



## CRS Report for Congress

# The Primary Residence Exception: Legislative Proposals in the 110th Congress to Amend Section 1322(b)(2) of the Bankruptcy Code

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### Summary

The recent downturn in the housing market has likely played a role in the rise of late mortgage payments and foreclosures occurring across the country. Some in Congress expect it will lead to increased filings for bankruptcy. As a result, at least four bills seeking to amend § 1322 of Chapter 13 of the Bankruptcy Code have been introduced in the 110th Congress. These bills are S. 2133 and H.R. 3778 (the Home Owners' Mortgage and Equity Savings Act, or HOMES Act); S. 2136 (the Helping Families Save Their Homes in Bankruptcy Act of 2007); and H.R. 3609 (the Emergency Home Ownership and Mortgage Equity Protection Act). This report provides an overview of the general Chapter 13 process and analyzes how these four bills seek to amend Chapter 13.

### Mortgage Market Backdrop

Subprime mortgages are loans extended to borrowers who have no credit history, a blemished credit history, and/or a weak debt-service-to-income ratio. The subprime mortgage market began to flourish in the 1990s. Prior to this time, many borrowers with less than perfect credit profiles were generally not extended credit. The expansion of the subprime market improved access to credit for these borrowers. As such, the subprime mortgage market has likely played a large role in the increase of homeownership in the country.<sup>1</sup> According to the U.S. Census Bureau, the national homeownership rate

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<sup>1</sup> For more information regarding the subprime mortgage market, see CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by Edward Vincent Murphy.

increased from 64.1% in 1993 to 68.9% in 2005.<sup>2</sup> This increase was even more dramatic for minority groups, who saw an increase of nearly 10% during that same time frame.<sup>3</sup> This period of time also happened to coincide with a strong overall housing market, when many homes increased in value.

The housing market began to slow down near the beginning of 2006. This downturn has likely played a role in the rise of late mortgage payments and foreclosures occurring across the country.<sup>4</sup> Some in Congress are concerned that the problems with the housing market will lead to increased filings for bankruptcy.<sup>5</sup> As a result, a number of legislative proposals have been introduced in the 110<sup>th</sup> Congress that are directed at the subprime mortgage market, including at least four bills seeking to amend § 1322 of Chapter 13 of the Bankruptcy Code (Chapter 13).<sup>6</sup>

This report provides an overview of the general Chapter 13 process and summarizes how the four bills mentioned above seek to amend Chapter 13. As these bills, in some cases, deal with matters beyond the scope of this report, the analysis of them is limited to proposed effects on when the modification of mortgages secured by the debtor's primary residence would be allowed; when prepayment penalties on these loans would be waived; whether and to what extent repayment of these loans would be allowed; whether and to what degree interest rates on these loans could be modified; and whether and in what circumstances the credit counseling requirement could be waived.

## Overview of Chapter 13

Bankruptcy provides an avenue by which debtors may get relief from their debts. There are two types of bankruptcies: liquidation and reorganization. Chapter 13 governs reorganizations for individuals. This chapter also provides a framework for debtor-creditor negotiations of repayment prior to a petition for bankruptcy by serving as a baseline, which provides leverage for each side during these negotiations. Outside of bankruptcy, debtors and creditors may consensually modify the terms of their contractual obligations with the understanding that where they cannot agree, the terms are to be modified in accordance with the parameters of the Code if the debtor files (and qualifies<sup>7</sup>)

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<sup>2</sup> *Id.* at 3-4.

<sup>3</sup> *Id.* (homeownership rate of minorities increased from 42.4% in 1993 to 51.3% in 2005).

<sup>4</sup> See CRS Report RL33930, *supra* note 1, and CRS Report RS22511, *Preliminary Observations on the Impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8)*, by Brian Cashnell, Mark Jickling, and Heather D. Negley.

<sup>5</sup> See CRS Report RS22511, *supra* note 4 (while the overall bankruptcy rate for the year 2006 is below the rate in 2005, it is likely that this reduction has more to do with a dramatic increase in filings prior to the implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8), which was widely viewed as more onerous to debtors than the law in place before the act, than a decreased need for bankruptcy protection during this period).

<sup>6</sup> See S. 2133, S. 2136, H.R. 3609, and H.R. 3778.

<sup>7</sup> For instance, 11 U.S.C. § 106(e) requires a Chapter 13 petitioner to have a regular income and limited amount of secured and unsecured debt. Also in most cases, a debtor must receive credit counseling prior to filing for bankruptcy under Chapter 13. For more information regarding the  
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for bankruptcy. When a qualified debtor cannot negotiate revised payments with his or her creditors, the debtor may file a petition for an individual reorganization. Under Chapter 13, the debtor is required to file a reorganization plan with the court.<sup>8</sup> Chapter 13 is a streamlined process, so the plan is generally submitted at the same time as the petition for bankruptcy.<sup>9</sup> Sec. 1322(a) states the requirements that all plans must meet. Sec. 1322(b) states additional parameters that a plan may meet, if applicable. If the plan meets the Code's requirements including the guidelines of § 1322, the court may confirm the plan in accordance with § 1325.<sup>10</sup>

The Code provides the court some leeway to adjust the value of certain liens. For many secured debts, the court has “cram down” authority, that is, the power to lower, over the creditor's objections, the debt's value to as low as the collateral's fair market value.<sup>11</sup> Among the secured debts that the court does not have authority to modify under the current Chapter 13 are those that are secured by the debtor's principal residence.<sup>12</sup> Section § 1322(b)(2) states in relevant part, “the plan may ... 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 primary residence.” By virtue of this provision, a court may modify the debt of a mortgage secured by a debtor's *vacation* home, for instance, but may not cram down the debt on a mortgage secured by the same debtor's *primary* residence. The purpose of the exception, at least based on analysis of its legislative history as expressed in a concurring opinion by Justice Stevens, was to “encourage the flow of capital into the home lending market.”<sup>13</sup>

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<sup>7</sup> (...continued)

Bankruptcy Code's credit counseling requirements, *see* CRS Report RL33737, *Credit Counseling Requirements Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and the Pension Protection Act of 2006*, by Jennifer Staman.

<sup>8</sup> 11 U.S.C. § 1321.

<sup>9</sup> Bankruptcy Rule 1007(c) allows the debtor to file a reorganization plan within 15 days of petition.

<sup>10</sup> 11 U.S.C. § 1325 provides the standards by which a bankruptcy court may confirm a reorganization plan.

<sup>11</sup> 11 U.S.C. § 1322(b)(2). To determine the fair market value of a collateral for the purpose of exercising its cram down authority, the court generally holds a hearing during which the parties submit evidence to support a value. After this hearing, the court determines the appropriate fair market value, and that amount is used to set the reduced debt value, which is plugged into the debtor's reorganization plan.

<sup>12</sup> *Id.*

<sup>13</sup> *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 332 (1992) (*citing Grubbs v. Houston First Am. Sav. Ass'n.*, 730 F. 2d 236, 245-46 (5<sup>th</sup> Cir. 1984)). Despite Justice Stevens' statement, it is unclear whether encouraging capital into the mortgage lending market was the only, or even primary, legislative purpose of 11 U.S.C. § 1322(b)(2). The language of § 1322(b)(2) was the result of a compromise between the House and Senate versions of the Bankruptcy Reform Act of 1978 (P.L. 95-598). However, there was no conference report for this bill, and our research of the legislative history of § 1322(b)(2) yielded no report language or recorded debate to explain the purpose behind the exception for debts secured by the debtor's primary residence. *Grubbs'* conclusion, which was relied upon by Justice Stevens, appeared to be based on witness testimony

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Some legislators have questioned the equity of this exception. In the chairwoman's opening statement of the Subcommittee on Commercial and Administrative Law's markup of H.R. 3609 (discussed below), Representative Linda Sanchez stated: "The current law is unfair and needs to be changed. That's why I'm proud to be behind this bill [H.R. 3609], which will restore fairness to hardworking American families struggling to save their homes from foreclosure in bankruptcy."<sup>14</sup> Similarly, Representative Brad Miller, another sponsor of H.R. 3609, argued that the disparate treatment of debts secured by the debtor's primary residence under the Code in relation to other secured debts is an indication that the Bankruptcy Code favors businesses but not average homeowners.<sup>15</sup>

## Bill Comparisons

**S. 2133.** S. 2133, the Home Owners' Mortgage and Equity Savings Act, or HOMES Act, would have the most limited effect on § 1322 of the four proposals. Section 2 of this bill would only allow judicial modification of a debt secured by the debtor's primary residence if the debtor meets specified income-level thresholds,<sup>16</sup> and then only if both the creditor and debtor agree to the adjustment in writing.<sup>17</sup> Because of the written

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<sup>13</sup> (...continued)

during hearings on the act, which were conducted in the 94<sup>th</sup> and 95<sup>th</sup> Congresses. Some of the more relevant testimony cited was given by Edward J. Kulik during the hearings from the 95<sup>th</sup> Congress. Mr. Kulik, representing the Real Estate Division of the Massachusetts Mutual Life Insurance Company, expressed concern about provisions of the bills that would allow modification of secured debts. He stated, "[t]hese provisions may cause residential mortgage lenders to be extraordinarily cautious in making loans in cases where the general financial resources of the individual borrower are not particularly strong." Mr. Kulik continued: "[s]erious consideration should be given to modifying both bills so that, at the least ... a mortgage on real property other than investment property may not be modified...." See Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. of Improvements in Judicial Machinery of the Sen. Comm. on the Judiciary, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess., 707, 714-15 (1977).

<sup>14</sup> *Linda Sanchez and Brad Miller Introduce Legislation to Relieve Homeowners From Sub-Prime Mortgage Crisis*, Press Release (September 27, 2007), [<http://www.lindasanchez.house.gov/news.cfm/article/348>].

<sup>15</sup> *Miller speaks out on behalf of middle class homeowners in a House Committee on Financial Services hearing on "Possible Responses to Rising Mortgage Foreclosures."* Press Release (April 17, 2007), [<http://www.house.gov/bradmiller/prpr20070417a.html>] (*stating*: "Bankruptcy laws have long been intended to help give people a fresh start ... [high net worth individuals and businesses] can go into bankruptcy, they can shirk their obligations ... And, usually after they come out of bankruptcy, the top executives all pat themselves on the back for their good work by giving themselves a nice bonus. But, for the American homeowner, they can't get a mortgage obligation rewritten in bankruptcy ... American homeowners, the American middle class needs someone on their side. American business has someone on their side. The American homeowners need someone on their side. They need Congress on their side and I hope we will be.").

<sup>16</sup> This means test is based on the state's median family income as well as the size of the debtor's family.

<sup>17</sup> S. 2133, § 2 (It is unclear how long the holder of the claim would continue to hold the lien on the property for the discharged portion of the debt under the bill.).

agreement requirement, this provision of the bill does not seem as if it would substantively change what is already allowed outside of bankruptcy.<sup>18</sup>

Currently, a debtor and creditor, if they so agree, could modify debt secured by the debtor's primary residence outside of bankruptcy. The provision from S. 2133 would basically reach this same end, just in a slightly different way. Instead of the debtor and creditor agreeing outside of bankruptcy to a repayment plan that includes a modification of the debt secured by the debtor's primary residence, S. 2133 would require a written statement of agreement to modify, followed by the reorganization plan that include the modification that would then be approved by the court. The only real difference between the two is that S. 2133 would require a written agreement in bankruptcy that is otherwise implicit to such an agreement outside of bankruptcy. What seems most important is that a creditor's agreement to modify a debt secured by the debtor's primary residence is presumably unlikely, especially in bankruptcy. Therefore, a proposal that does not provide a court some authority to modify these debts in absence of creditor approval does not substantively change what is currently allowed.

S. 2133 would also allow for a waiver of prepayment penalties and for certain modifications of interest rates of some adjustable rate mortgages, but only if the debtor meets the specified income-level thresholds provided in the bill.<sup>19</sup> The bill would additionally allow for a delay in the credit counseling requirement until after filing for bankruptcy if a foreclosure has been initiated against the debtor's primary residence.<sup>20</sup> S. 2133 would not provide an extension of repayment beyond what is currently allowed under the Code. Finally, the bill would sunset seven years after enactment.<sup>21</sup>

**H.R. 3778.** H.R. 3778, also named the Home Owners' Mortgage and Equity Savings Act or HOMES Act, is identical to S. 2133 with the lone exception that it would not require written agreement by the parties before a court could cram down a debt secured by the debtor's primary residence.

**S. 2136.** S. 2136, the Helping Families Save Their Homes in Bankruptcy Act of 2007, would allow judicial modification of a debt secured by the debtor's primary

<sup>18</sup> This interpretation seems to be shared by the bill's sponsor. Senator Specter, on October 5, 2007, stated on the Senate floor that S. 2133 "does not give bankruptcy judges the latitude to reduce the principal on a mortgage.... My bill would only allow the reduction of principal if the lender and the homeowner agree." See *Specter Speaks on Mortgage Crisis*, Press Release (October 5, 2007), [[http://specter.senate.gov/public/index.cfm?FuseAction=NewsRoom.ArlenSpecterSpeaks&ContentRecord\\_id=70319d9c-1321-0e36-bac8-2d8f6d5de585&Region\\_id=&Issue\\_id=](http://specter.senate.gov/public/index.cfm?FuseAction=NewsRoom.ArlenSpecterSpeaks&ContentRecord_id=70319d9c-1321-0e36-bac8-2d8f6d5de585&Region_id=&Issue_id=)].

<sup>19</sup> *Id.* (if the debtor meets the bill's means test, a court may modify an adjustable rate mortgage "by prohibiting or delaying adjustments to the rate of interest applicable to the debt on and after the date of filing of the plan or voiding any such adjustments that occurred during the 2-year period preceding that date of filing....").

<sup>20</sup> S. 2133, § 4. In most cases, a debtor must receive credit counseling prior to filing for bankruptcy under Chapter 13. For more information regarding the Bankruptcy Code's credit counseling requirements, see CRS Report RL33737, *Credit Counseling Requirements Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and the Pension Protection Act of 2006*, by Jennifer Staman.

<sup>21</sup> S. 2133, § 6.

residence but only if the debtor meets an income means test.<sup>22</sup> More specifically, a cram down would be allowed if

after deduction from the debtor's monthly income of the expenses permitted for debtors described in section 1325(b)(3) (other than amounts contractually due to creditors holding such allowed secured claims and additional payments necessary to maintain possession of the residence), the debtor has insufficient remaining income to retain possession of the residence by curing a default and maintaining payments while the case is pending....<sup>23</sup>

If the debtor meets the means test, S. 2136 would allow payment to extend for thirty years less the number of years that the mortgage has been outstanding.<sup>24</sup> The bill would also allow adjustment of the interest rate for repayment at a fixed annual percentage rate equal to "the most recently published annual yield for conventional mortgages" by the Federal Reserve's Board of Governors "plus a reasonable premium for risk," if the debtor meets the means test.<sup>25</sup> In addition, the bill would allow the court to waive any prepayment penalty provided in a mortgage secured by the debtor's primary residence, without regard to the means test.<sup>26</sup> Finally, the bill would eliminate the credit counseling requirement if a foreclosure sale has been scheduled, without regard to the chapter of the Bankruptcy Code under which the debtor has filed.<sup>27</sup>

**H.R. 3609.** The Emergency Home Ownership and Mortgage Equity Protection Act would provide the most significant changes to the Code of the bills analyzed in this report. By not providing a means test that must be met prior to cram down, H.R. 3609 entirely eliminates the exception from judicial modification of debts secured by the debtor's primary residence. As a result, courts would have cram down authority over these debts in all cases validly filed under Chapter 13. By granting the court such broad authority to modify these loans, the bill would seem to allow courts to adjust interest rates and prepayment penalties. The bill would allow for payment of claims secured by the debtor's primary residence beyond the five years allowed under the current Code, without specifying a new time limitation.<sup>28</sup> Additionally, H.R. 3609 would eliminate the credit counseling requirement for debtors who have filed a Chapter 13 petition that includes a claim secured by the debtor's primary residence if a foreclosure has been initiated on that residence.<sup>29</sup>

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<sup>22</sup> This means test is different from the one in S. 2133 and H.R. 3778. It is unclear how the bill would affect the creditor's lien on the portion discharged.

<sup>23</sup> S. 2136, § 101.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> S. 2136, § 201.

<sup>27</sup> S. 2136, § 102.

<sup>28</sup> H.R. 3609, § 6 (The holder of the claim would continue to hold a lien on the property for the discharged portion of the debt until the reorganized debt is paid. By not specifying a new time limitation, the bills apparently would allow a bankruptcy court to extend payment beyond even 30 years.).

<sup>29</sup> H.R. 3609, § 5.