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Cutting the Gordian Knot: The Case for Allowing Modification of Home Mortgages in Bankruptcy

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> *More than 5 million mortgages have been caught in foreclosure proceedings since the economy began slipping in 2007, and an estimated 8 million to 13 million more could follow in the next five years. The Treasury's goal is to help modify 3 million to 4 million mortgages in three years, but only about 1 percent of that number have completed the process.*[1]

IN 2007, THE UNITED STATES ENTERED A FORECLOSURE CRISIS that brought the nation's economy to its knees.[2] A rising tide of residential foreclosures is projected to continue unabated into 2010,[3] with the foreclosure epidemic spreading beyond subprime mortgages to include growing numbers of prime loans and high-value homes.[4] The stark numbers—more than 925,000 homeowners in the United States

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1. Chris Adams, *Feds Make Slow Progress on Stalling Foreclosures*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 3, 2010, at 3A.

2. Ironically, the initial harbinger of the foreclosure crisis was the financial failure of many of the subprime mortgage lenders responsible for originating the loans that would ultimately go into default. New Century Financial, the second largest subprime lender in 2006, filed bankruptcy on April 2, 2007, followed by American Home Mortgage Investment and Aegis Mortgage Corporation in August of 2007. *See American Home Mortgage Seeks Chapter 11 Bankruptcy Protection*, N.Y. TIMES, Aug. 7, 2007, at C3 (reporting bankruptcy of American Home Mortgage Investment); Julie Creswell & Vikas Bajaj, *Home Lender Is Seeking Bankruptcy*, N.Y. TIMES, Apr. 3, 2007, at C1 (reporting the bankruptcy of New Century Financial Corporation); *Subprime Lender Seeks Protection from Creditors*, N.Y. TIMES, Aug. 14, 2007, at C10 (reporting the bankruptcy of Aegis Mortgage Corporation).

3. *See, e.g.*, Renae Merle, *New Round of Foreclosures Threatens Housing Market*, WASH. POST, Mar. 12, 2010, at A1; Editorial, *More Foreclosures to Come*, N.Y. TIMES, Nov. 12, 2009, at A34 ("By conservative estimates, another 2.4 million homes will be lost in 2010 . . . ."); E. Scott Reckard, *Mortgages; Defaults Likely to Keep Rising; Job Losses Have Replaced Subprime Loans as the Main Cause, Experts Say*, L.A. TIMES, Oct. 14, 2009, at B1, *available at* http://www.latimes.com/business/la-fi-mortgage14-2009oct14,0,7151440.story.

4. Nick Timiraos, *Foreclosures Grow in Housing Market's Top Tiers*, WALL ST. J., Oct. 12, 2009, at A2 (reporting that prime loans accounted for 58% of foreclosure starts in the second quarter of 2009, and that 30% of foreclosures in June 2009 involved homes in the top third of housing values).

received a foreclosure filing in the third quarter of 2009[5]—represent homeless Americans,[6] abandoned homes,[7] and blighted neighborhoods.[8]

In earlier decades, foreclosures were caused by recession, job loss, or illness. The surge in foreclosures that began in 2007 was different. This new wave of foreclosures was not caused by an economic downturn or even by a decline in the purchasing power of the borrowers. Instead, it could be traced to the cumulative effect of unconventional mortgage products with payment obligations that reset and increase over time,[9] and falling home prices that made it impossible for homeowners to obtain more advantageous mortgages through refinancing.[10]

Spurred by the severity of the mortgage crisis and its impact on the national economy, Congress responded to the problem in July of 2008 with the HOPE for Homeowners Program, created as a part of the Housing and Economic Recovery Act of 2008.[11] The HOPE for Homeowners Program was premised on the notion that the problem could be solved by encouraging lenders to voluntarily modify

5. Renae Merle, *Foreclosures Continued to Rise in 3rd Quarter as Banks Worked on Backlog*, WASH. POST, Oct. 16, 2009, at A18 (describing a "foreclosure filing" as a lender-initiated event ranging from a default notice to a bank repossession). On November 20, 2009, the *New York Times* reported that almost 10% of homeowners with mortgages were at least one payment behind in the third quarter of 2009. David Streitfeld, *As Delinquencies Soar, One in 10 Mortgages Is a Month or More Late*, N.Y. TIMES, Nov. 20, 2009, at B6. "The combined percentage of those in foreclosure as well as delinquent homeowners is 14.41 percent, or about one in seven mortgage holders." *Id.*

6. Peter S. Goodman, *From Foreclosure to the Car to a Shelter Bed*, N.Y. TIMES, Oct. 19, 2009, at A1.

7. Vikas Bajaj, *Responding to a Housing Crisis*, N.Y. TIMES, Aug. 26, 2008, at C1 ("Many developers and home buyers are also not willing to take a chance on dilapidated properties in distressed neighborhoods. . . . [S]ome homes [are] staying vacant for months or even years . . . .").

8. *See* Creola Johnson, *Fight Blight: Cities Sue to Hold Lenders Responsible for the Rise in Foreclosures and Abandoned Properties*, 2008 UTAH L. REV. 1169, 1198–1232 (2008) (describing lawsuits by municipalities to hold lenders responsible for costs associated with neighborhoods blighted by properties abandoned after foreclosure).

9. *See infra* notes 109–12 and accompanying text; *see also* Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007, at C1 (discussing subprime mortgage lending and the impact of adjustable interest rates on foreclosures).

10. *See, e.g.*, Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Beyond Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A1 (noting that even homeowners with solid credit are finding it difficult to refinance their mortgages). The housing "bubble" that contributed to the subprime mortgage crisis has been extensively documented. *See, e.g.*, *id.*; Mara Der Hovanesian, *Bonfire of the Builders*, BUS. WK., Aug. 13, 2007, at 26 (describing the housing bubble and the role homebuilders played in creating the crisis); Vitaliy N. Katsenelson, Op-Ed., *The Fed's Irresponsible Move*, BUS. WK., Oct. 1, 2007, at 104 (tracing the housing bubble to the 2001 interest rate cuts); Ben Steverman & David Bogoslaw, *The Financial Crisis Blame Game*, BUSINESSWEEK.COM, Oct. 18, 2008, http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm (detailing the players involved in creating the housing bubble). In the third quarter of 2009, 23% of American homeowners owed more on their mortgages than what the underlying properties were worth. Ruth Simon & James R. Hagerty, *1 in 4 Borrowers Under Water*, WALL ST. J., Nov. 24, 2009, at A1 ("Nearly 10.7 million households had negative equity in their homes in the third quarter [of 2009] . . . .").

11. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654; HOPE for Homeowners Act of 2008, Pub. L. 110-289, §§ 1401–04; 122 Stat. 2654, 2800–10.

defaulted mortgages into conventional fixed-rate loans.[12] HOPE for Homeowners was one in a series of voluntary programs intended to prod reluctant lenders to work cooperatively with borrowers in trouble.[13] Voluntary loan modification programs have proven fundamentally ineffective,[14] leading President Barack Obama to implement the Making Home Affordable Plan,[15] a four-part program that, while still largely voluntary, requires modifications from lenders subject to government pressure.[16] The President's plan has also produced disappointing results through the

12. *See* Chad D. Emerson, *A Troubled House of Cards: Examining How the Housing and Economic Recovery Act of 2008 Fails to Resolve the Foreclosure Crisis*, 61 Okla. L. Rev. 561, 573 (2008) (describing the HOPE for Homeowners Act of 2008).

13. Other programs include the President's Making Home Affordable Plan; HOPE NOW, a voluntary non-governmental mortgage industry program; and FHA Secure (discontinued in 2008). *See* Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, 36 Fordham Urb. L.J. 509, 515–16 (2009) (describing the HOPE NOW program); FHA Secure Refinance Loan Program for Adjustable Rate Borrowers, http://www.fhainfo.com/fhasecure.htm (describing FHA Secure); Adam Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 Harv. L. & Pol'y Rev. Online, Jan. 19, 2009, at 1, http://hlpronline.com/Levitin_HLPR_011909.pdf (describing FHA Secure); *infra* note 15 (describing the Making Home Affordable Plan). Individual lenders have also initiated proprietary loan modification programs. These include Bank of America (Project Lifeline), Citibank (Citi Homeowner Assistance Program), and JP Morgan Chase (Proactive Outreach). Press Release, Bank of America, Bank of America Supports Project Lifeline (Feb. 12, 2008) (available at http://newsroom.bankofamerica.com/index.php?s=43&item=8100); Press Release, Citigroup, Inc., Citi Announces New Preemptive Initiatives to Help Homeowners Remain in Their Homes (Nov. 11, 2008) (available at http://www.citigroup.com/citi/press/2008/081111a.htm); Press Release, Chase, Chase Expands Clear & Simple Plan to Empower and Educate Customers on Smart Credit Use (June 6, 2007) (available at http://www.chaseclearandsimple.com/Media_Pressreleases_060607.aspx).

14. *See* Manuel Adelino et al., *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Res. Bank of Boston, Public Policy Discussion Paper No. 09-4, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.htm (documenting that loan servicers have been reluctant to renegotiate mortgages since the foreclosure crisis started in 2007); *see also* Peter S. Goodman, *Late-Fee Profits May Trump Plan to Modify Loans*, N.Y. Times, July 30, 2009, at A1.

15. The parameters of the President's Making Home Affordable plan were announced on February 18, 2009. President Barack Obama, Remarks by the President on the Home Mortgage Crisis (Feb. 18, 2009) (transcript available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-mortgage-crisis). Detailed information about the program is available at http://makinghomeaffordable.gov.

16. The Making Home Affordable plan requires participation from any bank that received government bailout funds after its implementation date of March 4, 2009. *See* Anna T. Pinedo & Amy Moorhus Baumgardner, *Federal Mortgage Modification and Foreclosure Prevention Efforts*, 41 UCC L.J. 4 (2009) (discussing the program, its key features, and its participants); Press Release, U.S. Dep't of the Treasury, Making Home Affordable, Summary of Guidelines (Mar. 4, 2009) (available at http://www.treas.gov/press/releases/reports/guidelines_summary.pdf).

end of 2009,[17] resulting in a strikingly small number of permanent loan modifications.[18]

Even as voluntary loan modification programs were being implemented, some members of Congress began proposing a much stronger solution to the problem: amending the United States Bankruptcy Code to allow borrowers to use chapter 13 bankruptcy to force the modification of unconventional mortgages on unwilling lenders.[19] Because most types of loans are routinely modified in bankruptcy,[20] this idea struck many bankruptcy professionals as simple common sense. The modification of residential mortgages in bankruptcy has, however, been strenuously opposed by the mortgage banking industry because it shifts the leverage of modification from the lender to the borrower.[21] An intense lobbying effort killed three mortgage modification bills introduced in the 110th Congress.[22] Similar legislation was filed when the 111th Congress resumed business in 2009[23] and remains stalled in early 2010,[24] although the threat of its passage has been used to push the mortgage industry into increasing the number of mortgages that are modified in some way.[25]

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17. *See* Peter S. Goodman, *U.S. Loan Effort Is Seen as Adding to Housing Woes*, N.Y. TIMES, Jan. 2, 2010, at A1 ("The Obama administration's $75 billion program to protect homeowners from foreclosure has been widely pronounced a disappointment, and some economists and real estate experts now contend it has done more harm than good."); Gretchen Morgenson, *Why Treasury Needs a Plan B for Mortgages*, N.Y. TIMES, Dec. 6, 2009, at BU1 ("After months of playing pretend, the Treasury Department conceded last week that the Home Affordable Modification Program, its plan to aid troubled homeowners by changing the terms of their mortgages, was a dud."). *See generally* Jean Braucher, *Fixing the Home Affordable Modification Program to Mitigate the Foreclosure Crisis* (Arizona Legal Studies, Discussion Paper No. 09-37, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1518098 (discussing the problems with the Home Affordable Modification Program and possible ways to improve its effectiveness).

18. The failure of the President's plan to produce results was the subject of the October 2009 Report of the Congressional Oversight Panel. CONGRESSIONAL OVERSIGHT PANEL, OCTOBER OVERSIGHT REPORT: AN ASSESSMENT OF FORECLOSURE MITIGATION EFFORTS AFTER SIX MONTHS (2009), *available at* http://cop.senate.gov/documents/cop-100909-report.pdf. The program's troubles have been widely reported in the press. *See, e.g.*, Peter S. Goodman, *U.S. to Pressure Mortgage Firms for Loan Relief*, N.Y. TIMES, Nov. 29, 2009, at A1; Renae Merle, *Foreclosure Relief Program Is Stuck in First; Just 4 Percent in Final Stage: Thousands Now Risk Losing Mortgage Help*, WASH. POST, Dec. 11, 2009, at A20 ("Only about 4 percent, or 31,382, of the 728,000 homeowners currently in the program have moved from the initial, or 'trial' phase, to a permanent loan modification.").

19. *See infra* Part II.A.

20. *See infra* Part I.A–B. The major exception has been residential mortgages. *See infra* Part I.C.

21. *See infra* Part II.A.

22. Helping Families Save Their Homes in Bankruptcy Act of 2008, S. 2136, 110th Cong.; Emergency Home Ownership and Mortgage Equity Protection of 2007, H.R. 3609, 110th Cong.; Home Owners' Mortgage and Equity Savings (HOMES) Act, S. 2133, 110th Cong. § 2 (2007). See *infra* Part III for a discussion of lobbying efforts by the Mortgage Bankers Association.

23. Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 200, 111th Cong.; Emergency Homeownership and Equity Protection Act, H.R. 225, 111th Cong. (2009); Helping Families Save Their Homes in Bankruptcy Act of 2009, S. 61, 111th Cong.

24. *See infra* Part II.A.

25. Throughout 2009, legislators used the threat of forced modification in bankruptcy as a lever to compel lenders to reach voluntary modification benchmarks. *See, e.g.*, Goodman, *supra* note 18; Dawn Kopecki, *'Cram-*

This Article endorses a targeted amendment to section 1322(b)(2) of the Bankruptcy Code[26] that would allow bankruptcy judges to oversee the modification of residential mortgages written to borrowers during years when mortgage-lending abuses were most rampant.[27] Part I of this Article examines existing Bankruptcy Code provisions that allow the modification of other types of loans and then traces the history of the existing statutory and case law that currently prevents homeowners from modifying the terms of most residential mortgages in bankruptcy.[28] Part II describes the legislation presently pending in Congress and explains why allowing home mortgages to be modified in chapter 13 bankruptcy offers an efficient and fair solution that not only allows borrowers to remain in their homes, but also benefits lenders and taxpayers.[29] Part III considers and distinguishes the counterarguments offered by the mortgage banking industry in opposition to amending the Bankruptcy Code. My conclusion is that a time-limited amendment to section 1322(b)(2) would provide a simple and elegant mechanism for reducing the pain that the home mortgage crisis is causing to borrowers, communities, creditors, and the national economy.

i. existing law on modification of loans in bankruptcy

Viewed broadly, the Bankruptcy Code provides consumer debtors with two options: a chapter 7 liquidation proceeding or a chapter 13 reorganization proceeding.[30] In chapter 7, the debtor's non-exempt assets are sold by a bankruptcy trustee who applies the proceeds to pay claims filed by creditors. A chapter 7 debtor

Down' May Be Revived to Boost Mortgage Relief (Update 1), Bloomberg.com, July 29, 2009, http://www.bloomberg.com/apps/news?pid=20670001&sid=ahyJ3X92DO8s.

26. 11 U.S.C. § 1322(b)(2) (2006).

27. *See infra* Part II.A. Current legislative proposals are also limited to this specific timeframe. *See infra* Part II.A.

28. *See infra* Part I.C. The Bankruptcy Code does not prevent the modification of all mortgages. *See infra* Part I.C. The prohibition on modification applies only to consumer mortgages secured by the borrower's primary residence. *See infra* Part I.C.

29. *See infra* Part II. In today's mortgage market, the term "lender" is an oversimplification. *Cf.* Susan E. Hauser, *Predatory Lending, Passive Judicial Activism, and the Duty to Decide*, 86 N.C. L. Rev. 1501, 1512–18 (2008). Because mortgages are routinely transferred and securitized, the lender side of the equation typically encompasses an originator, a special purpose vehicle, or SPV, (usually a trust) that holds the mortgage, investors who purchase securities from the SPV that are collateralized by the pool of mortgages held by the SPV, and a servicer responsible for collecting and transmitting payments, as well as foreclosing defaulted mortgages. *Id.* The various lender-side entities face different risks and have different incentives to pursue or avoid foreclosure. *See generally* Diane E. Thompson, Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior (2009), *available at* http://www.consumerlaw.org/issues/mortgage_servicing/content/Servicer-Report1009.pdf (describing the reasons behind lenders' hesitancy to adjust mortgages).

30. It is also possible for consumer debtors willing to pay a higher filing fee and attorney's fee to file for reorganization under chapter 11, although they rarely do so unless they exceed the debt limits imposed on chapter 13 debtors by § 109(e) of the Bankruptcy Code. *See infra* note 52. Chapter 12, the third reorganization chapter available to individual debtors, is restricted to "family farmers and family fishermen." *See* 11 U.S.C. § 109(f).

receives a swift discharge from most unsecured debts, but the debtor does not have the option of retaining non-exempt property in chapter 7.[31] By contrast, a debtor who chooses to reorganize under chapter 13 is allowed to retain non-exempt property by making monthly payments to creditors pursuant to a trustee-supervised and court-approved plan that lasts from three to five years.[32]

A. Treatment of Secured Claims Under § 506

In both chapters 7 and 13, secured creditors receive significantly better treatment than unsecured creditors. The treatment of secured creditors in bankruptcy is fixed by sections 541 and 506 of the Bankruptcy Code. Section 541 restricts the bankruptcy estate to the debtor's interests in property when the case is filed.[33] This excludes property interests belonging to secured creditors from the estate and has the effect of allowing secured claims to "ride through" the debtor's bankruptcy unscathed. The full meaning of section 541 becomes apparent, however, only when it is read in conjunction with sections 506(a) and (d), which define the extent of a creditor's secured claim.

Section 506(a) provides that a creditor's claim secured by a lien on property "in which the estate has an interest" is a secured claim to the extent that there is value in the collateral to secure it, but an unsecured claim to the extent that the amount owed exceeds the value of the collateral.[34] As a result of section 506(a), undersecured claims[35] in bankruptcy are split, or bifurcated, into two claims: a secured claim corresponding to the value of the collateral and an unsecured claim corresponding to the remaining amount owed.[36] Section 506(d) completes the remedy by providing that a creditor's lien is void in bankruptcy to the extent that it secures a claim that is "not an allowed secured claim."[37] In bankruptcy, the term

31. *See generally* 11 U.S.C. § 704 (duties of trustee); *id.* § 726 (distribution of property of the estate); *id.* § 727 (discharge).

32. *See generally id.* §§ 1322, 1325 (explaining contents of chapter 13 plan and confirmation of the plan, respectively).

33. *Id.* § 541(a)(1).

34. *Id.* § 506(a)(1). This section states:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

Id.

35. A creditor holds an undersecured claim when the amount of the debt exceeds the value of the collateral. *See, e.g.*, Tanner v. FirstPlus Fin., Inc. (*In re* Tanner), 217 F.3d 1357 (11th Cir. 2000).

36. For example, assume the debtor owes $2,000 on a refrigerator that is now worth $1,500. Section 506(a) would bifurcate the secured creditor's claim into a $1,500 secured claim and a $500 unsecured claim. *See* 11 U.S.C. § 506(a).

37. *Id.* § 506(d).

"lien stripping" is used to describe the bifurcation of a creditor's undersecured claim into secured and unsecured claims.[38]

Lien stripping tracks the result that the undersecured creditor would experience outside bankruptcy if the debtor defaulted on the debt: a payment equal to the value of the repossessed collateral and an unsecured deficiency claim for the remainder. Sections 506(a) and (d) express the straightforward policy that creditors should not receive better treatment in bankruptcy than outside bankruptcy, and it enforces this policy perfectly in the context of chapter 7 liquidation. The application of these provisions in chapter 13 has proven more contentious, however.

B. Treatment of Secured Claims in Chapter 13

Chapter 13 allows the debtor to retain collateral after default by making deferred payments over time, straining the analogy between bankruptcy and default that is implicitly drawn in section 506.[39] The true controversy, however, stems from a set of chapter 13 provisions—sections 1322 and 1325—that combine with section 506 to give debtors a much stronger set of remedies than those provided in Article 9 of the Uniform Commercial Code.[40]

Section 1322 of the Bankruptcy Code allows bankruptcy debtors to cure pre-petition defaults through the chapter 13 plan,[41] reclaim collateral that has been repossessed,[42] and reinstate loans that have been accelerated pursuant to the terms of the underlying security agreement.[43] In addition, section 1322(b)(2) specifically allows chapter 13 debtors to "modify the rights" of all unsecured creditors and many types of secured creditors.[44] The power to modify claims includes the ability to alter interest rates, reduce monthly payment amounts, reduce the amount to be paid, and extend the term over which payments are to be made.[45] Although the chapter 13 debtor has the power to invoke modification under section 1322(b)(2),

38. *See, e.g.*, Enewally v. Wash. Mut. Bank (*In re* Enewally), 368 F.3d 1165, 1167 (9th Cir. 2004).

39. *Compare* 11 U.S.C. § 506 (indicating that default results in a transfer of property used to secure the debt to the creditor), *with* 11 U.S.C. § 109(e) *and* § 1325 (allowing certain debtors to keep possession of property used to secure debt). Like chapter 13 generally, the privilege of making deferred payments is available only to consumer debtors with regular income to devote to a chapter 13 plan. 11 U.S.C. §§ 109(e), 1325.

40. *See* U.C.C. art. 9, pt. 6 (2005). In effect, the provisions of chapter 13 are contingent terms implicit in every security agreement that remain dormant until the debtor files chapter 13. *See, e.g.*, 11 U.S.C. §§ 506, 1322, 1325.

41. *See* 11 U.S.C. § 1322(b)(3) (providing for the curing of defaults); *see also id.* § 1322(b)(5) (providing for the curing of defaults and maintenance of payments on long-term debts).

42. *Id.* § 542 (providing for turnover of property to the estate).

43. *Id.* § 1322(b)(5). The power to cure defaults and maintain payments under § 1322(b)(5) gives the debtor the ability to reinstate accelerated loans. *See, e.g.*, Di Pierro v. Taddeo (*In re* Taddeo), 685 F.2d 24, 26–28 (2d Cir. 1982).

44. 11 U.S.C. § 1322(b)(2).

45. *See, e.g.*, Till v. SCS Credit Corp., 541 U.S. 465, 475 (2004) ("[I]n cases . . . involving secured interests in personal property, the court's authority to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract is perfectly clear.").

the parameters of any particular modification are cabined by the terms of the Bankruptcy Code and must be approved by the bankruptcy judge.

The provisions of section 1325 of the Bankruptcy Code are even stronger. Section 1325(a)(5)(B) allows a chapter 13 plan to be confirmed over the secured creditor's objection if the plan provides that the secured creditor will retain its lien and receive payments equal to the present value of the secured claim on the effective date of the plan.[46] Read in conjunction with section 506(a), this provision permits the chapter 13 debtor to bifurcate an undersecured claim into two claims: a secured claim equal to the value of the collateral and an unsecured claim equal to the resulting deficiency. The bifurcation of undersecured claims in chapter 13 over the creditor's objection is colloquially known as "cramdown"—an evocative term that aptly expresses the discomfort this procedure causes to secured creditors.[47]

Taken as a whole, sections 506(a), 1322, and 1325 allow chapter 13 debtors to modify secured claims in several significant ways. From the point of view of an "underwater" debtor,[48] cramdown—the ability to reduce a secured claim to the value of the collateral—is the most helpful because it allows the debtor to reduce the principal amount of the debt. On the other hand, from the perspective of the undersecured creditor, cramdown works the most serious interference with the parties' contract for precisely the same reason. As a result, cramdown has drawn the focused ire of secured creditors,[49] and organized industry groups have successfully limited its application to particular types of claims. In 2005, for example, car lenders fought to add language to the Code exempting certain debts secured by motor vehicles from the cramdown provisions of section 1325(a)(5).[50] The most significant limitation on cramdown by far, however, is the exemption of home mortgages from its reach.

46. 11 U.S.C. § 1325(a)(5)(B).

47. *See, e.g.*, Assocs. Commercial Corp. v. Rash, 520 U.S. 953, 957 (1997) (noting that "cram down" occurs when "the debtor is permitted to keep the property over the objection of the creditor"); Household Auto. Fin. Corp. v. Burden (*In re* Kidd), 315 F.3d 671, 675 (6th Cir. 2003) ("Although the Bankruptcy Code nowhere uses the words 'cram down,' the term has come to denote the confirmation of a plan over the objection of a secured creditor.").

48. A debtor is "underwater," or "upside down," when the value of the collateral is less than the amount of the debt. *See, e.g.*, Dumont v. Ford Motor Credit Co. (*In re* Dumont), 581 F.3d 1104, 1108 (9th Cir. 2009); *In re* Sneijder, 407 B.R. 46, 50 (Bankr. S.D.N.Y. 2009). Underwater debtors and undersecured creditors stand on opposite sides of the same transaction. *See In re* Sneijder, 507 B.R. at 47–48 (explaining the problem that occurs when a debtor intends to surrender the property to the creditor, but the debt is undersecured).

49. *See infra* Part III.

50. The result of their efforts was a notoriously unclear amendment placed at the end of § 1325(a) known as the "hanging paragraph." *See* 11 U.S.C. § 1325(a). In part, the hanging paragraph provides that "section 506 shall not apply . . . if the creditor has a purchase money security interest . . . , the debt was incurred within the 910-day [sic] preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . ." *Id.*

C. Current Treatment of Residential Mortgages in Chapter 13

Section 1322(b)(2) allows a chapter 13 plan to "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 principal residence."[51] This provision prevents bankruptcy debtors from using the chapter 13 cramdown provisions to modify most residential mortgages. It does not, however, prevent bankruptcy debtors from modifying *all* mortgages, and it is instructive to consider the mortgages to which this provision does not apply.

First, because it applies only to a mortgage that is attached to a consumer debtor's principal residence, by its terms, the section 1322(b)(2) exclusion does not apply to any commercial mortgage, any mortgage securing rental or investment property, or to any mortgage securing a second or vacation home. Similarly, by its terms, the exclusion does not apply to any mortgage that is jointly secured by the debtor's principal residence and some other form of collateral. In all of these situations, a mortgage loan held by an undersecured creditor is subject to cramdown in chapter 13.

Although it is theoretically possible for a chapter 13 debtor to benefit from these exceptions to the anti-modification rule, most debtors do not qualify because eligibility for chapter 13 is lost when the debtor's secured debts exceed the limit set by the Bankruptcy Code—currently slightly more than $1 million.[52] Nevertheless, these exceptions reflect a clear policy judgment that creditors secured by residential mortgages are entitled to greater protection than creditors secured by commercial or investment mortgages. The corollary proposition is that consumer debtors who mortgage their homes receive less protection from the Bankruptcy Code than debtors who mortgage commercial or investment property.[53]

More chapter 13 debtors are able to benefit from a judicially created rule that allows a junior mortgage that is wholly unsecured under section 506 to be stripped to an unsecured claim despite the anti-modification language in section 1322(b)(2).[54] Most courts that have addressed the issue have held that the anti-modification language does not apply to junior mortgages when the first mortgage

51. *Id.* § 1322(b)(2) (emphasis added).

52. 11 U.S.C.A. § 109(e) (West 2009). Section 109(e) presently limits chapter 13 eligibility to individuals with regular income who owe unsecured debts of less than $360,475 and secured debts of less than $1,081,400. *Id.* The dollar amounts in § 109(e) are adjusted by the Judicial Conference of the United States at three year intervals to reflect the change in the Consumer Price Index for urban consumers published by the Department of Labor. *See* 11 U.S.C. § 104.

53. As discussed in Part I.D. *infra*, this policy was originally justified by the contention that the exclusion of residential mortgages from cramdown ultimately benefitted consumers through lower interest rates and easier access to credit. *See* John Eggum et al., *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123, 1156–57 & nn.122–29.

54. In *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), the Supreme Court held that the anti-modification language of § 1322(b)(2) does prohibit modification of an *undersecured* residential mortgage. *See infra* Part I.D.

exceeds the value of the property.[55] These cases reason that the anti-modification language applies only when there is a "secured claim." If the first mortgage consumes all available equity—leaving no unencumbered equity to protect the junior lien—the junior mortgagee has no secured claim and may be treated as entirely unsecured in the context of the debtor's chapter 13 plan.[56]

D. Past as Prologue: The History of Mortgage Modification in Chapter 13

Section 1322(b)(2) was adopted in 1978 when Congress replaced the Bankruptcy Act of 1898 with the modern Bankruptcy Code. The Bankruptcy Act's chapter XIII wage earner plan was analogous to the current chapter 13 plan of reorganization, but had no provision for cramdown.[57] Instead, chapter XIII required the debtor to obtain the consent of all creditors as a condition of obtaining confirmation of a plan of reorganization.[58] Although the legislative history of section 1322(b)(2) is sparse, the cramdown power provided in section 1322(b)(2) was apparently intended to facilitate consumer reorganizations,[59] reflect the economic reality of secured transactions by placing some of the valuation risk on the secured creditor,[60] and promote the flow of mortgage capital to consumers.[61]

The version of section 1322(b)(2) that originally passed the House of Representatives gave chapter 13 debtors the ability to modify claims secured by both real and personal property.[62] The Senate amendment to the House bill added language that "exempted those claims that were wholly secured by *real property*."[63]

55. *See, e.g.*, Lane v. W. Interstate Bancorp (*In re* Lane), 280 F.3d 663 (6th Cir. 2002); Pond v. Farm Specialist Realty (*In re* Pond), 252 F.3d 122 (2d Cir. 2001); McDonald v. Master Fin., Inc. (*In re* McDonald), 205 F.3d 606, 609–15 (3d Cir. 2000); Bartee v. Tara Colony Homeowners Ass'n (*In re* Bartee), 212 F.3d 277, 284–96 (5th Cir. 2000); Zimmer v. PSB Lending Corp. (*In re* Zimmer), 313 F.3d 1220 (9th Cir. 2000); Tanner v. FirstPlus Fin., Inc. (*In re* Tanner), 217 F.3d 1357 (11th Cir. 2000). *Contra* Barnes v. Am. Gen. Fin. (*In re* Barnes), 207 B.R. 588, 593 (Bankr. N.D. Ill. 1997).

56. *See, e.g.*, *In re* McDonald, 205 F.3d at 611 (holding that there is a secured claim only when the lien attaches "to some existing value in the debtor's house"); Waters v. Money Store (*In re* Waters), 276 B.R. 879, 881–85 (Bankr. N.D. Ill. 2002) (approving a lien "strip off," as opposed to a "strip down," because the debtor was removing a wholly unsecured junior lien).

57. Jane Kaufman Winn, *Lien Stripping After* Nobelman, 27 LOY. L.A. L. REV. 541, 565–66 & nn.131–36 (1994); *see also* Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544–66 (repealed 1978).

58. Bankruptcy Act of July 1, 1898, ch. 541; *see also In re* Jones, 152 B.R. 155, 166–67 (Bankr. E.D. Mich. 1993) (comparing chapter XIII under the former Bankruptcy Act with chapter 13 of the Bankruptcy Code).

59. *See* Eggum et al., *supra* note 53, at 1155 & n.116.

60. *See* Winn, *supra* note 57, at 566 & n.140 ("The House Report specifically rejected 'a few misguided decisions' under the Bankruptcy Act in which creditors whose debts greatly exceeded their security were permitted to assert the entire debt as a secured claim 'in preference to all unsecured creditors.'" (quoting H.R. REP. NO. 95-595, at 180–81 (1977))).

61. Robert M. Zinman & Novica Petrovski, *The Home Mortgage and Chapter 13: An Essay on Unintended Consequences*, 17 AM. BANKR. INST. L. REV. 133, 137–38 (2009).

62. H.R. 8200, 95th Cong. § 1322 (1978); *see also* Grubbs v. Houston First Am. Sav. Ass'n, 730 F.2d 236, 245 (5th Cir. 1984).

63. *See Grubbs*, 730 F.2d at 245 (emphasis added) (quoting H.R. 8200, 95th Cong. § 1322(b)(2), *amended by* S. 2266).

The Senate and House versions of the bills were conformed by agreement in a series of floor amendments that narrowed the exemption of any claim secured by real property to a claim secured by *real property that is the debtor's principal residence*.[64]

Although the genesis of this compromise was not clearly recorded, it was contemporaneously viewed as responding "to perceptions, or to suggestions advanced in the legislative hearings . . . that, home-mortgagor lenders, performing a valuable social service through their loans, needed special protection against modification thereof."[65] This explanation has been widely accepted[66] and was adopted by Justice Stevens in his concurrence in *Nobelman v. American Savings Bank*:[67]

> *At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market.*[68]

Nevertheless, before 1993, a number of courts read section 1322(b)(2) in conjunction with section 506(a) to allow judicial modification of home mortgages that were undersecured.[69] These courts, which grew to include the Second, Third, Ninth, and Tenth Circuit Courts of Appeals,[70] found that the anti-modification provision applied only to the extent that the mortgagee held an "allowed secured claim"[71] in the debtor's residence. Because section 506(a) limits an unsecured creditor's allowed secured claim to the value of the collateral, an undersecured mortgage claim was considered "secured" only to the value of the collateral and

64. *Grubbs*, 730 F.2d at 246 n.16.

65. *Id.* at 246.

66. *See, e.g.*, *In re* Neal, 10 B.R. 535, 536–37 (Bankr. S.D. Ohio 1981); United Cos. Fin. Corp. v. Brantley, 6 B.R. 178, 189 (Bankr. N.D. Fl. 1980) ("Although the legislative history is silent, the plain intent of the exception is to provide stability in the residential long-term home financing industry and market."); *see also* Eggum et al., *supra* note 53, at 1156–57; Zinman & Petrovski, *supra* note 61, at 136–39.

67. 508 U.S. 324 (1993); *see also infra* text accompanying notes 75–76 (discussing the holding in *Nobelman*).

68. 508 U.S. at 332 (Stevens, J., concurring).

69. *See*, *e.g.*, Kehm v. Citicorp Homeowners Serv., Inc. (*In re* Kehm), 90 B.R. 117, 125 (Bankr. E.D. Pa. 1988); Cameron Brown Co. v. Bruce (*In re* Bruce), 40 B.R. 884, 888 (Bankr. W.D. Va. 1984); *In re* Morphis, 30 B.R. 589, 594–95 (Bankr. N.D. Ala. 1983); *In re* Neal, 10 B.R. at 541.

70. Bellamy v. Fed. Home Loan Mortgage Corp. (*In re* Bellamy), 962 F.2d 176, 179 (2d Cir. 1992); Eastland Mortgage Co. v. Hart (*In re* Hart), 923 F.2d 1410, 1415 (10th Cir. 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123, 127 (3d Cir. 1990); Hougland v. Lomas & Nettleton Co. (*In re* Hougland), 886 F.2d 1182, 1182 (9th Cir. 1989).

71. 11 U.S.C. § 506(a) (2006).

could be crammed down over the protest of an objecting creditor.[72] The Fifth Circuit Court of Appeals rejected this argument in *In re Nobelman*,[73] prompting the United States Supreme Court to grant certiorari in *Nobelman v. American Savings Bank*.[74]

In *Nobelman*, the Supreme Court held that section 1322(b)(2) controls section 506(a) and prohibits a chapter 13 debtor from bifurcating an undersecured home mortgage.[75]

> *[T]o give effect to § 506(a)'s valuation and bifurcation of secured claims through a Chapter 13 plan in the manner petitioners propose would require a modification of the rights of the holder of the security interest. Section 1322(b)(2) prohibits such a modification where, as here, the lender's claim is secured only by a lien on the debtor's principal residence.*[76]

With these words, the Court made it clear that the anti-modification provision currently found in section 1322(b)(2) prevents bankruptcy debtors from modifying most residential mortgages in chapter 13 plans.

II. The Case for Allowing Modification of Home Mortgages in Bankruptcy

Nobelman defines the current state of the law; however, the subprime mortgage crisis has prompted a number of legislative initiatives aimed at amending section 1322(b)(2) to once again allow residential mortgages to be modified in chapter 13.[77] Although these bills have met with strong opposition from the mortgage banking industry, existing bankruptcy processes offer a speedy, powerful, and efficient mechanism that can be used to cut through the otherwise intractable economic and social problems created when nearly 25% of American homeowners are locked into underwater mortgages[78]—a situation that creates incentives for homeowners to walk away when they cannot pay and to default even when they can afford to pay.[79]

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72. For a concise explanation of this interpretation of section 1322(b)(2), see Marianne B. Culhane, *Home Improvement? Home Mortgages and the Bankruptcy Reform Act of 1994*, 29 Creighton L. Rev. 467, 478 (1996).

73. 968 F.2d 483, 489 (5th Cir. 1992); *see also* Mark S. Scarberry & Scott M. Reddie, *Home Mortgage Strip Down in Chapter 13 Bankruptcy—A Contextual Approach to Sections 1322(b)(2) and (b)(5)*, 20 Pepp. L. Rev. 425, 448–53 (1993).

74. 506 U.S. 1020 (1992).

75. Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993).

76. *Id.* at 332.

77. *See infra* Part II.A.

78. Simon & Hagerty, *supra* note 10.

79. *Id*. A study by Experian and the consulting firm Oliver Wyman found that "[a]bout 588,000 borrowers defaulted on mortgages last year even though they could afford to pay—more than double the number in 2007." *Id.* The study went on to say that "[t]he American consumer has had a long-held taboo against walking away from the house, and this crisis seems to be eroding that . . . ." *Id.*; *see also* Roger Lowenstein, *Just Walk*

A. Current Legislative Proposals

As early as 2007, members of Congress spotted the possibility that the Bankruptcy Code could be a useful tool to keep Americans in their homes during the foreclosure crisis. Because this assistance would necessarily come in the context of chapter 13 for most consumer borrowers, three separate bills introduced in the 110th Congress proposed amending section 1322(b)(2) to limit or eliminate the current prohibition on modification of residential mortgages in chapter 13.[80] These initiatives were opposed by the Bush Administration, and the 110th Congress adjourned in December of 2008 without taking action on them.[81]

When the 111th Congress resumed business in 2009, the Congressional backers of mortgage modification quickly reintroduced this legislation, this time with the backing of the Obama Administration.[82] Two bills, H.R. 200 and H.R. 225, were almost immediately introduced in the House by Representatives John Conyers, Jr. of Michigan and Brad Miller of North Carolina, respectively.[83] On January 6, 2009, S. 61, a companion bill to both House bills, was introduced in the Senate by Senator Dick Durbin of Illinois.[84]

The new bills received an immediate boost when Citigroup, the recipient of nearly $300 billion in government assistance, agreed not to oppose mortgage modification legislation so long as it applied only to existing mortgages.[85] Nevertheless, the bills quickly ran into stiff and sustained opposition from other players in the banking industry.[86] The bills' opponents would ultimately succeed in

Away, N.Y. TIMES, Jan. 10, 2010, at MM15. In January of 2009, a Credit Suisse research report found "that close to 70% of delinquent non-agency loans have negative equity, compared to only 37% of current loans with negative equity, indicat[ing] that lack of equity potentially is an important driver of today's performance deterioration." ROD DUBITSKY ET AL., BANKRUPTCY LAW REFORM—A NEW TOOL FOR FORECLOSURE AVOIDANCE 1 (2009), http://judiciary.house.gov/hearings/pdf/Suisse090126.pdf. For another view of this issue, see Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis* (Arizona Legal Studies, Discussion Paper No. 09-35, 2009), *available at* http://ssrn.com/abstract=1494467.

80. *See* Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong.; Emergency Home Ownership and Mortgage Equity Protection of 2007, H.R. 3609, 110th Cong.; Home Owners' Mortgage and Equity Savings (HOMES) Act, S. 2133, 110th Cong. § 2 (2007).

81. *See* Dina ElBoghdady, *White House Objects to Parts of Mortgage-Reform Bill*, WASH. POST, Nov. 15, 2007, at D03.

82. *See* Renae Merle & Lori Montgomery, *Democrats Tailor Foreclosure Bill to Obama Goals: Plan Would Change Bankruptcy Law*, WASH. POST, Feb. 14, 2009, at D01.

83. Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 200, 111th Cong.; Emergency Homeownership and Equity Protection Act, H.R. 225, 111th Cong. (2009).

84. Helping Families Save Their Homes in Bankruptcy Act of 2009, S. 61., 111th Cong.

85. *See* Carl Hulse, *Homeowner Relief Bill Wins Backer*, N.Y. TIMES, Jan. 9, 2009, at B1.

86. *See, e.g.*, Vikas Bajaj & Tara Siegel Bernard, *Forestalling Foreclosure*, N.Y. TIMES, Feb. 6, 2009, at B1 ("[T]he banking industry fiercely opposes the proposal to amend bankruptcy law."); Stephen Labaton & Eric Dash, *Banks Sway Bills to Aid Consumers*, N.Y. TIMES, Apr. 22, 2009, at B1 ("Having won some early skirmishes . . . the banks now appear to have the upper hand and may wind up killing—or at least substantially diluting—both pro-consumer measures.").

derailing them, in spite of a supportive President, supportive Democratic majorities in the House and Senate, and a banking industry that lacked popular support.

Although President Obama supported the proposed amendment to the Bankruptcy Code, the provision was removed from the stimulus package signed into law on February 17, 2009[87] to avoid delaying passage of that legislation.[88] On February 18, 2009, the President announced the general provisions of his housing plan and voiced his continued support for "reforming our bankruptcy rules so that we allow judges to reduce home mortgages on primary residences to their fair market value—as long as borrowers pay their debts under court-ordered plans."[89]

On February 24, 2009, H.R. 200, the Helping Families Save Their Homes in Bankruptcy Act of 2009, was reported from the Committee on the Judiciary to the full House of Representatives.[90] The bill was subsequently incorporated into H.R. 1106, the Helping Families Save Their Homes Act of 2009, and passed by the House of Representatives by a vote of 234-191 on March 5, 2009.[91]

As adopted by the House of Representatives, the legislation allowed the cramdown of residential mortgages, but with several important limits. First, rather than repeal the section 1322(b)(2) exclusion generally, H.R. 1106 proposed adding a new time-limited section 1322(b)(11) allowing the modification of loans originated *before* the effective date of the new law.[92] For such pre-existing loans, cramdown would be allowed as to the debtor's principal residence, but only if the residence was "the subject of a notice that a foreclosure may be commenced with respect to such loan."[93]

For loans falling within these restrictions, the House bill allowed the following forms of modification to an undersecured mortgage:

- Cramdown of the creditor's allowed secured claim to the value of the property as allowed by section 506(a);
- The prohibition, reduction, or delay of adjustments to the rate of interest on adjustable rate loans;
- Extension of the repayment period to a maximum of forty years, reduced by the period for which the loan has been outstanding; and

87. The stimulus bill was enacted as the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

88. Merle & Montgomery, *supra* note 82.

89. *See* Obama, *supra* note 15. The President's remarks on the subject concluded with the caveat: "I just want everybody to understand, that's the rule for investors who own two, three, and four homes. So it should be the rule for folks who just own one home . . . as an alternative to foreclosure." *Id.*

90. H.R. REP. NO. 111-19 (2009).

91. The final vote results on the passage of H.R. 1106 were reported on March 5, 2009 and are available at http://clerk.house.gov/evs/2009/roll104.xml.

92. Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. §103.

93. *Id.*

–Conversion of the post-filing interest rate to a fixed annual rate equal to the average prime rate "plus a reasonable premium for risk."[94]

The bill also added a new subsection (g) to section 1322 that allowed the lender to recapture value if the debtor sold appreciated property after confirmation of the chapter 13 plan, and a new subsection (h) that required a debtor seeking mortgage cramdown to seek voluntary loan modification from the creditor or show that a foreclosure sale was scheduled within the thirty days following the filing of the bankruptcy petition.[95]

Despite the limits placed on cramdown in the House of Representatives, including its application only to mortgages originated before its enactment (effectively a built-in sunset provision), support for the legislation deteriorated in the days before the measure was placed before the Senate for a vote.[96] In the Senate, the bill was weakened further "by requiring homeowners to be two months delinquent and have an outstanding balance of less than $729,750 to qualify."[97]

The mortgage modification provision came before the Senate for a vote as part of S. 896, the Helping Families Save Their Homes Act of 2009, an omnibus bill encompassing a number of housing initiatives sought by the Obama Administration.[98] Although S. 896 was ultimately signed into law on May 20, 2009, the proposal to give bankruptcy judges the power to modify the terms of home mortgages was soundly defeated on April 30, 2009 by a vote of 45-51.[99]

Despite the Senate's April 30, 2009 vote, the pros and cons of allowing residential mortgages to be modified in bankruptcy were repeatedly considered by Congress in the months that followed. Some of the continued debate came in the form of congressional hearings bringing forth competing testimony from academics, bankers, and consumers.[100] Lawmakers also continued to publicly state their positions on the issue.[101] And proponents of the measure continued to push for its

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94. *Id.*

95. *Id.*

96. Renae Merle, *Mortgage Modification Bill Faces Trouble in Senate*, WASH. POST, Apr. 28, 2009, at A18 ("Days before an expected vote, Senate leaders yesterday touted their version of a proposal to allow bankruptcy judges to modify mortgages, but have yet to secure the support of the financial services industry and face fierce opposition that could derail the proposal again.").

97. *Id.*

98. Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1703.

99. *U.S. Senate Rejects Mortgage Modification in Chapter 13 Cases: Sens. Durbin, Kyl Debate the Response to America's Foreclosure Crisis*, AM. BANKR. INST. J., June 2009, at 10, 10 [hereinafter *Senate Rejects Mortgage Modification*] (noting that twelve Democrats joined all Republicans in voting against the provision).

100. *See, e.g.*, *The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform?: Hearing Before the Subcomm. on Admin. Oversight and the Courts of the S. Comm. on the Judiciary*, 111th Cong. (2009) (statement of Alys Cohen, Staff Att'y, National Consumer Law Center) ("Congress should pass legislation to allow bankruptcy judges to modify appropriate mortgage loans . . . . Congress should soon recognize that voluntary measures . . . can not [sic] lead us out of this crisis.").

101. *See, e.g.*, *Senate Rejects Mortgage Modification*, *supra* note 99, at 10.

passage, adding—and then deleting—an amendment allowing residential mortgage cramdown to the financial regulatory legislation passed by the 111th Congress in December of 2009.[102] As evidenced by the persistence of its proponents, strong policy arguments support the attractiveness of bankruptcy as a potential remedy to the foreclosure crisis.

B. Policy Arguments Favoring Mortgage Modification in Chapter 13

By its very nature, chapter 13 bankruptcy offers numerous advantages to consumer borrowers facing foreclosure. Chapter 13 also offers benefits to lenders and investors who hold mortgages that are underwater and in default because these creditors are likely to realize a larger loss when the borrower does not file bankruptcy. In this situation, borrowers and creditors have common interests because both benefit when borrowers remain in their homes and continue to make payments on their mortgages.[103] A reasonable mortgage modification helps the parties on both sides of the loan transaction by allowing the mortgagor to remain in his home and by providing a continued flow of cash to the creditor-side entities. In addition, allowing residential mortgages to be modified in bankruptcy benefits taxpayers and communities by reducing foreclosure rates, stabilizing neighborhoods and tax-bases, increasing the financial stability of creditors, and—most importantly—reducing moral hazard to *both* borrowers and lenders.

1. Advantages to Borrowers

Bankruptcy provides borrowers with a comprehensive and collaborative method of restructuring all debts. It allows the debtor to compel all creditors to participate in a uniform and simultaneous resolution of claims. Bankruptcy also offers an efficient and well-established system that allows borrowers to cut through the bureaucratic inefficiency that currently characterizes the voluntary loan modification process.[104]

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102. Representative John Conyers submitted the provision as an amendment to H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, the financial reform bill revamping the financial regulatory system and creating the Consumer Financial Protection Agency. *See* Press Release, Committee on the Judiciary, Conyers and Eight Others Introduce Amendment to Provide Mortgage Modification Relief to Struggling Homeowners, Dec. 7, 2009 (available at http://judiciary.house.gov/news/091207.html). On December 11, 2009, H.R. 4173 passed the House by a vote of 223-202, U.S. House of Representatives, Final Vote Results for Roll Call 968, http://clerk.house.gov/evs/2009/roll968.xml (last visited Feb. 23, 2010), but only after the cramdown provision had been deleted. *See* Dawn Kopecki, *Mortgage 'Cram-Down' Amendment Fails in U.S. House (Update 2)*, BLOOMBERG.COM, Dec. 11, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=aWt97uj9FV.o; *see also* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong.

103. *See* Goodman, *supra* note 17 (reporting that "roughly 15 million American homeowners . . . are underwater," which is a far better indicator of potential defaults than unemployment).

104. Many communication snafus in the modification process have been reported anecdotally. *See, e.g.*, *id*. The article reports the story of a borrower who received nearly simultaneous notices of foreclosure and acceptance for a permanent loan modification from the same lender. *Id.* The borrower was apparently not in default, and the foreclosure was mistakenly initiated because she made reduced payments pursuant to a lender-approved temporary loan modification. *Id.*

Existing bankruptcy law also provides the debtor with a built-in mechanism for dealing with junior liens and stripping them to unsecured status when they are completely underwater.[105] This facet of bankruptcy law not only benefits the debtor, it helps the senior mortgagee by freeing cash flow that can be used to service the senior debt.

Even without the option of residential mortgage modification, existing chapter 13 law offers a package of remedies that is frequently superior to the voluntary mortgage modification programs that currently exist. The bankruptcy petition itself triggers an automatic stay of collection and foreclosure activity that provides immediate relief to strapped consumers.[106] The automatic stay freezes pending foreclosure proceedings, and the chapter 13 debtor may possibly recover possession of foreclosed property so long as the foreclosure sale has not become final under state law.[107] If the foreclosure sale has not yet occurred, chapter 13 very clearly allows the debtor to avoid the consequences of default by reinstating the accelerated mortgage, curing any arrearage through the plan, and then maintaining future payments on a current basis.[108]

Enhancing this package of remedies with the power to modify residential mortgages would address two problems that are endemic to the current foreclosure crisis. First, the power to modify mortgage terms would allow chapter 13 debtors to reduce and stabilize interest rate terms on above-market adjustable rate mortgages ("ARMs").[109] This power could allow the debtor to convert an adjustable rate

105. *See supra* notes 55–57 and accompanying text.

106. 11 U.S.C. § 362 (2006).

107. Many states allow the debtor to reclaim property after the foreclosure sale by complying with an upset bid procedure. *See, e.g.*, N.C. Gen. Stat. § 45-21.27 (2006), *available at* http://www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_45/GS_45-21.27.html. If the debtor files chapter 13 during the upset bid period, some courts find that bankruptcy law allows the debtor to reclaim foreclosed property by reinstating the mortgage, curing the default through the chapter 13 plan, and maintaining future payments under the contract. *See, e.g.*, *In re* Faulkner, 240 B.R. 67, 70 (Bankr. W.D. Okla. 1999); *In re* Barham, 193 B.R. 229, 232 (Bankr. E.D.N.C. 1996). *But see In re* Connors, 497 F.3d 314, 323 (3d Cir. 2007); LaSalle Nat'l Bank v. Price (*In re* Price), 305 B.R. 240, 241 (Bankr. D. Md. 2003) (foreclosure sale is complete when auctioneer's gavel falls).

108. *See supra* notes 41–43 and accompanying text.

109. Before 2008, many subprime ARMs were written as 30-year mortgages with a low introductory interest rate guaranteed for two or three years. *See* Scott Frame et al., A Snapshot of Mortgage Conditions with an Emphasis on Subprime Mortgage Performance 2–3 (2008), http://federalreserveonline.org/pdf/MF_Knowledge_Snapshot-082708.pdf. After the expiration of the introductory rate, the adjustable rate would typically increase every six months until it reached a maximum rate based on the London Interbank Offered Rate ("LIBOR") plus an additional percentage to reflect the higher risk of the subprime loan. *See id.* at 13. Depending on the length of the initial terms, mortgages of this type are known as 2/28 or 3/27 mortgages, and more vividly as "exploding" ARMs. *See, e.g.*, Commonwealth v. Fremont Inv. & Loan, 23 Mass. L. Rep. 567 (Mass. Super. 2008); Deutsche Bank Nat'l Trust Co. v. Castellanos, 841 N.Y.S.2d 819 (N.Y. Sup. 2007); EMC Mortgage Corp. v. Batista, 841 N.Y.S.2d 819 (N.Y. Sup. 2007). Some subprime loans were written so that the initial years of payment were interest-only, and some required a minimum payment so low that it was insufficient to cover interest on the loan, resulting in negative amortization—a situation in which the debtor's principal balance increases even as loan payments are kept current. *See* Sec. Exch. Comm'n v. Mozilo, No. CV 09-3994-JFW (MANx), 2009 WL 3807124, at *3 (C.D. Cal. Nov. 3, 2009).

mortgage to a more manageable fixed rate and reduce above-market interest rates to a market rate that includes a reasonable premium to account for the risk facing the lender.[110] Standing alone, this change would decrease mortgage payments to a manageable level for some debtors, since many foreclosures and defaults result from the "payment shock"[111] that occurs when ARMs adjust and dramatically increase the borrower's monthly payment amount.[112] Second, the power to cramdown the secured claim to the value of the property—which, by definition, applies only to mortgages that are undersecured—would further reduce monthly payment amounts.[113] Residential mortgage cramdown would also give debtors the hope of accumulating equity in their homes and a new incentive to continue payments under the mortgage.

Finally, the mere possibility that a debtor could invoke involuntary loan modification through chapter 13 would allow the consumer to initiate conversations on voluntary loan modification with lenders. Even when the borrower has not yet filed chapter 13, the very prospect of cramdown would change the terms of negotiation between the debtor and creditor. The cramdown remedy would give the borrower additional leverage and provide an incentive for the lender to cooperate in voluntary loan modification.[114] In addition, since the current cramdown proposals require the debtor to request a voluntary loan modification before seeking cramdown, passage of this legislation is likely to increase the number and attractiveness of voluntary loan modifications offered to borrowers.[115]

2. Advantages to Lenders and Investors

The all-inclusive and compulsory nature of chapter 13 offers rewards to creditors as well as to debtors. Senior mortgagors benefit from increased cash flow when the underwater debtor is able to shed junior mortgages that become wholly unsecured claims in chapter 13.[116] Chapter 13 also forces debtors to comply with a stringent

110. This is the approach to interest rate modification approved by the Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465, 479–80 (2004).

111. The term "payment shock" has been coined to refer to the increase in monthly payments that occurs when an exploding ARM resets. *See* FED. DEPOSIT INS. CORP., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS: ARE THEY FOR YOU? 1, *available at* http://www.fdic.gov/consumers/consumer/interest-only-index.html ("Your payments may go up a lot—as much as double or triple—after the interest-only period or when the payments adjust.").

112. *See, e.g.*, Bajaj & Siegel Bernard, *supra* note 86 ("Rosa Benitez, a real estate agent, and her husband, Carlos, who works in construction, have been unable to pay their mortgage since payments on their adjustable rate loan shot up in early 2008.").

113. *See* DUBITSKY ET AL., *supra* note 79, at 14 exhibit 6 (providing illustrations of the effect of mortgage cramdown on different loan scenarios).

114. *Id.* at 3 ("[W]e expect the new bankruptcy reform will increase loan mods, particularly principal reduction mods, as it is likely to both pressure and give justification to servicers to more actively pursue principal reduction mods.").

115. Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103.

116. *See supra* notes 54–56 and accompanying text.

budget, deal with existing debts in a disciplined and responsible manner, and obtain court permission before incurring substantial new debts. Finally, amending section 1322(b)(2) to allow the modification of home mortgages creates a strong incentive for the debtor to actually complete her chapter 13 plan, since the benefits of modification are lost if the plan is not completed.[117]

Bankruptcy also allows lenders, servicers,[118] and investors to cut through the complex thicket of potential liability created by the modification of mortgages that have been assigned and securitized.[119] Loans that are assigned for securitization are typically serviced pursuant to a pooling and servicing agreement that creates legal obligations between the servicer and the investors who purchase securities backed by the assigned mortgages.[120] When the servicer voluntarily modifies the loans, payments to investors are likely to be reduced,[121] creating the possibility that the servicer will be sued by injured investors.[122] This particular litigation risk to the servicer would be eliminated if modification were not voluntary, but instead was mandated by an order from the bankruptcy court.[123] This concept is already working with respect to other types of debts—car loans, for example—that are currently subject to modification in bankruptcy proceedings. These types of debts are routinely securitized in the same way as home mortgages and are modified in bankruptcy on a daily basis.

Finally, for some mortgages, a reasonable loan modification may offer the maximum economic benefit to lenders and investors.[124] When a mortgage is

117. Helping Families Save Their Homes Act of 2009, H.R. 1106 § 103.

118. *See* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 126–28 (2008) (describing the nature and purposes of mortgage servicing).

119. *See* Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2206–13 (2007) (describing the process of securitization in the home mortgage industry); *see also* Leland C. Brendsel, *Securitization's Role in Housing Finance: The Special Contributions of the Government-Sponsored Enterprises*, *in* A PRIMER ON SECURITIZATION 17, 18 (Leon T. Kendall & Michael J. Fishman eds., 2000) ("[S]ecuritization—that is, pooling the loans and using them to back guaranteed mortgage-backed securities—turns individual mortgages into homogeneous, liquid instruments that can be traded efficiently in capital markets.").

120. *See* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 585 (2009).

121. *See* DUBITSKY ET AL., *supra* note 79, at 10–11 (describing the impact of loan modifications on investors holding residential mortgage-backed securities).

122. *See* Gretchen Morgenson, *Countrywide Loses Ruling in Loan Suit*, N.Y. TIMES, Aug. 20, 2009, at B1. The article reports a ruling from the Southern District of New York allowing Countrywide Financial Corporation to be sued by investors injured when "loans were modified for troubled borrowers." *Id.*; *see also* Greenwich Fin. Servs. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192 (S.D.N.Y. 2009).

123. *See* Morgenson, *supra* note 122. The litigation risk attendant to the voluntary modification of securitized mortgages is increased by the fact that all investors in the same loan pool are not similarly situated. *See id.* Investors in different tranches will have very different interests, so that loan modification may harm some investors more than others. *See id.* This creates a potential conflict of interest for the servicer charged with a fiduciary duty to all investors. *See id.* This may make it difficult for the servicer to agree to a voluntary modification of the mortgages that it services. *See id*.

124. This is not true of loan servicers, the only creditor-side entities who typically receive more economic benefit from foreclosure than modification. *See supra* note 14.

undersecured, the beneficial holder of the note, whether a lender or an investor, will always realize a loss when the property is liquidated through foreclosure. Economically, the loss realized on cramdown should be roughly equivalent to the loss realized when the property is sold at foreclosure—indicating that the creditor's bottom line will remain similar in both procedures.

Chapter 13 bankruptcy, however, has the potential to increase the return to the creditor in several ways. First, chapter 13 allows the debtor to remain in possession of the property, and an occupied property is more likely to increase in value. Second, chapter 13 saves the creditor from paying the costs of foreclosure and resale. Third, the creditor will receive guaranteed cash flow during the debtor's bankruptcy, and this cash flow will not only service the creditor's secured claim, it will also provide some payment on the unsecured component of the creditor's claim.[125] Thus, the total cash received in chapter 13 should exceed the proceeds received at a foreclosure sale of the same property. Finally, if the debtor subsequently defaults on the chapter 13 plan or sells the property before plan completion, the amended section 1322 would allow the creditor to recapture appreciation in the value of the underlying property.[126] On the whole, cramdown is likely to provide the creditor with better treatment than the alternative of foreclosure.[127]

3. Advantages to Taxpayers and Communities

The proponents of amending section 1322(b)(2) argue that allowing judicial mortgage modification will reduce the number of foreclosures.[128] This argument is intuitively correct and draws important empirical support from a January 2009 Credit Suisse Research Report projecting that the simple step of amending section 1322(b)(2) would reduce the foreclosure rate by approximately twenty percent.[129] No one disputes that taxpayers and communities benefit when foreclosures are reduced and homes remain owner-occupied. Every foreclosure reduces the value of adjacent homes, and multiple foreclosures within the same neighborhood have a cumulative negative impact on property values.[130] Conversely, when at-risk homes

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125. *See supra* Part I.B.

126. Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103.

127. *See* DUBITSKY ET AL., *supra* note 79, at 4 (describing the overall impact of an amendment to § 1322(b)(2) as "modestly positive" for Credit Suisse and the holders of its structured investment products).

128. *See, e.g.*, Henry E. Hildebrand III, *Let's Remove Special Bankruptcy Protection for Subprime Mortgages*, 26 AM. BANKR. INST. J. 14, 34 (2007); Melissa B. Jacoby, *Bankruptcy Reform and the Financial Crisis*, 13 N.C. BANKING INST. 115, 115–16 (2009).

129. DUBITSKY ET AL., *supra* note 79, at 1 ("Overall we think the bankruptcy reform will be a net positive in terms of foreclosure reduction, as it may be an effective way to improve both home equity and affordability. . . . We expect the bankruptcy plan will provide about a 20% reduction in foreclosures.").

130. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 58, 69 (2006), *available at* http://www.mi.vt.edu/web/page/595/sectionid/580/pagelevel/2/parentid/580/interiorHPD.asp (estimating that

escape foreclosure, the value of adjacent homes remains higher, and the community's tax-base is strengthened accordingly.[131]

The United States already has an existing and largely self-supporting system of bankruptcy courts, judges, clerks, and courthouses.[132] If loan modifications are permitted in chapter 13 cases, there will be no need to develop and fund a costly new bureaucracy to administer them, and this benefits the taxpayers who have been left with the task of cleaning up the wreckage of the foreclosure crisis.[133] Moreover, the bankruptcy system brings with it an experienced corps of valuation experts. Bankruptcy judges already value property on a daily basis and are eminently qualified to determine accurate property values in the local areas they serve.[134]

Residential mortgage modification through an amended section 1322(b)(2) would also provide a form of time-limited relief that is carefully targeted to benefit only the subset of debtors who are eligible to file chapter 13. Chapter 13 is an option only for individual consumer debtors who have sufficient regular income to service their debts.[135] Eligibility for chapter 13 is limited to debtors with relatively low levels of debt,[136] and the Bankruptcy Code requires debtors to make payments according to a statutory formula that takes into account both the debtor's income and the value of the creditor's collateral.[137] These chapter 13 eligibility requirements impose a series of automatic screens on bankruptcy debtors that channel relief to qualified

each conventional, single-family foreclosure within an eighth of a mile reduces the value of single-family homes by a minimum of 0.9 percent and finding that this impact is cumulative); *see also* CTR. FOR RESPONSIBLE LENDING, SUBPRIME SPILLOVER: FORECLOSURES COST NEIGHBORS $223 BILLION; 44.5 MILLION HOMES LOSE $5,000 ON AVERAGE (2007), *available at* http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Subprime_mortgages/subprime-spillover111307.pdf ("When a home goes into foreclosure, the negative effects extend beyond individual families losing their homes to surrounding neighbors and the wider community.").

131. *Cf.* John Conyers Jr., *Loan Modification Can Stop the Foreclosure Crisis*, WALL ST. J., Jan. 30, 2009, at A11.

132. *See* William W. Schwarzer & Neil McGaraghan, *The Administrative Relationship Between the District and Bankruptcy Courts*, 17 BANKR. DEV. J. 9, 10–11 (2000) (noting the separation of bankruptcy courts from other federal courts and the congressional intent behind such a separation). The bankruptcy court system is largely self-supporting because it is funded, in part, by filing fees charged to bankruptcy debtors and litigants. *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 365 (1993) ("While the general taxpayer obviously contributes to the costs of keeping a bankruptcy court open, the fees imposed on those who use the system minimize the taxpayer costs.").

133. *See* Letter from the Chief Legal Officers of Twenty-Two States and the District of Columbia to Nancy Pelosi, Speaker of the House, and John Boehner, House Minority Leader (Jan. 6, 2009) (available at http://www.mass.gov/Cago/docs/press/2009_01_06_bankruptcy_code_attachment1.pdf) (urging the House to adopt an amendment that allows Bankruptcy courts to order loan modifications, which would minimize foreclosures at no cost to the taxpayers).

134. For a bankruptcy judge's perspective on residential loan modification, see Rich Leonard, Op-Ed, *A Win-Win Bankruptcy Reform*, WASH. POST, Nov. 28, 2008, at A29. Judge Leonard of the U.S. Bankruptcy Court in the Eastern District of North Carolina observes that bankruptcy judges are well-equipped to modify the terms of home mortgages—a solution that benefits the homeowner, the lender, and the community. *Id.*

135. 11 U.S.C. § 109(e) (2006).

136. *Id.*

137. *Id.* §§ 1322, 1325.

borrowers. Finally, the proposed amendment would apply only to mortgages originated *before* the effective date of the new law. This limitation focuses relief on the subset of borrowers most impacted by the foreclosure crisis but does not expand mortgage modification in any way that would erode mortgage markets generally.

Finally, and most importantly, allowing the modification of mortgages in chapter 13 would reduce the moral hazard that results when borrowers, lenders, and investors are allowed to avoid the costs associated with their risky behavior.[138] Moral hazard is reduced on the debtor's side of the equation because chapter 13 is a "pay to play" system. Arguments to the contrary are disingenuous and fail to recognize the substantial costs associated with filing bankruptcy.[139] As the Mortgage Bankers Association itself has acknowledged:

> *There are very real and severe consequences for consumers who declare bankruptcy. Bankruptcy is a long, arduous, very public and expensive process, costing thousands of dollars in legal costs. Even when people file for bankruptcy, almost two thirds of them are unable to fulfill the terms of their repayment plans. Filing bankruptcy will allow a federally appointed trustee to scrutinize the consumer's every expenditure. Additionally, bankruptcy stays on a consumers' [sic] credit report for 10 years, making it difficult to acquire future credit, buy a home, car or insurance and in some cases, even obtain employment.*[140]

Bankruptcy is not a pleasant process, and moral hazard is reduced when debtors bear these costs. This is especially true when the alternative choice for many debtors is simply to walk away and default on underwater loans.[141] Finally, because current

138. Moral hazard is an economic concept recognizing that insurance has the possibility to encourage risky behavior when it removes or reduces the costs associated with that behavior. *See* Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531, 531–37 (1968) (defining moral hazard as "every deviation from correct human behavior that may pose a problem for an insurer" (citation omitted)); Lawrence Summers, *Beware Moral Hazard Fundamentalists*, FT.COM, Sept. 23, 2007, http://www.ft.com/cms/s/0/5ffd2606-69e8-11dc-a571-0000779fd2ac.html (providing an example of the term "moral hazard" as "when holders of health insurance use more healthcare than they would if they were not insured").

139. The specter of moral hazard is an implicit theme in the Mortgage Bankers Association's arguments against mortgage modification in bankruptcy. *See, e.g.*, *Straightening out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?—Part II: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 110th Cong. (2007) (statement of David G. Kittle, Chairman-Elect, Mortgage Bankers Ass'n) [hereinafter Statement of David G. Kittle] (implying that extending cramdown provisions to primary residences would create moral hazard by encouraging borrowers to use bankruptcy as an inexpensive method for refinancing mortgages, adding to the turmoil in the market).

140. Press Release, Mortgage Bankers Ass'n, MBA's Kittle Challenges Bankruptcy Myths at Hearing (Jan. 29, 2008) (available at http://www.mortgagebankers.org/NewsandMedia/PressCenter/59656.htm).

141. *See* DUBITSKY ET AL., *supra* note 79, at 6 ("Perhaps among all loss mitigation alternatives, bankruptcy may have the least moral hazard. . . . Borrowers who are looking for a 'free ride' and want to expunge their negative equity should find foreclosure a more palatable alternative.").

legislative proposals limit cramdown to mortgages originated before the effective date of the new law, there is no risk that consumers will "overborrow" with the thought of using future cramdowns to better their positions.

On the creditor's side of the equation, allowing residential mortgages to be modified in bankruptcy forces lenders, servicers, and investors to bear some of the costs of the irresponsible loan-underwriting decisions that allowed disaster to strike when home prices fell. The current wave of foreclosures was caused, in part, by reckless lending practices that ignored the default risk of borrowers in the pursuit of the short-term profits that could be made through securitization.[142] If borrowers and taxpayers are forced to carry all of the costs, creditors will be allowed to escape the economic consequences of their own folly. This creates moral hazard—the risk that they will behave irresponsibly in the future because they have learned that irresponsible behavior has no down-side risk.

III. ARGUMENTS AGAINST MORTGAGE MODIFICATION

The mortgage banking industry has been fighting the possibility of residential mortgage modification in bankruptcy since 2007.[143] Many of the industry's initial arguments against mortgage modification have been rendered obsolete by subsequent developments in the mortgage market.[144] Other arguments, however, remain active battlegrounds that draw attention from academics and policymakers.

142. The issuance of "no-doc" and "no equity" loans during the heyday of subprime lending has been extensively documented. *See, e.g.*, Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1 (explaining how loans without proper documentation led to difficulties in properly securitizing the mortgages). These loans violated common-sense underwriting principles because the lender extended credit without documenting the borrower's income and without obtaining sufficient collateral to defray loss on default. *Cf. id.* (noting the change in attitude during the subprime boom from questioning whether the loan was proper to questioning whether the loan complied with guidelines "which can sometimes be vague and allow exceptions" (quoting Kathleen Tillwitz, Senior Vice President, DBRS)).

143. The Mortgage Bankers Association maintains a dedicated webpage that collects industry-generated material opposing cramdown. *See* Mortgage Bankers Association, Stop the Bankruptcy Cram Down Resource Center, http://www.mortgagebankers.org/stopthecramdown (last visited Feb. 16, 2010). Material on the webpage dates back to 2007. *See, e.g.*, Letter from John M. Robbins, Chairman, Mortgage Bankers Ass'n, to John Conyers, Chairman, H. Comm. on the Judiciary, and Lamar Smith, Ranking Member, H. Comm. on the Judiciary (Oct. 15, 2007) (on file with author), *available at* http://www.mortgagebankers.org/files/StopTheCramDown/MBAOpposesH.R. 3609.pdf.

144. For example, a November 6, 2007 letter from Robert L. Clarke, former Comptroller of the Currency, William M. Isaac, former FDIC Chairman, and Donald E. Powell, former FDIC Chairman, to Representatives Conyers and Smith states: "The suggestion that changes to the bankruptcy code need only last for a short while in order to be effective misses the point. Anything that delays the market from getting back to normal as soon as possible—as H.R. 3609 certainly will—will only create more havoc and lead to more bankruptcy filings." Letter from Robert L. Clarke, former Comptroller of the Currency, William M. Isaac, former Chairman, FDIC, and Donald E. Powell, former Chairman, FDIC, to John Conyers, Chairman, H. Comm. on the Judiciary, and Lamar Smith, Ranking Member, H. Comm. on the Judiciary (Nov. 6, 2007) (on file with author), *available at* http://www.mortgagebankers.org/files/StopTheCramDown/FormerRegulatorsLettertoHouseJudiciaryCommittee.pdf [hereinafter Letter from Robert L. Clarke et al.]. From the vantage point of 2010, we know that mortgage markets did not painlessly self-correct and that bankruptcy rates have skyrocketed without the incentive of cramdown. *See, e.g.*, Bajaj & Story, *supra* note 10; *More Foreclosures to Come*, *supra* note 3.

Viable arguments against mortgage modification follow the following five themes: (1) increased cost of credit, (2) harm to the bankruptcy system, (3) harm to borrowers, (4) harm to creditors, and (5) ethical arguments.

A. Increased Cost of Credit

Since 2007, the Mortgage Bankers Association (MBA) has predicted that allowing residential mortgage modification in bankruptcy, particularly cramdown, would have dire consequences for the cost of home-mortgage credit. In October of 2007, the MBA predicted that passage of cramdown legislation would result in required down payments of "20% or more," fewer high loan-to-value loans for borrowers, and a 2% jump in mortgage interest rates.[145] This argument is repeated in nearly every document produced by the MBA,[146] and it has an intuitive common-sense appeal. The possibility of *post hoc* mortgage modification increases the lender's risk, and increased risks are naturally offset by charging a higher rate of up-front interest.[147]

This may be true of normal markets; however, we are not currently in a normal market. To the contrary, abnormal market conditions have created a situation with dangerously large numbers of undersecured creditors and underwater borrowers. When these borrowers go into default, they presently face a choice between foreclosure or some form of voluntary mortgage modification. If a time-limited amendment to section 1322(b)(2) provides a sufficiently advantageous third choice, the current market may benefit even if this choice is accompanied by a temporary tightening of credit terms.

Moreover, despite the common sense appeal of the MBA's statement that bankruptcy modification will cause interest rates to increase, there is little empirical evidence to support this argument. Professor Adam Levitin has criticized the MBA's data and conducted an independent empirical analysis showing that "mortgage markets are indifferent to bankruptcy-modification risk."[148] Professor Levitin argues that when lenders face larger losses from foreclosure than modification, "the mortgage market will not price and ration credit based on bankruptcy-modification

145. *See* Statement of David G. Kittle, *supra* note 139, at 3.

146. *See, e.g.*, Letter from John A. Courson, Chief Operating Officer, Mortgage Bankers Ass'n, to Members of Congress (Sept. 23, 2008) (on file with author), *available at* http://www.mortgagebankers.org/files/Advocacy/2008/LetterUrgingCongressNottoInclude_BankruptcyCramDown.pdf ("Changing these rules will inevitably raise the cost of credit."); Press Release, Mortgage Bankers Ass'n, MBA Urges Caution on Mortgage Debt "Cramdown" Legislation (Oct. 4, 2007) (available at http://www.mortgagebankers.org/NewsandMedia/PressCenter/57426.htm) ("As a result [of cramdowns], lenders and investors would likely demand a higher premium for offering these loans. . . . in the form of higher fees, a higher interest rate or the requirement for a larger downpayment . . . .").

147. *See* Todd J. Zywicki, *Don't Let Judges Tear up Mortgage Contracts*, WALL ST. J., Feb. 13, 2009. at A13 (arguing that mortgage costs will rise if judges can modify mortgage contracts after they are made).

148. Levitin, *supra* note 120, at 575.

risk."[149] By definition, creditors exposed to the risk of cramdown are undersecured, and most borrowers seeking cramdown will already be in default or experiencing difficulty paying their mortgages. It follows that the risks associated with this subset of underperforming mortgages will already have been realized before bankruptcy is filed. Although poorly performing mortgages may justify higher interest rates, it is difficult to see how the process of cramdown will sufficiently augment these existing losses to provide an independent justification for higher interest rates.[150]

B. Harm to the Bankruptcy System

Opponents of mortgage modification in bankruptcy also argue that an amendment to section 1322(b)(2) has the potential to harm the bankruptcy system itself. The most commonly voiced concern is that residential mortgage modification has the potential to "unleash a torrent of bankruptcies" that will overwhelm and disable the bankruptcy system.[151] Other critics of the legislation have argued that cramdown may cause a backlash against bankruptcy by fostering resentment among non-qualifying borrowers,[152] or that changing the structure of the Bankruptcy Code itself will work systemic harm.[153]

In assessing the seriousness of these concerns, it is helpful to recall that residential mortgages were, in fact, modified by bankruptcy judges before the Supreme Court's 1993 *Nobelman* decision.[154] Bankruptcy filings did not skyrocket during this period, and they did not appreciably fall in response to *Nobelman*.[155]

149. *Id.* at 576. *But see* Mark S. Scarberry, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13 Bankruptcy*, 37 Pepp. L. Rev. (forthcoming 2010), *available at* http://paperps.ssrn.com/sol3/papers.cfm?abstract_id=1520794 (providing a critique of Professor Levitin's empirical study).

150. *See* Dubitsky et al., *supra* note 79, at 13.

> Assuming most borrowers who file can't pay their mortgage [sic] anyway, the losses lenders would suffer would not seem to be any higher under the bankruptcy proposal and may in fact be lower as shown in our test. Therefore we don't believe the bankruptcy reform will materially impact the pricing or availability of mortgage credit.

Id.

151. Zywicki, *supra* note 147; *see also* Statement of David G. Kittle, *supra* note 139, at 3 ("Bankruptcy filings will no doubt skyrocket . . . .").

152. *See* Scarberry, *supra* note 149, at 122 (noting that cramdown could "cause resentment among those persons who could not benefit from them" as well as those who would receive a "smaller benefit").

153. *See* Statement of David G. Kittle, *supra* note 139, at 1. Kittle states that the policy prohibiting the modification of mortgages of a primary residence "has been in existence over 100 years, since the Bankruptcy Act of 1898, and is a cornerstone to an efficient U.S. residential mortgage market." *Id.* This, of course, is an overstatement, since bankruptcy judges modified residential mortgages prior to the decision in *Nobelman*. *See* Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993); *see also supra* Part I.D (describing the effect of *Nobelman* on Chapter 13 bankruptcy decisions).

154. *See supra* notes 69–75 and accompanying text.

155. In calendar year 1990, 782,960 bankruptcy cases were filed. U.S. Courts, Bankruptcy Statistics, http://www.uscourts.gov/bnkrpctystats/statistics.htm (follow "1990–2002 Calendar Year Bankruptcy Filings by Chapter and District" hyperlink) (last visited Feb. 16, 2010). This number increased to 875,202 in 1993 and rose to 1,404,145 in 1997. *Id.*

Moreover, in response to the foreclosure crisis and accompanying economic downturn, bankruptcy filings have nearly doubled from fiscal year 2007 to fiscal year 2009, and this dramatic increase has left the bankruptcy system unscathed.[156] It is also worth noting that bankruptcy judges themselves have expressed little trepidation about a possible increase in their workloads.[157]

It is possible that borrowers who file bankruptcy may be resented by borrowers who do not. However, this is equally true under current law, and it is purely speculative to predict that cramdown would generate sufficient additional resentment to harm the bankruptcy system. Similarly, there is no reason to project systemic harm from the amendment of one bankruptcy statute; the bankruptcy system is resilient and has survived many statutory revisions, including the far-reaching amendments of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[158]

C. Harm to Borrowers

The Mortgage Bankers Association is on record as stating that an amendment to section 1322(b)(2) will harm borrowers by encouraging them to file bankruptcy,[159] by tightening credit,[160] and by prompting servicers to rush foreclosures through in advance of the amendment.[161] These arguments, which were made in 2007 and early 2008, seem quaint in retrospect. In 2009, bankruptcy filings increased 35% over the prior year.[162] In 2008, credit became uncomfortably tight,[163] and foreclosures reached record levels in both years.[164] From the perspective of the borrower, the many benefits of allowing residential mortgages to be modified in bankruptcy clearly outweigh the possibility that cramdown will make matters worse.

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156. In fiscal year 2007, 801,269 bankruptcy cases were filed. *Id.* (follow "2007 Fiscal Year by Chapter" hyperlink) (last visited Feb. 16, 2010). That number increased to 1,402,816 in fiscal year 2009. *Id.* (follow "2009 Fiscal Year by Chapter" hyperlink) (last visited Feb. 16, 2010). These numbers remain far short of the 2,078,415 cases filed in calendar year 2005. *Id.* (follow "2005 Calendar Year by Chapter" hyperlink) (last visited Feb. 16, 2010).

157. *See, e.g.*, Leonard, *supra* note 134.

158. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).

159. *See supra* note 140 and accompanying text.

160. *See* Statement of David G. Kittle, *supra* note 139, at 12.

161. MORTGAGE BANKERS ASS'N, OPPOSE CRAMDOWN LEGISLATION (2007), http://www.mortgagebankers.org/files/StoptheBankruptcyCramDown/BankruptcyTwoPager.pdf.

162. *See supra* note 156.

163. *See Cheaper Homes Are Attracting Some Buyers*, N.Y. TIMES, Sept. 25, 2008, at C17 (noting that credit remained "tight" in 2008).

164. *See* Stephanie Armour, *Foreclosures Jump in December After Months of Declines*, USA TODAY, Jan. 13, 2010, http://www.usatoday.com/money/economy/housing/2010-01-13-foreclosures-rise-in-december_N.htm (reporting a record 2.8 million properties with foreclosure filings in 2009, an increase of 21% over 2008 and 120% over 2007).

D. Unfairness to Creditors

Critics of residential mortgage cramdown have predicted "[e]normous [w]indfalls to [b]orrowers" that will come "at the expense of servicers, investors and borrowers who honor their debts."[165] This argument is premised on the debtor's post-cramdown right to any future appreciation in the value of the mortgaged property.[166] Although the quantity of these "windfalls" is unlikely to deserve the MBA's hyperbolic characterization, the underlying concern is valid. The bills presently before Congress address this problem by allowing the creditor to recapture appreciation on a phased-out basis when the debtor sells the property before completing payments under the chapter 13 plan.[167] Although this leaves the creditor with no ability to recapture value when appreciated property is sold after the plan is completed,[168] the possibility of eventually accruing equity in the property gives the debtor an incentive to complete payments and maintain the property.[169] If, as creditors might prefer, recapture of appreciation is extended for the life of the modified loan, the mortgage effectively becomes a long-term lease unless the property strongly appreciates in value.

Critics of mortgage modification have also expressed concern about revising the terms of existing contracts and are particularly resistant to giving this power to bankruptcy judges. The Mortgage Bankers Association, for example, has protested that the cramdown legislation "gives judges free rein to rewrite these contracts without statutory or economic restraint."[170] These arguments are based on a fundamental misunderstanding of the Bankruptcy Code and the role of bankruptcy judges.

Like all judges, bankruptcy judges have the power to weigh evidence and determine disputed issues of fact; however, they operate within a carefully designed statutory framework that limits their discretion. Bankruptcy judges do not exercise unfettered power to determine property values and rewrite contracts based on their whim. To the contrary, their decisions are constrained by a web of statutes and case law that applies uniformly and predictably to all creditors. If mortgage contracts are

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165. Statement of David G. Kittle, *supra* note 139, at 9.

166. *See* Zywicki, *supra* note 147. Professor Zywicki provides a concrete example of the opportunity for abuse when market prices fluctuate and cramdown occurs at the property's lowest value. *Id.*

167. Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103 (adding a new subsection (g) to 11 U.S.C. § 1322).

168. This point is made by Professor Scarberry in his forthcoming article. *See* Scarberry, *supra* note 149, at 283 ("A provision giving the mortgage holder a real and substantial right to recapture most of the future appreciation to the extent needed to restore the stripped down principal would make the legislation far less objectionable and less likely to provoke resentment and cynicism." (footnote omitted)).

169. This point is also recognized by Professor Scarberry, who concedes that "[t]he debtor should be allowed to share to some extent in the appreciation so that the debtor will have an incentive to maintain and improve the property and an incentive to make the payments on the modified mortgage." *Id.* at 283 n.430.

170. MORTGAGE BANKERS ASS'N, *supra* note 161.

to be involuntarily modified, the bankruptcy system offers a tested mechanism for accomplishing these modifications fairly.

E. Ethical Arguments

Finally, opponents of residential mortgage modification in bankruptcy make a number of non-economic points that rest on ethical or moral grounds. Arguments of this type range from the perceived unfairness of "windfalls" for debtors who fail to "honor" their debts,[171] to the fear that cramdown will increase fraud and bankruptcy abuse,[172] to the concern that cramdown will benefit undeserving debtors who are "investors" seeking to be bailed out of a bad investment.[173] These are *ad hominem* arguments that are raised pejoratively against consumer debtors—as opposed to commercial entities—and add little to a reasoned debate.

Most of these arguments can be dispatched by recalling that chapter 13 comes with a built-in set of safeguards against fraud, misrepresentation, and abuse. Debtors are subject to examination by creditors and the trustee at the section 341 meeting of creditors and are subject to continued supervision by the trustee.[174] Cases that are not filed in good faith are subject to immediate dismissal,[175] and a broadly defined range of debts procured by fraud or misrepresentation are not dischargeable in bankruptcy.[176] In addition, bankruptcy fraud, including the making of a "false or fraudulent representation, claim, or promise" relating to a bankruptcy case, is a federal crime punishable by a fine, imprisonment, or both.[177]

Bankruptcy is not a cost-less system. To receive the benefit of a chapter 13 bankruptcy, a debtor must pay thousands of dollars in attorney's fees and costs;[178] publicly disclose assets, income, and debts in an exhaustive set of schedules and statements;[179] agree to a trustee-supervised budget;[180] begin payments almost

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171. *See* Zywicki, *supra* note 147.

172. Letter from Am. Bankers Ass'n et al. to John Conyers, Chairman, H. Comm. on the Judiciary, and Lamar Smith, Ranking Member, H. Comm. on the Judiciary (Jan. 27, 2009) (on file with author), *available at* http://www.mbaa.org/files/AU/2009/JointLetter_Cramdown_2709.pdf.

173. Letter from Robert L. Clarke et al., *supra* note 144. This argument is particularly ill-founded since investment property is already eligible for cramdown under current law. *See supra* Part I.C.

174. 11 U.S.C. §§ 341, 1302 (2006).

175. *Id.* § 1325(a)(7).

176. *Id.* §§ 523(a), 1328(c).

177. 18 U.S.C. § 157 (2006).

178. Fees for debtor's attorneys must be approved by the bankruptcy court and will vary by federal district. As an example, the base fee for a routine chapter 13 case in the Eastern District of North Carolina is currently $3,000. *See* BANKR. E.D.N.C. R.2016-1, *available at* http://www.nceb.uscourts.gov/documents/Admin%20Guide%2020091201.pdf. The total filing fee for a chapter 13 petition in the E.D.N.C. is $274. U.S. Bankruptcy Court E.D.N.C., Schedule of Fees, http://www.nceb.uscourts.gov/newcode/fee_schedule.php (listing a $235 filing fee and a $39 administrative fee for chapter 13 petitions); *see also* 28 U.S.C. § 1930(a) (2006) (listing the chapter 13 filing fee as $235).

179. 11 U.S.C. § 521.

180. *Id.* § 1302.

immediately;[181] and commit substantial resources to a chapter 13 plan for a period of three to five years.[182] Bankruptcy remains on the debtor's credit report for ten years[183] and will negatively influence future extensions of credit and employment.[184] Consumer debtors do not typically file bankruptcy lightly, and they must exercise discipline to complete the lengthy chapter 13 plan.

IV. CONCLUSION

The time has come to change bankruptcy law to reflect current economic conditions. The section 1322(b)(2) home mortgage modification exclusion was created in 1978 to protect a mid-twentieth century mortgage financing model that no longer exists.[185] Today, it has become a tool that is being misused by servicers and investors defending mortgages with terms that would have been unimaginable in 1978.[186] Because housing prices have declined dramatically, the terms of these mortgages have made it difficult or impossible for large numbers of Americans to remain in their homes. The resulting economic destruction calls for a solution tailored to the problem: modification of these mortgages to manageable terms.

Amending section 1322(b)(2) of the Bankruptcy Code to allow mortgages to be modified in chapter 13 plans offers distinct advantages to all parties. Bankruptcy offers a comprehensive and cost-efficient system for loan modification that is already in place. Borrowers would benefit from increased leverage and would be greatly advantaged by the ability to modify the terms of underwater mortgages with above-market interest rates. Senior mortgage-holders would benefit from increased cash flow when junior mortgages are stripped off, debtors are forced into the discipline of a chapter 13 plan, and payments are made on both secured and unsecured claims. Taxpayers and communities benefit when foreclosures are reduced, homes remain owner-occupied, and tax revenues increase. Finally, the modification of mortgages in bankruptcy would reduce moral hazard to borrowers, lenders, and investors by placing the costs of bankruptcy on borrowers, while forcing lenders and investors to recognize losses caused by reckless loan underwriting.

American taxpayers have spent billions of dollars to protect financial institutions from the consequences of their bad decisions.[187] Billions more have been spent on

181. *Id.* § 1326 (requiring the debtor to commence making payments no later than thirty days after filing her bankruptcy petition).

182. *Id.* § 1325(b)(4).

183. 15 U.S.C. § 1681c(a)(1) (2006).

184. *See supra* note 140 and accompanying text.

185. *See* Eggum et al., *supra* note 53, at 1154–60.

186. *See id.*

187. *See, e.g.*, *Adding up the Government's Total Bailout Tab*, NYTIMES.COM, Feb. 4, 2009, http://www.nytimes.com/interactive/2009/02/04/business/20090205-bailout-totals-graphic.html ("The largest

an ineffectual effort to encourage these same institutions to voluntarily modify the terms of the mortgages that caused the crisis.[188] In its present form, section 1322(b)(2) pins the cost of underwater mortgage transactions squarely on the shoulders of consumer borrowers, while allowing lenders to delay or escape recognition of losses caused by poor underwriting decisions. It is time to amend the Bankruptcy Code to allow bankruptcy judges to effect reasonable modifications to unreasonable mortgages and give borrowers the help they need to stay in their homes.

recipients [of the government's Trouble Asset Relief Program's funds] are A.I.G. ($70 billion), Bank of America ($45 billion) and Citigroup ($45 billion cash and $5 billion in support of a loan guarantee).").

188. *See* Adelino et al., *supra* note 14, at 2 ("Every major policy action to date has involved encouraging lenders, in one way or another, to renegotiate loan terms in order to reduce borrower debt loads."); Paul Kiel, *Homeowners Say Banks Not Following Rules for Loan Modifications*, PROPUBLICA, Jan. 14, 2010, http://www.propublica.org/ion/bailout/item/homeowners-say-banks-not-following-rules-for-loan-modifications (noting that even though the government had created a program to help "4 million homeowners through the $75 billion mortgage modification program [,] . . . as of November [2009], only about 31,000 [mortgage modification plans] had been made permanent").