CENTER FOR RESPONSIBLE LENDING

# Constitutionality of Applying Bankruptcy Code Amendments to Existing Mortgages

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CRL Policy Brief

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This memo analyzes whether there is any constitutional impediment to applying to existing debts the Bankruptcy Code amendments proposed by the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, HR 3609,[1] and the Helping Families Save Their Homes in Bankruptcy Act of 2007, S 2136[2] (referred to herein as "the Bill"). The answer is that no such impediment exists.

Indeed, throughout this country's history, and continuing through the major bankruptcy law changes of the modern era, new bankruptcy provisions *typically* have been applied to existing debts. Any claim of unconstitutionality would overlook two centuries of practice, and would ignore clear Supreme Court precedent distinguishing between a creditor's *property* rights and its *contractual* rights. Creditors have a *property* right up to the value of the mortgaged property. Above that value, the creditor's right to repayment is a *contractual* right, and is undeniably subject to modification by bankruptcy courts – without regard to whether the contract predated the enactment of the applicable bankruptcy provision. Because the Bill would preserve the creditors' rights up to the value of the property (indeed, would net the mortgage holder *more* than the mortgage holder would otherwise receive), there can be no serious suggestion of any constitutional impediment.

The analysis below lays out how the history of American bankruptcy jurisprudence establishes the constitutionality of the Bill, and explains why a legal challenge to its provisions would clearly fail.

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Bankruptcy statutes in this country are typically construed to apply to preexisting contractual rights. The Supreme Court has repeatedly held that Congress's power to enact bankruptcy laws authorizes the enactment of laws that modify or impair existing contractual obligations.[3] The suggestion that bankruptcy statutes should not be applied to debts in existence at the time of enactment turns the history and practice of bankruptcy legislation on its head: Making new bankruptcy legislation applicable to existing debts has been the norm since the nation's founding. Until the late nineteenth century, bankruptcy legislation "took the form of temporary relief measures adopted in response to specific financial crises and [were] repealed when the precipitating cause had passed."[4] The very purpose of this legislation was to assist distressed borrowers with their existing debts.[5] The application of newly enacted bankruptcy legislation to existing debts has been the norm not only historically, in the case of the Depression era statutes, but also with modern bankruptcy laws. In fact, the current Bankruptcy Code was enacted in 1978 and applied to existing debts without any constitutional problem. This is true of the Code generally, and of the provision that allows for the modification of mortgages and other debts. The same was true of the Bankruptcy Code amendments of 1986 and 1994, which in each instance, added categories of mortgages that could be modified in bankruptcy, was applied to existing mortgages, and had no constitutional impediments.

The Family Farmer Bankruptcy Act of 1986 is useful precedent. There, Congress did for family farmers precisely what is being proposed for ordinary homeowners today. In response to the farm financial downturn of the early 1980s, Congress added Chapter 12 to the Bankruptcy Code, which

empowered bankruptcy courts to modify farmers' secured and unsecured debts – including all mortgage debts – allowing such debts "to be written down to the fair-market value of the collateral and repaid at lower interest rates over extended periods."[6] The Family Farmer Bankruptcy Act applied to loans that had been made before the statute was enacted. There was no constitutional impediment to its enactment or this application. (Nor did credit dry up, or become more expensive, as some in industry now claim would inevitably result from the more limited changes proposed by the Bill.)

Set out below is the applicable constitutional analysis, as established by Supreme Court precedent, which shows that the proposed Bankruptcy Code changes easily pass constitutional muster.

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### *Overview of Relevant Constitutional Provisions*

Three provisions of the Constitution merit mention. First, the Contracts Clause, contained within Article I, section 10, clause 1, provides: "No State shall ... pass any law impairing the Obligations of Contracts." The law is well-settled and non-controversial that the Contracts Clause applies only to state, and not federal, laws. Moreover, as the Supreme Court has explained, Congress's power under the Bankruptcy Clause of the Constitution "has been regularly construed to authorize the retrospective impairment of contractual obligations."[7]

The Bankruptcy Clause, contained within Article I, section 8, clause 4, provides, "Congress shall have the power ... To establish ... uniform laws on the subject of Bankruptcies throughout the United States." The elevation of the bankruptcy power to a specific constitutional mandate reflects the importance, long enshrined in American public policy, of providing a mechanism for over-burdened debtors to clear their debts and obtain a fresh start.[8] As discussed below, the Supreme Court has clearly shown that the Bankruptcy Clause empowers Congress to promulgate laws that, in the context of bankruptcy, modify the rights of creditors vis-à-vis the bankrupt debtor, to an existing creditor's detriment. As the Court has stated, Congress' power under the Bankruptcy Clause is broad, and "[a] court of bankruptcy may affect the interests of lienholders in many ways."[9] That said, the scope of the Bankruptcy Clause power is constrained by the Fifth Amendment.

The Fifth Amendment provides, "No person shall ... be deprived of life, liberty or property without due process of law; nor shall private property be taken for public use, without just compensation." Creditor challenges to the constitutionality of new Bankruptcy Code provisions generally center on the claim that the provision effects a taking of private property without just compensation. Critical to any such claim is the impairment of a "property" right, as that phrase is understood in the Supreme Court's long-standing constitutional jurisprudence. The discussion below explains why no such claim could properly be made with respect to the Bankruptcy Code amendments proposed in the Bill.

### *Application of the Takings Clause to the Proposed Bankruptcy Code Amendments*

In considering whether a governmental action constitutes the taking of private property without just compensation, courts must determine: (i) whether there has been a "taking" and (ii) whether private "property" is at stake.

(i) <u>What constitutes a "taking"?</u>

A law or regulation can effect a taking where it either constitutes a "physical invasion" of property or where it "denies an owner all economically beneficial or productive use of land."[10] Additionally, a law or regulation can effect a taking where a court concludes it has "gone too far,"[11] based on an "*ad hoc*" consideration of several factors. In *Penn Central Transportation Co. v. City of New York*, the Supreme Court explained these factors as follows:

> [T]he Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant, and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations. ... So, too, is the character of the governmental action. A "taking" may more readily be found when the interference with property can be characterized as a physical invasion by government ... than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the public good.[12]

(ii) What constitutes a "property" right (as opposed to a contractual right)?

In *Penn Central Transportation*, the Court reiterated "that government may execute laws or programs that adversely affect recognized economic values," and noted the precedent in prior Court decisions for finding no constitutional violation where the economic interests harmed by government action were not "sufficiently bound up with the reasonable expectations of the claimant to constitute 'property' for Fifth Amendment purposes."[13]

What constitutes "property" for Fifth Amendment purposes entails, in the context of secured loans, the distinction between a creditor's "property" rights and its "contractual" rights. In the 1982 case of *U.S. v. Security Industrial Bank*, the Supreme Court stated, "the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right of the creditor in the collateral."[14] The difference is crucial, because, while it is long-settled that Congress has the authority to impair contractual obligations through bankruptcy laws, such as modifying interest rates,[15] its power to impair property rights is more limited.[16] And while it is true that "bankruptcy statutes are usually construed to apply to preexisting rights" the same cannot always be said with respect to "property" rights.[17]

The Bill impairs no property right because it would permit loan balances to be written down only to the value of the mortgaged property, but not below that value. Up to the value of the property, the lender's interest is fully protected. The Supreme Court unequivocally held in *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940), that a creditor has a constitutionally protected property right up to the value of the mortgaged property. However, beyond the value of the mortgaged property, the creditor's claim is a contractual right subject to impairment in bankruptcy without regard to whether the contractual right was created prior to the promulgation of the relevant bankruptcy law provision.[18] Because the Bill would permit loan balances to be written down only to the amount of the property's value, and because the creditor has no *property* right to more than that value, no the Bill does not impair any Constitutionally recognized property right.

*Wright v. Union Central Life* involved a constitutional challenge to the Frazier-Lemke Act, a Depression era statute that amended the existing bankruptcy law to provide debt relief for over-extended farmers. The statute provided, among other things, for a three year stay of foreclosure, the Court denied a creditor's constitutional challenge to the application of a bankruptcy law that entitled the

debtor to a stay of foreclosure sale for a period of three years, and permitted the debtor to purchase her mortgaged property at the sale, over the objection of the creditor-mortgagee. The Court held:

> Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that.[19]

The Court also upheld the application to existing debts of the same statute in *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke*, [20] and dismissed a creditor's challenge to the provisions that permitted the debtor to remain in possession of the property during a three-year stay of foreclosure sale. The Court said: "The legislation is designed to aid victims of the general economic depression. The mortgagor is familiar with the property, and presumably vitally interested in preserving ownership thereof … [U]nder these circumstances, the interests of all concerned will be better served by leaving him in possession than by installing a disinterested receiver or trustee." In light of this, and because the creditor would be repaid on its claim up to the value of the property at the foreclosure sale, the Court held that application of the statute to existing debts was constitutional.

Both *Wright v. Union Central Life*, and *Wright v. Vinton Mountain Trust*, upheld the constitutionality of the Frazier-Lemke Act, a Depression era bankruptcy statute that provided relief to debt-burdened farmers, by providing both a three-year stay of foreclosure and giving the debtor the right to purchase the property, free and clear of the mortgage, by paying the amount of the property's appraised value – rather than the full amount of the outstanding loan. In other words, the Frazier-Lemke Act empowered the bankruptcy court to "cram down" the mortgage to value of the property, so that the debtor could purchase it for value, rather than the loan amount. Finally, the Frazier-Lemke Act expressly provided: "This Act shall be held to apply to all existing cases now pending in any Federal court … as well as to future cases…"[21] In both cases, the Supreme Court held that the Frazier-Lemke Act was constitutional and could properly be applied to debts already existing at the time of enactment.

The Bill is far better for creditors than the Frazier-Lemke Act, which the Supreme Court upheld in *Wright v. Union Central Life*, and *Wright v. Vinton Mountain Trust*. In addition to providing for a three-year stay of foreclosure, Frazier-Lemke entitled the debtor to remain in possession of the property making only rental payments, which were to be applied to the payment of taxes and maintenance of the property. Creditors would be paid only if and to the extent there were any amounts left over. Moreover, the debtor was not required to make any repayments of the principal balance during the three-year stay, unless the court determined such payments were appropriate given "the debtor's ability to pay, with a view to his financial rehabilitation."[22] In contrast, under the enactment of the Bill, the debtor would be required to repay the loan monthly installments, at the prevailing market interest rate plus a risk premium. In light of the two Supreme Court decisions upholding the constitutionality of applying the Frazier-Lemke Act to existing debts, there can be no doubt of the constitutionality of so applying the Bill here.

The Securities Industry and Financial Markets Association ("SIFMA") has erroneously suggested that applying the Bill to existing mortgages would be unconstitutional. In making this claim, SIFMA ignores these two cases, relying instead on the earlier case of *Louisville Joint Stock Land Bank v. Radford*, [23] in which the Court held unconstitutional an earlier version of the Frazier-Lemke Act. *Radford* has no bearing here, because in *Radford*, the relevant provisions of the Frazier-Lemke Act provided the lender with "*much less* than the appraised value" of the property.[24] This critical aspect of the *Radford* decision was highlighted by the Supreme Court in the 1982 case of *U.S. v. Security Industrial Bank*, which explained the *Radford* decision, noting that, "The Frazier-Lemke Act, which

by its terms applied only retrospectively, permitted the debtor to purchase the property for less than its fair market value."[25] No such impediment applies to the Bill.[26]

### ***The Proposed Amendments Do Not Effect a Taking Of Property***

The Bill's proposed Bankruptcy Code amendments would permit the mortgage to be crammed down to the value of the property, but would not permit any cram-down below that value. As the Supreme Court said in *Wright v. Union Central Life*, "[t]here is no constitutional claim of the creditor to more than that."[27] The creditor's right to recover loan balances beyond the value of the property is contractual, and is unquestionably subject to modification or impairment pursuant to amended provisions of the Bankruptcy Code.[28] The Bill thus carefully avoids any impingement on any property right, and thus stays well clear of any constitutional objection.

For these reasons, the application of the Bill's proposed amendments to existing mortgages is not subject to any serious constitutional challenge.

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[1] HR 3609 was introduced on September 20, 2007, by Representatives Miller, Linda Sánchez, Frank, Maloney and Watt.

[2] S 2136 was introduced on October 3, 2007 by Senators Durbin and Schumer.

[3] *U.S. v. Security Industrial Bank*, 459 U.S. 70, 75, 80 (1982).

[4] Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, (hereafter "Rogers"), 96 Harv.L.Rev. 973, 1016 (1983). http://www.ers.usda.gov/publications/aib788/aib788.pdf; *and see* Jerome M. Stam and Bruce L. Dixon, *Farmer Bankruptcies and Farm Exits in the United States*, 1899-2002, United States Department of Agriculture, Economic Research Service Agriculture Information Bulletin Number 788 ("The National Bankruptcy Act of 1898 (Ch. 541, 30 Stat. 544) marked the first modern bankruptcy law and the beginning of the era of permanent Federal bankruptcy legislation. The principal provisions of this legislation are that any debtor who is unable to meet his or her obligations as they mature may present his or her case to a Federal court, listing his or her assets and liabilities. If the court, after verifying assets and claims and after hearing creditors, decides that the case warrants the action, it may apportion the assets among the creditors, subject to the borrower's exemptions as specified under the law and may declare the debtor free from all but certain specified obligations. Enacted in the aftermath of the severe 1893 depression, this bankruptcy legislation, with subsequent amendments, governed the procedure for the legal adjustment involved in bankruptcy cases under Federal jurisdiction for over 80 years.")

[5] Rogers, 96 Harv.L.Rev. at 1016 ("As long as bankruptcy acts were seen as temporary relief measures enacted to alleviate existing economic troubles, the idea of non-retroactive bankruptcy legislation would be almost an absurdity.")

[6] Jim Monke, *Agricultural Credit*, Congressional Research Service Agricultural Policy Briefing Book, http://www.cnie.org/nle/crsreports/briefingbooks/Agriculture/Agricultural%20Credit.htm

[7] *See, e.g.*, *U.S. v. Security Industrial Bank*, 459 U.S. 70, 75 (1982).

[8] *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934), citing *Williams v. U.S. Fidelity & Guaranty Co*., 236 U.S. 549, 554, 555 (1915). See also, Rogers, 96 Harv.L.Rev at 1001, n. 107 and text, citing *Local Loan Co. v. Hunt*; Sousa, *Are You Your Produce Vendor's Keeper? The Perishable Agricultural Commodities Act and § 523(a)(4) of the Code,* 15 J.Bankr.L. & Prac. 6 Art. 3.

[9] *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke*, 300 U.S. 440, 470 (1937).

[10] *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1015 (1992); *see also* Forrester, *Bankruptcy Takings*, ("Forrester") 51 Fla.L.Rev. 851, 865 (1999). The Supreme Court itself acknowledged that this formulation is ambiguous: "When, for example, a regulation requires a developer to leave 90% of a rural tract in its natural state, it is unclear whether

we would analyze the situation as one in which the owner has been deprived of all economically beneficial use of the burdened portion of the tract, or as one in which the owner has suffered a mere diminution in the value of the tract as a whole." *Lucas*, 505 U.S. at 1016 n. 7; *see* Fee, *Comment: Unearthing the Denominator in Regulatory Taking Claims*, 61 U.Chi.L.Rev. 1535 (1994).

[11]In *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922), Justice Holmes first articulated the now "oft-cited maxim that, 'while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.'" *Lucas*, 505 U.S. At 1015 (citing *Pennsylvania Coal*, 260 U.S. at 415.

[12]*Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 124 (1978) (internal citations omitted).

[13]*Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 124 -25(1978) (internal citations omitted).

[14]*See U.S. v. Security Industrial Bank*, 459 U.S. at 75.

[15] *See Wright v. Vinton Branch*, 300 U.S. at 440; *Wright v. Union Central Life*, 311 U.S. at 273.

[16]*U.S. v. Security Industrial Bank*, 459 U.S. at 75.

[17]*U.S. v. Security Industrial Bank*, 459 U.S. at 80.

[18]*Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940)

[19]311 U.S. at 278 (*emphasis supplied*).

[20]300 U.S. 440, 466 (1937).

[21] 9 Stat. 942, 74th Cong., Sess. I., Ch. 792 (Aug. 28, 1935), Sec. 6(s)(5).

[22]9 Stat. 942, 74th Cong., Sess. I., Ch. 792 (Aug. 28, 1935), Sec. 6(s)(2).

[23]295 U.S. 555 (1935).

[24]*Radford* , 295 U.S. at 591 (under the Frazier-Lemke Act, "a sale at <u>much less than the appraised value is prescribed</u>") (emphasis supplied).

[25] 459 U.S. 70, 76 n. 7 and text (1982) (emphasis supplied). ("The Frazier-Lemke Act, which by its terms applied only retrospectively, permitted the debtor to purchase the property <u>for less than its fair market value.</u>" (emphasis supplied)). The Court explained that, as originally enacted, the Frazier-Lemke Act (48 Stat. 1289, 73d Cong., Sess. II., Chs. 868-69 (June 27-28, 1934) (s)(3)) gave the debtor the right to purchase the property through deferred payments made in installments over five years, paying only one percent interest. "Given the interest rate of 1%, the present value of the deferred payments was much less than the value of the property." *Security Industrial Bank*, 459 U.S. at 76 n.7. *Security Industrial Bank* involved a creditor's challenge to the retroactive application of the lien avoidance provision of the 1978 Bankruptcy Act (Bankruptcy Code section 522(f)(2)), which permitted debtors to avoid the liens on certain types of property. Although the Court decided the question on statutory, rather than constitutional grounds, it stated in *dicta* that because the provision would void the <u>entire lien</u> – not just the creditor's right to recover the excess over the value of the mortgaged property – thereby resulting in "a <u>complete destruction</u> of the property right of the secured party," the constitutionality of its retroactive application was in "substantial doubt."459 U.S. at 75, 78 (emphasis supplied).

[26]Moreover, whatever Radford's continued viability for propositions not in issue here, in light of SIFMA's reliance on the case, it merits note that, while never expressly overturned, the Supreme Court itself later cited Radford as an example of Supreme Court error. *See* Rogers, 96 Harv. L. Rev. at 981 n. 33 (noting "the Supreme Court itself once admitted that it may have fallen into error in *Radford* and corrected itself in *Vinton Branch*," and citing *Helvering v. Griffiths*, 318 U.S. 371, 400-01 & n.52 (1943), in which the court observed that, "this Court may fall into error," citing *Radford* as an example of error, and *Wright v. Vinton Branch* (in which the Court upheld the amended Frazier-Lemke Act), as the correction of that error. Both decisions were authored by Justice Louis D. Brandeis)).

[27] 311 U.S. at 278.

[28] *U.S. v. Security Industrial Bank*, 459 U.S. at 75.