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Bankruptcy Reform and the Financial Crisis

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The recent financial crisis has generated a sharp shift in public discourse about, and regulatory interest in, the federal bankruptcy system and financially distressed families. Once, the news media were disproportionately fascinated by the fallen executive with a house in Florida that his creditors could not touch. Today, the featured debtor is more likely to be the low-income homeowner whose mistake was answering the door when a dishonest mortgage broker came calling. Just a few short years ago, lawmakers overwhelmingly supported a giant reform bill, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA),[1] based partly on the notion that bankruptcy judges had too much discretion and bankruptcy professionals were not to be trusted.[2] BAPCPA was well understood to increase the cost and decrease the effectiveness of bankruptcy relief for filers, with little attention to how this might affect the stability of their homeownership. Now, a new bankruptcy reform bill is touted as granting bankruptcy judges *more* flexibility to stabilize mortgages

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1. Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, 19 Stat. 23 (codified in 11 U.S.C.S §§ 101-1501).

2. *See* Jean Braucher, *The Challenge to the Bench and Bar Presented by the 2005 Bankruptcy Act: Resistance Need Not Be Futile*, 2007 U. ILL. L. REV. 93, 94; *see also* Karen Gross, Kathryn R. Heidt, & Lois R. Lupica, *Legislative Messaging and Bankruptcy Law*, 67 U. PITT. L. REV. 497, 505 (2006) (discussing the distrust of participants in the bankruptcy system conveyed in the 2005 amendments).

and communities.[3] With North Carolina Representative Brad Miller helping to take the lead, the legislation *expands* bankruptcy relief for debtors with the express intent to advance housing and economic policy goals through mortgagor protection.[4]

Prior to the current financial crisis, housing policy experts did not publicly reckon with the role of bankruptcy law in managing mortgage delinquency, let alone the limits of bankruptcy law to accomplish those goals. Regardless of their awareness, the existing bankruptcy system has long served as a national anti-deficiency law for debtors who part with their homes for less than the amount of their mortgage debt. Through Chapter 13 of the Bankruptcy Code, in which debtors participate in a supervised repayment plan, bankruptcy has allowed homeowners to reinstate their mortgages in installment payments over the objections of their mortgage holders, although statistics are scarce on actual home retention. But beyond this reversal of acceleration clauses, home mortgages usually cannot be restructured in bankruptcy without consent of the mortgage holder – whoever that may be these days. Consequently, unlike other secured debts, this precludes imposing reductions in interest rate or principal on a mortgage holder.[5] As lawmakers and housing policy experts seek to limit the social costs of widespread foreclosure, they see that a temporary relaxation of this special insulation of home mortgages could prevent poorly underwritten mortgages from wreaking even more havoc in communities and housing markets. In other words, if bankruptcy law permitted a repayment plan to reduce the interest rate on a subprime mortgage, perhaps a borrower in

3. *See, e.g.*, Ronald D. Orol, *Bill to Allow Judges to Modify Loans Passes Hurdle; Judges Can Modify Mortgages According to Legislation OK'd by House Panel*, WALL STREET JOURNAL MARKETWATCH Jan. 27, 2009, *available at* http://www.marketwatch.com/news/story/court-mortgage-modification-bill-passes-house/story.aspx?guid=% 7BBB747EF3%2DD3BF%2D4A8F%2DAA44%2D60896B90F246%7D&dist=msr_ 1 (reporting on passage of Conyers bill by House Judiciary Committee, and framing legislation as being about bankruptcy judge discretion to help prevent foreclosures).

4. Emergency Homeownership and Equity Protection Act, H.R. 225, 111th Cong. (2009) (sponsored by Rep. Miller); Helping Families Save their Homes in Bankruptcy Act, S. 61, 111th Cong. (2009) (sponsored by Sen. Durbin); Helping Families Save Their Homes in Bankruptcy Act, H.R. 200, 111th Cong. (2009) (sponsored by Rep. Conyers).

5. *See* 11 U.S.C. § 1322(b)(2), (5) (2007).

default could keep her home and her neighbors would not see further declines in their property values.[6] If bankruptcy law reduced the mortgage debt to the value of the collateral, perhaps the borrower could see the potential upside in the future and have less of incentive to abandon the home.[7]

In the 110th Congress, even very limited versions of mortgage modification legislation faltered. Chances of passage looked dim. But the 111th Congress brings some new lawmakers, an even more distressed financial climate, and unexpected allies. Although trade associations continue to assert industry opposition, the Wall Street Journal declared that the legislation cleared a "key hurdle" when Citigroup withdrew its own opposition in early January 2009.[8] Many state attorneys general, including North Carolina's, have offered support.[9] The expansion of bankruptcy's mortgagor protection role, at least temporarily, seems plausible, if not imminent.

To the extent that some sort of government mandate of modifications is needed, building an emergency response into an existing legal infrastructure makes sense. Indeed, had Congress acted a year ago, as Representative Miller and the Center for Responsible Lending encouraged them to do, perhaps things would be better today. But administering this response through the bankruptcy system does pose challenges. Those challenges

6. Rich Leonard, *A Win-Win Bankruptcy Reform*, WASH. POST, Nov. 28, 2008, at A29 (reporting on example of homeowner who could retain her mortgage if the interest rate on her refinanced mortgage were reduced, and discussing benefits to her community of doing so).

7. As Quercia & Stegman explain in a literature review, an important group of real estate finance scholars have characterized mortgage termination as a function of the debtor's equity position. Roberto G. Quercia & Michael A. Stegman, *Residential Mortgage Default: A Review of the Literature*, 3 J. HOUSING RESEARCH 341, 357-58 (1992) (explaining that borrowers will tend to exercise their option to default when the net equity value in the house, plus the cost of exercising the option (such as "transaction costs, moving costs, and the value of the borrower's reputation and credit rating") falls below the amount of the mortgage.).

8. Elizabeth Williamson & Ruth Simon, *Plans to Cut Foreclosure Rate Clears Key Hurdle*, WALL ST. J., Jan. 9, 2009, http://online.wsj.com/article/SB123144562914865337.html.

9. *See* Letter from Attorneys General of Twenty-one States to United States House Leadership (Jan. 6, 2009), *available at* http://www.mass.gov/Cago/docs/press/2009_01_06_bankruptcy_code_attachment1.pdf, Letter from Attorneys General of Twenty-one States to United States Senate Leadership (Jan. 6, 2009), *available at* http://www.mass.gov/Cago/docs/press/2009_01_06_bankruptcy_code_attachment2.pdf.

arguably are tempered to the extent the pending reform would create leverage for meaningful non-bankruptcy workouts (with more assurance for servicers that they will not be sued by investors for engaging in them).[10] On the other hand, what happens to cases actually processed through the bankruptcy system is hardly irrelevant to the workout climate.

For example, although bankruptcy law is federal law, the thick existing culture in each district will play some role in shaping the impact of this emergency intervention, just like with any other formal law enactment. This may not entail an intentional subversion, but rather an inevitable filtering process. Pending versions of the mortgage modification legislation build upon Chapter 13 and thus incorporate a generation's worth, or more, of beliefs about that part of the bankruptcy system. In some districts, repeat player professionals – lawyers, trustees, judges, and others - believe that a Chapter 13 plan must make significant promises to pay old, *unsecured* debts beyond what many scholars believe the Bankruptcy Code requires.[11] If Congress has enacted legislation to reduce monthly payment obligations of distressed homeowners, it makes little sense to require every penny of the debtor's savings to be redirected to pay old credit card debts. But at least in some districts, this may be how the law is interpreted. To address this issue, mortgage modification legislation could be accompanied by the clear message that housing and broader economic policy objectives supersede inferred goals of maximizing unsecured debt payment beyond literal Bankruptcy Code requirements. Also, Congress could convey that determinations of disposable income for unsecured debt payment should build in cushions for

10. *Priorities of the Next Administration: Use of TARP funds under EESA: Hearing Before the H. Comm. On Fin. Services,* 111th Cong. 13 (2009) (statement of Michael Calhoun, President and Chief Operating Officer, Center for Responsible Lending).

11. *See* Jean Braucher, *Counseling Consumer Debtors to Make their Own Informed Choices – A Question of Professional Responsibility*, 5 AM. BANKR. INST. L. REV. 165 (1997); *see also* Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L. J. 501, 519 (1993); Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARVARD J. L. & PUB. POL'Y 801, 817 (1994); William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L. J. 397, 415 (1994).

emergencies to further enhance plan stability and the home saving objective.

As a related matter, although stabilizing neighborhoods and housing prices are explicit goals of the pending legislation, bankruptcy law does not have clear mechanisms to account for community interests unrepresented by an explicit legal claim or right.[12] I have previously discussed a more integrated home mortgage delinquency management system that directly considers core housing policy issues such as neighborhood stabilization.[13] No Chapter 13 plan confirmation requirement, however, explicitly accounts for such interests. And no professional in the consumer bankruptcy system is charged with representing them. This is relevant because mortgage modification may be useful to neighborhoods and communities to delay and stagger home loss, even if it does not ultimately prevent home loss.[14] Thus, even when a Chapter 13 plan looks infeasible (and thus technically should not be confirmed),[15] perhaps a neighborhood would benefit if home loss were forestalled a year or two. The broader goals of this emergency legislation may lead judges to generously interpret the requirement that plans be feasible, giving more debtors a chance (even a long-shot chance) to save their homes. If this happens, it becomes especially important that debtors' lawyers stay involved with cases to handle plan adjustments or conversion to Chapter 7 to avoid dismissal without discharge. And, again, debtors should not be pushed to overpromise unsecured debt payments.

12. *See generally* KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997); Karen Gross, Taking *Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L. Q. 1031 (1994) (providing that "community interests must be taken into account in both the corporate and personal bankruptcy systems").

13. Melissa B. Jacoby, *Home Ownership Risk Beyond a Subprime Crisis*, 76 FORDHAM L. REV. 2261, 2287 (2008). I also posited that compliance with Federal Housing Authority guidelines on percentage of income committed to debt service could be factored into approval of workout plans. *Id.*

14. Even with a mortgage modification, a debtor may still ultimately lose her home if the modified mortgage payment will still consume too much of the debtor's income, if non-mortgage homeownership costs remain high, or if the debtor's income is too unstable.

15. Feasibility in chapter 13 means, according to the Bankruptcy Code, that "the debtor will be able to make all payments under the plan and to comply with the plan." 11 U.S.C. § 1325(a)(6) (2007).

For a third challenge, we return to the subject with which this commentary began: the climate and assumptions that preceded the passage of BAPCPA in 2005. In the eight years it took for BAPCPA to become law, overwhelming majorities of elected representatives repeatedly voted in favor of a bill that quite evidently would make bankruptcy harder for filers, including distressed homeowners, in literally dozens of ways. Even if BAPCPA did not contribute to the financial crisis,[16] it has undermined the goal of an efficient bankruptcy system that is increasingly seen as important part of managing the current crisis. After BAPCPA, filers seeking to save their homes in Chapter 13 pay substantially more in attorneys' fees and costs.[17] In addition, statutory drafting problems with BAPCPA have been well documented.[18] Disputes over this language continue to consume disproportionate resources of the bankruptcy system that could be productively directed to so many more pressing matters. In addition, although other factors also are at work, some blame BAPCPA's amendments to Chapter 11 and related provisions for the inability of retailers and other businesses to reorganize.[19] As

16. Some researchers believe that the legislation did contribute to the crisis. *See, e.g.,* DONALD P. MORGAN, BENJAMIN CHARLES IVERSON, AND MATTHEW BOTSCH, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORT NO. 358, SEISMIC EFFECTS OF THE BANKRUPTCY REFORM (NOV. 2008) (arguing that the 2005 amendments contributed to the surge in subprime foreclosures by making it harder for debtors to discharge unsecured debt so that they could concentrate their resources on their mortgages).

17. U.S. GOV'T ACCOUNTABILITY OFF., BANKRUPTCY REFORM: DOLLAR COSTS ASSOCIATED WITH THE BANKRUPTCY ABUSE AND CONSUMER PROTECTION ACT OF 2005, GAO-08-697 (JUNE 2008) ("For chapter 13 cases, our review found the standard attorney fee approved by courts (and which, in practice, is the fee Chapter 13 attorneys typically charge their clients) rose in nearly all the districts and divisions with such fees. In more than half of these cases, the increase was 55 percent or more."); *see also id.* at 21-27 (reviewing fees in greater detail and finding that the median chapter 13 standard had moved from $2,000 just prior to the act to $3,000, a few months after the effective date).

18. *See, e.g.,* Braucher, *supra* note 2, at 97 ("The problems with the 2005 Act are breathtaking. There are typos, sloppy choices of words, hanging paragraphs, and inconsistencies. Worse, there are largely pointless but burdensome new requirements.").

19. *See* Peter Lattman & Jeffrey McCracken, *Clock Ticks for Circuit City Sale*, WALL ST. J., Jan. 16, 2009, http://online.wsj.com/article/SB12320654239698 8067.html (citing financial advisory spokesperson describing as a "real killer" the 2005 limits imposed on time to assume or reject non-residential real property leases, and noting "It's not a coincidence all these liquidations are going on since the code changed."). *See generally* Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of*

retailers fail and workers lose jobs, mortgage problems may expand, increasing the pressure on the bankruptcy system.

One possible supplemental response is to repeal BAPCPA. It took a financial crisis to help the public understand the bankruptcy system and its role in housing policy, and thus why BAPCPA was a bad idea. It may take a repeal of BAPCPA to help get us back on track.

Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 79 AM. BANKR. L. J. 603 (2005) (stating that the 2005 amendments place burdens on debtors that impair their ability to reorganize).