

A Comment on Misbehavior and Mistake in Mortgage Bankruptcy Claims

Professor Angela Littwin*

Professor Porter has done the bankruptcy system a considerable service in writing *Misbehavior and Mistake in Bankruptcy Mortgage Claims*.¹ The information generated by the underlying empirical investigation would be important enough standing on its own, but Porter's greater contribution may lie in her argument for shifting the foreclosure-crisis discussion away from the exclusive focus on loan origination and toward an examination of mortgagee behavior that harms borrowers after closing papers have been signed.

During the current economic crisis, much attention has been paid to the problems within the mortgage-servicing industry. Commentators in the popular and academic presses began to recognize that the complex way in which mortgages and mortgage-servicing rights were sold and resold was making it onerous for defaulting homeowners to figure out who their servicers *were*, much less to make alternative payment arrangements that might allow them to save their homes. But Professor Porter takes this one step further, demonstrating that this diffuse mortgage-ownership structure has not only left servicers less able to remedy some of the harms begun at loan origination, but has actively caused harm itself. She estimates that mortgagees may be overcharging homeowners in bankruptcy by as much as \$1 billion a year. Given that these borrowers are already in bankruptcy, any overcharging puts them at even more severe risk of losing their homes. Still worse, she argues persuasively that abuses in bankruptcy are probably just the tip of the iceberg because bankruptcy courts provide more judicial oversight and consumer protection than courts provide in state-law foreclosures.

Porter and her co-investigator Tara Twomey² examined the court records of 1,733 homeowners who had filed Chapter 13 bankruptcy cases. The study randomly selected cases within forty-four judicial districts from the twenty-four states that allow nonjudicial foreclosures on primary residences. The investigators gathered a wealth of information about

* Assistant Professor, The University of Texas School of Law

1. Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEXAS L. REV. 121 (2008).

2. Lecturer on Law, Stanford Law School.

homeowners in bankruptcy, but Littwin's article focuses on mortgagee submission of proofs of claim. The results are disturbing.

To appreciate why Porter's findings are so shocking, it is necessary to understand the central role that proofs of claim play in bankruptcy. In a bankruptcy proceeding, a proof of claim functions as a complaint does in an adversarial lawsuit. Each creditor who wants to receive a distribution in a bankruptcy case must file a claim to establish the amount of the debt. As such, they are an essential part of the process. A bankruptcy case without proofs of claim would be like an adversarial case where the plaintiff neglected to specify damages—only in bankruptcy, there are multiple parties seeking to collect.

Despite their importance, the mortgage claims Porter examined were riddled with errors and missing documentation. Here is a brief sampling of her results. Just over half of mortgagees neglected to file one or more of the three forms of required documentation.³ These are not technical documents either. They include basics, like itemized lists of charges the debtor owes. Even when claims did provide itemized charges, their value was often limited. There was no standardized method of presenting the charges, and the lists were often so vague as to be nearly useless.⁴ Some "lists" included just three items: principal, interest, and "other."⁵ This lack of clarity makes it nearly impossible for debtors and their lawyers to determine whether the fees are allowed under the bankruptcy code and, indeed, whether the events that triggered them even took place.

This lack of record keeping almost certainly contributed to the wide discrepancy between debtors' and creditors' perceptions of the total amount owed. Porter found that the two parties agreed on the size of the debt in just 4.4 % of cases.⁶ In approximately 70 % of cases, it was the mortgagee who provided a higher figure.⁷ Over the course of the study, these charges added up to a net discrepancy of nearly \$6 million in the creditors' favor. Porter multiplied this figure by the number of homeowners in bankruptcy and found that, if her sample is representative, mortgagees are charging \$1 billion a year more than the debtors submitted in their filings.⁸

These findings are particularly striking in light of the lengths to which Congress has gone to ensure the accuracy of consumer bankruptcy petitions. In the 2005 amendments to the bankruptcy code, Congress dramatically increased the amount of paperwork and documentation debtors must submit

3. See Porter, *supra* note 1, at 146 (52.8% lacked one of the required documents).

4. See *id.* at 152 (finding standardization of charges absent and that some filings had "little detail.")

5. *Id.* at 153.

6. *Id.* at 162.

7. See *id.* (70.4%).

8. *Id.* at 166–67.

in order to file,⁹ required that their attorneys make a “reasonable investigation” into the accuracy of all debtor submissions,¹⁰ and mandated automatic dismissal when debtors fell short.¹¹ If debtors were submitting documents of the same quality as those filed by mortgagees, their cases would be dismissed¹² and their attorneys exposed to sanctions.¹³

Porter offers several ideas for improving mortgagee proofs of claim. She argues persuasively that the market provides little incentive for mortgagees to make changes. Homeowners almost never have direct contact with the parties who own their loans. Currently, these are usually investors who own small pieces of hundreds of different loans in the form of mortgage-backed securities. Homeowners instead interact with loan servicers, who serve as intermediaries between mortgagors and the investors.

It is mortgage servicers who assess fees and who file proofs of claim in bankruptcies. But servicers have no incentive to provide competent loan management for homeowners and, in fact, have an incentive to overcharge them. Borrowers have no ability to change servicers. Servicing rights are sold and resold with no borrower consent required. Porter points out that even if a homeowner were to take the relatively extreme measure of refinancing in order to change servicers, there is no guarantee that the mortgage’s servicing rights would not be sold to the same servicer. Moreover, most agreements allow servicers to keep the various fees they charge upon default rather than passing these fees along to the investors. So servicers have a direct profit incentive to assess more and higher fees.

This article will undoubtedly become an important starting point for commentators looking for ways to reduce foreclosure rates. Porter offers several suggestions, focusing on procedural options for improving the claims process. In the remainder of this comment, I consider their probability of success, both in terms of the likelihood of their adoption and their effectiveness once put in place. It also occurred to me that her research provides powerful support for the proposal to allow judges to modify mortgages in bankruptcy, the main substantive reform that was discussed by Congress during the financial-bailout debates—and one that is already reemerging after the election.¹⁴

9. 11 U.S.C. § 521(a)–(g) (2006).

10. 11 U.S.C. § 707(b)(4)(C)–(D) (2006).

11. 11 U.S.C. § 521(i).

12. *Id.*

13. 11 U.S.C. § 707(b)(4)(A)–(B).

14. See *Durbin Introduces Bill to Help Families Keep Their Homes, Strengthen Taxpayer Protections*, Nov. 17, 2008, <http://durbin.senate.gov/showRelease.cfm?releaseId=305067> (discussing Senator Dick Durbin’s recently introduced bill, the Homeowner Assistance and Taxpayer Protection Act, which allows bankruptcy judges to modify mortgages on primary residences).

Her first suggestion is to disallow claims that do not provide adequate or accurate documentation.¹⁵ This is the logical place to begin. Mortgagees cannot collect any more from debtors than they can demonstrate—in a way that is comprehensible to courts and debtors—that they are owed. This idea has a certain appeal in terms of basic fairness. Why should mortgagees be able to collect on debts that they cannot document when debtors are subject to dismissal for documentation shortfalls far less severe than the errors Porter found in her study? Disallowing poorly documented claims also properly aligns mortgagee incentives. The possibility of losing their claim in bankruptcy, and therefore losing the entire debt their investors had purchased, is a sufficiently negative consequence to make it worthwhile for servicers to develop better claims-processing procedures.

On the other hand, disallowing a secured claim is strong medicine. Even assuming that judges would allow mortgagees to amend inadequate proofs of claim, mortgage lenders and servicers would likely find this remedy so contrary to their interests that they would hotly contest its implementation. In addition, unlike Porter's other proposals, this one may have to be enacted at a legislative level through an amendment to the bankruptcy code.

As the statute stands, courts may disallow a claim if one party objects and the party being challenged cannot provide adequate documentation. The difficulty is that because the mortgagee has control over the relevant information, the debtor often does not have enough information to support its contention that the balance is incorrect. Some courts have ruled that showing incomplete documentation alone is enough to disallow a claim, but the majority require the debtor to show some evidence of inaccuracy before the burden of proof will shift to the mortgagee.¹⁶ A statutory amendment that makes inadequate documentation alone sufficient grounds for disallowance would protect homeowners more effectively. Legislative involvement, however, would heighten the profile of the debate and enable mortgagee interests to marshal substantial resources to fight this change.

Porter offers two proposals that could be enacted at the agency-regulatory level. First, she suggests making evaluation of mortgage claims an official part of the duties of a trustee.¹⁷ Second, she argues that the Advisory Committee on Bankruptcy Rules should standardize the format of the documentation mortgagees must submit to support their proofs of claim.¹⁸ The first idea has the advantage of capitalizing on the presence of the one party to bankruptcy cases who has strong nonfinancial incentives as well as financial ones. Adding claims review to the criteria upon which Chapter 13

15. Porter, *supra* note 1, at 173–74.

16. *See id.* at 173 (explaining court decisions).

17. *Id.* at 174.

18. *Id.* at 175.

trustees are evaluated provides one party with incentives to look closely at proofs of claim without resorting to the legislative changes required to realign financial motivations. Porter appears to have already made some progress towards this goal. She presented her findings to the Office of the U.S. Trustee in July of 2007, and by November of that year, it announced a decision to pursue faulty mortgage claims more aggressively.¹⁹

Her proposal to standardize proofs-of-claim documentation, such as itemizations of the charges that make up the balance owed, is equally strong. It has the additional advantage of benefitting all parties. While mortgage servicers would face startup costs, they would benefit in the long term by having consistent standards that they could implement efficiently on a nationwide basis instead of being subject to different procedures in different localities.

Her final suggestion is the most intriguing: an educational effort to inform consumer bankruptcy attorneys about the potential advantages of investigating claims more closely.²⁰ Porter points out that deficiencies and inaccuracies in mortgage proofs of claim can lead to damage-generating causes of action under state and federal law.²¹ Some of these actions also provide for recovering attorneys fees when successful. One major reason that so many inadequate proofs of claim have gone unchallenged is that, in order to stay in business, consumer bankruptcy lawyers have to manage high-volume practices. The fees they charge are restricted by their clients' inability to pay, so a successful practice must limit the amount of attorney time invested in each case. This means that debtors lawyers cannot afford to pore over mortgagee claims seeking illegal fees to challenge. The opaque proofs of claim that servicers submit make reviewing them a time-consuming endeavor for any lawyer who undertakes it and makes it difficult to assign this task to a legal assistant. But if identifying and challenging problematic proofs of claim could lead to damages awards for their clients and attorneys fees for them—and they can—then reviewing mortgage submissions could be an economically sustainable proposition for consumer bankruptcy lawyers.

While Professor Porter's procedural reforms would almost certainly have a large impact on the quality of mortgage proofs of claim, it is still worth considering the relationship of her findings to proposals for substantive reform that would lessen the harm caused by questionable claims in the first place. The most likely alternative is the proposal to allow

19. Gretchen Morgenson, *Dubious Fees Hit Borrowers in Foreclosures*, NYTIMES.COM, Nov. 6, 2007, <http://www.nytimes.com/2007/11/06/business/06mortgage.html>.

20. Porter, *supra* note 1, at 177.

21. *Id.* at 178.

consumers to “cram down” their home mortgages in bankruptcy.²² Under current law, Chapter 13 allows debtors to “strip” an undersecured lien down to the value of its collateral. So if a consumer bought a washer–drier on credit and still owes \$800 on it, even though it is now worth only \$300, she can restructure the debt so that the lender’s security interest is reduced to \$300.²³

Mortgages on the debtor’s principal residence have always been exempt from cramdown.²⁴ This exemption went largely unnoticed outside the bankruptcy community when home values were rising because cramdown is not relevant when collateral is worth more than the loan. But in the last few years, as foreclosure rates jumped and real estate prices plummeted, waves of consumers began arriving in bankruptcy with houses worth less than their loans. The acute economic crisis that began this September triggered calls for the elimination of the primary-residence cramdown exemption.²⁵ Not surprisingly, mortgage lenders and servicers opposed this change, as did Republicans in the House of Representatives, and it was not a part of the bailout package that Congress eventually passed.

The economic arguments for and against cramdown of home mortgages are complex and beyond the scope of this comment,²⁶ but Porter’s findings add an administrability element to the debate. If debtors could cram down their primary residential mortgages, the accuracy of mortgagee proofs of claim would become much less important, at least in the many cases where it is undisputed that the remaining balance is higher than the value of the home.

With cramdown, the bankruptcy court would modify the debtor’s mortgage so that the consumer would need to pay only the value of the home to prevent foreclosure. In such cases, the balance listed on the mortgagee’s proof of claim would no longer be determinative. The remaining deficiency would become an unsecured claim, to be paid at the same rate as, for example, the debtor’s credit-card debt. Any inaccuracies in the total balance would become significantly less important because a debtor’s inability to pay

22. See 11 U.S.C. § 1325(a)(5)(B)(ii) (2006) (allowing for reduction of secured claims to the value of property)

23. The remaining \$500 becomes an unsecured claim. The consumer’s ability to cram down the loan to the value of the collateral also depends on satisfaction of the timing criteria established by 11 U.S.C. § 1325(a).

24. 11 U.S.C. § 1322(b)(2). Debtors may, however, cram down mortgages that are not the debtor’s primary residence, such as investment properties and second homes. *Id.*

25. See Tara Siegel Bernard, *A Bill Encouraging to Distressed Homeowners, but Its Reach Is Unclear*, N.Y. TIMES, Sept. 29, 2008, at A16, available at <http://www.nytimes.com/2008/09/29/business/yourmoney/29consumer.html> (noting that the financial industry has long opposed giving bankruptcy courts the authority to alter the terms of mortgages on a person’s primary residence).

26. For an excellent brief summary, see Adam Levitin, *Debunking the Mortgage Bankers Association’s Cramdown Claim*, <http://www.law.georgetown.edu/faculty/levitin/documents/MBAClaimDebunked.pdf> (Sep. 24, 2008).

them in full would no longer act as a bar to plan confirmation. In addition, the debtor would almost certainly be paying only a fraction of the now-unsecured part of the claim.

From a policy perspective, if the repackaging of mortgages into complex mortgage-backed securities has rendered mortgagees incapable of consistently producing accurate loan records, then perhaps courts should not rely on these loan records in determining the amount the debtors must pay to avoid losing their homes. The existence of a business practice that makes basic record keeping difficult should not excuse mortgagees from the documentation requirements of bankruptcy. Rather, it is an argument in favor of revising or even discontinuing the practice of repackaging.

Of course, the valuation of a home for cramdown purposes poses its own administrative challenges, albeit ones that bankruptcy courts address routinely. At least, it is a question that debtors and their attorneys can begin answering with their own information instead of having to rely on figures under the creditor's control. In addition, the potential for large savings from a cramdown would make the time and expense required to evaluate mortgage claims more financially feasible for consumer bankruptcy attorneys.

It is not possible to estimate the number of families who are facing inflated claims as a result of poor record keeping, but Porter's data suggest that the number may be quite high. Her findings point to—dare I say it?—a crisis in the bankruptcy system. All legal systems seek to promote the rule of law, but this goal is closer to the heart of bankruptcy than most. One of its overarching policies is the orderly disposition of debts and assets. But that is impossible to accomplish when the documents that in many cases will single-handedly determine a debtor's financial future are so unreliable so much of the time.