VENABLE LLP

financial services alert

A PUBLICATION OF VENABLE'S FINANCIAL SERVICES GROUP

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WHAT THE CRAM-DOWN LEGISLATION MEANS TO MORTGAGE LENDERS, SERVICERS AND INVESTORS

There is a sense of inevitability that Congress will pass legislation allowing a Chapter 13 bankruptcy plan (also referred to as a wage-earner's plan) to "cram-down" the value of a mortgage on a consumer's principal residence to its market value and/or reset debtor interest rate and monthly payments to an amount that permits them to remain in their homes. This alert summarizes the latest version of H.R. 200 that emerged from a mark-up in the House Judiciary Committee this week, and analyzes how it may affect loan portfolios, servicing and the recovery of the mortgage market, and also offers recommendations on how to prepare for the change.

Experts in the mortgage market believe there is the potential for between 2 and 3 million Chapter 13's after the legislation is enacted (it is on a fast track) as homeowners who receive foreclosure notices and otherwise qualify for protection. This likely will mean a wave (or tsunami) of Chapter 13 cases that might be filed in the immediate future by home borrowers seeking relief from residential mortgage debt.

Understanding Chapter 13 and the Cram-Down

To qualify for Chapter 13 relief, a consumer's secured debts (excluding a mortgage on his/her primary residence) cannot exceed $1,010,650, and unsecured debts cannot be more than $336,900. Chapter 13 allows the debtor to pay creditors over time – generally five years—an allowed amount on each secured claim and unsecured creditors at a rate that ensures they receive more than they would in a Chapter 7 liquidation using a "plan" proposed by the debtor (typically computed by counsel) and approved by the bankruptcy court. A key aspect of every Chapter 13 proceeding is the ability of the debtor to establish a current value for secured collateral, such as a car, that is often lower than the amount of the loan and "cram-down" the secured claim to the lower amount. The rest of the previously secured loan is paid at the same rate as other unsecured creditors.

The Proposed Legislation

Bills in both the House (H.R. 200, Rep. Conyers (D-MI) and H.R. 225, Rep. Miller (D-NC)) and Senate (S. 61, Sen. Durbin (D-IL)) would allow bankruptcy judges the same cram-down power for the first time to modify mortgages secured by a debtor's principal residence. (As noted above, for purposes of the analysis that follows, the

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version of H.R. 200 that passed the House Judiciary Committee on Tuesday, January 27, 2009 will be used.)

A consumer who receives a notice that foreclosure on his/her principal residence has commenced would be able to file a Chapter 13 proceeding, regardless of the amount of secured debt. The bankruptcy court (there are 324 judges authorized for the 94 federal judicial districts) would then be authorized to modify *any* first- or subordinate-lien residential mortgage loan (*not* limited to high-rate, no-documentation, loans or subprime loans) to:

- Bifurcate the mortgage loan into a secured portion and an unsecured portion by lowering or craming-down, the amount of the allowed secured claim to the current market value of the home established by evidence in the case;
- Treat the difference between the allowed secured claim amount and the loan balance as unsecured;
- Prohibit, reduce or delay adjustments in the interest rate on the secured portion;
- Extend the repayment period on the secured loan for up to the longer of 40 years (reduced by the amount of time the loan has been outstanding) or the remaining term of the loan; and
- Provide for a fixed rate of interest on the affected mortgage loan at the current *average prime offer rate* published by the Federal Financial Institutions Examination Council ("FFIEC") in its "Average Prime Offer Rates – Fixed" *plus* a reasonable premium (*i.e.,* an interest margin) for risk.

Most Chapter 13 plans are completed in five years. The legislation would make permanent the secured amount of the loan established by the bankruptcy court until the later of:

- Payment of the allowed secured claim in full; or
- Discharge under Chapter 13 by the bankruptcy court.

As adopted by the House Judiciary Committee, the cram-down authority only applies to residential mortgages originated *prior to* the effective date of the legislation, but in its current form would apply to virtually all types of residential loan products, and not, as noted above, to high-rate or other non-traditional loans.

The House Judiciary Committee in the mark-up earlier this week approved an amendment that is an improvement over the original bill. Specifically, the amendment provides for a rule of construction that nothing in H.R. 200 should affect the obligation of FHA to insure or VA to guarantee a loan. (It was explained that this amendment is a placeholder for a more robust provision that would make the bifurcation of a residential mortgage loan secured by a primary dwelling an “insurable event,” meaning that a servicer or investor could make a claim for an insurance or guaranty payment on the part of the loan that the bankruptcy judge deemed unsecured.)

The current House Judiciary Committee version of H.R. 200 also provides that upon the sale of the real property security prior to the date that a debtor receives a discharge (generally after completing a 5-year plan), a secured creditor would receives 80% of the difference between the sales price and the original secured claim (reduced by 20% per year in years two, three and four). (It is not clear, however, how junior lien holders would participate if the amount of a claim was completely unsecured after the cram-down under a Chapter 13 plan.) For example, if a $100,000 residential loan was crammed down to an $80,000 current value and the property was sold in the first year of the Chapter 13 plan for $90,000, the secured creditor whose loan was crammed down would receive $ 8,000 of the $10,000 above the secured value received at closing.

Impact of the Changes

It is important that mortgage lenders, servicers and investors understand the context in which a Chapter 13 case operates. In particular, a Chapter 13 case is *debtor-driven*, which means that the debtor and his/her counsel controls the creation of the plan submitted to the court for approval. Stated another way, provided that the consumer files an action in *good faith*, the bankruptcy court is likely to confirm a plan that crams-down the value of the lender's secured loan to the value established in court and will use the debtor's declared "disposable income" to fashion a repayment schedule that meets the debtor's ability to pay.

For loans held in portfolio, this means immediate and long-term loss of value – both principal and interest. Each loan affected will likely have to be marked-to-market under the fair value accounting rules. Although the legislation does not directly address the issue, if the value of the real estate is crammed down to less than the amount of the first lien, both home equity lines-of-credit and closed-end mortgages in junior position will be placed in a class of unsecured loans.

For loans sold into the secondary market and securitized, holders of collateral will not receive the anticipated income. In the case of private loan guarantors, applicable contractual obligations may commit a guarantor to continue to pay at a rate specified in a guaranty contract or a securitization agreement even though the cash flow has been modified. Similarly, loan servicers may have a continuing commitment based upon existing loan servicing agreements to continue advancing payments at the original loan contract rate notwithstanding the effect of a Chapter 13 plan.

Finally, while the current version of Chapter 13 permits a limited ability to cram down unsecured debt, the inclusion of a consumer's residence raises the possibility of several competing interests among lenders to preserve the status and amount of outstanding debt. Unsecured creditors such as card issuers may incur larger than expected elimination of recoverable debt, while junior lienors may have some or all of their second lien loans converted to unsecured status, as well as the principal amount being reduced.

In short, the legislation, if adopted, may create a significant market disruption.

Recommended Steps to Consider

First, appreciate that bankruptcy exists to provide a "fresh start" for debtors. The Bankruptcy Code of 1979 and its several amendments are necessarily "pro-debtor." When a notice of a mortgage foreclosure is sent, although timely and legally permissible, make sure the collection actions leading up to the notice clearly demonstrate an attempt by the lender to assist the debtor to avoid foreclosure. Although the House Judiciary Committee version does at least require the consumer debtor to contact the lender about the possibility of a loan modification before filing a Chapter 13 action, there is no better way to demonstrate good faith than being prepared to show attempts to help distressed debtors prior to an actual bankruptcy filing.

Second, lenders that wish to contest elements of a debtor's case (*e.g.,* the diminution in the value of the real property security), will need to show how their valuation was calculated. This is often difficult because lenders use a variety of tools that are too complicated for the court (or the bankruptcy trustee) to understand in the limited time available to it. Among other things, for national lenders and servicers this may mean establishing a comprehensive coordinated approach that can be quickly adopted by local agents and lawyers responding to bankruptcy filings.

Third, the person who shows up to represent the lender, loan servicer or security holder must be able to show who holds the mortgage note and prove they actually represent the person or entity who holds the note. This will be especially challenging for servicers of mortgages that have been securitized.

Practically speaking, every lender with residential mortgages in their portfolio and servicers with obligations to a lender or security holders need to evaluate and periodically re-evaluate the value of the collateral in a way that can easily be demonstrated to a court. This would include:

- Current LTVs
- Current local market analysis and data
- Adopting a “standardized approach” to handling every Chapter 13 cram-down

Where a matter appears headed toward a Chapter 13, an effective presentation of a secured party's position is likely to require:

- Current credit scores and an analysis of the ability of a debtor to repay, and
- Being able to demonstrate the relationship of the mortgage debt to non-real estate secured consumer debt.

For lenders, servicers and others holding residentially secured mortgage notes, the first several months following the adoption of the new Chapter 13 authority will be critical as the bankruptcy courts adapt procedures for valuing residential real estate in current market conditions. Each of the Bankruptcy judges will sort through the cases and develop an understanding of the evidence they will accept when valuations proposed by debtor's counsel are contested. (A "black box" approach that the court cannot penetrate or understand may not overcome valuation testimony provider by the debtor's local appraiser who handles local transactions.)

For a copy of the **Manager's amendment**, click here.

For a copy of the **Manager's explanation**, click here.

Additional Information

Venable attorneys in the firm's Legislative Practice are focusing on this legislation and are available to provide updates as they become available. In addition, members of Venable's Creditor's Rights Practice are available to discuss possible outcomes in a revised Chapter 13 proceeding.

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