., Credit Suisse, *Bankruptcy Law Reform – A new tool for foreclosure avoidance* 9 (2009), <http://judiciary.house.gov/hearings/pdf/Suisse090126.pdf>.

⁸ 11 U.S.C. § 1322(b) (2006).

⁹ The four bills are: S. 61 and H.R. 200, the Helping Families Save Their Homes in Bankruptcy Act of 2009; H.R. 1106, the Helping Families Save Their Homes Act of 2009; and H.R. 225, the Emergency Home Ownership and Mortgage Equity Protection Act.

the debtor, as provided under the plan, made regular ongoing payments on his or her debts over a period of three to five years. This statutory structure allows the Chapter 13 debtor to keep his or her home while assuring, for example, home mortgage creditors of consistent and regular payments on outstanding debts, including the arrearages from before bankruptcy and also the ongoing contractual monthly obligations. This bankruptcy administrative process is very orderly. A Chapter 13 trustee is assigned to oversee each Chapter 13 case and plan and also to ensure that the debtor is making regular payments allocated to the creditors in accordance with the Chapter 13 plan. This process is transparent and has several statutory provisions to ensure adequate notice and opportunity for a hearing to all parties having an interest in the debtor and his or her estate created by 11 U.S.C. §§ 541(a) and 1306.

Summary of Current Law as Applicable to Home Modification:

Since its enactment as part of the Bankruptcy Reform Act of 1978,¹⁰ section 1322(b)(2) has allowed Chapter 13 plans in appropriate cases 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.*”¹¹ The latter part of § 1322(b)(2) of the Bankruptcy Code was interpreted by the Supreme Court in *Nobelman v. American Savings Bank*¹² as an antimodification provision, thereby prohibiting the use of the 11 U.S.C. § 506(a) bifurcation provisions/process to modify undersecured residential mortgages.¹³

Currently, § 506(a) of the Bankruptcy Code generally allows the bankruptcy judge to approve a debtor’s Chapter 13 plan to bifurcate claims into secured and unsecured components, depending upon the value of the collateral to which the lien is attached. Ordinarily, an allowed

¹⁰ Pub. L. No. 95-598, 92 Stat. 2549 (1978).

¹¹ 11 U.S.C. § 1322(b)(2) (emphasis added).

¹² 508 U.S. 324 (1993).

¹³ *Id.* at 330.

secured claim is determined by the actual value of the collateral. This dynamic process of bifurcating claims into two distinct components is commonly referred to as “cramdown,” “strip-down,” or “strip-off.” These statutory cramdown, strip-down, or strip-off provisions may be applied to all undersecured loans, except for claims secured *only* by a security interest in real property that is the debtor’s principal residence.¹⁴ In other words, cramdowns, strip-downs, and strip-offs are not allowed on primary liens on a debtor’s principal residence if the home is the only collateral securing the loan. Nonetheless, investment properties, vacation homes, wholly underwater junior mortgages, and loans secured by multiple or mixed forms of collateral, even on the principal residence, are subject to cramdowns, strip-downs, or strip-offs under §§ 1322(b)(2) and 506(a) and applicable case law.¹⁵

Sparse legislative history exists to explain why Congress included the antimodification provision in § 1322(b)(2) of the Bankruptcy Reform Act of 1978. The final statutory language represents a compromise between the competing House and Senate bills regarding bankruptcy reform. The House bill included no antimodification provision, while the Senate bill contained a stiffer antimodification provision applicable to all secured claims on real property. Most, like Justice Stevens in his *Nobelman* concurring opinion,¹⁶ have assumed the provision provides “favorable treatment of residential mortgagees [and] was intended to encourage the flow of capital into the home lending market.”¹⁷ Clearly, the antimodification provision protects the

¹⁴ § 1322(b)(2).

¹⁵ To further elaborate, currently strip-downs may occur when, *e.g.*, a vacation home mortgage is stripped down to the home’s actual current market value or where a junior home mortgage is removed entirely as a secured claim because there is no real value or equity in the collateral to support the claim after satisfaction of the senior mortgages. *See, e.g., In re Lane*, 280 F.3d 663 (6th Cir. 2002) (allowing for strip-offs of wholly unsecured mortgages in Chapter 13 cases).

¹⁶ *Nobelman*, 508 U.S. at 332 (Stevens, J., concurring).

¹⁷ *Id.*

long-term interest of the home mortgage industry and fosters the legislative policy of favoring home ownership and fulfilling the “American Dream.”¹⁸

Congress has strongly encouraged home loan modification through voluntary mortgage modifications. Many programs put in place to accomplish these goals, like the Home Affordable Modification Program (HAMP), are not achieving the intended widespread participation and effect. It is said that voluntary home loan modifications have achieved a principal reduction in only 10% of modifications.¹⁹ Indeed, most consensual modifications of home loans involve recapitalizing unpaid interest and fees into the loan increasing most borrowers’ overall debt burden.²⁰ Different federal entities’ modification programs, like HAMP, may be seeing lower participation and success rates in part because of the borrowers’ unfamiliarity with the programs and the programs’ inability to coordinate modifications with home loan servicers. In fact, only 21% of the 1.2 million borrowers who began the process of modifying their home loans in these programs actually completed the modification.²¹ While voluntary modification is desirable, additional remedies to avoid foreclosure (*i.e.*, bankruptcy home loan modification) may be more efficient and effective at reducing foreclosures and stabilizing the housing market. Congress may have already begun to incorporate the reality of how many homeowners file for bankruptcy and to recognize the strength of the nation’s bankruptcy system. For example, HAMP was recently amended to allow debtors in bankruptcy to participate in the program.²²

¹⁸ See *In re Seidel*, 752 F.2d 1382 (9th Cir. 1985); *Grubbs v. Houston First Am. Sav. Ass’n*, 730 F.2d 236, 246 (5th Cir. 1984).

¹⁹ Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications*, 41 Conn. L. Rev. 1107, 1116-17 (2009).

²⁰ *Id.* at 1114.

²¹ Associated Press, *Foreclosure Rates Jump 35%*, CBSNews.com, April 15, 2010, <http://www.cbsnews.com/stories/2010/04/15/business/main6398303.shtml>.

²² Press Release, Making Home Affordable, HUD Secretary Donovan Announces New FHA-Making Home Affordable Loan Modification Guidelines (March 26, 2010); see also Dep’t of Hous. & Urban Dev., HAMP Improvements Fact Sheet 3 (2010), http://makinghomeaffordable.gov/docs/HAMP%20Improvements_Fact_%20Sheet_032510%20FINAL2.pdf.

Summary of Proposed Home Modification Reform:

With the value of home prices having dropped nearly 30% from peak home prices in 2006, many homeowners are now burdened with mortgage debts far greater than the actual current value of their home.²³ Today, these underwater homeowners must attempt to consensually modify their mortgages or, if those efforts prove fruitless, surrender their home to foreclosure because effective and meaningful relief under the Bankruptcy Code does not exist due to the antimodification provision of § 1322(b). However, cramdown legislation is a tool Congress may implement. Such implementation is estimated to reduce foreclosures by approximately 20% and generate significant savings for borrowers, lenders, financial markets, and other third parties.²⁴

Congress has considered and continues to consider whether an effective cure for the rise in foreclosures for certain distressed debtors could be to pass cramdown reform for use in Chapter 13 cases. Such reform could include the modification of § 1322(b)(2) to remove the current antimodification provision, thus allowing bankruptcy judges the express statutory discretion under § 506 to approve debtors' Chapter 13 plans containing modifications to mortgages secured only by a debtor's principal residence. This statutory modification, referred to as a cramdown procedure, might be similar to the strip-downs that regularly take place on other secured claims. By such a procedure, the home mortgage (*i.e.*, the secured claim) could be reduced to the actual current fair market value of the home with the amount of the claim in excess of that value converting to an unsecured claim for distribution purposes under the Chapter 13 plan. The unsecured claim (or undersecured portion) might then be pooled with other

²³ Standard & Poors, S&P/Case-Shiller Home Price Indices, March 2010, *available at* http://www.standardandpoors.com/spf/docs/case-shiller/SA_CSHomePrice_History_052506.xls (noting that home prices for the twenty city composite index have declined from 206.47 in May 2006 to 145.93 in March 2010, which represents approximately a 30% decline).

²⁴ Dubitsky et al., *supra* note 7.

prepetition unsecured claims and repaid in full or in part under the Chapter 13 plan. The remainder of the unpaid unsecured debt—representing the amount of the original mortgage in excess of the fair market value of the home—would be discharged upon successful completion of all payments under the plan. The remaining secured claim—in the amount of the fair market value of the home—would, of course, survive the bankruptcy discharge. This modified mortgage would more accurately reflect home values, provide a more manageable debt burden for the debtor, and represent a consistent and reliable cash flow for the lender.

Other discretionary modifications might permit the bankruptcy judge to approve modifications of the terms of the debtor's loan and/or the interest rate of the loan. Congress could additionally decide to require the debtor to attempt a voluntary modification in good faith and to provide proof of that attempt to the bankruptcy court as a precondition to modify a loan secured solely by a principal residence under the Chapter 13 plan. Cramdown legislation also may incentivize lenders to voluntarily negotiate more favorable modifications with debtors outside of bankruptcy. Together, bankruptcy strip-down modifications and increased voluntary modifications may be a boon to current financial markets and help both lenders facing significant losses in foreclosure and the honest but unfortunate debtor. Additionally, domestic difficulties may be reduced as financial and domestic problems oftentimes place a tremendous amount of pressure on a marriage or relationship.

Effect on the Bankruptcy Courts:

The modification of home loans in Chapter 13 plans could supplement the home loan modification efforts Congress has already implemented. Congressional policy has been to assist Americans in keeping their homes. Congress has noted a national policy for loan modifications

may be an effective means of helping “struggling borrowers to avoid foreclosures.”²⁵ By leveraging the bankruptcy courts’ experience, capacity, and expertise with loan modification, the modification of principal residence loans may increase flexibility for Americans to save their homes from foreclosure and to help stabilize the family unit.

Bankruptcy courts already have the discretion to allow for the modification of the amount, terms, and interest rates of most secured and unsecured loans under Chapter 13 plans. Presently, section 1322(b)(2) of Title 11 allows the Chapter 13 debtor’s plan to modify the rights of secured creditors as long as the claim is not secured *only* by a debtor’s principal residence.²⁶ This means Congress currently authorizes the bankruptcy judges’ express statutory discretion to approve similar modifications on loans secured by, for example, investment and vacation homes, investment properties, and farms. There is no significant distinguishing factor between these types of secured loans and loans secured only by debtors’ principal residences, except perhaps that the collateral in a principal residence mortgage may be more significant to a borrower of limited financial means.

The existing structure of the bankruptcy courts, along with the high volume of bankruptcy cases and proceedings that take place in bankruptcy courts throughout the country, provides the statutory capacity to assess, monitor, and administer home mortgage modifications over the life of a Chapter 13 plan. In the 12-month period ending March 2010, for example, there were 1,531,997 cases filed in bankruptcy courts nationally. Of those, 415,966—or 27%—were Chapter 13 cases.²⁷ In the Western District of Tennessee during the same period, there

²⁵ H. Comm. on Financial Services, 111th Cong., Oversight Plan 11 (Feb. 12, 2009), *available at* <http://financialservices.house.gov/111th%20FSC%20Oversight%20Plan-final.pdf>.

²⁶ 11 U.S.C. § 1322(b)(2).

²⁷ Administrative Office of the U.S. Courts, Table F-2: U.S. Bankruptcy Courts—Business and Non-Business Cases Commenced, by Chapter of the Bankruptcy, During the 12-Month Period Ending September 30, 2009, *in* Judicial Business 2009, *available at* <http://www.uscourts.gov/Statistics/JudicialBusiness/JudicialBusiness2009.aspx>.

were 19,746 bankruptcy cases filed and 13,612—or 69%—of those were Chapter 13 cases.²⁸ The sheer volume of these highly technical, financially based cases, as well as their administration over a period of 3-5 years, demonstrates the bankruptcy courts’ capacity to administer loan modifications. CM/ECF (*i.e.*, electronic case filings) has been very effective in the bankruptcy courts by increasing capacity and efficient use of the courts’ resources. Should Congress decide to change § 1322(b)(2), the courts would be well able to analyze whether the proposed modifications were fair and equitable to the creditors and debtors and whether the debtor would be reasonably likely to complete the plan with the terms of the modified home loan payments over an extended period of time. Bankruptcy judges are not strangers to the valuation (and market rates of interest) process. Appellate courts exist for debtors and creditors who seek judicial review of a bankruptcy judge’s decision. Additionally, it is noted that a Chapter 13 trustee is appointed in every Chapter 13 case and the United States Trustee program, a division of the U.S. Department of Justice, is already in place to prevent abuse of the bankruptcy system by monitoring case and proceeding filings. The collective experience and technical excellence allows for an independent review in addition to that of the judiciary. The bankruptcy system especially is blessed to have highly capable and efficient Chapter 13 trustees.

The practices and procedures already in place for modifying home loans regarding non-principal residences provide further safeguards to ensure the bankruptcy courts are acting in the best interests of all parties in a bankruptcy case or proceeding. The bankruptcy courts frequently hear testimony from real estate experts, appraisers, and other industry experts to aid their decision-making. Bankruptcy judges are therefore able to perform strip-down and strip-off modifications of junior liens. Accordingly, if Congress chooses to employ cramdown modifications as an additional statutory tool to help stabilize the current housing market and tax

²⁸ *Id.*

bases, help save homes from foreclosures, and help support the family unit, it will find in the bankruptcy courts a pre-existing, proven system capable of analyzing and supporting regular financial and collateral valuations, calculations, and disbursements over several-year periods.

Additionally, the ability to modify principal home mortgages under Chapter 13 plans may actually encourage lenders to consensually modify home loans outside of bankruptcy, *i.e.*, extrajudicially, in order to achieve more favorable terms and to avoid bankruptcy entirely. Considering the law and the bankruptcy system favor and reward compromise, the bankruptcy judge would strongly encourage and likely confirm a Chapter 13 plan agreed to by the debtor and the mortgage holder and approved by the Chapter 13 trustee. This attitude of compromise and negotiation would compliment Congress' existing home loan modification programs, like HAMP, by providing alternatives for those honest but unfortunate individual debtors to satisfy their obligations. For most Chapter 13 debtors, a home loan is their most significant debt (and the home also is their greatest asset); voluntary modification by a lender may make the debtor's burden more bearable and avoid foreclosure and its resulting delays and expenses.

Effect on Borrowers:

Removing the antimodification provision in § 1322(b)(2) may be a boon to borrowers/homeowners because the borrower may then be able to avoid the costs and effects of foreclosure and keep his or her home. Modifying underwater home loans in an orderly Chapter 13 case with all applicable protections of the bankruptcy system and due process will require borrowers and lenders to come to the bargaining table. Cramdown legislation's most obvious potential benefit is to allow many borrowers to remain in their family homes while continuing to make regular payments to lenders under the Chapter 13 plan. Thus, families are not uprooted and domestic difficulties may be calmed. It is said that foreclosure avoidance has resulted in

reduced domestic problems and divorces. Borrowers may retain possession of their home so long as they make the monthly payments required under their Chapter 13 plan. A foreclosure is costly for borrowers because of the loss of their home, the costs of relocation, and the disruption of moving and finding a new place to live or to house their family. These costs are both monetary and psychological, as the foreclosed borrower, the dispossessed homeowner, is left in a fragile and vulnerable position. Additionally, the demands of locating a new place to live may require the debtor to take additional time off work, which not only means less income but may, as a practical matter, result in the loss of a job. By avoiding foreclosure and the filing of a Chapter 13 case, the debtor may keep his or her home without the monetary and psychological costs of relocation and the expenses of bankruptcy.

Furthermore, the debt burden for the homeowner may be reduced if bankruptcy judges are provided the statutory authority to approve a modification of the principal amount of the loan secured only by the principal residence to reflect the fair market value of the home securing the loan. Currently, 54% of filed Chapter 13 cases containing a securitized subprime loan do not successfully complete the Chapter 13 plan, ultimately resulting in the foreclosure of the debtor's home.²⁹ This exceedingly high failure rate can be explained in part because the home mortgage is generally one of the Chapter 13 estate's most significant debts for many, if not most, Chapter 13 debtors, and these debtors currently are without the ability to modify this large debt burden in bankruptcy. Even the most well-intentioned debtors sometimes cannot make the plan payments. Removing the antimodification provision from the Bankruptcy Code will allow bankruptcy judges to approve appropriate modifications of the debtor's largest debt making the debtor's

²⁹ Dubitsky et al., *supra* note 7.

burden more manageable and ultimately assisting the success of the Chapter 13 plan for the benefit of the debtor and all creditors.

Finally, debtors may benefit from cramdown legislation because the ability to modify home loans in bankruptcy may provide the debtor a more level playing field in extrajudicial negotiations between lenders and borrowers to voluntarily modify home loans. Lenders, typically the more sophisticated party in most home loan transactions, are positioned as the more powerful bargainer, thus, frequently creating an inequality in bargaining positions between the lender and the debtor. This inequality in bargaining positions may be why so few lenders are willing to voluntarily modify home loans. Servicers of home mortgages usually do better economically as a result of a foreclosure rather than a modification because foreclosures typically generate more service fees. The ability to modify home mortgages in Chapter 13 cases may provide the borrower with a bargaining chip that could incentivize more lenders to negotiate voluntary modifications on a more balanced or equal bargaining table. This equality may increase successful consensual modifications and may be the most efficient outcome of such bankruptcy reform.

Effect on Lenders:

In reality, bankruptcy cramdown appears to be a benefit to all parties because, in addition to keeping borrowers in their homes, lenders may recover more of their outstanding loan balances in bankruptcy than in foreclosure actions. Lenders' fear of mortgage cramdown may be misplaced. Lenders may realize losses when a borrower goes into bankruptcy. These losses, however, are expected to be considerably less than if the lender were to foreclose on the home. Foreclosure frequently produces gloomy prospects for lenders. The foreclosure process is time intensive and costly. Nationally, the average time between the first delinquent payment and the

foreclosure sale is nearly one year.³⁰ The costs of foreclosure are large, as foreclosure losses are routinely over \$50,000 per home and range from 30-50% of the loan value.³¹ The lender may face costs related to the principal loss on the loan, property maintenance, appraisal fees, legal fees, lost revenues, insurance, marketing, and clean-up. Altogether, foreclosure is a costly last resort for lenders who at that point, with respect to the undersecured portion of the secured claim, are likely to receive pennies on the dollar for their bad investments.

If the antimodification provision of § 1322(b)(2) were removed, Congress would be allowing lenders to generate a better return on their investments because the modification may allow lenders to keep a secured interest in their collateral to the extent of the actual value, receive interest payments on the value of the collateral, and receive a proportionate share of funds for unsecured claims based on the bifurcated, unsecured part of the loan under the Chapter 13 plans. Foreclosure can only offer the liquidation value of the collateral less foreclosure administrative costs and fees. Therefore, modifications in bankruptcy may offer a better financial return on lenders' investments.

Effect on Financial Markets:

The effect on the financial markets resembles the effect on borrowers and lenders, as the markets are designed to efficiently price borrower and lender decisions. Bankruptcy cramdown most likely would impact the financial markets; however, the negative effect appears to be de minimis and in fact many parties may benefit. Bankruptcy cramdown legislation on such home mortgages would be unlikely to significantly impact interest rates or security pricing, except perhaps where securities contain bankruptcy carve-out provisions.

³⁰ Amy Crews Cutts & William A. Merrill, *Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs* 4-5 (Freddie Mac, Working Paper No. 08-01, 2008), available at http://www.freddiemac.com/news/pdf/interventions_in_mortgage_default.pdf.

³¹ Mortgage Bankers Association, *Lender's Cost of Foreclosure* (2008), <http://www.nga.org/Files/pdf/0805FORECLOSUREMORTGAGE.PDF>.

Financial markets are organized to try to allow the most efficient pricing and transfers between parties. Uncertainty about risk of loss, however, can cause the markets to restrict credit, thus, making the markets less efficient in capital allocation. The current financial crisis has exposed many investors in Residential Backed Mortgage Securities (RMBS) to potential losses due to foreclosures and modifications and concerns have been voiced that allowing bankruptcy cramdowns may expose RMBS to additional losses, thus, reducing the value of these instruments. The concern continues that lenders may raise interest rates in order to compensate for these losses, inevitably restricting credit.

This concern about increased interest rates and restricted credit does not appear significantly justified. Empirical testing suggests interest rates are not significantly affected by strip-downs, concluding markets are indifferent to bankruptcy modification losses because the alternative of foreclosure loss is significantly more costly.³² Interest rate increases result from an increase in realized losses or an expectation of increased risk of loss; therefore, for bankruptcy cramdown to increase interest rates, the losses from bankruptcy cramdowns must be greater than corresponding losses in foreclosure. Generally, foreclosure losses are expected to outweigh cramdown losses after the completion of a Chapter 13 plan. In foreclosure, the lender receives only the value of the collateral less foreclosure administrative costs and fees. Under Chapter 13 plans, however, the lender may receive principal and interest payments on the value of the collateral and additionally receive a proportionate share of funds for unsecured claims based on the bifurcated, unsecured part of the loan. If bankruptcy cramdown does prove more efficient than foreclosure, which is generally forecast, lenders and financial markets should generate better returns for their investments.

³² Levitan, *supra* note 6; Adam J. Levitan & Joshua Goodman, *The Effect of Bankruptcy Strip-down on Mortgage Markets*, (Georgetown University Law Center, Faculty Working Paper No. 51, 2008), available at http://scholarship.law.georgetown.edu/fwps_papers/51.

That is not to say there are no exceptions. Many non-agency RMBS may be exposed to potential losses because of “bankruptcy loss carve-out” provisions. Moody’s Investors Services estimates that 26% of jumbo loans³³ issued between 2006 and 2008 contain such provisions.³⁴ Most losses related to RMBS are allocated to subordinate tranches first and then to more senior tranches. Accordingly, the RMBS market currently prices securities as if losses from foreclosure or home loan modifications will be allocated to these subordinate tranches. The bankruptcy loss carve-out is an exception to this loss allocation method. It limits the amount of loss that can be absorbed by the subordinate tranches, instead allocating losses pro rata to all tranches, regardless of seniority, after the ceiling for subordinate tranches has been reached.

The limits set by bankruptcy loss carve-outs have generally been low, *e.g.*, \$100,000, because nearly all residential mortgages are not exposed to any bankruptcy risk due to the protection of mortgages securing only primary residences under § 1322(b)(2). Bankruptcy risk is currently limited to the properties excluded from the antimodification provision, *e.g.*, investment property mortgages, secondary mortgages, and vacation home mortgages. Considering the nearly 30% drop in home prices since the peak home prices in 2006,³⁵ bankruptcy modification of even one jumbo loan may be enough to trigger the bankruptcy loss carve-out, thus exposing senior tranches to losses typically allocated to subordinate tranches in the case of foreclosure or voluntary modification.

These bankruptcy loss carve-outs may add uncertainty to the RMBS market if § 1322(b)(2) is changed; most loans, however, would not be affected and any new securities

³³ Jumbo loans are any loans valued at over \$417,000 that cannot be purchased by Fannie Mae or Freddie Mac, as Government Sponsored Entities. See Fannie Mae, *Confirmation of Conventional Loan Limits for 2010* (2010), available at <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2009/0934.pdf> (finding conventional loans limited to \$417,000).

³⁴ Amy Tobey, Eric Fellows, & Yehudah Forester, *Proposed Bankruptcy Code Amendments Expected to Impact RMBS Ratings*, Moody’s Investors Service (February 2, 2009), http://www.americansecuritization.com/uploadedFiles/cram_down_moodys.pdf.

³⁵ See Standard & Poors, *supra* note 23.

issued can choose to exclude these provisions to ensure that going forward bankruptcy losses are allocated similarly to losses from foreclosure or voluntary modification. As such, the overall financial market should benefit from bankruptcy modifications due to the cost savings that bankruptcies offer in contrast to foreclosures.

Effect on Third Parties:

For quite some time, the analysis of housing policy and related lending neglected to consider the long-term effects on third parties. Recognizing, in light of the past several years, the reach of housing policy and related lending and the impact on markets and unintended third parties, it is appropriate to identify affected third parties and assess any potential consequences. Though much of the effect of any potential bankruptcy reform may be felt directly by borrowers, lenders, and the courts, indirectly affected third parties include, among others, neighbors of the debtors and the American taxpayers.

For every neighbor with a home in foreclosure, the value of a surrounding home drops on average by \$7,200.³⁶ Homeowners in good standing are, therefore, negatively impacted by honest but unfortunate neighbors unable to service their debts and are forced to relinquish their homes to the mortgage holders. Foreclosure allows for the removal of the occupant from a home, thereby increasing the supply of vacant homes available on the market and consequentially reducing the sales value of all homes in the area and also tax revenues. Most appraisals and home valuations are based on comparable home sales within the neighborhood. Foreclosed properties deflate comparable home prices and force neighbors in good standing to suffer declines in the fair market values of their homes. Additionally, unoccupied homes generally suffer from neglect and lack of upkeep. Insurance and vandalism always are concerns.

³⁶ Center for Responsible Lending, *Soaring Spillover: Accelerating Foreclosures to Cost Neighbors \$502 Billion in 2009 Alone 2* (May 2009), <http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf>.

This neglect creates eyesores that reflect negatively on the neighborhood and its prosperity. The phenomenon, called blight, depresses home values even further and in some cases proves to be a significant hurdle for neighborhoods struggling to improve.³⁷

Removing the antimodification provision under the Bankruptcy Code and allowing underwater homeowners to receive protection in bankruptcy rather than suffer foreclosure may provide a huge benefit to the debtors and also the neighborhoods and those neighbors in good standing along with the taxing authorities. Allowing the debtors to retain their homes while in a Chapter 13 case may prevent foreclosures and the resulting negative impacts. Under that scenario, foreclosed homes would not have to be sold at distressed sales thereby preventing a supply glut on the housing inventory. The Chapter 13 debtor would stay in the home with a more manageable debt burden, which allows for maintenance and upkeep for the property. The neighbors, who are diligent stewards of their mortgages and cash flow, are not negatively impacted by events completely outside their control and by the corresponding price deflation. Bankruptcy cramdown therefore would indirectly offer neighbors in good standing a means to avoid foreclosures in their own communities.

Another third party indirectly affected by the foreclosure rate and the potential modifications to § 1322(b)(2) is the American taxpayers, who in reality fund the government modification programs, the judicial system, and other government efforts. Government spending deficits elicit public disapproval and create uncertainty for the stability of the financial system.

The Congressional Budget Office has estimated that bankruptcy cramdown legislation could

³⁷ Foreclosure is a primary cause of blight. For example, in a study done on Memphis area neighborhoods, the rate of blight for all residential properties in one neighborhood was 18.5%, but for foreclosed properties, the rate was three times as high—reaching 60.8%. Considering there were 115 foreclosures during the period of the study (2007-2008), that is a significant number of homes suffering from blight. Correspondingly, in the same neighborhood, there was a vacancy rate of 2.5% for all residential properties. For foreclosed properties, it was 35.7%. Phyllis Betts, Director, Center for Community Building & Neighborhood Action, Stabilizing Home Ownership in a Post-Foreclosure Environment (June 21, 2010).

reduce deficit spending by \$31 million over ten years and produce revenues of \$23 million in the same period.³⁸ If the forecast is correct, cramdown legislation could save the American taxpayers \$54 million. In a climate where many solutions and policies could cost the American taxpayers billions or trillions of dollars, Congress may in cramdown modifications have a remedy for the foreclosure crisis that involves little additional funding and may even reduce deficit spending.

Conclusions:

As has been demonstrated, bankruptcy home modification offers a tenable and workable remedy to reduce the home foreclosure and economic crisis that exists in America. Removing the antimodification provision of § 1322(b)(2) of the Bankruptcy Code would provide the bankruptcy judges with express statutory authority on a case-by-case basis to approve (or disapprove) modifications of Chapter 13 debtors' home loans contained in Chapter 13 plans thereby benefitting borrowers, lenders, and other third parties. In summary, borrowers may avoid surrendering their homes and bearing the costs of relocation; lenders may collect under a Chapter 13 plan more than they would receive under a foreclosure or pursuant to applicable state law collection procedures; security markets could face less uncertainty and volatility, as bankruptcy losses should be less than foreclosure losses; neighborhoods may better retain their values; tax bases would not be eroded to the same degree; and, ultimately, individuals who want to be productive members of society may be more likely to successfully complete a Chapter 13 plan. Additionally, stability to the family unit may result and it is also said that the divorce rate actually may decrease as domestic difficulties concomitantly decrease.

³⁸ Congressional Budget Office, Cost Estimate for H.200 (February 2009), *available at* <http://www.cbo.gov/ftpdocs/100xx/doc10007/hr200.pdf>.

Please know that the nation's bankruptcy courts and judges stand willing, able, and prepared for the opportunity to foster and provide this relief by reviewing and approving in appropriate cases the modification of underwater home loans under § 506(a) should Congress decide to amend Title 11 to remove the antimodification provision of § 1322(b).

While the bankruptcy judges are not eagerly requesting more work, bankruptcy judges can provide the necessary services in the event the antimodification provision of § 1322(b) were to be modified. With home foreclosures still on the rise, cramdown under Chapter 13 of the Bankruptcy Code regarding the debtors' principal residence indeed is a sensible and workable solution that would not overwhelm or unduly burden the bankruptcy courts. As noted earlier, under current law bankruptcy judges for many years have been presiding over valuation and market rates of interest hearings and applying procedures for modifying debts secured by collateral other than first mortgages on the debtor's principal residence, including, for example, investment houses, vacation homes, principal residences secured by mortgages with mixed collateral, and other real and personal properties of individual debtors.

The elimination of the § 1322(b)(2) antimodification provision would impose no new costs and would not require any new courthouses or the creation of new federal agencies; the sky would not fall on lenders. Many State Attorneys General strongly support such modification provisions.³⁹ The experience of the bankruptcy courts has been that once statutory standards of modification of allowed secured claims are established and a few test cases are actually tried, parties frequently thereafter will work out agreements based on those circumstances without judicial intervention; the implementation of Chapter 12 family farmer provisions support this statement.

³⁹ Please see "Attachment A" hereto which is incorporated by reference. The State Attorneys General are on the front line of efforts to assist homeowners and independently support the § 1322(b)(2) loan modification provisions in order to protect families from foreclosure and stabilize tax bases.

Thank you for your consideration regarding this highly important subject matter. I am happy to attempt to answer any questions that you may have.

Attachment A

A Communication From the Chief Legal Officers
Of the Following States:

Arizona ▪ California ▪ Connecticut ▪ Delaware ▪ District of Columbia ▪ Illinois ▪ Iowa ▪ Kentucky
Louisiana ▪ Massachusetts ▪ Minnesota ▪ Mississippi ▪ Montana ▪ New Mexico
North Carolina ▪ Ohio ▪ Oklahoma ▪ Rhode Island ▪ South Dakota
Tennessee ▪ Vermont ▪ Washington ▪ West Virginia

January 6, 2009

The Honorable Nancy Pelosi, Speaker
235 Cannon House Office Building
U.S. House of Representatives
Washington, D.C. 20515

The Honorable John Boehner, Minority Leader
1011 Longworth House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Via Facsimile and Mail

Dear Madame Speaker and Congressman Boehner:

We are writing to urge you to help alleviate the mortgage and financial crises facing the country by amending the Bankruptcy Code to permit United States bankruptcy courts to protect families from foreclosure.

The State Attorneys General have been on the front line of efforts to assist homeowners facing unsustainable mortgage loans. We receive thousands of complaints from consumers who have been victims of predatory lending practices, unscrupulous mortgage brokers and foreclosure rescue schemes. In recent months, State Attorneys General have especially focused on urging mortgage servicers to avoid unnecessary foreclosures by modifying unaffordable loans in a manner that serves holders, servicers, homeowners and the public. Through the multi-state Foreclosure Prevention Working Group, we collected data which demonstrates that voluntary loan modification measures have failed. The recently-enacted "Hope for Homeowners" program, regrettably, has generated little interest from mortgage holders (HUD recently reported only 111 applications nationwide). Because most troubled mortgages are securitized, multiple stakeholders may be involved in the decision to modify mortgage loans, causing a continued paralysis. Although some major lenders have recently embarked on loan modifications on a wide scale, many servicers and secondary market investors remain unwilling or unable to act, even when their own economic interests dictate otherwise. Despite our best efforts, we conclude that more still needs to be accomplished.

Allowing the bankruptcy courts the ability to order loan modifications is a sensible and workable approach that can provide our housing market with the stability our country so desperately needs. Reasonable and limited reforms of the bankruptcy laws would allow judges to readjust debt owed on primary residences, just as they can for vacation homes and family farms. The bankruptcy system is well-equipped to handle this crisis, as there are nearly 300 bankruptcy judges with years of expertise in valuing property. No new agency, no new regulations and no additional personnel are needed. The courtrooms, judges and filing system are already in place. The proposal could take effect immediately. Further, it would cost the taxpayers nothing. Any concern that amending the bankruptcy laws in this manner will cause an increase in bankruptcy filings is unfounded. Indeed, such an amendment will likely motivate mortgage servicers and secondary market investors to achieve sustainable mortgage loan modifications, thus preventing bankruptcy filings.

Under the proposed amendment, losses and benefits are shared between homeowners and investors. The homeowner would be required to pay the loan based on the current secured value and the mortgage holder absorbs the losses for that portion of the debt which exceeds the value of the home. In addition, the homeowner with regular income retains the family home while paying a sustainable mortgage. The mortgage holder receives a steady stream of income and market rate interest, while avoiding the losses and expenses incident to a foreclosure sale.

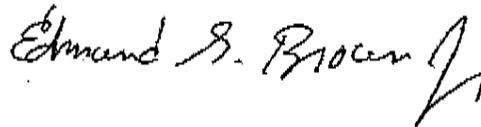
It is clear, we believe, that the amendment will help all involved. Foreclosures impact not only the homeowner at issue, but their neighbors as well. The amendment will help neighboring properties by stabilizing prices in the housing market and reducing the negative externalities associated with foreclosures. It will help cities and counties by stabilizing and improving the tax base. By re-writing mortgage instruments to affordable amounts, it will help secondary market investors and other owners by making the stream of income on mortgage-backed securities more certain. Finally, it will help the worldwide financial markets by halting the ruinous cycle of foreclosures at the heart of this crisis, thus helping to stabilize markets.

We urge your immediate consideration of this measure to address the personal crisis faced by each distressed homeowner, the market crisis in the housing sector and the worldwide financial crisis. Please do not hesitate to contact any of us if we can be of assistance with this or any other matter.

Cordially,



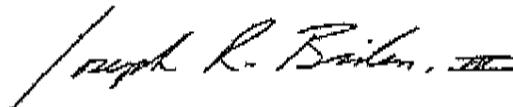
Terry Goddard
Attorney General of Arizona



Edmund G. Brown, Jr.
Attorney General of California



Richard Blumenthal
Attorney General of Connecticut



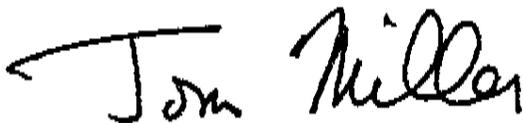
Joseph R. Biden, III
Attorney General of Delaware



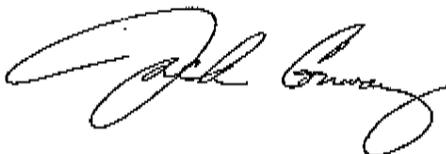
Peter J. Nickles
Attorney General of the District of Columbia



Lisa Madigan
Attorney General of Illinois



Tom Miller
Attorney General of Iowa



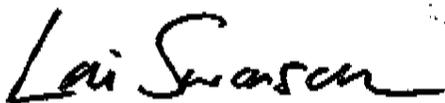
Jack Conway
Attorney General of Kentucky



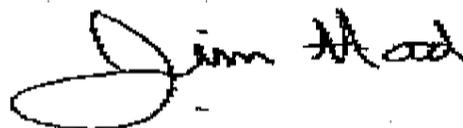
James D. Caldwell
Attorney General of Louisiana



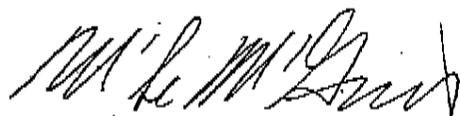
Martha Coakley
Attorney General of Massachusetts



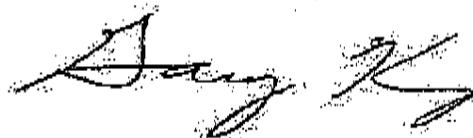
Lori Swanson
Attorney General of Minnesota



Jim Hood
Attorney General of Mississippi



Mike McGrath
Attorney General of Montana



Gary K. King
Attorney General of New Mexico

6/2/09

Supporters of Judicial Modification of Mortgages**President Barack Obama****Vice President Joe Biden****Lawrence Summers, Chief Economic Advisor to President Obama and former Secretary of the Treasury¹****Robert Reich, former Secretary of the U.S. Department of Labor²****Jack Kemp, former Secretary of the U.S. Department of Housing and Urban Affairs and former Member of Congress³****Governor Jennifer Granholm, Michigan****Governor Bill Richardson, New Mexico****Governor Ted Strickland, Ohio****22 Attorneys General and the Attorney General of the District of Columbia⁴****Mayor Michael Bloomberg, New York City****U.S. Conference of Mayors****Mark Zandi, Chief Economist and co-founder of Moody's Economy.com⁵**

¹Letter from Lawrence Summers, Director-Designate, National Economic Council, to Nancy Pelosi, Speaker, U.S. House of Representatives, *et al.* (Jan. 15, 2009) (on file with the Committee).

²*A Comprehensive Jobs and Recovery Plan: Hearing before the Democratic Steering and Policy Comm.*, 111th Cong. (2009) (testimony of Robert Reich).

³*Hearing on the Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. (2008) (testimony of Jack Kemp, former Secretary of the U.S. Dep't of Housing and Urban Affairs); Op. Ed., Jack Kemp, *Bringing Bankruptcy Home*, L.A. TIMES, Jan. 18, 2008.

⁴Letter from Terry Goddard, Attorney General of Arizona, *et al.* to Rep. Nancy Pelosi, Speaker, U.S. House of Representatives (Jan. 6, 2009) (on file with the Committee).

⁵*Hearing on the Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. (2008) (testimony of Mark Zandi, Chief Economist, Moody's Economy.com).

March 9, 2008: *When Ben Bernanke Speaks*
 January 14, 2008: *The Candidates Discuss the Economy*
 December 5, 2007: *Where's the Stick*
 November 19, 2007: *Keeping Americans in Their Homes*
 October 8, 2007: *The American Dream in Reverse*
 September 15, 2007: *Wall Street Casualties*

Los Angeles Times:

January 26, 2009: *Real Estate Reality – Government and the Financial Sector Must Do More To Stem the Rising Tide of Foreclosures*

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February 20, 2009: *Our View on the Economy: Can Obama's Housing Plan Stabilize Plunging Values – Preventing Foreclosures Might Be Distasteful, But Everyone Could Gain*

Saint Louis Post-Dispatch:

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 February 20, 2009: *Keep the Hammer*

Iowa City Press-Citizen:

February 13, 2009: *Our View: Give Homeowners Other Than Just Walking Away*

Orlando Sentinel:

March 1, 2009: *Mortgage Relief, We Think: The Spillover From Foreclosures Argues for An Aggressive Effort To Reduce Them*

Anchorage Daily News:

January 27, 2009: *Troubled Homeowners Should Get Help in Bankruptcy Court*

Commercial Law League of America, North America's oldest creditors' rights organization⁹

National Conference of Bankruptcy Judges

National Association of Consumer Bankruptcy Attorneys

National Bankruptcy Conference

National Association of Chapter 13 Trustees

⁹Letter from David R. Gamrche et al. to Sen. Chris Dodd, Chair, Committee on Banking, U.S. Senate (Oct. 31, 2008).

International Brotherhood of Teamsters
International Union, United Auto Workers
Japanese American Citizens League
Jewish Council for Public Affairs
Kirwan Institute for the Study of Race and Ethnicity
KLD Research & Analytics
Laborer's International Union of North America
Lawyers' Committee for Civil Rights Under Law
Leadership Conference on Civil Rights
Legal Momentum
Low Income Investment Fund
National Alliance of Postal and Federal Employees
National Association for the Advancement of Colored People (NAACP)
NAACP Legal Defense & Educational Fund, Inc.
National Association of Chapter 13 Trustees
National Association of Consumer Advocates
National Bar Association
National Coalition for Asian Pacific American Community Development
National Community Reinvestment Coalition
National Consumer Law Center (on behalf of its low income clients)
National Council of La Raza
National Education Association
National Fair Housing Alliance
National Federation of Community Development Credit Unions
National Federation of Filipino American Associations
National Housing Law Project
National Housing Trust Community Development Fund
National Korean American Service & Education Consortium
National Low Income Housing Coalition
National NeighborWorks Association
National Organization for Women
National Policy and Advocacy Council on Homelessness
National Training and Information Center
National Urban League
National Women's Law Center
New Jersey Community Capital
North Star Asset Management
Opportunity Finance Network
Organization of Chinese Americans
Pax World Mutual Funds
Rainbow Push Coalition
Service Employees International Union
Social Investment Forum
Trillium Asset Management

Seattle Economic Development Fund, Seattle WA
SJF Ventures, Durham NC
Southern Coalition for Social Justice, Durham NC
Southern Poverty Law Center, Montgomery AL
The Housing Fund, Nashville TN
United Community Housing Council, Detroit MI
Warm Springs Community Action Team, Warm Springs OR
Women's Opportunities Resource Center, Philadelphia PA