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* Professor of Law, Pepperdine University School of Law. The author would like to thank Professors Grant Nelson, Katherine M. Porter, Joseph R. Mason, and Robert Lawless, and Mr. Alex J. Pollock (Resident Fellow at the American Enterprise Institute) for their helpful comments on the ideas presented in this Article. Although this Article is highly critical of the conclusions drawn by Professor Adam J. Levitin from his thoughtful and creative empirical research, the author would like to thank Professor Levitin for his courtesy in engaging in dialogue on the issue of home mortgage modification in bankruptcy. *See infra* note 14 for additional thanks to the organizers of and participants in the *Pepperdine Law Review* mortgage crisis symposium.

## I. INTRODUCTION

Suppose a homeowner who is in financial distress owes more on the home than it is worth and thus has "negative equity."[1] Should the

1. According to a recent Deutsche Bank report, twenty-six percent of homes in the United States were subject to mortgages for more than their value at the end of the first quarter of 2009. *See* KAREN WEAVER & YING SHEN, DEUTSCHE BANK, DROWNING IN DEBT – A LOOK AT "UNDERWATER" HOMEOWNERS 3 (2009), http://www.sacbee.com/static/weblogs/real_estate/Deutsche%20research%20on%20underwater%20mortgages%208-5-09.pdf. The report predicts a further average decline in home values of fourteen percent through the first quarter of 2011, with forty-eight percent of homeowners then having mortgages larger than the value of their homes and twenty-eight percent having mortgages equal to one hundred twenty-five percent or more of their homes' value. *Id.* at 2–3, 5, 8; Jody Shenn, *'Underwater' Mortgages to Hit 48%, Deutsche Bank Says*, BLOOMBERG.COM, Aug. 5, 2009, http://www.bloomberg.com/apps/ news?pid=newsarchive&sid=ac9y1xr7yNhQ (discussing the report issued by Deutsche Bank analysts Karen Weaver and Ying Shen); Al Yoon, *About Half of U.S. Mortgages Seen Underwater by 2011*, REUTERS, Aug. 5, 2009, http://www.reuters.com/article/ousiv/idUSTRE5745JP20090805. Some analysts, including housing economist Tom Lawler, believe home prices will not fall as steeply; others, such as banking analyst

homeowner be able to use the bankruptcy laws to write down the amount of the mortgage to the value of the home in what is called a "strip down," or sometimes a "cram down," of the mortgage? Multiple aspects of current bankruptcy law usually prevent homeowners from stripping down home mortgages and from otherwise substantially modifying the rights of home mortgage holders.[2] But, in response to the home mortgage crisis, Congress is considering amendments to the Bankruptcy Code[3] that would permit strip down of home mortgages, along with other substantial modifications of home mortgages, in Chapter 13 bankruptcy.[4] The amendments would allow

Meredith Whitney, believe they may fall even more steeply; and others, like Robert Shiller of the S&P/Case-Shiller U.S. National Home Price Index, predict little change, even over the longer term. *See* Nick Timiraos, *48% Underwater? Lawler Challenges Deutsche Bank Report*, WALL ST. J., Aug. 7, 2009, http://blogs.wsj.com/developments/ 2009/08/07/48-underwater-lawler-challenges-deutsche-bank-report/; *Home Prices Could Fall by Another 25%: Whitney*, CNBC.COM, Sept. 10, 2009, http://www.cnbc.com/id/32773345; Nina Koeppen, *Q&A: Shiller Sees 5 Years of Stagnant Home Prices*, WALL ST. J., Sept. 30, 2009, http://blogs.wsj.com/economics/2009/09/30/qa-shiller-sees-5-years-of-stagnant-home-prices/. Recent small upticks in home prices may be washed out by the impending expiration of the tax credit for new home buyers. *See House Prices Rise, but Tax Credit Is Due to End*, CHIC. TRIB., Oct. 27, 2009, http://www.chicagotribune.com/business/yourmoney/sns-200910271553mctnewsservbc-real-prices-mk103060,0,1709450.story. Some analysts believe that the current effort to delay home foreclosures is building up a backlog of homes that will eventually be foreclosed upon and flood the market, resulting in a further decline in the market. *See* Ruth Simon & James R. Hagerty, *Delayed Foreclosures Stalk Market*, WALL ST. J., Sept. 23, 2009, at A10. First American CoreLogic reports that approximately thirty-two percent of mortgaged properties—apparently meaning homes—had negative equity as of the end of both the first and second quarters of 2009. *See* First Am. CoreLogic, Summary of Second Quarter 2009 Negative Equity Data from First American CoreLogic (Aug. 13, 2009) (unpublished summary report), http://www.loanperformance.com/infocenter/library/FACL%20Negative%20Equity_final_081309. pdf; *see also* Stan Liebowitz, *New Evidence on the Foreclosure Crisis*, WALL ST. J., July 3, 2009, at A13 ("What is really behind the mushrooming rate of mortgage foreclosures since 2007? The evidence from a huge national database containing millions of individual loans strongly suggests that the single most important factor is whether the homeowner has negative equity in a house—that is, the balance of the mortgage is greater than the value of the house.").

2. *See infra* text accompanying notes 45–222.

3. The Bankruptcy Code is Title 11 of the United States Code. 11 U.S.C. §§ 1–1532 (2006). Section references in this article are to sections of the Bankruptcy Code, unless otherwise noted.

4. *See* H.R. 1106, 111th Cong. (2009); S. 895, 111th Cong. (2009); S. Amend. 1014 to S. 896, 111th Cong. (2009) [hereinafter Durbin Amendment], *reprinted in* 155 CONG. REC. S4980–84 (daily ed. Apr. 30, 2009) (setting out text of Senator Durbin's amendment to Senate Bill 896, for himself and for Senators Dodd, Reid, Schumer, Whitehouse, and Harkin). House Bill 1106 passed in the House of Representatives on March 5, 2009, but no action has yet been taken on it in the Senate. No substantive action has been taken in the Senate on Senate Bill 895. Senator Durbin's proposed amendment to Senate Bill 896 represents the Senate Democrats' latest attempt to craft a provision that could pass the Senate. A majority of Senators voted against the Durbin Amendment; thus it fell far short of the sixty votes needed, as a practical matter, for such a provision to pass the Senate and was withdrawn by Senator Durbin. *See* 155 CONG. REC. S4937–38 (daily ed. Apr. 30, 2009). Senate Bill 896 then was enacted, without the Durbin Amendment, but with other amendments, as

such a mortgage to be stripped down to the court-determined value of the home, with the homeowner then being permitted to pay off the stripped down mortgage at a court-determined rate of interest over a period of up to forty years.[5] The amendments thus would allow the debtor to modify the interest rate and duration of the home mortgage along with stripping it down to the value of the home.

Although proponents of the amendments assert that forced mortgage modifications in Chapter 13 bankruptcy would benefit mortgage holders by preventing costly foreclosures,[6] proponents ignore or minimize the serious risks that would be created by the amendments and the costs that would be imposed on mortgage holders.[7] Proponents do not seem to recognize risks

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Public Law 111-22. *See infra* note 228. For a chart comparing bills—none of which were enacted—from the previous (110th) Congress on the subject of Chapter 13 home mortgage modification, see Mark S. Scarberry, *Detailed Chart Comparing Provisions of Current Bankruptcy Bills Dealing with Modification of Home Mortgages, as of October 17, 2007*, 36 N.Y. REAL PROP. L.J. 58 (Spring 2008) (printing complete text of chart that had been printed in incomplete form in Winter 2008 issue), *available at* http://www.abiworld.org/pdfs/Home_Mortgages.pdf.

5. *See infra* text accompanying notes 228–29.

6. *See, e.g.*, Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. 565, 575–76 (stating that the article "marshals a variety of original empirical evidence from mortgage origination, insurance, and resale markets to show that mortgage markets are indifferent to bankruptcy-modification risk," arguing that this "indifference" is due to the larger losses faced by mortgage holders in foreclosure as opposed to bankruptcy modification, and stating that "as long as lenders face larger losses in foreclosure than modification, the mortgage market will not price and ration credit based on bankruptcy-modification risk"); *id.* at 578 ("Using data from Chapter 13 bankruptcy filings, [the article] examines the impact of permitting strip-down on mortgage lenders and shows that its impact is usually far less than the lenders would lose in foreclosure. Because lenders would generally fare better in bankruptcy than in foreclosure, they do not price adversely to a bankruptcy-modification option.").

7. *See infra* text accompanying notes 144, 337–43 (noting and criticizing claims by strip down proponents that a mortgage holder whose mortgage was stripped down under the proposed legislation would be guaranteed to receive value in the Chapter 13 plan equal to the value of the home); *The Looming Foreclosure Crisis: How to Help Families Save Their Homes: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 182, 185–87 (2007) [hereinafter *The Looming Foreclosure Crisis Hearing*] (statement of Mark S. Scarberry), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110shrg511/pdf/CHRG-110shrg511.pdf (noting that proposed home mortgage strip down legislation would substantially change risk characteristics of home mortgages); *id.* at 76, 78–79 (letter from Mark S. Scarberry to Sen. Leahy) (noting that proposed home mortgage strip down legislation would place risk of future depreciation in home prices on home mortgage holders but deny them the benefit of future appreciation); Testimony of Paul S. Willen, Fed. Reserve Bank of Boston, Before Congressional Oversight Panel: Philadelphia Field Hearing on Mortgage Foreclosures 3 (Sept. 24, 2009), http://cop.senate.gov/documents/testimony-092409-willen.pdf (stressing "redefault risk" and "self-cure risk," explaining that research showed that the reason few mortgage modifications were being accomplished was that mortgage holders did not financially benefit from such modifications, and arguing that assistance for the unemployed was the best policy approach to preventing foreclosures); Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Boston Public Policy Discussion Paper No. 09-4, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf; *see also* Joseph R. Mason, Role of the Lending Industry in the Home Foreclosure Crisis 1–12 (Sept. 9, 2009) (written testimony before the

that are recognized by, and play a central role in, the "Net Present Value" (NPV) test, a test that in turn plays a central role in the Obama Administration's Home Affordable Mortgage Program (HAMP)[8] under

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Subcommittee on Commercial and Administrative Law of the House Committee on the Judiciary), http://judiciary.house.gov/hearings/pdf/Mason090909.pdf (noting that many borrowers simply cannot afford to pay amortizing mortgages on their homes, apparently even if the mortgages are stripped down; noting the high failure rate of voluntary modifications and of Chapter 13 plans; noting that savings from successful modification as opposed to foreclosure may not be great; and noting that voluntary modifications may cover most cases in which modification makes economic sense).

Debtors complete payments on Chapter 13 plans in only about a third of Chapter 13 cases, in part due to difficulty in making mortgage payments during their Chapter 13 plans. See infra note 336. Redefault in the Chapter 13 context is thus a serious problem. There is also a serious redefault problem when mortgages are modified outside of Chapter 13, even when monthly payments are reduced substantially in the modification:

> As was the case for the last half of 2008, the first nine months of 2009 indicated that materially all modifications given featured a lowering in the borrower's principal and interest payment. . . . [T]he most prevalent payment change continues to be in the decreased over 20% group, followed by the decreased from 10%–20% group. . . . [T]he loans that received mod[ification]s with payment reductions, even including up to and above 20%, also continue to re-default in a range of 40%–50% after 12 months.

Diane Pendley, Mary Kelsch & Thomas Crowe, FitchRatings Structured Finance Residential Mortgage Special Report: U.S. RMBS Servicers' Loss Mitigation and Modification Efforts Update 10–11 (Oct. 20, 2009), http://www.fitchratings.com/creditdesk/reports/ report_frame.cfm?rpt_id=474916 (free registration required for access).

8. HAMP is part of the Obama Administration's Homeowner Affordability and Stability Plan. Most home mortgages in the United States now are subject to HAMP. *See infra* note 273. The servicer of a mortgage that is subject to the HAMP program must modify the mortgage if the requirements of the HAMP Guidelines, including the NPV test, are met. *See* U.S. Department of the Treasury, Home Affordable Modification Program Guidelines 6 (March 4, 2009) [hereinafter March 4 Treasury Guidelines], http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf ("If the NPV Test generates a positive result when applying the Standard Waterfall, the servicer is required to offer a Home Affordable Modification to the borrower."). The NPV test is designed to determine whether the net present value of payments that the mortgage holder will receive will be enhanced by the modification. The test thus compares the value of the payments the mortgage holder is likely to receive if there is no modification—including possible payments resulting from foreclosure—with the value of the payments the mortgage holder is likely to receive if the loan is modified. *See id.* at 16 ("This NPV test will compare the net present value (NPV) of cash flows expected from a modification to the net present value of cash flows expected in the absence of modification. If the NPV of the modification scenario is greater, the NPV result is deemed positive, and the servicer must modify the loan (absent fraud, etc.)."). If the mortgage holder likely would have to foreclose absent a modification, and if a modification is likely to result in the debtor making the modified payments so that no foreclosure occurs, then the mortgage holder may benefit from avoiding a costly foreclosure. In such a case, a modification makes economic sense from the point of view of maximizing the value of the mortgage, and thus the NPV test would be satisfied.

But every modification that is given to a debtor who would have paid the mortgage on its original terms had no modification been made is costly to the mortgage holder; by modifying the mortgage, the mortgage holder gave up the full payment that otherwise would have been forthcoming. That cost results from the possibility of "self-cure"; the mortgage holder loses value by modifying a mortgage where the debtor would have cured any default (thus engaging in a "self-cure") and made payment in full under the contractual terms of the mortgage. *See supra* note 7. Thus the possibility of self-cure is one of the factors used in the NPV test. *See* March 4 Treasury Guidelines, *supra*, at 16–17 (noting inclusion of "Cure Rate" in NPV test). And if a modification is followed nevertheless by a foreclosure, then the mortgage holder may suffer various costs, including the cost of entering into the futile modification and the possible cost of delaying foreclosure while the value of the home declines, which then results in the mortgage holder receiving less value when it finally forecloses than it would have received if it had foreclosed earlier rather than modifying the mortgage. Those costs result from the "redefault" risk, the risk that the debtor, despite being given assistance by way of a mortgage modification, may nevertheless default again, or redefault. *See supra* note 7. The risk of redefault thus also is built into the NPV test. *See* March 4 Treasury Guidelines, *supra*, at 16–17. These risks also would be built into any custom NPV test that a particular mortgage servicer might be entitled to use. *See id.* at 17. Some experts believe that these risks or costs explain why financial institutions engage in fewer mortgage modifications than might be thought desirable; the risks result in modifications being, on the whole, losing propositions for the financial institutions or other mortgage holders. *See supra* note 7.

The proposed legislation in effect would mandate forced modifications of home mortgages in Chapter 13 without requiring that a net present value test be satisfied. Proponents of the legislation seem to assume that mortgage holders would benefit from such modifications, because the modifications supposedly would be less costly than foreclosure. *See, e.g.*, Levitin, *supra* note 6, at 617–18 ("The market's indifference to bankruptcy-modification risk is because losses due to modification (including strip-down) would generally be smaller than those incurred in foreclosure."). Proponents thus seem to assume that a net present value test would be automatically satisfied. In particular, they ignore the "self-cure" factor by assuming that the debtor will not use the new Chapter 13 to modify the mortgage if the debtor could otherwise keep the home. And they ignore the "redefault" risk by assuming that Chapter 13 guarantees that the undersecured mortgage holder will receive present value equal to the value of its collateral. *See infra* notes 144, 233. That assumption could only be correct if all such debtors successfully complete their Chapter 13 plans rather than defaulting on their plans and thus engaging in a "redefault" on the mortgage. Historically, most debtors have failed to complete their Chapter 13 plans, and thus no reasonable analysis can ignore the redefault risk.

Proponents of the proposed legislation set up a false choice between, on the one hand, the certainty of a costly foreclosure with no chance of self-cure, and on the other hand, the certainty of successful completion of a Chapter 13 plan with no chance of redefault. That this is indeed a false choice is shown by the Obama Administration's embrace of an NPV test that takes into account both the possibility of self-cure and the possibility of redefault.

The actual NPV test used in the HAMP program for servicers who do not develop their own custom NPV tests does not seem to be publicly available, but instead seems only to be available to participating servicers through a secured web portal. *See* Federal National Mortgage Association, Supplemental Documentation—Frequently Asked Questions: Home Affordable Modification Program 6, https://www.hmpadmin.com/portal/docs/hamp_servicer/hampfaqs.pdf (last visited Oct. 28, 2009) ("The NPV model software tool resides on the servicer Web portal (www.HMPadmin.com), and is available to all participating servicers of both GSE and non-GSE mortgage loans eligible for a Home Affordable Modification."). However, the FDIC net present value test used by the FDIC in modifying IndyMac mortgages is publicly available. *See* FED. DEPOSIT INS. CORP., FDIC LOAN MODIFICATION PROGRAM 11-14 (2008), http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf (explaining NPV test, including role of cure rate and redefault rate); FDIC Loan Modification Program Guide, http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html (last visited Nov. 10, 2009) (follow "Net Present Value Worksheet" hyperlink) (providing Excel spreadsheet incorporating FDIC NPV test). Federal Reserve Bank of Boston researchers have also published a model of an NPV test. *See* Adelino, Gerardi & Willen, *supra* note 7, at 20–23.

which homeowners are offered modifications of their mortgages[9] in an effort to prevent foreclosures.

The proposed amendments to the Bankruptcy Code would substantially alter the risk characteristics of home mortgages, with likely substantial effects on future mortgage interest rates and future mortgage availability.[10] Thus, the future societal cost of such a change in the law likely would be large.[11] This Article, which flows from the author's December 2007 testimony before the Senate Judiciary Committee,[12] from a presentation made at the annual meeting of the Association of American Law Schools (AALS) in January 2009,[13] and from a presentation made at the *Pepperdine Law Review* symposium on the mortgage crisis in April 2009,[14] explains and supports that thesis, primarily on the ground that the proposed changes would leave mortgage holders with all of the future downside risk in the real property market while denying them the benefit of future appreciation.[15]

9. For a recent update on efforts under HAMP and other efforts to modify mortgages to prevent foreclosure, see Pendley, Kelsch & Crowe, *supra* note 7.

10. *See infra* notes 223–343 and accompanying text.

11. *See infra* text accompanying notes 330–429.

12. *See The Looming Foreclosure Crisis Hearing*, *supra* note 7, at 12–20, 74–88, 182–93 (reporting December 5, 2007 oral testimony, subsequent letters responding to Senators' questions, and December 5, 2007 written statement, respectively).

13. The three-hour program, entitled *Real Estate Transactions in Troubled Times*, was a joint program of the AALS Section on Creditors' and Debtors' Rights and the AALS Section on Real Estate Transactions. Presenters were chosen pursuant to a call for papers. The author wishes to thank the members of the selection committee, Professors Daniel B. Bogart of Chapman University, Jean Braucher of the University of Arizona, R. Wilson Freyermuth of the University of Missouri-Columbia, and Katherine Porter of the University of Iowa, for their work on the program and for giving him the opportunity to participate. The participants for the third panel, entitled *Bankruptcy Modifications and Other Possible Remedies for Failed Transactions*, were Professor Melissa B. Jacoby of the University of North Carolina School of Law, Professor Adam J. Levitin of the Georgetown University Law Center, and the author. A podcast (audio only) of the program is available free of charge at http://aals.org/events_am2009.php. In the panel presentation and in the discussion following it, the author pointed out what he considers to be the serious flaws in Professor Levitin's empirical studies. *See* discussion *infra* Part IV and accompanying text.

14. The *Pepperdine Law Review* symposium *Bringing Down the Curtain on the Current Mortgage Crisis and Preventing a Return Engagement* was organized through the excellent work of Symposium Editor Julie Wainrib Connelly, with the assistance of Professor Grant Nelson of the Pepperdine University School of Law and the author, who wishes to express his deep appreciation to Ms. Connelly, Professor Nelson, the other symposium participants, and all the members of the *Pepperdine Law Review*. For videos of the symposium sessions at no charge, see Pepperdine University's iTunes University web page, https://itunesu.pepperdine.edu (last visited Nov. 10, 2009) (follow "Public Access" hyperlink; then follow "Law" hyperlink under "Academics"; then follow "Law Review Symposium" hyperlink under "Pepperdine University School of Law Special Events"). Videos two and three deal with mortgage modification in bankruptcy.

15. *See infra* text accompanying notes 202–22, 321–43. A mortgage holder who believes the

market is going to improve in the near future might buy the home at its own foreclosure sale and hold it until it appreciates. Although for some mortgage holders that would be a viable strategy, banks are limited in their ability to hold and in effect speculate on the value of real property, and securitization trusts, which hold a great many mortgages, are limited by tax considerations. *See* 12 U.S.C. § 29 (2006) (limiting time bank may hold real property on which it has foreclosed to five years with a possible five year extension); 12 C.F.R. §§ 34.82–.83 (2009) (requiring bank to "dispose [of such property] at the earliest time that prudent judgment dictates" and noting that even in the limited circumstances in which a bank is permitted to enter into a lease of such property, the bank would be subject to enforcement measures if the lease were entered into for speculation purposes in violation of 12 U.S.C. § 29 and other regulations); I.R.C. § 860G(a)(5), (8) (2006) (defining narrowly the property which must make up substantially all the assets held by a real estate mortgage investment conduit (REMIC), but including as a "permitted investment" property that is "foreclosure property"—defined, for the most part, in I.R.C. § 856(e)); I.R.C. § 856(e) (defining "foreclosure property" and providing that property obtained by way of mortgage foreclosure ordinarily will cease to be foreclosure property "as of the close of the 3d taxable year following the taxable year in which the trust acquired such property"); Thomas A. Humphreys & Shamir Merali, *Tax Treatment of Structured Finance Transactions*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 403, 443, 450 (2008), *available on Westlaw at* 851 PLI/TAX 403 (noting time limit on holding of foreclosure property and noting high tax rate on income from foreclosure property). The effect of the saving provision in I.R.C. § 860G(a)(8) is not clear to the author. It provides that "[s]olely for purposes of section 860D(a), the determination of whether any property is foreclosure property shall be made without regard to section 856(e)(4)." I.R.C. § 860G(a)(8). That could permit a REMIC to rent out "foreclosure property" and engage in activities with respect to such property that otherwise would cause the property to cease to be "foreclosure property."

Despite these limitations on bank holding of real property, Freddie Mac, in its amicus brief to the Supreme Court in *Nobelman v. Am. Sav. Bank*, 508 U.S. 324 (1993), stressed the value of the option that a mortgage holder has to buy the property and hold it pending a recovery in the market. *See* discussion *infra* text accompanying notes 151–52, 187–89 (discussing the *Nobelman* decision). As the author wrote to Senate Judiciary Committee Chairman Patrick Leahy in late 2007, in response to a written question from Senator Richard J. Durbin:

> [E]ven if a foreclosure is necessary, the mortgage holder could purchase the property at its foreclosure sale and hold the property until it appreciates. Of course that is not ideal from the lender's point of view, and thus often the lender would be willing to reduce the interest rate so that a foreclosure would be avoided. But it is a possibility, and even banks, as I understand the law (though this is not my core area of expertise), are permitted to hold foreclosed properties for five years under 12 U.S. Code section 29.
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> Both Freddie Mac and the State of Alaska made that point in their amicus briefs opposing strip down in Nobelman. I urge Committee members to read those amicus briefs. Petitioners, who sought to strip down their home mortgage, argued, according to Freddie Mac, that the Bankruptcy Code
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>> must be read with an eye towards life in the real world of real estate and mortgage foreclosure. Yet it is they who ignore reality. Petitioners mistakenly believe that cram-down merely replicates a foreclosure sale at which "the lienholder will receive something approximating the fair market value [of the collateral], with the balance of its claim becoming an unsecured deficiency claim". In point of fact, rather than mirror foreclosure, cram-down destroys the essence of a mortgagee's rights in a foreclosure.
>>
>> Faced with an undersecured loan, a mortgagee can credit-bid at the foreclosure sale and become the owner of the property. The mortgagee then holds the hope that the real estate market will improve and at least some of its deficiency can be recovered. This is the real world of bank examiners and loan officers—deciding when to and when not to credit-bid[,] i.e., on which properties should they play the market hoping for a turnaround and on which should they simply take what they

This Article also explains why a common argument made in favor of allowing strip down as a matter of fairness is simply mistaken; enactment of the proposed amendments would not treat home mortgages the same as other secured debt in Chapter 13 bankruptcy, but in fact would treat home mortgages much less favorably than other secured debt.[16] Home mortgages would be the only secured debts that could be stripped down and paid off at a court-determined interest rate, with monthly payments lower than those required by the credit contract, over a period of up to nearly forty years, rather than the no-more-than-five year period that would still apply to other secured debts.[17]

Additionally, the Article provides a brief critique of Professor Adam J.

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> can get and write off the rest. In fact, typically the lender will credit-bid its claim and become the owner of the property. This is the real world that cram-down eliminates by taking away this option from the mortgagee.
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> [A]s Freddie Mac pointed out in its Nobelman amicus brief, under current law the mortgage holder who forecloses decides whether or not to buy the property at its foreclosure sale by considering the risks and the potential benefits. The mortgage holder may decide to cut its losses and let someone else buy the property at the foreclosure sale. Or the mortgage holder may decide to credit bid a sufficient amount to be the winning bidder, thus preserving the possibility of benefiting from a market recovery—but also taking the risk that the home's value may decline further, and that it may end up selling the home for less than it could have gotten in cash at the foreclosure sale (or in a private sale conducted shortly after the foreclosure).

*The Looming Foreclosure Hearing*, *supra* note 7, at 76, 78–79 (citations and footnote omitted).

Perhaps the law should be changed to make such a strategy more viable, with the homes owned by the mortgage holders then being available as rentals. Increasing the store of single family rental homes would improve accessibility to such housing.

In any event, this article focuses on a different point, which also was an important focus of the author's letter to Senator Leahy. A mortgage holder who is permitted to foreclose can obtain whatever value is available at that time and need not bear the risk of a further drop in home values. If the mortgage holder is prevented from foreclosing on a defaulted mortgage for a period of time, and then later ends up foreclosing, the mortgage holder bears the risk of a drop in home values during that time. A change in the law to place that new risk on the mortgage holder should be balanced by giving the mortgage holder the opportunity to benefit from a possible upturn in home values. Thus, any changes in the current bankruptcy law to allow strip down or other modifications of home mortgages should provide for the mortgage holder not only to bear the risk of future declines in value but also to at least share in the benefits of future gains in value. The federal government certainly believes that it should be protected in this way when it provides relief to homeowners; the Federal Housing Administration (FHA) takes a substantial share of future appreciation in such cases. *See infra* text accompanying notes 268–70.

16. *See infra* text accompanying notes 94–144, 176–219, 330–85.

17. *See infra* text accompanying notes 94–144; *cf. In re* Plourde, 402 B.R. 488 (Bankr. D.N.H. 2009) (denying confirmation of Chapter 13 plan that stripped down mortgage on nonresidential real property and otherwise modified mortgage holder's rights because plan did not provide for—and could not feasibly provide for—payment over no more than five years of entire amount of stripped down secured claim with interest at an appropriate court-determined interest rate).

Levitin's empirical studies.[18] Even though serious flaws in his empirical studies have been pointed out,[19] Professor Levitin continues to claim in congressional testimony that "the clear finding from [his] research is that mortgage prices are largely insensitive to bankruptcy modification risk."[20] He continues to testify that, based on his empirical research, "[p]ermitting bankruptcy modification is unlikely to result in higher mortgage costs or lower mortgage credit availability."[21] Supporters of strip down in Congress continue to rely heavily on Professor Levitin's studies as showing that the proposed changes in the law would not substantially affect mortgage interest rates or mortgage availability. Senator Richard J. Durbin, in arguing unsuccessfully for the Durbin Amendment—his amendment to Senate Bill 896 that would have permitted strip down and other modifications of home mortgages in Chapter 13 bankruptcy[22]—stated that Professor Levitin "has analyzed this and says the argument that interest rates will go up because of this provision is plain wrong."[23] Senator Durbin went on to argue that "a study by Adam Levitin of the Georgetown Law School proves definitively that the availability of bankruptcy assistance to some borrowers in the past led to no increase in borrowing costs for others."[24]

Unfortunately, Professor Levitin's empirical studies, though thoughtful and creative in their design,[25] rely on incorrect understandings of current and past bankruptcy law and of the proposed legislation.[26] They, in effect,

18. *See* Levitin, *supra* note 6; Adam J. Levitin & Joshua Goodman, Mortgage Market Sensitivity to Bankruptcy Modification (Apr. 15, 2008) (working paper) [hereinafter Levitin & Goodman, *Mortgage Market Sensitivity*], http://ssrn.com/abstract=1121054; Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Georgetown Univ. Law Ctr., Public Law & Legal Theory Working Paper Series, Research Paper No. 1087816, 2008) [hereinafter Levitin & Goodman, *Effect on Markets*], http://ssrn.com/abstract=1087816; Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 HARV. L. & POL'Y REV. ONLINE 1 (2009) [hereinafter Levitin, *Helping Homeowners*], *available at* http://www.hlpronline.com/Levitin_HLPR_011909.pdf.

19. *See supra* note 13.

20. Adam J. Levitin, The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform? 9 (July 23, 2009) (written testimony before the Subcommittee on Administrative Oversight and the Courts of the Senate Committee on the Judiciary) [hereinafter *July 2009 Levitin Testimony*], *available at* http://judiciary.senate.gov/pdf/07-22-09LevitinTestimony.pdf.

21. *Id.*

22. *See supra* note 4; *infra* note 228.

23. 155 CONG. REC. S4917 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin).

24. *Id.* at S4934. Senator Durbin made this statement as part of his attempt to refute what he termed the "myth" that "[a]llowing troubled homeowners to receive mortgage assistance in bankruptcy will lead to higher borrowing costs for future borrowers." *Id.*

25. *See infra* text accompanying notes 386–96.

26. The four most serious incorrect understandings are (1) the view that an undersecured creditor is "guaranteed" to receive the value of its collateral under a Chapter 13 plan, *see infra* note 144; *infra* text accompanying notes 333–36; (2) the view that the kind of home mortgage strip down permitted by some courts before 1993 is the same kind, or at least very similar to the kind, that

compare apples with oranges—or perhaps a bumper crop of apples with a frost-ravaged crop of oranges—by comparing the effects of the kind of strip down that would be widely available under the legislation now before Congress, with the effects of the very different kinds of strip down that, in limited circumstances, are currently available or were at one time available.[27] His studies also fail to take into account the very different incentives that the proposed legislation would create were it to be enacted, both in terms of encouraging debtors with large negative equity to file Chapter 13 bankruptcy petitions and encouraging Chapter 13 debtors to argue for a low value for their homes rather than to report an inflated

would be permitted under the proposed legislation, *see infra* text accompanying notes 410–16; (3) the view that the kind of strip down currently permitted, at least as a theoretical matter, with respect to vacation homes and multi-unit real property is the same kind, or at least very similar to the kind, that would be permitted under the proposed legislation, *see infra* text accompanying notes 358–74, 397–409; and (4) the view that the limited level of availability of strip down before 1993 and the limited level of availability of strip down under current law somehow are comparable to level of availability of strip down under the proposed legislation, *see infra* text accompanying notes 397–416.

Professor Levitin also assumes that the question whether a mortgage holder's collateral consists only of the debtor's principal residence—a question that determines whether the mortgage holder's claim is protected against modification by the "other than" clause of § 1322(b)(2), *see infra* text accompanying notes 147–202, depends on the state of affairs as of the date of the bankruptcy petition filing. Thus he confidently states that home mortgage holders cannot rely on receiving such protection, because it requires cooperation from the debtor: "It is important to note that the protections given mortgage holders depend on owner-occupancy status, so mortgage holders' protections are dependent upon debtor cooperation, a factor upon which mortgage holders cannot justifiably rely." Levitin, *supra* note 6, at 581 n.44. Professor Levitin argues that lenders certainly cannot rely on any such protection, because debtors can easily eliminate the protection: "[I]t is as easy as moving in a tenant the day before filing for bankruptcy." *Id.* at 593–94 n.91. Thus, according to Professor Levitin, if the property is being used at least in part as a rental property as of the petition filing date, the mortgage holder does not receive protection under § 1322(b)(2). But the courts are very much split on this issue, with the only circuit court to have ruled holding flatly to the contrary, and lower courts split, with perhaps a majority taking the view that the time of the petition filing is the relevant time, but others very much disagreeing. *See* Scarborough v. Chase Manhattan Mortg. Corp. (*In re* Scarborough), 461 F.3d 406, 412 (3d Cir. 2006) (rejecting specifically the notion that debtor could "sidestep" the protection the mortgage holder is entitled to under § 1322(b)(2) by "adding a second living unit to the property on the eve of" the bankruptcy filing, noting that "for purposes of § 1322(b)(2), the critical moment is when the creditor takes a security interest in the collateral," and explaining that the court "look[s] to the terms of the mortgage" and to "the character of the collateral at the time of the mortgage transaction" (internal quotation marks omitted)); U.S. Dep't of Agric. v. Jackson, No. 05-CV-20, 2005 WL 1563529, at *5 (M.D. Ga. July 1, 2005) (holding that the status of the property at the time the loan is made is controlling); *In re* Baker, 398 B.R. 198, 200–04 (Bankr. N.D. Ohio 2008) (applying a hybrid approach to reflect concerns in both lines of cases that the level of the mortgage holder's protection should not be subject to manipulation).

27. *See infra* text accompanying notes 386–412.

value.[28] The empirical studies thus do not provide a solid foundation for the making of public policy.[29]

In addition, adoption of the proposed amendments to the Bankruptcy Code would cause somewhat perverse results. Strip down provides the greatest benefit to debtors who have the greatest amount of negative equity.[30] Homeowners who made the lowest down payments, paid the most inflated prices for their homes, and refinanced to take equity out of their homes for purposes of consumption thus would receive the greatest benefits[31]—benefits that would include, in essence, a free option on future appreciation[32] and that would not be well calibrated to the homeowners' financial need—while homeowners who made large down payments, were careful not to pay inflated prices, and did not use their home equity to

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28. One part of Professor Levitin's studies considers likely losses if strip down is permitted. *See* Levitin, *supra* note 6, at 606–18. The losses are estimated by considering the typical amount of negative equity reported by debtors in their bankruptcy schedules. *Id.* In the schedules, a debtor will list the amount of the home mortgage debt and give the debtor's estimate of the value of the home. Professor Levitin uses these figures to calculate average negative equity and thus the likely average amount of the mortgage lien that would be eliminated if home mortgage strip down were permitted. *Id.* But under current law, which prohibits home mortgage strip down, there is little incentive for homeowners with large amounts of negative equity to try to use bankruptcy to save their homes. Enactment of the proposed legislation allowing home mortgage strip down would greatly change the incentive that debtors with large negative equity would have to file Chapter 13 bankruptcy petitions; thus it cannot be assumed that debtors who file such petitions under the bankruptcy law as amended by the proposed legislation would have levels of negative equity similar to the levels of negative equity of those who file under the current law. Also, under current law, the debtor has an incentive to create the appearance in the schedules that the home mortgage lender is adequately secured by the home's value, so that the home mortgage lender cannot obtain relief from the automatic stay and foreclose. *See* 11 U.S.C. § 362(d)(1) (2006) (providing that secured creditor whose lien is not adequately protected is entitled to relief from the automatic stay). Thus, even if we otherwise would have reason to think that the typical debtor could accurately value his or her home, there would be little reason to trust the valuations reported on debtors' schedules. Of course, if the legislative proposals were enacted, the debtor's incentives would be reversed; he or she would have every incentive to claim a low value for the home and to seek appraisals supporting a low value.

29. *See infra* text accompanying notes 386–417.

30. For example, a debtor who owed $300,000 on a home currently worth $200,000 would have $100,000 in negative equity and would receive the benefit of a $100,000 reduction in mortgage principal. By contrast, a debtor who owed only $240,000 on a home of the same value, and who thus had only $40,000 in negative equity, would receive only a $40,000 reduction in mortgage principal.

31. Note that a low down payment makes it more likely that the mortgage will become undersecured, and more likely that it will become substantially undersecured, in the event of a market downturn, because the debtor begins with less equity than the debtor would have had if a larger down payment had been made. Similarly, if the dollar amount (or even percentage level) of the down payment is kept constant, a debtor who pays the most inflated price, near the top of a housing bubble, will have a correspondingly large mortgage that will quickly become substantially undersecured in a market downturn. Debtors who refinance to obtain cash for consumption obviously reduce their equity, making it more likely that a market downturn will cause their mortgage to become undersecured.

32. *See infra* text accompanying notes 208–11.

finance consumption would receive the least benefits.

These perverse results are not only undesirable in and of themselves from a public policy "moral hazard" perspective. They also may cause resentment among those persons who could not benefit from them or who would receive a perversely smaller benefit were they to encounter financial distress and need bankruptcy assistance.[33] In the longer term, such resentment may undermine public support for the primary function of consumer bankruptcy laws: "to grant a fresh start to the honest but unfortunate debtor."[34]

On the other hand, homeowners with substantial negative equity may have little incentive under current law to continue to make mortgage payments.[35] We could expect then that if many homeowners have substantial negative equity, the rate of foreclosures on home mortgages will be high.[36] A high rate of home foreclosures in turn helps to further depress the market prices of homes, harming not only mortgage holders whose homes are sold in foreclosure at low prices, but also homeowners who have faithfully paid their mortgages and whose home values drop when foreclosure strikes nearby homes.[37] Thus, the foreclosures that occur due to negative equity have an indirect effect on the wealth of homeowners who have not defaulted on their mortgages. On a broader scale, the effect may be a downward spiral in which negative equity causes a high foreclosure level, which causes home prices to drop, which creates additional negative equity, which then causes foreclosure levels to remain high, which causes home prices to drop further, and so on.[38] It is possible that steps taken to reduce the levels of negative equity, including allowing homeowners to strip down their mortgages, could help stop the spiral, help home values stabilize, and help bring the current high foreclosure rate back to a historically normal level.[39]

But how could this be accomplished without causing unacceptable

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33. *See, e.g.*, Randy Cohen, *Thy Neighbor's Mortgage*, N.Y. TIMES, Apr. 21, 2009, http://ethicist.blogs.nytimes.com/2009/04/21/thy-neighbors-mortgage/ (including comments by readers and an update by Mr. Coh.n responding to the many comments that expressed resentment of debtors who might receive mortgage assistance from the U.S. Treasury).

34. Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007) (internal quotation marks omitted).

35. *See, e.g.*, Liebowitz, *supra* note 1; *see also infra* Part II.D.

36. *See infra* Part II.D.

37. *See* Levitin, *supra* note 6, at 568–69; *infra* text accompanying note 428.

38. *See infra* text accompanying note 428.

39. *See infra* text accompanying note 428.

effects on future mortgage affordability and availability, without creating perverse results, and without triggering substantial resentment? In an attempt to answer that question, this Article turns, finally, to the provisions that should be included in any legislation that allows modification of home mortgages.[40] First, any such legislation that permits strip down should include a strong provision for recapture by the mortgage holder of a substantial portion of any future upturn in the value of the home whether or not the debtor sells or refinances the home.[41] Such a provision would minimize the effect of strip down on the risk characteristics of mortgages by preserving for mortgage holders most of the benefit of a future upturn in the market for homes. It would also minimize the perverse effects of strip down by denying the homeowner the free option on future appreciation that strip down otherwise would provide, and it would, as a result, help to minimize resentment. Second, any such legislation should have clear eligibility criteria designed to minimize the negative effects that likely otherwise would occur.[42] And third, alternatives should be considered to the kind of strip down that the current legislative proposals would permit, perhaps alternatives based on approach taken in the Obama Administration's program for modification of home mortgages, the Home Affordable Modification Program.[43] Any such legislation should limit home mortgage modification to mortgages originated prior to January 1, 2008, by which time it had become very clear that the nation had entered a serious mortgage crisis, such that Congress was actively considering legislation to deal with the crisis, including home mortgage strip down legislation.[44]

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40. *See infra* Part VI.

41. *See infra* text accompanying note 430. *The Looming Foreclosure Crisis Hearing*, *supra* note 7, at 28 (suggestion by the author—in response to question from Senator Sessions—that a recapture provision be considered); *id.* at 78 n.5, 87 (responding to Senators' questions and suggesting a recapture provision); Robert M. Zinman & Novica Petrovski, *The Home Mortgage and Chapter 13: An Essay on Unintended Consequences*, 17 AM. BANKR. INST. L. REV. 133, 162–64 (2009) (suggesting that recapture provision be included with strip down legislation); *infra* text accompanying note 430. Professor Zinman apparently was the first to suggest recapture in connection with strip down, when he made that suggestion in 1986 connection with proposals to enact the family farm bankruptcy provisions that now are in Chapter 12 of the Bankruptcy Code. *See* Robert M. Zinman, Proposed Modification of Chapter 12 Confirmation Provisions (1986) (on file with author).

42. *See infra* text accompanying note 435.

43. *See supra* note 8 and accompanying text; *infra* text accompanying notes 273–310, 431.

44. *See infra* text accompanying note 437; *see, e.g.*, Scarberry, *supra* note 4; *The Looming Foreclosure Crisis Hearing*, *supra* note 7. For other discussions of whether the Bankruptcy Code should be amended to allow home mortgage strip down and other kinds of modifications of home mortgages, see Zinman & Petrovski, *supra* note 41, at 133; John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123; Joseph R. Mason, Mortgage Loan Modifications: Promises and Pitfalls (Oct. 3, 2007) (working paper), http://ssrn.com/abstract=1027470; Mason, *supra* note 7.

## II. CURRENT PROTECTIONS FOR HOME MORTGAGE HOLDERS IN BANKRUPTCY

Holders of mortgages on debtors' principal residences currently have multiple layers of protection under the bankruptcy laws.[45] The proposed legislation would remove or lessen many of those protections.[46] The effect of the proposed legislation on the risk characteristics of home mortgages must then be understood in light of all of the current protections.

The arguments concerning the proposed legislation have focused on the particular protection provided to holders of home mortgages by the "other than" clause of § 1322(b)(2).[47] That section permits Chapter 13 plans to modify 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. . . ."[48] This focus is a mistake, though an understandable mistake, given the prominence of the Supreme Court's decision in *Nobelman v. American Savings Bank*, which held that, where the "other than" clause applies, it precludes strip down.[49] In fact, the "other than" clause provides only limited additional protection to holders of home mortgages.[50] Most of the protection they enjoy in bankruptcy is provided by other provisions of the Bankruptcy Code and by the general approach taken by Congress in the Code.[51]

The federal bankruptcy laws are, for the most part, an overlay on state and non-bankruptcy federal law.[52] That is particularly true with respect to property rights,[53] including liens created by the giving of real property

45. *See infra* text accompanying notes 59–205.

46. *See infra* text accompanying notes 223–385.

47. As noted above in footnote 3, section references are to sections of the Bankruptcy Code, Title 11, United States Code.

48. § 1322(b)(2).

49. 508 U.S. 324 (1993).

50. *See infra* text accompanying notes 145–201.

51. *See infra* text accompanying notes 59–201.

52. *See, e.g.*, § 502(a)–(b) (providing, with limited exceptions, that claims will be allowed in bankruptcy unless unenforceable against the debtor and the debtor's property under non-bankruptcy law); § 506(a)–(b) (recognizing liens and setoff rights created under non-bankruptcy law); § 541(a)(1) (providing, with limited exceptions, that the property of the bankruptcy estate consists of the property interests held by the debtor at the time of commencement of the bankruptcy case).

53. *See, e.g.*, Butner v. United States, 440 U.S. 48 (1979) (holding that state law should control issue of mortgage holder's right to rents). The Court in *Butner* noted that "[p]roperty interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Id.* at 55.

mortgages.[54] Bankruptcy law often changes the procedure by which non-bankruptcy property rights are enforced,[55] and it often delays their enforcement.[56] But the substance of non-bankruptcy property rights usually is respected,[57] and the value of non-bankruptcy property rights generally is

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As between a debtor and a creditor, an unsecured debt is not, as the author uses the term, a property right. The creditor has no right to have any particular property that is owned by the debtor used to pay off the debt until and unless the creditor obtains a lien. It is true that the debt is a kind of property as between the creditor and another party to whom the creditor might assign the debt. Thus, if two persons claim to be assignees of the debt, there is a dispute over a property interest, ownership of the debt. But the unsecured debt does not give to its holder any property rights as against the debtor so that a failure to pay would violate the creditor's property rights. *See, e.g.*, Citizens Bank of Md. v. Strumpf, 516 U.S. 16 (1995) (unanimous opinion) (holding that temporary freeze of bank account to protect bank's setoff rights did not violate automatic stay, in part because a bank's refusal to pay money owed by it to the debtor was not an exercise of control over any property owned by the debtor but could be at most a failure to perform a promise).

54. *See Butner*, 440 U.S. at 48.

55. Bankruptcy law is a collective proceeding; thus the race-to-the-courthouse approach under which creditors seek to obtain liens and be paid under the state collection procedure is modified. But substantive rights are for the most part respected in bankruptcy. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (2001).

56. *See* § 362(a) (providing, inter alia, for an automatic stay of most creditor collection activities, including foreclosure of mortgages and other liens).

57. There are, of course, exceptions to this general approach. The bankruptcy trustee's avoiding powers allow the trustee, or the debtor in possession in a Chapter 11 case, in some instances to recover prepetition transfers of money or other property, including transfers of liens to creditors, that would be allowed to stand under non-bankruptcy law. Thus, for example, if the debtor pays a debt shortly before filing the bankruptcy petition, the payment may be an avoidable preference that must be returned by the creditor to the bankruptcy estate. *See* § 547. Similarly, if the debtor gives a creditor a lien shortly before filing the bankruptcy petition to secure a pre-existing debt, the lien may be an avoidable preference, which may be stripped from the creditor. *See id.*; *see also* § 101(54) (defining "transfer" to include "creation of a lien"). This is so even though non-bankruptcy law for the most part allows such preferences to stand and does not consider them to be fraudulent. *See, e.g.*, UNIF. FRAUDULENT TRANSFER ACT § 3(a), 7A (Pt. II) U.L.A. 47 (2006) (providing that "[v]alue is given for a transfer or an obligation if, in exchange for the transfer or obligation, property is transferred or an antecedent debt is secured or satisfied" and thus rendering most payments of antecedent debts non-fraudulent); § 5(b), 7A (Pt. II) U.L.A. at 129 (providing a limited circumstance under which payment on an antecedent debt to an insider creditor who has reason to know of the payor's insolvency will be considered fraudulent); MARK S. SCARBERRY, KENNETH N. KLEE, GRANT W. NEWTON & STEVE H. NICKLES, BUSINESS REORGANIZATION IN BANKRUPTCY: CASES & MATERIALS 381–85, 438 (3d ed. 2006). Unperfected Article 9 security interests and unrecorded mortgages also can be avoided in bankruptcy, even though they might be effective under non-bankruptcy law as against the other creditors in the case, who might not qualify as the persons entitled under non-bankruptcy law to defeat such unperfected or unrecorded interests. *See* 11 U.S.C. § 544(a)(1), (3) (2006); SCARBERRY, ET AL., *supra*, at 383–84, 416. Debtors who are natural persons also are allowed in some instances to avoid liens that would impair their exemptions, even though such liens might be valid under non-bankruptcy law. *See* § 522(f).

The bankruptcy discharge, which eliminates the personal liability of the debtor on discharged debts, might be thought to be a huge exception to this general approach of recognition of non-bankruptcy property interests, but it is not. First, the personal liability of the debtor on a debt is not properly considered to be a property interest, as between the creditor and the debtor. *See supra* note 53. Second, with limited exceptions, *e.g.*, § 522(b)(3)(C) (exempting certain retirement funds), the Bankruptcy Code gives holders of unsecured claims, as a group, access to the value they could have protected, at least in terms of nominal dollars, if not always in terms of present value.[58]

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obtained from the debtor's current property under non-bankruptcy law. *See, e.g.*, § 541(a)(1) (providing that the debtor's property interests as of the commencement of the bankruptcy case become property of the bankruptcy estate); § 522(b) (allowing the debtor in the usual case to exempt from the bankruptcy estate only those assets that would be exempt under state or non-bankruptcy federal law from creditor collection activity, though with some added protection of retirement accounts and the possibility that the debtor may use the exemptions listed in § 522(d) if the relevant state chooses not to prevent debtors from doing so); § 704 (giving the trustee in a Chapter 7 case the duty to convert the property of the estate to cash); § 726(a)–(b) (providing in a Chapter 7 case for pro-rata payment to holders of timely filed general unsecured claims out of the property of the estate); § 1129(a)(7) (providing that a Chapter 11 plan may not be confirmed unless each holder of a claim or interest in a class that is impaired by the plan either accepts the plan or else receives value at least equal to the value that the holder would receive in a Chapter 7 liquidation case); § 1325(a)(4) (prohibiting confirmation of a Chapter 13 plan that would provide less present value to any unsecured claim holder than the present value the claim holder would receive in a Chapter 7 liquidation case). Third, the Bankruptcy Code makes clear that the discharge does not, by itself, eliminate any liens; the discharge only affects the debtor's personal liability. *See* § 524(a)(1)–(2). A limitation of recovery to the debtor's current property—the property held by the debtor as of the commencement of the bankruptcy case—is better seen as a limitation on personal liability than as a reduction of existing property rights. The creditor ordinarily cannot have obtained a property interest from the debtor in property that the debtor does not yet have; note the venerable maxim that one cannot give what he or she does not have ("nemo dat quod non habet"). It is true that under non-bankruptcy law a creditor ordinarily can reach property acquired by the debtor after incurring the debt—in addition, of course, to property already owned by the debtor. But it is the personal liability of a debtor on the debt that allows the creditor to reach that property by obtaining a judgment against the debtor and then executing on the property. Similarly, although non-bankruptcy law, U.C.C. § 9-204(1) (2009), enforces commercial security agreements under which a debtor may agree *now* that property the debtor acquires *in the future* will be subject to a lien, the secured creditor does not possess a property interest in the collateral until the debtor acquires it, or at least acquires rights in it, *see* § 9-203(1)(c), a position embraced by the Bankruptcy Code. *See* 11 U.S.C. § 547(e)(3). It is contractual obligation rather than any existing property interest that causes the security interest to attach to the newly acquired property; at least that is true unless the newly acquired property is traceable as proceeds of property in which the secured creditor previously had a lien, as would be true when the property was acquired with funds in which the secured creditor already had a lien. Thus, the Bankruptcy Code's provision that, for the most part, property acquired by the debtor postpetition is not property of the bankruptcy estate, § 541, and also is not subject to liens under prepetition agreements, § 552(a), is consistent with protection of existing property interests and with protection of the debtor from personal liability. Where property acquired by the debtor postpetition is sufficiently related to property held by the debtor as of the petition date, it does become property of the estate and thus subject to being used to pay creditors. § 541(a)(6). Similarly, prepetition real property mortgages and U.C.C. Article 9 security interests are permitted in bankruptcy to extend to property acquired postpetition by the debtor if the newly acquired property is sufficiently related to the prepetition collateral, such as where it consists of rents on mortgaged real property or where it is acquired with proceeds of sale of prepetition collateral. *See* § 552(b).

58. Sections 502(b) and 506(b) provide that the allowed amount of a claim does not include postpetition interest except to the extent that the claim holder has a lien on property worth more than the amount owed as of the petition date. *See* § 502(b) (providing for allowance of claim in amount owed as of the date of the filing of the bankruptcy petition and disallowing unmatured interest);

## A. *Limitation on Strip Down Under § 506(d):* Dewsnup v. Timm[59]

The protections available in bankruptcy for holders of home mortgages begin with the protections available to all secured creditors. Proponents of home mortgage strip down often suggest that the norm in bankruptcy is for

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§ 506(b) (providing for allowance of postpetition interest to oversecured creditor). Thus, even a creditor whose claim is paid in full may not receive the full present value of its claim from the standpoint of the date on which the bankruptcy petition was filed. Note, however, that to the extent the creditor has a sufficiently valuable property interest—a lien on property of sufficient value—§ 506(b) does protect the creditor's entitlement to present value as of the commencement of the case by allowing interest out of the value of the property in which the creditor has a lien. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 372 (1988). Of course a decline in the value of the creditor's collateral during the case may threaten the value of its lien; thus several provisions of the Code provide remedies to the secured creditor whose property interest is not "adequately protected." *See* § 361 (providing examples of how adequate protection may be provided); § 362(d)(1) (providing for relief from the automatic stay if the secured creditor's lien is not adequately protected, which then would allow the secured creditor to foreclose on the collateral before the value diminishes further); § 363(e) (requiring courts to prohibit use or sale, or proposed use or sale, of property of the estate to the extent needed to provide adequate protection of liens and other property interests). The Supreme Court held in *Timbers* that adequate protection deals with the dollar value of the collateral, not with maintenance of the present value of the creditor's entitlement as of the time of commencement of the bankruptcy case. *Timbers*, 484 U.S. at 374. Thus, an undersecured creditor—the value of whose collateral is less than the amount owed—may suffer loss due to delay during the case, because the creditor will not be entitled under § 506(b) to have interest added to the amount of its secured claim. It will therefore not receive present value as of the date of the filing of the bankruptcy petition equal to the value of its collateral. Consider that under non-bankruptcy law the creditor might well have been able to receive such interest, because under non-bankruptcy law the creditor could foreclose and then reinvest the proceeds of the foreclosure sale in bonds or other interest-bearing investments, and thus could earn interest on the foreclosure value of the collateral. Thus, the automatic stay, by preventing foreclosure, may create a kind of loss of present value. But the loss of that present value—the loss of the opportunity to earn interest on the value of the collateral—is not a lack of adequate protection, as the Supreme Court interpreted the Code in *Timbers*. If the collateral is not losing nominal dollar value, the secured creditor's property interest may be adequately protected; the Court in *Timbers* held that adequate protection does not require that the creditor be given compensation for the lost opportunity to foreclose and reinvest or to protect the present value of its secured claim as of the petition date. *Timbers*, 484 U.S. at 374. Several provisions of the Code do provide for protection of present value as of the date on which a plan becomes effective. *See* § 1129(a)(7) (requiring that the Chapter 11 plan provide present value as of the effective date of the plan at least equal to the value the creditor would have received in a Chapter 7 liquidation case); § 1129(a)(9) (requiring in several instances that payments to be made to holders of priority claims have a present value as of the effective date of the plan equal to the amount of the claims); § 1129(b)(2)(A)(i)(II) (requiring that payments made to the holder of a secured claim have a present value as of the effective date of the plan equal to the value of the creditor's lien); § 1129(b)(2)(B) (providing that a plan may not provide any distribution on account of claims or interests in junior classes if a senior class does not accept the plan, unless each holder of a claim in the senior class receives property under the plan that has a present value as of the effective date of the plan equal to the amount of the senior creditor's claim); § 1325(a)(4) (requiring that the Chapter 13 plan provide for distribution of property to unsecured claim holders with present value as of the effective date of the plan at least equal to what they would receive in a Chapter 7 liquidation case); § 1325(a)(5)(B)(ii) (requiring that property distributed pursuant to Chapter 13 plan to a secured claim holder who has not accepted the plan must have present value as of the effective date of the plan equal to the amount of the secured claim).

59. 502 U.S. 410 (1992).

creditors who are undersecured to have their liens stripped down to the value of their collateral.[60] That has never been correct and in fact was explicitly rejected by the Supreme Court seventeen years ago in *Dewnsup v. Timm*.[61]

It is true that the amount of the secured claim recognized in bankruptcy in most cases cannot exceed the value of the creditor's collateral;[62] thus, if there is a need to determine the amount of the secured claim—for example, to determine the amount of value that must be paid to the secured creditor on account of its secured claim under a Chapter 11 or Chapter 13 plan[63]—the court will value the collateral, and the claim will be considered a secured claim only up to that value.[64] But that does not mean that the secured

60. *See, e.g.*, Blog Post of Nathalie Martin on Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2007/12/on-the-home-mor.html (Dec. 12, 2007, 10:52 WST) (post entitled "On the Home Mortgage Stripdown Bills . . . Why Perpetuate Philosophical Inconsistencies and Hurt People for No Gain?"); Blog Post of Robert Lawless on Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2007/11/mortgages-in-ba.html (Nov. 20, 2007, 19:51 WST) (post entitled "Mortgages in Bankruptcy 101"); *see also Mortgage "Cramdown" Laws Needed: Warren*, REUTERS, Apr. 27, 2009, http://www.reuters.com/article/ousivMolt/idUSTRE53Q6T420090427 ("[Elizabeth] Warren, a Harvard Law School professor, said the inability to write down home mortgage debt was an exception to most bankruptcy law, which allows judges to reduce other forms of debt. 'If this were business property, a chapter 11, or a corporate chapter 7 proceeding, there would be no restriction to write down the secured debt to the value of the collateral,' she said. 'The law recognizes everywhere the importance, in a financial crisis, of recognizing losses, taking the hit and moving on,' she said.").

61. 502 U.S. at 410.

62. *See* § 506(a). The value of the creditor's collateral—the value to which the secured creditor is entitled to look—is the collateral's value minus the amount of any liens senior to the secured creditor's lien.

63. *See* §§ 1129(b)(2)(A)(i), 1325(a)(5)(B)(i)–(ii).

64. There are at least two exceptions to the rule that a secured claim may not exceed the value of the collateral. First, under the language added in 2005 to the end of § 1325(a), the "hanging paragraph," claims secured by purchase money security interests on automobiles apparently are not limited by the value of the collateral, but are considered secured claims for the full amount of the debt, unless the debt was incurred more than 910 days, two and a half years, prior to the filing of the bankruptcy petition; at least that seems to be the case with respect to the amount of the secured claim for purposes of the confirmation requirement contained in § 1325(a)(5), with the result that the amount of the lien that the secured creditor is entitled to retain and the amount of present value that the plan must provide will equal the full amount of the debt even if the automobile is worth less than that amount. Second, in Chapter 11 cases, undersecured creditors often have the right to make the § 1111(b)(2) election and have the entire amount of their debt allowed as a secured claim. *See* § 1111(b)(2). The best understanding of such an election is that it prevents the debtor from obtaining title free and clear before a total number of dollars equal to the full debt has been paid, but that it does not increase the minimum amount of present value to which the plan must entitle the secured creditor; thus, if the plan is permitted to stretch payments out long enough, the plan can pay enough total dollars without paying more in present value than the value of the collateral, even if the creditor is seriously undersecured, because every dollar of interest that is paid can count against the

creditor's lien on the collateral is automatically limited to the amount of its secured claim. If that were true, there would seemingly be no need for the Bankruptcy Code's carefully tailored provision on redemption, § 722.[65]

Section 722 provides a limited right to Chapter 7 debtors to pay off liens on certain personal property and thus own the property free and clear—to redeem the property—by paying the secured creditor a lump-sum cash amount equal to the amount of the allowed secured claim.[66] Note that by its terms § 722 does not apply unless all of the following requirements are met: the property subject to the lien must be tangible personal property consisting of consumer goods; the property subject to the lien must either have been exempted by the debtor or abandoned by the trustee; the debt secured by the lien must be a consumer debt; and the debt secured by the lien must be dischargeable.[67] If the filing of a bankruptcy petition and the valuation of collateral automatically reduced any lien on the collateral to the value of the collateral, § 722 would seem to be superfluous, and most of its limitations would seem to be overridden.

Suppose a Chapter 7 trustee abandoned investment real property—for example, an apartment building—to the debtor because the mortgage on it exceeded the value of the property so that there was no value in it for the bankruptcy estate.[68] Suppose also that there had been a valuation of the building by the bankruptcy court, perhaps in connection with a motion to void a portion of the lien under § 506(d),[69] in connection with a motion filed by the mortgage holder for relief from the automatic stay,[70] in connection

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total debt. *See, e.g.*, *In re* Kvamme, 93 B.R. 698 (Bankr. D.N.D. 1988). The election is thus not as beneficial as it might seem, but it does give the secured creditor leverage if the debtor wishes to sell the property free and clear or refinance it before all payments have been made.

65. § 722.

66. Most courts required a lump-sum payment and prohibited the debtor from making installment payments to redeem property under § 722 even before it was amended in 2005 to make that requirement explicit. *See, e.g.*, Gen. Motors Acceptance Corp. v. Bell (*In re* Bell), 700 F.2d 1053, 1054–57 (6th Cir. 1983).

67. § 722 ("An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 of this title or has been abandoned under section 554 of this title, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien in full at the time of redemption.").

68. *See* § 554(a).

69. An arguably plain meaning interpretation of § 506(d) would void the lien to the extent it exceeds the value of the property, but the Supreme Court rejected that interpretation in *Dewsnup v. Timm*, 502 U.S. 410 (1992). After *Dewsnup*, such a hearing ordinarily would have no point in a Chapter 7 case.

70. The value of property could be at issue in a Chapter 7 case in at least two ways in connection with a motion for relief from stay: valuation may be sought with regard to whether there is a value cushion that would provide adequate protection for purposes of § 362(d)(1) or to determine whether the debtor has equity in the property for purposes of § 362(d)(2).

with an attempt by the trustee to sell the property free and clear of the mortgage lien,[71] in connection with allowance of the mortgage holder's claim,[72] or in connection with an attempt to confirm a Chapter 13 plan prior to conversion of the case to Chapter 7.[73] The debtor could not redeem the building under § 722 because it would be real property rather than personal property, because it would be investment property rather than consumer goods,[74] and also because the debt secured by it would probably not be considered a consumer debt.[75] But, if the mere filing of a bankruptcy petition and valuation of the building caused the lien to be reduced to the value of the building, then how could the mortgage holder refuse to release the lien upon tender of payment of the reduced amount of the lien by the debtor—who perhaps thought the building was worth more than the judicial valuation and who managed to borrow some money from relatives?

Thus, the Supreme Court in *Dewnsup* held that liens are not automatically reduced in bankruptcy by § 506(d) to the value of the

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71. Most courts hold that a trustee may not sell property free and clear of a lien under § 363(f)(3) unless the sale price is greater than the total amount of the liens on the property as determined under non-bankruptcy law. *See, e.g.*, *In re* Riverside Inv. P'ship, 674 F.2d 634, 640 (7th Cir. 1982); Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW LLC), 391 B.R. 25, 39–41 (B.A.P. 9th Cir. 2008). A few hold that a trustee may sell property free and clear if the property is sold for at least the court-determined value of the property. *See, e.g.*, *In re* Beker Indus. Corp., 63 B.R. 474, 476 (Bankr. S.D.N.Y. 1986).

72. For example, if there were substantial unencumbered assets in the bankruptcy estate, an undersecured mortgage holder might seek to have the amount of its unsecured claim determined so that it could receive a distribution on account of that unsecured claim; such a determination could require a valuation of the collateral by the court.

73. A Chapter 13 debtor has a nonwaivable right to convert the Chapter 13 case to Chapter 7 at any time. *See* § 1307(a). Thus, some Chapter 7 cases previously were Chapter 13 cases. In such a case the debtor might have tried, while the case was in Chapter 13, to confirm a plan calling for payment of the secured creditor's § 506(a) allowed secured claim with interest over the period of the plan. The § 506(a) allowed secured claim ordinarily cannot exceed the value of the collateral and thus, a valuation might have been required in the Chapter 13 case. *See infra* notes 94–110 and accompanying text.

74. *See, e.g.*, Cypher Chiropractic Ctr. v. Runski (*In re* Runski), 102 F.3d 744, 746–47 (4th Cir. 1996) (holding that medical and office equipment was not "intended primarily for personal . . . use" for purposes of § 722 even though owned by the individual debtor and intended to be used by her in her chiropractic business); *id.* at 747 ("[T]he proper course in deciding whether personal property is 'intended primarily for personal, family, or household use,' and thus is subject to redemption, is to examine the purposes for which the property is used. Because the property at issue is used solely for the operation of a business, it is not redeemable under § 722.").

75. *See id.* (holding that debt incurred to purchase chiropractic business was not a "consumer debt" within the meaning of § 722). It might also be the case that the debt secured by the building was nondischargeable in the Chapter 7 case; perhaps the debtor committed fraud in obtaining the loan. *See* § 523(a)(2). That would be one more independent ground disqualifying the debtor from using § 722 to redeem the building.

collateral, or so reduced on motion of the debtor, even where there has been a valuation.[76] Instead, the lien remains on the property for the entire amount of the creditor's claim, including any part of the claim that would be considered unsecured under § 506(a).[77]

The Court has been criticized severely—including by the dissenters on the Court—for that holding,[78] because it seems to ignore the plain meaning of § 502(d), which provides that "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void."[79] Because § 506(a) provides that an "allowed claim" is a "secured claim" only to the extent of the value of the collateral,[80] it would be easy to conclude that a lien is void under § 506(d) to the extent it exceeds the value of the collateral because to that extent it is not an allowed secured claim.[81] However, the Court read the term "allowed secured claim" in § 506(d) to mean a claim that (1) is secured by a lien and (2) has not been disallowed by any provision of the Code.[82] Thus, § 506(d) only voids liens for amounts of claims that have been affirmatively disallowed by some provision of the Bankruptcy Code.

As noted above,[83] the apparent plain meaning of § 506(d) is inconsistent with the limitations on redemption under § 722. The Court did not rely explicitly on that inconsistency[84] but instead argued that Congress would not have changed pre-Code law—which the Court described as preventing such strip down in liquidation bankruptcy proceedings—in such a stark manner nor taken away from mortgage holders the benefit of future appreciation without some indication in the legislative history of an intent to do so.[85] Justice Scalia's strong dissent criticized that argument and also attempted, unsuccessfully in the author's view, to explain away the inconsistency with § 722 that would be created by acceptance of the apparent plain meaning of

76. Dewsnup v. Timm, 502 U.S. 410, 413, 417 (1992).

77. *Id.* at 417–20.

78. *See id.* at 420–35 (Scalia, J., dissenting) (joined by Justice Souter). *See, e.g.*, David Gray Carlson, *Bifurcation of Undersecured Claims in Bankruptcy*, 70 AM. BANKR. L.J. 1, 12–20 (1996) (referring to *Dewsnup* as a "cancer" and as doing "overt interpretive violence" to the text of the Bankruptcy Code).

79. § 506(d).

80. § 506(a).

81. *See Dewsnup*, 502 U.S. at 420–23 (Scalia, J., dissenting).

82. *See id.* at 417 (majority opinion).

83. *See supra* text accompanying notes 65–75.

84. *See* 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, 459 (1993) (suggesting that the Court probably had in mind the conflict with § 722 in its consideration of whether the language of § 506(d) should be considered ambiguous).

85. *See Dewsnup*, 502 U.S. at 417–20.

§ 506(d).[86]

Right or wrong, the *Dewnsup* interpretation of § 506(d) has been the law for seventeen years, and Congress has not chosen to overrule it by amending the Code. Under *Dewnsup*, § 506(d) voids liens only to the extent that the provisions of the Code disallow a claim.[87]

For example, § 502(d) requires disallowance of a claim held by a creditor who received an avoidable preference and has not paid it over to the bankruptcy estate.[88] Suppose, for example, that the debtor owed a creditor $100,000, secured by a security interest in the debtor's equipment worth $40,000, and that the debtor paid the creditor $55,000 shortly before bankruptcy, thus leaving $45,000 owed. The creditor would seem to have a claim for $45,000 secured by $40,000 worth of collateral, and thus a $40,000 secured claim and a $5,000 unsecured claim under § 506(a). However, the $55,000 payment is an avoidable preference.[89] Thus, until and unless the creditor pays over the $55,000 to the bankruptcy estate, the creditor's claim will be disallowed. Disallowance of the claim will result in the voiding of the lien on the equipment under § 506(d).[90]

To give a second example, a claim that includes unmatured interest, such as unearned (unamortized) original issue discount, is to that extent disallowed by § 502(b)(2).[91] Thus, if a holder of a bond with a face amount

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86. *See id.* at 420–35 (Scalia, J., dissenting).

87. *Id.* at 410 (majority opinion).

88. § 502(d).

89. *See* § 547.

90. *See, e.g., In re* Mid Atlantic Fund, Inc., 60 B.R. 604, 605 (Bankr. S.D.N.Y. 1986).

91. *See In re* Solutia Inc., 379 B.R. 473, 473 (Bankr. S.D.N.Y. 2007); *see also* Mark S. Scarberry, *Interpreting Bankruptcy Code Sections 502 and 506: Post-Petition Attorneys' Fees in a Post-*Travelers *World*, 15 AM. BANKR. INST. L. REV. 611, 619, 653 (2007). Thus, a $10,000 face amount bond that is sold by its issuer for $9,500 includes $500 in unmatured interest, called original issue discount. If the bond is fully payable in one year, the buyer will earn $500 in interest from the issuer due to having purchased the bond from the issuer for less than the amount that will be payable at maturity. If the bond carries a stated interest rate coupon of three percent, with interest payable monthly and principal all due at maturity, then the buyer will earn interest in one year of $300 (three percent of the $10,000 face amount, payable $25 per month) plus the $500 original issue discount (the $10,000 face amount of the bond that will be payable at maturity minus the $9,500 price paid by the buyer) for a total of $800 in interest. On the $9,500 invested, that works out to an 8.42% interest rate, which is much higher than the 3% stated rate. The bond may provide, as may be permitted by state law, that on default the entire face amount of the bond is payable immediately. Thus, if the issuer defaults after six months, state law may entitle the buyer immediately to the $10,000 face amount of the bond plus any unpaid part of the three percent interest. Suppose instead that the issuer files a bankruptcy petition six months after issuance of the bond. Section 502(b)(2) would disallow half of the $500 in original issue discount because only half of the time for which the $500 of original issue discount is payable has passed. Thus half of the $500 is unmatured interest. The

that included unearned original issue discount claimed it had a lien securing the entire amount, the lien would be voided by § 506(d) to the extent of the unearned original issue discount as of the petition filing date.[92]

However a homeowner whose $250,000 home was subject to a $350,000 mortgage could not file a bankruptcy case and use § 506(d) to reduce the mortgage lien to $250,000, because no provision of the Code would disallow the $100,000 amount by which the mortgage exceeded the value of the home.[93] The entire $350,000 claim would be an allowed claim,

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result is that $250 of the $10,000 claim will be disallowed. Section 506(d) would then void the lien on the collateral for that $250 amount. Note, however, that as time passes, the bondholder's secured claim will accrue postpetition interest under § 506(b) to the extent that the claim is oversecured; the lien thus will grow back if there is sufficient value in the collateral. *See In re Solutia*, 379 B.R. at 486 (noting entitlement of secured noteholders to have interest under § 506(b) added to the amount of their claims after those claims had been reduced to account for unamortized original issue discount as of the date of the commencement of the case). The court in *Solutia* did not consider the possible effect of § 551, under which the bankruptcy estate could claim to hold a lien on the collateral for the amount of the lien that was voided under § 506(d); such a lien held by the estate arguably would reduce the value of the collateral to which the secured creditor could look for purposes of accruing postpetition interest under § 506(b).

92. *See supra* note 91. As noted in the next to the last sentence of note 91, *supra*, to the extent the secured creditor is oversecured, the lien can grow back as postpetition interest accrues.

93. If the mortgage were a nonrecourse mortgage, there would be a question whether § 506(d) could be used to strip down the mortgage lien to $250,000. If the court were to allow the mortgage holder's secured claim in the amount of $250,000 and then disallow a $100,000 unsecured claim—as noted below, because of the nonrecourse nature of the debt—it is possible that the Supreme Court's analysis in *Dewnsup* could allow § 506(d) to void $100,000 of the lien; after all, if $100,000 of the $350,000 claim is disallowed, that would seem to satisfy the Court's requirement that § 506(d) only be used to void liens to the extent a claim has affirmatively been disallowed.

Some home mortgages are nonrecourse, typically by statute (under Depression-era state antideficiency statutes), but occasionally as a result of the debtor having previously obtained a Chapter 7 discharge of personal liability. *See, e.g.*, Carol Burns, Comment, *Will Refinancing Your Home Mortgage Risk Your Life Savings?: Refinancing and California Code of Civil Procedure Section 580b*, 43 UCLA L. REV. 2077, 2081–83 (1996) (describing California's antideficiency statutes adopted during the Great Depression); Johnson v. Home State Bank, 501 U.S. 78 (1991) (holding that the nonrecourse mortgage debt remaining after discharge of personal liability in a Chapter 7 case is a claim that may be dealt with in a later Chapter 13 case, if the requirements of Chapter 13 otherwise are met). Outside of Chapter 11, where § 1111(b)(1) often entitles nonrecourse creditors to be treated as if they had recourse, the holder of an undersecured nonrecourse claim ordinarily would not be entitled to allowance of an unsecured claim for purposes of sharing in any distribution from property of the estate other than its own collateral. *See* CC Britain Equities, L.L.C. v. Allen-Main Assocs. Ltd. P'ship (*In re* Allen-Main Assocs. Ltd. P'ship), 223 B.R. 59 (B.A.P. 2d Cir. 1998). Thus, courts sometimes note that such a creditor's deficiency claim would be disallowed as an unsecured claim. *See* Liona Corp. v. PCH Assocs. (*In re* PCH Assocs.), 949 F.2d 585, 604 (2d Cir. 1991) ("However, section 502(b)(1) operates to disallow the unsecured or deficiency claim of such a creditor when the financing that provides the basis for the claim was advanced on a *nonrecourse* basis."). Certainly, if an undersecured nonrecourse creditor asserts an unsecured claim for purposes of obtaining a distribution from property of the estate other than its collateral—such as when the creditor is permitted to foreclose and then files an unsecured claim for the portion of the debt not paid off by the foreclosure sale—the claim will be disallowed. That is true even in Chapter 11 cases, if foreclosure is permitted, even though the explicit language of § 1111(b)(1) might seem to allow the undersecured nonrecourse creditor to be treated as if it had and the claim would be secured by a lien on the home. Thus, the Court's holding in *Dewsnup* would preclude use of § 506(d) to strip down the mortgage.

### *B. The Five-Year Limit on Plan Payments in Chapter 13 Cases*

*Dewsnup* precludes a mortgagor from using § 506(d) to strip down the mortgage, but neither *Dewsnup* nor § 506(d) precludes use of other Code provisions to do so.[94] Section 1322(b)(2) specifically permits Chapter 13 debtors to include provisions in their Chapter 13 plans to "modify the rights of holders of secured claims,"[95] with an exception for certain claims secured by home mortgages —the "other than" clause[96]—which is noted above[97] and discussed at length below.[98] Section 1325(a)(5) specifies what a plan proposing such a modification must provide "with respect to each allowed secured claim provided for by the plan. . . ."[99] Assuming the secured

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recourse. *See, e.g.*, Tampa Bay Assocs., Ltd. v. DRW Worthington, Ltd. (*In re* Tampa Bay Assocs., Ltd.), 864 F.2d 47 (5th Cir. 1989). For our purposes, the question is moot if the unsecured claim is disallowed only after the mortgage holder is permitted to foreclose. Of course, then the mortgage holder will not have a lien on the home, which it will sell free and clear of its mortgage lien to itself or to whoever else may purchase the home at the foreclosure sale. But what if no foreclosure has occurred, the debtor seeks to have the court value the home to determine the amount of the nonrecourse mortgage holder's secured and unsecured claims under § 506(a), and the debtor then seeks to have the court disallow the unsecured claim because of the nonrecourse nature of the debt? The debtor might hope to find financing in order to pay off the secured claim, and thus attempt to eliminate the mortgage holder's lien by paying the court-determined value of the property. Although such an approach could fit with the analysis of § 506(d) in *Dewsnup*, it would deprive the mortgage holder of any appreciation of the collateral that might occur after the court valuation, which the Court in *Dewsnup* said would be improper. Dewsnup v. Timm, 502 U.S. 410, 432 (1992). The Court probably would hold that there was no legitimate reason for the bankruptcy court to hold a valuation hearing absent an attempt by the mortgage holder to assert an unsecured claim for purposes of sharing in the value of other assets of the estate. Perhaps the Court would hold that no one other than the mortgage holder would have standing to seek such a valuation for purposes of allowance or disallowance of an unsecured claim. Absent a valuation, there would be no basis for determining that any portion of the claim was not allowable. Note that § 502(b)(1) appears to call for disallowance of the claim only if it is enforceable neither against the debtor nor against property of the debtor; absent a valuation there seems to be no reason not to consider the claim fully enforceable against the property. § 502(b)(1).

94. Harmon v. United States *ex rel.* Farmers Home Admin., 101 F.3d 574, 581 (8th Cir. 1996).

95. § 1322(b)(2).

96. *Id.*

97. *See supra* text accompanying notes 47–51.

98. *See infra* text accompanying notes 146–200.

99. § 1325(a)(5). Several courts have noted that it is compliance with § 1325(a)(5), working together with § 1327, that authorizes a plan to strip down a secured claim, where that is permitted in Chapter 13. *See, e.g.*, Am. Gen. Fin., Inc. v. Paschen (*In re* Paschen), 296 F.3d 1203, 1205–06 (11th

creditor does not accept the plan,[100] and assuming the debtor does not surrender the collateral to the secured creditor,[101] § 1325(a)(5)(B)(ii) requires that "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim" must be "not less than the allowed amount of such claim."[102]

Note first that the antecedent of "such claim" in § 1325(a)(5)(B)(ii) is "allowed secured claim provided for by the plan."[103] Even though the Court in *Dewsnup* refused to read the term "allowed secured claim" in § 506(d) to mean the allowed secured claim as determined under § 506(a),[104] the Court's own methodology in *Dewsnup* suggests that the term as used in § 1325(a)(5)(B)(ii) should be given the § 506(a) meaning.[105] Almost all courts have done so, including the Supreme Court in *Associates Commercial Corp. v. Rash*[106] and *Till v. SCS Credit Corp.*,[107] thus allowing strip down, at least in theory, of secured claims—other than those secured only by a principal residence[108]—in Chapter 13, so long as the plan pays the entire stripped down secured claim with interest over the three to five years of the plan. Thus, if the secured creditor is owed $5,000, and if the collateral is worth $3,000, the "allowed secured claim" is $3,000, and that is the amount of present value, as of the effective date of the Chapter 13 plan, that the plan must provide during the term of the plan to the secured creditor on account of the secured claim.

The "property to be distributed under the plan" for purposes of

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Cir. 2002); *In re* Perry, 337 B.R. 649, 654 (Bankr. N.D. Ohio 2005).

100. *See* § 1325(a)(5)(A).

101. *See* § 1325(a)(5)(C).

102. § 1325(a)(5)(B)(ii).

103. § 1325(a)(5).

104. *See supra* text accompanying notes 59–93.

105. The Court in *Dewsnup* noted that in reorganization cases liens were modified under pre-Code practice to reduce the amount of a secured creditor's lien. Dewsnup v. Timm, 502 U.S. 410, 418–19 (1992). The language of § 1129(b)(2)(A), though not simple, appears designed to permit that practice to continue by allowing an undersecured claim to be paid off by payments with a present value as of the effective date of the plan equal to the value of the collateral. If that language in § 1129(b)(2)(A) is so interpreted, the very similar, though simpler, language of § 1325(a)(5) should be interpreted similarly in what is also a kind of reorganization, or perhaps more properly rehabilitation, case under Chapter 13.

106. 520 U.S. 953, 956–57 (1997).

107. 541 U.S. 465, 468–70 (2004).

108. *See, e.g.*, Enewally v. Wash. Mutual Bank (*In re* Enewally), 368 F.3d 1165, 1172 (9th Cir. 2004), *cert. denied*, 534 U.S. 1021 (2004) ("As both the district court and bankruptcy court noted, lien stripping on debts secured by real property that is not the debtor's primary residence is permissible in Chapter 13, even after *Nobelman*. However, it must be accomplished in a manner consistent with § 1322(b)(2). Because § 1322(b)(2) does not allow a modified secured debt to be paid over a period of time longer than the plan term, the debtors' proposed plan modification must be disallowed."); United Carolina Bank v. Hall, 993 F.2d 1126 (4th Cir. 1993); *In re* Thompson, 224 B.R. 360 (Bankr. N.D. Tex. 1998); *In re* Hernandez, 175 B.R. 962 (Bankr. N.D. Ill. 1994).

§ 1325(a)(5)(B)(ii) nearly always consists of monetary payments.[109] For payments that are made after the effective date of the plan to have a present value, as of the effective date of the plan, equal to the amount of the secured claim, the total dollar amount of the payments has to be more than the amount of the secured claim. A dollar paid tomorrow is worth less than a dollar paid today, which requires that the dollar paid tomorrow be paid with some interest if it is to be economically equivalent to the dollar paid today. Thus, interest has to be added at an appropriate rate, so that the payments will have the required present value as of the effective date of the plan.[110]

The crucial point for our purposes is that there is an iron-clad rule prohibiting confirmation of plans that call for payments to be made over longer than five years:[111] "[T]he plan may not provide for payments over a period that is longer than five years."[112] Although the point is disputed, the heavy weight of authority—and the best reading of the Bankruptcy Code—requires that any secured claim that has been stripped down must be paid off (in the stripped down amount with interest) during the plan, and thus over a period of no more than five years.[113] As Justice Ginsburg noted in *Rash*, where the debtor seeks to strip down a lien by "invok[ing] the so-called 'cram down' power, . . . the debtor is required to provide the creditor with payments, over the life of the plan, that will total the present value of the allowed secured claim, *i.e.*, the present value of the collateral."[114] In *Enewally v. Washington Mutual Bank (In re* Enewally),[115] the Ninth Circuit

109. For a different possibility that as far as the author knows has never been used in an actual Chapter 13 case, a possibility that would involve distribution of a new mortgage instead of cash, and that would eviscerate the three-to-five-year limit, see *infra* note 132.

110. *See, e.g.*, Till v. SCS Credit Corp., 541 U.S. 465 (2004) (plurality opinion) (arguing that the appropriate interest rate is the prime rate charged very creditworthy borrowers plus an upward adjustment for risk).

111. *See* 11 U.S.C. § 1322(d) (2006). The courts have taken this five year maximum quite seriously, because it "reflects the concerns of Congress that the debtor be protected from an overly burdensome, lengthy repayment plan." *In re* Musselman, 341 B.R. 652 (Bankr. N.D. Ind. 2005). Thus there is a vigorous debate over exactly when the five year period begins, *see id.* at 654–57, a determination that is required if courts are to police the five year limit strictly.

112. § 1322(d)(1). Subsection (d)(1) applies to debtors with above-median incomes. Note that if the debtor's income is below the state median, "the plan may not provide for payments over a period that is longer than 3 years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than 5 years." § 1322(d)(2).

113. *Enewally*, 368 F.3d at 1171; *see infra* text accompanying notes 114–25.

114. Assocs. Commercial Corp. v. Rash, 520 U.S. 953, 957 (1997).

115. *Enewally*, 368 F.3d at 1165; *see also* Barnes v. Barnes (*In re* Barnes), 32 F.3d 405 (9th Cir. 1994) (holding that compliance with § 1325(a)(5)(B)(ii) is a mandatory requirement for plan confirmation and thus reversing district court's affirmance of bankruptcy court order confirming

flatly held that a Chapter 13 plan may not strip down a lien and then provide for payment of the stripped down amount over longer than the five year maximum length of a plan.[116] *Enewally* is the only post-*Nobelman* circuit court decision with a direct holding on this issue, and its approach is consistent with the Supreme Court's rationale in *Rash*.

At least one bankruptcy court considers this *Enewally/Rash* approach to be so clearly correct that a departure from it would violate Bankruptcy Rule 9011—the Bankruptcy Rule equivalent of Federal Rule of Civil Procedure 11.[117] Further, to the extent that § 1325(a)(5) is recognized as providing the authority to strip down a secured claim,[118] the logical consequence is that the stripped down claim must be satisfied with interest during the three-to-five-year term of the plan; note that § 1325(a)(5)(B)(ii) requires that property with a present value equal to the amount of the allowed secured claim must be distributed "under the plan,"[119] which cannot last longer than five years.[120]

The alternative to the *Enewally/Rash* approach is what we might call the *Bellamy* approach, after the Second Circuit's overruled pre-*Nobelman* decision in *Bellamy v. Federal Home Loan Mortgage Corp.* (*In re* Bellamy).[121] Courts that accept the *Bellamy* approach allow Chapter 13 plans to invoke § 1322(b)(5) to allow stripped down secured claims to be paid off over more than five years. But even under the *Bellamy* approach, as the Second Circuit explained in *Bellamy*, the five year limit applies if a Chapter 13 plan modifies the contractually-set interest rate or the contractually-set amount of the monthly payments to be made on a stripped down secured claim. Any such modification would be inconsistent with the requirement of § 1322(b)(5) for "maintenance of payments" and would instead trigger the requirements of § 1325(a)(5)(B), which apply, according

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Chapter 13 plan that called for secured claim to be paid off over nineteen years).

116. *Enewally*, 368 F.3d at 1172.

117. *See In re* Bulson, 327 B.R. 830, 851–52 (Bankr. W.D. Mich. 2005) (holding that submission of a plan calling for payment of stripped down mortgage over period of more than five years was a fraud on the court that provided a basis for revoking confirmation of the plan).

118. *See supra* note 99.

119. 11 U.S.C. § 1325(a)(5)(B)(ii) (2006).

120. Courts sometimes allow a plan to continue a short time past the five year limit if that is necessary for the debtor to complete payments. *See, e.g.*, *In re* Harter, 279 B.R. 284, 287–88 (Bankr. S.D. Cal. 2002). But courts refuse to confirm plans that provide initially for payments to be made over longer than five years. *See supra* text accompanying note 111 and accompanying text.

121. 962 F.2d 176 (2d Cir. 1992), *overruled by* Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993). *Nobelman* overruled *Bellamy* with respect to the availability of strip down of mortgage secured only by debtor's principal residence. *See Nobelman*, 508 U.S. at 330–32. The Supreme Court in *Nobelman* did not reach the aspect of the decision in *Bellamy* described in this article as the "*Bellamy* approach" and thus did not directly overrule *Bellamy* on the question whether a stripped down secured claim must be paid off within the three-to-five-year term of the Chapter 13 plan.

to *Bellamy*, when a secured claim is modified.[122] Courts have nearly universally followed either the *Enewally/Rash* approach[123] or, mostly in the

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122. *See infra* text accompanying notes 158–64, 191–99. Consider the Second Circuit's explanation in *Bellamy* of its approach:

> Appellant's related argument that if the Bellamys seek to reinstate the mortgage, then under § 1322(b)(5) the entire debt must be treated as secured, is specious. If a debtor seeks to cure a default and reinstate a long-term residential mortgage, two steps must be taken: 1) the arrearages must be paid within a reasonable time, and 2) the parties' original contract must be reinstated. The crux of the matter is what is meant by stating that the parties' contract is reinstated. Does this mean that the total due under the contract must be paid, or merely that the terms of payment (*e.g.*, rate of interest, monthly installments, etc.) must be maintained until the secured claim is paid?
>
> Leaving aside what the parties may choose to do by agreement, the *terms* of payment must, at a minimum, remain unchanged or the prohibition on modification is meaningless. Federal Home goes further, arguing that "reinstating" the parties' agreement requires classifying the entire debt as secured, so that the debtor must pay off the note in full in order to retain his or her home. But this presupposes that § 1322(b)(2) prohibits modification of the entire claim which, as we have concluded, it does not. Reading §§ 1322(b)(2) and (b)(5) as precluding a debtor from reinstating a mortgage in its stripped down form confuses the distinction between modification and bifurcation and undermines the purpose of Chapter 13. Consequently, appellant's suggestion that the Bellamys are not helped by bifurcation because they must thereafter pay off the entire secured claim (generally a long-term obligation) within the life of the Chapter 13 plan is misguided.
>
> Secured creditors whose secured claims may be modified and who are subjected to such a cramdown must have their secured claim paid within five years. Federal Home's secured claim is *not being modified*, and therefore need not be paid off within the life of the plan. If appellant's definition of modification (as encompassing bifurcation) was correct, a debtor wishing to retain his overencumbered home would face this quandary—pay off its actual value within five years (most likely an impossible proposition, thereby precluding confirmation), or pay more than market value.
>
> The first option is not a realistic one. The second creates perverse incentives in favor of liquidation (contrary to the purpose of the Code), pursuant to which the debtor's personal liability generally is discharged once the creditor's *in rem* rights are exercised. . . .
>
> Section 1322(b)(5) addresses, as does the Code in general, secured and unsecured claims. In light of the goals of Chapter 13, § 1322(b)(2) and (5) must be read as allowing a debtor to reinstate in its stripped down form a residential mortgage that comes due beyond the life of the plan. The debtor must cure arrearages within a reasonable time, but need make scheduled mortgage payments only until the secured claim is fully paid. Such treatment of a residential mortgage lender's secured claim is neither a modification prohibited by § 1322(b)(2) nor does it implicate §§ 1325(a)(5)(B) or 1322(c).

*In re Bellamy*, 962 F.2d at 184–85 (citations omitted). Thus, the *Bellamy* court held that any change in the "payment terms," including any change in the interest rate or in the amount of the monthly payments, would modify the secured claim, which would not only be prohibited by the "other than" clause of § 1322(b)(2) but also would in any event trigger the requirement that the stripped down secured claim be paid in full during the plan under § 1325(a)(5)(B).

A very recent bankruptcy court opinion gives a clear explanation, though referring to bifurcation instead of strip down, of what this article calls the *Bellamy* approach:

> The parties agree that AHMS's claim can be bifurcated pursuant to § 1322(b)(2). Upon bifurcating a claim, a debtor has two options: (1) modify the terms of the claim, 11

First Circuit at least since the Supreme Court's 1993 *Nobelman* decision, the *Bellamy* approach.[124] The weight of recent authority seems clearly on the

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U.S.C. § 1325(a)(5); or (2) cure the mortgage default within the plan period, 11 U.S.C. § 1322(b)(5). If the debtor chooses to modify the terms of the claim, he must pay the amount of the secured claim as valued by the court in full within the life of the plan. If the debtor chooses to cure the mortgage default within the plan period, the original contract terms are reinstated and the debtor can maintain the original contract payments during and beyond the life of the plan. A change in monthly payments of principal and interest with respect to the allowed secured claim triggers § 1322(d), which requires the full amount of the secured claim to be paid over the life of the plan. The Debtors in the present case have chosen to bifurcate AHMS's claim. Because the Debtors propose to modify the claim by changing the monthly payments of principal and interest, they must pay the entire portion of the secured claim in full during the life of the plan. The Debtors cite to *Fed. Nat'l Mortg. Ass'n v. Ferreira (In re Ferreira)*, 223 B.R. 258 (Bankr.D.R.I.1998) to support their argument that they may make payments over the remaining term of the loan. *Ferreira* simply clarifies the interplay between subsections (b)(2) and (b)(5) of § 1322 in stating that bifurcation of a claim in and of itself does not trigger § 1322(d)'s requirement that payments be completed over the life of the plan. Payments with respect to the secured portion of a bifurcated claim can extend beyond the life of the plan, *if* all the provisions of § 1322(b)(5) are complied with. That is, if the debtor cures the default, then his original contract payments (at the contract interest rate) can extend beyond the life of the plan. Further, *Ferreira* cites to cases within the First Circuit which affirmatively hold that a change in monthly payments requires the claim to be paid in full during the life of the plan.

*In re* Plourde, 402 B.R. 488, 490–92 (Bankr. D.N.H. 2009) (citations and footnotes omitted).

123. *See, e.g.*, Tina Livestock Sales, Inc. v. Schachtele (*In re* Schachtele), 343 B.R. 661, 667–68 (B.A.P. 8th Cir. 2006); Columbia Nat'l Inc. v. Brown, (*In re* Brown), 399 B.R. 574, 575 (D. Conn. 2008) (holding that strip down on the one hand and curing of defaults/maintenance of payments apparently under § 1322(b)(5)) on the other hand "are mutually exclusive"); *In re* Stiller, 323 B.R. 199, 210 n.15 (Bankr. W.D. Mich. 2005) (dictum); *In re* Bulson, 327 B.R. 830 (Bankr. W.D. Mich. 2005); *In re* Stivender, 301 B.R. 498 (Bankr. S.D. Ohio 2003) (using *Enewally/Rash* approach though decided prior to *Enewally*); *In re* Koper, 284 B.R. 747 (Bankr. D. Conn. 2002) (same); *In re* Sarkese, 189 B.R. 531 (Bankr. M.D. Fla. 1995) (same); *In re* Strober, 136 B.R. 614, 623–24 (Bankr. E.D.N.Y. 1992) (using *Enewally/Rash* approach though decided prior to *Bellamy*, *Nobelman* and *Enewally*; perhaps abrogated with respect to this issue by *Bellamy*, despite *Bellamy*'s overruling by *Nobelman*); *see also* Landmark Fin. Servs. v. Hall, 918 F.2d 1150, 1154 (4th Cir. 1990) ("To summarize, the principal components of a § 1325 cramdown are retention of the lien by the secured creditor and provision for the payment, during the life of the plan, *i.e.*, 3–5 years, of the full value of the secured claim."); *In re* Musselman, 341 B.R. 652 (Bankr. N.D. Ind. 2005) (refusing to confirm a plan that would allow payment of stripped down mortgage holder's secured claim over up to five years from date of plan confirmation because five year limit runs from date of first payment that must be made to trustee, which is prior to plan confirmation). It seems that neither the district court in *Brown* nor the bankruptcy court in *Koper* thought themselves bound to use the *Bellamy* approach, even though they are in the Second Circuit.

124. *See, e.g.*, Fed. Nat'l Mortgage Ass'n v. Ferreira (*In re* Ferreira), 223 B.R. 258 (D.R.I. 1998) (using *Bellamy* approach and citing several bankruptcy court opinions in the First Circuit that took same approach); *In re* Plourde, 402 B.R. 488 (Bankr. D.N.H. 2009); *In re* Pruett, 178 B.R. 7 (Bankr. N.D. Ala. 1995); *In re* McGregor, 172 B.R. 718 (Bankr. D. Mass. 1994) (holding that a plan that stripped down mortgage on apartment building, reduced contractually-set interest rate, and reduced contractually-set monthly payment could not be confirmed because payments would stretch beyond three-to-five year limit on plan payments, but also holding that plan could be confirmed if amended so that neither interest rate nor monthly payment would be changed). Note that of these cases only the 1995 *Pruett* decision comes from outside the First Circuit. For pre-*Nobelman* cases applying this

side of the *Enewally/Rash* approach, with the Ninth Circuit, the Eighth Circuit Bankruptcy Appellate Panel, and most other courts outside the First Circuit following the *Enewally/Rash* approach.[125]

Of course, the proposed home mortgage strip down legislation provides both for adjustments in the contractual interest rate and for reduction in the monthly payments on stripped down home mortgages. The legislation would be nearly pointless if it did not allow a reduction in the monthly payment. The major rationale for the legislation is that homeowners who cannot afford their mortgage payments need relief in order to stem the tide of foreclosures.[126] Even under the *Bellamy* approach, such changes would prevent the plan from using § 1322(b)(5); thus, even under the most liberal approach to current law, the Chapter 13 plan would have to provide for payment of the stripped down secured claim with interest over no more than five years. The proposed legislation instead allows payment of stripped down home mortgage claims over a period that could extend to almost forty years. It is clear, then, that the proposed legislation creates a kind of strip down that has previously been unknown and that will continue to be unavailable with respect to any secured debt other than mortgages on debtors' principal residences.[127]

As the author pointed out sixteen years ago, in an article co-authored with attorney Scott M. Reddie (then a *Pepperdine Law Review* editor), the five year limit under current law should make it nearly impossible, as a practical matter, for Chapter 13 debtors to strip down first mortgages on homes of substantial value, even if the Code otherwise would permit strip down.[128] At least that is the case if the *Enewally/Rash* approach is followed; in any event it is also the case under the *Bellamy* approach if the plan modifies the contractually-set interest rate or the contractually-set monthly

approach outside the First Circuit, see cases cited below in note 176.

125. *See supra* notes 123–24.

126. *See, e.g.*, 155 CONG. REC. S4915–17 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin).

127. *See* H.R. 1106, 111th Cong. § 103 (2009) (limiting application of the proposed § 1322(b)(11) to claims "secured by a security interest in the debtor's principal residence"); Durbin Amendment, *supra* note 4, § 503, at S4981 (same).

128. Scarberry & Reddie, *supra* note 84, at 428, 467–74; *see* First Am. Title Ins. Co. v. Nation (*In re* Nation), 352 B.R. 656, 666 (Bankr. E.D. Tenn. 2006) ("The debtor will often lack the financial ability to carry out a plan that applies § 1325(a)(5)(B) to a debt secured by the debtor's home." (citing 11 U.S.C. § 1322(b)(2), (d) (2006); 2 KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY § 128.2, at 128-15 to -16 (3rd ed. 2006))); *In re* Strober, 136 B.R. 614, 623 (Bankr. E.D.N.Y. 1992) ("Like the Strobers, few debtors would have the capacity to pay off their entire mortgage within a five year period, through regular monthly payments, even when reduced by bifurcation to the present value of the debtor's residence."); *see also supra* note 122 and accompanying text.

payment. Many of us struggle to pay off our home mortgages over fifteen, twenty, or thirty years. Does a debtor belong in bankruptcy who is so flush with cash that he or she can afford to pay off the entire value of his or her home with interest over a mere five years? A Chapter 13 plan, under which the debtor would do so, would be proposed in bad faith, and thus not confirmable,[129] at least unless it also provided for full payment of all unsecured claims.[130] Otherwise the debtor would be diverting funds that could easily be used to pay unsecured claims so as instead to quickly pay off the home mortgage and allow the debtor to exit bankruptcy with a home owned free and clear. That would not be a fresh start but very much a head start, putting the debtor in a much better financial position than most of the rest of us.[131] There may be cases in which the debtor's home is not very

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129. *See* § 1325(a)(3) (providing that a plan may only be confirmed if it is, inter alia, "proposed in good faith"); Scarberry & Reddie, *supra* note 84, at 471–73. *But see* Tina Livestock Sales, Inc. v. Schachtele (*In re* Schachtele), 343 B.R. 661, 667–68 (B.A.P. 8th Cir. 2006) (holding that payment of secured claim over three year term of plan did not constitute bad faith because it was required by Code).

130. Under such a plan, the unsecured claim holders would not be substantially prejudiced by the making of increased payments to the mortgage holder, because they would receive payment in full. However, it may be wondered whether a debtor is in need of bankruptcy relief who can afford over a period of five years not only to pay the entire value of his or her home with interest, but also to pay all of his or her other debts in full. It seems unlikely that a debtor with such a high level of income and relatively low level of debt would be unable to pay current debts or unable to borrow money to deal with a temporary cash flow problem.

131. A plan that called for a large balloon payment, based on a contemplated sale or refinancing of the home during the Chapter 13 plan, could possibly satisfy the requirement of § 1325(a)(5)(B) that the amount of the allowed secured claim be paid off with interest during the Chapter 13 plan without providing such a "head start." *See* Richard N. Gottlieb, *Up, Up and Away: Considering "Balloon Payment" Plans in Chapter 13 Cases*, 14 AM. BANKR. INST. J. 1 (1997). But Chapter 13 plans calling for large balloon payments to be made near their end by way of refinancing or sale of the home will seldom be confirmable in this context. *See, e.g.*, *In re* Strober, 136 B.R. 614, 623 (Bankr. E.D.N.Y. 1992) (noting that it was "most dubious" whether a plan calling for a balloon payment could meet the feasibility requirement of § 1325(a)(6)). To confirm a plan, the court must find that "the debtor will be able to make all payments under the plan and to comply with the plan." § 1325(a)(6). Courts have described in several different ways how the Chapter 13 feasibility requirement applies to balloon payments. Some ask whether there is "credible and definite evidence that [the debtor] actually could make the balloon payment." *In re* Hendricks, 250 B.R. 415, 421 (Bankr. M.D. Fla. 2000) (following *In re* Crotty, 11 B.R. 507, 511 (Bankr. N.D. Tex. 1981)); *accord In re* Tornheim, 239 B.R. 677, 683 n.5 (Bankr. E.D.N.Y. 1999). Other courts require that the debtor "prove with reasonable certainty his ability to make the payments under the proposed plan." *In re* Harrison, 203 B.R. 253 (Bankr. E.D. Va. 1996); *see In re* Schenk, 67 B.R. 137, 140 (Bankr. D. Mont. 1986). The First Circuit Bankruptcy Appellate Panel seemingly endorsed both of those approaches. *See* First Nat'l Bank of Boston v. Fantasia (*In re* Fantasia), 211 B.R. 420, 423–24 (B.A.P. 1st Cir. 1997) (listing factors courts have considered and citing approvingly both *Crotty* and *Schenk*). Another approach is to say that certainty is not required, but the plan must have "a reasonable likelihood of success." *See, e.g.*, *In re* Gillis, 333 B.R. 1 (Bankr. D. Mass. 2005).

The key seems to be whether the debtor has sufficient equity in the home, or will have sufficient equity in the home due to principal amortization under the plan, to make it likely that the debtor can refinance. "Without question, plans may contain balloon payments in situations where it is shown that the mortgage debt will be significantly reduced and result in sufficient equity build up, thereby indicating a significant likelihood that the debtor could obtain refinancing of the property." *In re Tornheim*, 239 B.R. at 683 n.5. The court in *Gillis* found that there was a reasonable likelihood of success where the balloon payment would require the debtors to refinance their $780,000 home, in which they had at least $180,000 of equity, by taking out a new first mortgage for less than $640,000, with a back-up plan of a sale for a net of at least $640,000 after real estate commissions. *In re Gillis*, 333 B.R. at 5–10. The court found that even in the event of a downturn in the market, the debtors were reasonably likely to be able to obtain the new mortgage or sell the home for the required amount. *Id.* at 9–10. Note, of course, that if a Chapter 13 debtor strips down a home mortgage, the debtor will begin the plan not with $180,000 in equity, but with zero equity, as in *Strober*. Principal amortization during a three-to-five year plan will likely be small, and thus the debtor would need to refinance with nearly a one hundred percent loan-to-value ratio, assuming there is no change in the value of the home. A court should have difficulty concluding five years in advance that a debtor is reasonably *likely* to be able to refinance the home at such a level, or that there is "credible and definite evidence" that the debtor will be able to do so, or that it is reasonably certain the debtor will be able to do so, whichever of the formulations may be applied. "Relevant case law provides no support for balloon payments in circumstances such as those presented here, i.e., plans requiring the payment of a large sum at the end with no source of funding for the payment in sight." *In re* Felberman, 196 B.R. 678, 688 (Bankr. S.D.N.Y. 1995). One court did find such a plan to be feasible with regard to a stripped down mortgage where a bank president testified that his bank would provide the refinancing when the balloon payment came due, "if his bank's underwriting standards were met"; the court considered that commitment to be "not illusory" though also not "ironclad." *In re* Groff, 131 B.R. 703 (Bankr. E.D. Wis. 1991). The court in *Groff* was "impressed by the debtors' family lifestyle, resiliency and sheer determination," *id.* at 709, and concluded that "[b]ecause the debtors have a realistic shot at 'making it' while at the same time protecting the Bank's interest, they should be given that opportunity." *Id.* No other case found has used the "realistic shot" test. It is also possible that the 2005 amendments to the Bankruptcy Code preclude use of balloon payments. *See* § 1325(a)(5)(B)(iii)(I) (requiring that if periodic payments are made on a secured claim, "such payments shall be in equal monthly amounts").

For other reported cases in which a Chapter 13 plan calling for a balloon payment was confirmed, see Magnolia Mortgage, LLC v. Arnett (*In re* Arnett), 278 B.R. 239 (S.D. Ala. 2002); *In re Nation*, 352 B.R. at 656. Neither *Arnett* nor *Nation* dealt explicitly with whether it was permissible to use a balloon payment to satisfy § 1325(a)(5)(B).

The opinion in *Nation* dealt with discharge issues under a plan that had been confirmed and that called for a balloon payment of approximately $30,000 to pay off a first mortgage on the debtor's home, which was worth well over $100,000. The plan as modified called for sale of the home to generate the cash for the balloon payment, and it is hardly surprising that the bankruptcy court—in an unpublished order—found that it would be feasible to sell a home worth well over $100,000 for at least $30,000; as it turned out, the home was sold for $160,000.

The only issue before the district court in *Arnett* was how to interpret § 1322(c)(2). *See In re Arnett*, 278 B.R. at 240. The terms of the undersecured second mortgage on the debtor's principal residence required that it be paid off by a balloon payment on December 1, 2005. *Id.* at 241. The debtor filed a Chapter 13 case in 2001, and the last payment under the debtor's plan would be made after December 1, 2005. *Id.* at 240. Thus, the district court correctly held that under § 1322(c)(2)—the short-term mortgage exception to the "other than" clause, *see infra* note 150—the mortgage could be stripped down so long as the full amount of the stripped down secured claim was paid off with interest during the term of the debtor's plan. *See In re Arnett*, 278 B.R. at 242. The confirmed plan stripped down the second mortgage to the value of the second mortgage holder's collateral—the value of the home minus the amount of the first mortgage—provided for monthly payments at the contractual rate of interest, and provided for a balloon payment to be made on December 1, 2005 to pay off the remaining principal owed on the stripped down secured claim. *Id.* It is not clear to the valuable—a very modest home in a depressed area, for example—and in which it might not be financially impossible or in bad faith for the debtor to pay its value with interest in a Chapter 13 plan in five years, but such cases are not the standard case contemplated by the proposed congressional legislation allowing strip down.[132]

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author that the plan should have been confirmed, given the uncertainty in whether the debtor would be able to make the balloon payment. But note that the original mortgage payment schedule called for a balloon payment on the same date as the date set under the plan, and the amount of the balloon payment under the original terms of the mortgage would have been larger that the stripped down amount of the balloon payment to be made under the plan. Thus, it does not seem that the risk of nonpayment of the balloon payment was increased by the plan over the risk that would have existed in any event; perhaps the reduced amount of the balloon payment under the plan, and the ability of the debtor under the plan to reduce payments on other debts, made it more likely that the debtor would be able to make the balloon payment.

132. An alternative approach suggested by a few academics would be for the plan to "distribute" to the mortgage holder a long-term debt obligation: a new mortgage with a term of perhaps thirty years, and certainly more than five years. Professor Robert Lawless made that suggestion to the author in a conversation. Such an approach may also have been suggested in a recent law review article by Professor Robert Zinman and Mr. Novica Petrovski. *See* Zinman & Petrovski, *supra* note 41, at 154–55 (discussing whether mortgage "distributed" under plan would have sufficient present value to satisfy § 1322(a)(5)(B)(ii), but perhaps only for purposes of analyzing Takings Clause questions). The new mortgage would have a principal amount equal to the stripped down amount of the mortgage debt and a court-determined interest rate. Because this long-term debt obligation would be distributed during the plan, probably at its beginning, it is argued that the plan thus would distribute "property"—the long-term debt obligation—of a sufficient value within the permitted three-to-five year term of the plan to satisfy § 1325(a)(5)(B). As far as the author knows, a debt obligation has never been permitted to be distributed as "property" under a Chapter 13 plan. Such an approach would eviscerate the mandated three-to-five-year limit. It is not clear that there is any principled way to limit this approach, once it is accepted, to debts secured by home mortgages or even debts secured by real property, or even debts secured by any property. Debtors' plans then presumably could distribute long-term debt obligations even on account of unsecured debt. That would eviscerate not only the three-to-five year limit, but also the "best interest of creditors" requirement of § 1325(a)(4)—the requirement that holders of claims receive at least as much present value under the plan as they would receive in a Chapter 7 liquidation bankruptcy; debtors presumably could retain large amounts of nonexempt property merely by giving out long-term debt obligations under the plan. Such an approach also would be designed in effect to result in the debtor's personal liability on the original debt surviving the Chapter 13 discharge to the extent of the unpaid amount of the long-term obligation. Chapter 13 already provides, through a different approach, for survival of long term debts past the Chapter 13 discharge, under § 1322(b)(5). There is no reason to think Congress intended to allow this alternative approach to be engrafted onto the process. The absolute nature of the Chapter 13 discharge, and the explicit provision for a way in which long-term debts may survive the discharge under § 1322(b)(5), suggest very strongly to the contrary. Further, as a textual matter, it seems reasonable to treat payments made on a debt obligation distributed under the plan as payments made under the plan; and the Code is very clear that the court may not confirm a plan that provides for payments "over a period that is longer than 5 years." § 1322(d).

It is of course true that long-term debt obligations may be, and in fact often are, distributed under Chapter 11 plans. But a Chapter 11 plan is very different from a Chapter 13 plan. When a Chapter 11 plan is confirmed, the obligations under the plan replace any prior obligations, which are immediately discharged. *See* § 1141(a), (d). Chapter 11 does not provide for a limited term during which payments under the plan are to be completed; rather, it calls for a recapitalization of the debtor's business. Distribution of long-term debt under a Chapter 13 plan runs directly contrary to

As a practical matter then, a home mortgage holder whose first mortgage is secured by a home of substantial value is protected against Chapter 13 strip down under current law by the five year limit on plan payments. This point will be considered further below at several points in this Article,[133] and in particular, in connection with criticism of one of the arguments made by proponents of home mortgage strip down: the argument that allowing home mortgage strip down would simply treat holders of home mortgages the same as holders of other secured claims in bankruptcy.[134] Not surprisingly, the congressional proposals allowing home mortgage strip down explicitly extend the permitted payment period beyond five years to as much as forty years,[135] with the section-by-section analyses noting that, otherwise, the stripped down mortgages would have to be paid off within five years,[136] an admission also made by the Congressional Oversight Panel chaired by Harvard Law School Professor Elizabeth Warren.[137] Of course, subjecting mortgage holders to a thirty or forty year period of repayment at a court-determined rate of interest hardly amounts to treatment equal to that of other secured creditors, who are entitled to be paid over no more than five years.

This point also is considered further below in connection with criticism

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the congressional mandate that the burdens of a Chapter 13 plan not last longer than five years. *See* § 1322(d). Congress of course expressed no such mandate with regard to Chapter 11, and with the discharge occurring immediately upon confirmation of the plan, it is obvious that all obligations created under Chapter 11 plans survive the discharge.

As Professor Zinman and Mr. Petrovski note, it would be highly unlikely that a one hundred percent loan-to-value mortgage distributed under a Chapter 13 plan could have a present value equal to the value of the home. Certainly such a mortgage would sell at a drastic discount in the secondary market. *See* Zinman & Petrovski, *supra* note 41, at 154–55. For consideration of a similar question in the context of Chapter 11 business reorganizations, see SCARBERRY ET AL., *supra* note 57, at 832 (Problem 15-1(b)).

133. *See infra* text accompanying notes 193, 198, 363–67, 371–74, 400–04.

134. *See infra* text accompanying notes 344–85.

135. *See infra* text accompanying note 228; Scarberry, *supra* note 4 (showing provisions of legislative proposals as of December, 2007).

136. *See* S. 2136, 110th Cong. (2007); SENATE JUDICIARY COMMITTEE, HELPING FAMILIES SAVE THEIR HOMES ACT: SECTION BY SECTION SUMMARY 1 (Dec. 4, 2007) (on file with author) ("Under current law, Chapter 13 requires that secured creditors be paid the value of their allowed secured claim within three to five years. Thus, even with the change to section 1322 in section 101 [of S. 2136], this requirement would preclude most borrowers from benefitting from the change because with an amortization period of three to five years, the monthly payments even on a stripped-down loan would be too high for borrowers to afford.").

137. *See* CONGRESSIONAL OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION 54 (2009) [hereinafter WORKING TOWARD A SOLUTION], http://cop.senate.gov/documents/cop-030609-report.pdf.

of Professor Levitin's empirical research, which has been interpreted to show that allowing home mortgage strip down under the proposed congressional legislation would not cause substantial increases in interest rates or substantially restrict the availability of home loans.[138] Those studies, in part, compare interest rates on mortgages secured by principal residences with interest rates on mortgages secured by second homes and multiple unit real property, such as duplexes and triplexes, where only one unit would be used as the debtor's principal residence.[139] Mortgages on second homes and on multiple unit properties are not protected against strip down by the specific protection given to holders of mortgages on principal residences under § 1322(b)(2)'s "other than" clause,[140] which is discussed in the next section of this Article.[141] Thus the studies are designed to see whether the absence of such protection affects interest rates.[142] But, as we have seen, first mortgages on second homes and multiple unit properties of substantial value enjoy substantial protection against Chapter 13 strip down because of the five year limit on plan payments.[143] Thus, there is no substantial risk of Chapter 13 strip down of such mortgages, even though they do not enjoy protection under § 1322(b)(2) 's "other than" clause. The absence of any substantial risk suggests that there should be little or no risk premium charged for that risk by lenders. A study finding that lenders charge little or no risk premium for a mostly nonexistent risk shows nothing about the risk premium that would be charged were strip down to be made practically available, as it would be under the proposed congressional legislation, which allows payments to be stretched out for as much as nearly forty years even as interest rates are modified and monthly payments reduced.[144]

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138. *See supra* notes 20–24 and accompanying text.

139. *See* Levitin, *supra* note 6, at 578, 586–98.

140. *Id.* at 581. Such mortgages would not be secured "only by a security interest in real property that is the debtor's principal residence," as required by the terms of § 1322(b)(2) for its protections to apply. *See* 11 U.S.C. § 1322(b)(2) (2006).

141. *See infra* text accompanying notes 145–201.

142. *See* Levitin, *supra* note 6, at 578, 586.

143. *See supra* text accompanying notes 111–37.

144. *See infra* text accompanying notes 386–417. At one point Professor Levitin describes his finding as astonishing. *See* Levitin, *supra* note 6, at 586 ("Astonishingly, all three measures indicate that mortgage markets are indifferent to bankruptcy-modification risk, at least in terms of pricing."). Elsewhere he describes the result as exactly what would be expected, given his view that allowing mortgage modification in bankruptcy will not increase losses to mortgage holders. *See id.* at 617–18, 647. Of course, that view is based on an incorrect assumption that undersecured mortgage holders are guaranteed in a Chapter 13 case to receive payments with a value equal to the value of the home. *See id.* at 579–80 ("In Chapter 13, a creditor is guaranteed to receive the value of a secured claim."); *July 2009 Levitin Testimony*, *supra* note 20, at 9 ("[B]ankruptcy law guarantees that lenders will recover at least as much as in a foreclosure."); *see infra* text accompanying notes 330–37.

### C. *The Limited Additional Protection Given by the § 1322(b)(2) "Other Than" Clause (Prohibiting Modification of Rights of Holders of Mortgages Secured Only by the Debtor's Principal Residence) Even as Broadly Interpreted by the Supreme Court in* Nobelman v. American Savings Bank[145]

It is apparent that a Chapter 13 debtor typically cannot strip down or otherwise modify[146] a substantial first mortgage on real property of substantial value under current law, even if the real property is the debtor's home; very few debtors could afford the payments required, and, due to the good faith requirement, even fewer would be permitted to confirm plans calling for such payments to be made.[147] Even in those few courts that currently follow the *Bellamy* approach, debtors who cannot afford to pay their full contractually required monthly payments, plus something each month toward a cure of past defaults, cannot do so.[148] It is true that a Chapter 13 debtor who somehow could manage to pay the value of his or her home with interest over five years, and who somehow could convince a court that a plan providing for such payments was proposed in good faith, would run into a final obstacle that sometimes would prevent strip down: the "other than" clause. Section 1322(b)(2) permits modification of "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*, or of holders of unsecured claims. . . ."[149] The "other than" clause thus protects the rights of holders of home mortgages where the only collateral securing the debt is the debtor's principal residence.[150] To the extent that the "other

145. 508 U.S. 324 (1993).

146. Debtors are, however, permitted to cure and reinstate defaulted mortgages, even though such cure and reinstatement modify the rights that the mortgage holder would have outside of bankruptcy. *See infra* text accompanying notes 167–74.

147. *See supra* text accompanying notes 94–143.

148. *See supra* text accompanying notes 121–22; *infra* text accompanying notes 166–83.

149. 11 U.S.C. § 1322(b)(2) (2006) (emphasis added).

150. The Bankruptcy Code was amended in 1994 to add an exception to the "other than" clause for short-term mortgages—primarily mortgages calling for a balloon payment after only a few years. *Id.* If the last payment due under the mortgage's original payment schedule would be due before the end of the debtor's Chapter 13 plan, then § 1322(c)(2), as added in 1994, allows the plan "[to] provide for the payment of the claim as modified pursuant to section 1325(a)(5)." § 1322(c)(2); *see* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301, 108 Stat. 4106, 4131 (codified at § 1322(c)(2)). Note that this would allow strip down of an undersecured first mortgage but then would require payment of the § 506(a) secured claim—the full value of the home—with interest, over no more than five years. *See, e.g.*, First Union Mortgage Corp. v. Eubanks (*In re* Eubanks), 219 B.R. 468 (B.A.P. 6th Cir. 1998). *Eubanks* involved an approximately $14,500 second mortgage on

than" clause would prevent strip down, it would provide additional protection in the rare case in which strip down might otherwise be available and practicable.

From 1989 to 1992, four circuit courts—one each year—held that the "other than" clause did not prevent strip down of home mortgages even where it applied, that is, where the only collateral for the mortgage obligation was "real property that [was] the debtor's principal residence."[151] In 1993, in *Nobelman v. American Savings Bank*,[152] the Supreme Court overruled those circuit court decisions and similar lower court decisions with respect to their interpretation of the "other than" clause, holding that the "other than" clause precludes strip down;[153] however, the overruled decisions still are instructive. In those overruled decisions the circuit courts held that strip down did not modify a mortgage holder's rights with respect to its secured claim, because under § 506(a) the secured claim was limited to the value of the home. Thus, those courts held strip down modified the mortgage holder's rights with respect to its unsecured claim—the excess of the debt over the value of the home—and such a modification was not, by the terms of § 1322(b)(2), subject to the limitation of the "other than" clause.[154]

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the debtor's home, which was worth $45,000 and subject to a first mortgage of about $35,000. *Id.* at 469. The value of the home to which the second mortgage holder was entitled to look was therefore only about $10,000, leaving the second mortgage holder with about a $10,000 § 506(a) secured claim, and about a $4,500 § 506(a) unsecured claim. *Id.* at 469–70. The bankruptcy court confirmed a Chapter 13 plan under which the second mortgage holder's $10,000 secured claim would be paid in full with interest during the course of the plan, and under which the second mortgage holder would receive the same ten percent payment on its unsecured claim that other unsecured claim holders would receive. *Id.* at 473. Most courts have accepted the *Eubanks* approach under which, at least in theory, an undersecured short-term mortgage falling within § 1322(c)(2)'s ambit can be stripped down, with the stripped down amount then being paid in full with interest during the plan, per § 1325(a)(5). *See* Am. Gen. Fin., Inc. v. Paschen (*In re* Paschen), 296 F.3d 1203 (11th Cir. 2002) (affirming the district court's affirmance of the bankruptcy court's confirmation of a plan calling for a payment of $6,000 home equity loan holder's secured claim "at twelve percent interest over a sixty-month period"). Of course, payment of $10,000 or $6,000 with interest over the three to five years of a plan may often be feasible, but a stripped down first mortgage would usually be too large for a debtor to feasibly, and in good faith, pay in full with interest over no more than five years.

151. *See* Hougland v. Lomas & Nettleton Co. (*In re* Hougland), 886 F.2d 1182 (9th Cir. 1989); Bellamy v. Fed. Home Loan Mortg. Corp. (*In re* Bellamy), 962 F.2d 176 (2d Cir. 1992); Eastland Mortgage Co. v. Hart (*In re* Hart), 923 F.2d 1410 (10th Cir. 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123 (3d Cir. 1990); Scarberry & Reddie, *supra* note 84, at 432–48, 464–76. All four of these circuit court decisions were overruled by the Supreme Court in *Nobelman v. Am. Sav. Bank*, 508 U.S. 324 (1993).

152. 508 U.S. at 324.

153. *Id.* at 330–31.

154. Note that Chapter 13 plans often pay little or nothing to holders of unsecured claims on account of such claims. Available statistics indicate that little is paid to holders of unsecured claims in the typical Chapter 13 case; in fact, the median amount paid to holders of unsecured claims in Chapter 13 cases seems to be zero dollars. *See* Scott F. Norberg, *Chapter 13 Project: Little Paid to Unsecureds*, 26 AM. BANKR. INST. J. 1, 54 (2007). Note also that nonrecourse mortgage holders

The courts that allowed strip down under this theory did not, in general, require that the stripped down secured claim be paid off over the three-to-five-year term of the Chapter 13 plan. Instead, if such a court reached the issue it typically would use what this article calls the *Bellamy* approach.[155] Thus the court would permit the debtor to use § 1322(b)(5), which allows a debtor to deal in a special way with a long-term debt—that is, a debt with a contractual amortization schedule calling for it to be paid off over a period extending past the end of the debtor's three-to-five-year Chapter 13 plan.[156]

The Supreme Court did not deal specifically with § 1322(b)(5) in *Nobelman*, but the Supreme Court's approach in *Nobelman* should at least undermine the *Bellamy* approach—the interpretation of § 1322(b)(5) in the overruled decisions under which § 1322(b)(5) could be used in conjunction with strip down. The Supreme Court's decision in *Nobelman* did not, however, in any way undermine two correct conclusions reached by the courts that applied the *Bellamy* approach: use of § 1322(b)(5) to allow payments to be made beyond the life of the plan precludes (1) any change in the contractual interest rate, and (2) any change in the contractually required amount of the monthly mortgage payment.[157]

It should also be noted that only one of the four overruled circuit court opinions—the Second Circuit's in *Bellamy v. Federal Home Loan Mortgage Corp.*[158]—directly addressed the use of § 1322(b)(5).[159] As discussed above, the court in *Bellamy* held that the stripped down mortgage did not need to be

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apparently do not have allowable unsecured claims in Chapter 13 or in any kind of bankruptcy case other than a Chapter 11 case for purposes of distribution. *See supra* note 93. Thus, a mortgage holder often would receive little or nothing on account of any unsecured claim.

155. *See supra* text accompanying notes 121–25.

156. *See infra* text accompanying notes 167–74; *see, e.g.*, *In re Bellamy*, 962 F.2d at 176; Franklin v. Union Mortgage Co. (*In re* Franklin), 126 B.R. 702 (Bankr. N.D. Miss. 1991), *abrogated by Nobelman*, 508 U.S. at 324; *In re* Honett, 116 B.R. 495 (Bankr. E.D. Tex. 1990), *abrogated by Nobelman*, 508 U.S. at 324; *In re* Hayes, 111 B.R. 924 (Bankr. D. Or. 1990).

157. *See supra* text accompanying notes 121–25.

158. *In re Bellamy*, 962 F.2d at 176.

159. *Id.* at 184–85. The Third Circuit's decision in *Wilson* did not directly address this issue; but in a later decision—before the Supreme Court's *Nobelman* decision—the Third Circuit seemed to endorse use of § 1322(b)(5) to maintain the full monthly payments on a stripped down home mortgage until the stripped down principal would be paid off at the contractual interest rate. *See* Sapos v. Provident Inst. of Sav. in the Town of Boston, 967 F.2d 918, 928 (3d Cir. 1992), *overruled by Nobelman*, 508 U.S. at 324. Note, however, that the court in *Sapos* also stated that "[s]uch a plan could not be approved over the objections of the creditor unless it met the requirements set out in 11 U.S.C. § 1325. We express no view regarding the acceptability of Sapos' plan under section 1325." *Id.* at 928. The court thus apparently did not consider whether § 1325(a)(5)(B) might entitle the mortgage holder to payment of the secured claim during the life of the plan.

paid off over the life of the plan;[160] instead, the debtor could make payments over whatever period of time was required for the principal balance of the stripped down mortgage to be paid off by the making of the regular contractually-required monthly payments at the contractual interest rate.[161] In its reasoning, the court noted that if a debtor's plan were to reduce the monthly mortgage payment or change the contractual interest rate, then § 1322(b)(5) could not be used, and thus the stripped down mortgage would have to be paid off during the three-to-five-year life of the plan.[162] Under the facts of *Bellamy*, that would have required more than a doubling of the debtor's monthly mortgage payment.[163] The court recognized that such a plan would not have been feasible and that, in any event, the "other than" clause would prohibit any modification of the monthly payment or interest rate.[164]

The Ninth Circuit, the first of the circuits to hold (pre-*Nobelman*) that strip down did not violate the § 1322(b)(2) "other than" clause,[165] has now held that a plan cannot both strip down a secured claim—one not protected by the "other than" clause and thus still potentially subject to strip down even after *Nobelman*—and then use § 1322(b)(5) to pay off the stripped down claim over more than the three-to-five-year term of the plan.[166]

To understand the way in which § 1322(b)(5) normally is used, outside the context of an attempted home mortgage strip down, consider a debtor who has a thirty-year home mortgage, secured only by the debtor's principal residence. Suppose three years after obtaining the mortgage, the debtor defaults by failing to make one or more mortgage payments and then files a Chapter 13 petition. The original amortization schedule for the mortgage would provide for the final payment to be made twenty-seven years after the petition filing date and thus of course after—long after—any three-to-five-year Chapter 13 plan would be concluded; thus the mortgage debt is the kind of long-term debt with respect to which the debtor's plan may invoke § 1322(b)(5).[167] As noted above, few debtors could pay off such a home mortgage over the three-to-five-year term of the plan, as would be required

160. *In re Bellamy*, 962 F.2d at 184–85.

161. *Id.*

162. *Id.*

163. *See* Scarberry & Reddie, *supra* note 84, at 469 n.325.

164. *In re Bellamy*, 962 F.2d at 184–85.

165. *See supra* note 151.

166. Enewally v. Wash. Mutual Bank (*In re* Enewally), 368 F.3d 1165 (9th Cir. 2004), *cert. denied*, 534 U.S. 1021 (2004).

167. Note that under its express language, § 1322(b)(5) may be used only where "the last payment is due after the date on which the final payment under the plan is due." 11 U.S.C. § 1322(b)(5) (2006).

if the plan provided for payment of the secured claim under § 1325(a)(5).[168] The debtor's plan instead would use § 1322(b)(5) to provide for "maintenance of payments" on the mortgage "while the case is pending."[169] The debtor would make the regular contractually-required monthly mortgage payments during the three to five years of the plan. The debtor then would continue to be contractually required to make payments even after completion of the plan, because § 1328(a)(1) would exclude the mortgage debt from the discharge of debts that the debtor would receive on completion of the plan.[170]

Crucially, § 1322(b)(5) would allow the plan to provide for the defaults under the mortgage to be cured "within a reasonable time,"[171] often determined by courts to be the entire term of the Chapter 13 plan.[172] Thus the debtor would pay the regular mortgage payment each month during the plan plus something extra so that the mortgage arrearages would be paid off by the time the plan would be completed. The debtor would exit Chapter 13 with a mortgage no longer in default and would have saved the home from foreclosure.

Note that § 1322(b)(5) begins with the phrase "notwithstanding paragraph (2) of this subsection."[173] Such a debtor probably would not have the right, outside Chapter 13, to cure the mortgage defaults over such an extended period, or to cure them at all. In fact, by the time the debtor filed the Chapter 13 petition, the mortgage debt likely would have been accelerated by the mortgage holder—under a standard provision in the mortgage allowing the mortgage holder to declare the entire mortgage balance immediately due and payable because of the uncured default—and it might have been too late, under the mortgage's terms and under non-bankruptcy law, for the debtor to cure the defaults and reinstate the original amortization schedule.[174] Thus, under non-bankruptcy law, the debtor could

168. *See supra* text accompanying notes 128–37, 159–64.

169. § 1322(b)(5).

170. Section 1328(a)(1) provides that debts "provided for under section 1322(b)(5)" will be excepted from the discharge of debts granted by the court on completion of the plan. Note that this is merely an exception of a debt from the discharge; it does not create personal liability where none previously existed. Thus, if the mortgage were nonrecourse by agreement or under antideficiency statutes, the debtor would not be personally liable on the mortgage debt after completing the plan.

171. § 1322(b)(5).

172. *See, e.g.*, *In re* Hence, 358 B.R. 294 (Bankr. S.D. Tex. 2006), *aff'd*, Hence v. Indian Cave Park P'ship, No. 07-0098, 2007 WL 1176787 (S.D. Tex. Apr. 20, 2007), *aff'd*, 255 F. App'x 28 (5th Cir. 2007).

173. § 1322(b)(5).

174. *See, e.g.*, Di Pierro v. Taddeo (*In re* Taddeo), 685 F.2d 24 (2d Cir. 1982) (holding that debtor

have kept the home only by immediately paying the entire balance of the mortgage in a lump sum. A Chapter 13 plan providing for payment of the regular monthly mortgage payment each month and for curing of the defaults over a period of years, and thus for reinstatement of the original amortization schedule, would modify the mortgage holder's right to immediate payment of the entire principal balance of the mortgage or right to insist on a shorter cure period. That would seem to violate the "other than" clause in § 1322(b)(2). But because § 1322(b)(5) may be used "notwithstanding paragraph (2) of this subsection," there is no such violation.

As noted above, the courts that held that home mortgages could be stripped down despite § 1322(b)(2)'s "other than" clause often went on to allow debtors to use § 1322(b)(5) to deal with the stripped down mortgages so that the plan would not have to provide for payment of the entire amount of the stripped down mortgage with interest during the three-to-five-year life of the plan.[175] But if, as those courts thought, the term "secured claim" as used in § 1322(b)(2)'s "other than" clause meant only the secured claim as defined under § 506(a)—and thus protected the rights of the holder of the secured claim only up to the amount of the value of the collateral—what amount would have had to be paid each month under § 1322(b)(5)'s requirement of "maintenance of payments" on the stripped down "secured claim"? The mortgage documents would not have specified any payment amount for a stripped down secured claim. Could payments be "maint[ained]" by payment of a reduced monthly amount: perhaps the contractually required mortgage payment reduced in proportion to the amount of the mortgage lien that was stripped away? That would preserve the maturity date of the mortgage so that the stripped down mortgage would be paid off on the same date that the original mortgage would have been paid off under its original terms. Such an approach would have allowed the debtor to make smaller monthly payments and would have assisted the financially distressed debtor in keeping the home. Or would "maintenance of payments" with respect to the stripped down secured claim have required payment of the full originally required monthly mortgage payment?

Courts almost uniformly refused to allow debtors to reduce the monthly payment; instead, they required debtors to make monthly payments in the

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could cure defaults and deaccelerate mortgage that had been accelerated prior to Chapter 13 filing). The Bankruptcy Code was amended in 1994 to clarify the point at which a foreclosure process will have gone too far for a Chapter 13 debtor to cure defaults and reinstate the original payment schedule; § 1322(c)(1) was added, providing that a default could be cured "until such residence is sold at a foreclosure sale that [has been] conducted in accordance with applicable nonbankruptcy law." Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301, 108 Stat. 4106, 4131 (codified as amended at 11 U.S.C. § 1322(c)(1) (2006)).

175. *See supra* text accompanying notes 156–64.

originally required amount in order to satisfy the requirement for "maintenance of payments."[176] But that sensible result seemed to suggest that the "secured claim" on which payments had to be maintained under § 1322(b)(5) was the entire mortgage debt, rather than just the allowed secured claim as defined under § 506(a). That in turn created tension, at least, with the view of those same courts that only the secured claim as defined under § 506(a) was protected by § 1322(b)(2)'s "other than" clause.

The courts did hold that any provision of the plan reducing the amount of the monthly mortgage payments would violate § 1322(b)(2)'s "other than" clause in cases where it applied.[177] Apparently the courts thought that the mortgage holder's rights to the stripped down secured claim included the right to full payment of the monthly mortgage amount. In fact, the courts held that the "other than" clause prohibited a debtor's plan from changing the interest rate, required monthly payment, or any other term of the

176. *See supra* notes 162–64 and accompanying text; *see, e.g.*, Bellamy v. Fed. Home Loan Mortgage Corp. (*In re* Bellamy), 962 F.2d 176 (2d Cir. 1992), *overruled by* Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993); Franklin v. Union Mortgage Co. (*In re* Franklin), 126 B.R. 702, 712 (Bankr. N.D. Miss. 1991) ("In this context, the Chapter 13 plan may not modify the regular monthly installment payments as required by the mortgage instrument, nor may the plan modify the contractual interest rate."), *abrogated by Nobelman*, 508 U.S. 324; *In re* Honett, 116 B.R. 495, 498 (Bankr. E.D. Tex. 1990) ("[A]ll relevant payment terms of the mortgage instrument are to remain intact save the necessary shortening of the maturity date."), *abrogated by Nobelman*, 508 U.S. 324; *In re* Hyden, 112 B.R. 431 (Bankr. W.D. Okla. 1990) (requiring that monthly payments and interest rates be left unchanged); *In re* Hayes, 111 B.R. 924, 928 (Bankr. D. Or. 1990) (permitting no "change in the interest rate, amount of installment payment or curing of defaults"); *In re* Demoff, 109 B.R. 902, 920 (Bankr. N.D. Ind. 1989) ("The result reached by this Court will not otherwise 'modify' or alter the terms and conditions of the creditor's mortgage instruments. The size and timing of the installment payments will not be altered and thus the scheduled amount of the monthly contract payment will remain the same, as will the interest rate. Obviously the amortization schedule will be changed in that the principal amount of the secured mortgage debt will be reduced to the extent the claim is voided, thus changing the amount of the contract payment allocable to principal and interest."); *In re* Ross, 107 B.R. 759, 762–63 (Bankr. W.D. Okla. 1989) ("To the extent Local's claim is a secured claim, debtors' plan may not modify the rights of the creditor. Thus, the amount of the payments required to be made under the governing documents may not be changed, although the result may be that the obligation secured by the mortgage may be paid in full much more rapidly. Neither, of course, may the interest rate or other provisions of the documents be altered. Such prohibition, however, relates only to the extent that the claim is determined to be a secured claim. Debtors are not prohibited, by § 1322(b)(2) or otherwise, from proposing a plan which would modify Local's rights as to the unsecured portion of its claim."). Only one case has been found in which the court may have been willing to permit payment of something less than the contractually required monthly payment. *See In re* Dequinzio, 110 B.R. 628, 629 (Bankr. D.R.I. 1990) (implying that smaller payments could be made by stating that the debtors were free to modify their Chapter 13 payment to the secured creditor at least to the extent of the unsecured portion).

177. *See* cases cited *supra* note 176.

mortgage, except for the number of required payments.[178] Such changes, even if not prohibited by the "other than" clause, in any event would have triggered the requirement that the stripped down secured claim be paid off with interest over the term of the plan,[179] a requirement that would be "most likely an impossible proposition."[180] With the principal balance of their mortgage reduced due to strip down, but with the monthly payment kept the same, debtors would pay off the principal sooner—often years sooner—than under the original amortization schedule, and thus would end up making fewer monthly payments.[181]

The difficulty, of course, was that the mortgage holder had no separate rights under non-bankruptcy law with respect to the part of the mortgage debt that § 506(a) might classify as a secured claim and with respect to the part that § 506(a) might classify as an unsecured claim.[182] How could the plan leave unmodified the mortgage holder's rights with respect to only the secured claim as defined in § 506(a), when under non-bankruptcy law the mortgage holder did not have a separate set of rights with respect to that portion of its mortgage? And why could the monthly payment not be reduced, but the number of monthly payments could? The courts' approach bordered on the incoherent.[183]

The result of their approach also was rather perverse. The financially distressed debtor would receive no immediate relief in the required amount of payments, but instead would only receive a benefit years in the future, when the mortgage was paid off early, or perhaps somewhat sooner when

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178. *See* cases cited *supra* note 176. Only one case was located in which a court indicated that the interest rate could be changed. *See In re* Neal, 10 B.R. 535 (Bankr. D. Ohio 1981) (stating that an alteration of the contractual interest rate was not a modification of the secured claim).

179. *See, e.g., In re Bellamy*, 962 F.2d at 185.

180. *Id.*

181. *See In re Hayes*, 111 B.R. at 927 ("Since utilizing § 1325(a)(5) to change the monthly payments or the rate of interest would be an impermissible modification, the only remedy left to the debtors is to maintain the regular payments and cure all defaults under § 1322(b)(5). . . . Note that under the *Hougland* ruling, some term of the agreement *must* be changed if the debt is not going to be repaid in full. When the claim is divided into an allowed secured claim and an allowed unsecured claim, the amount to be paid on the secured claim will be less than the debt contemplated by the agreement. There necessarily must be some additional change from the terms of the agreement since following it in all respects would result in payment of the entire debt. If the monthly payment and interest rate remain the same, and if the debtors must cure defaults as provided in § 1322(b)(5), then obviously the maturity date will be shortened.") The attempted strip down in *Nobelman* would have allowed the debtors to pay off their mortgage about twenty years earlier than under the original payment schedule. *See* Scarberry & Reddie, *supra* note 84, at 486.

182. *See* Scarberry & Reddie, *supra* note 84, at 477.

183. One approach might be to treat the strip down as if it were a prepayment of an amount of principal equal to the amount stripped from the principal balance. Such a prepayment ordinarily would not entitle the debtor to reduce his or her monthly payments but would result in the mortgage being paid off more quickly. That approach would be consistent with the approach taken by the courts.

appreciation in the real property market—and quicker amortization of the principal amount of the mortgage than under the original schedule—might allow the debtor to refinance the stripped down mortgage.

In 1992 a fifth circuit—actually *the* Fifth Circuit—spoke to the issue of whether strip down violated § 1322(b)(2)'s "other than" clause.[184] The Fifth Circuit held that it did.[185] That created a circuit split, and the Supreme Court granted certiorari. Not surprisingly, in 1993 the Supreme Court in its decision in *Nobelman v. American Savings Bank*,[186] affirmed the Fifth Circuit and overruled the decisions that had held that strip down did not violate § 1322(b)(2)'s "other than" clause.[187] In a unanimous opinion, the Court held that the protected rights of the mortgage holder as holder of a secured claim are not limited to the mortgage holder's rights with respect to the part of its claim treated as secured under § 506(a), but rather include the entirety of its rights with respect to the full amount of the mortgage.[188] Those rights include the right to have a lien on the home for the full amount of the mortgage, not just for the value of the home; thus, strip down violates § 1322(b)(2)'s "other than" clause.[189]

Note, however, the relatively limited extra benefit provided to home mortgage holders by the "other than" clause, even as interpreted by the Supreme Court in *Nobelman*. Most of the protection mortgage holders receive does not depend on the "other than" clause.[190]

Even if the "other than" clause does not apply—typically because the collateral for the mortgage is not, or not only, the debtor's principal residence- debtors still generally cannot reduce their mortgage interest rates or the amount of their monthly mortgage payments.[191] It is true that either of those reductions would violate the "other than" clause if it applied, whether as interpreted in *Nobelman* or in the decisions that were overruled in *Nobelman*.[192] But even when the "other than" clause does not apply, either of those reductions would trigger the requirement that the mortgage holder's

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184. *See* Nobleman v. Am. Sav. Bank (*In re* Nobleman), 968 F.2d 483 (5th Cir. 1992), *aff'd*, Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993). The style of the case in the Fifth Circuit included a misspelling of the Nobelmans' name.

185. *Id.*

186. 508 U.S. at 324.

187. *Id.* at 325–27.

188. *Id.* at 328–32.

189. *Id.* at 329.

190. *See supra* text accompanying notes 59–144.

191. *See supra* text accompanying notes 159–64.

192. *See supra* text accompanying notes 164, 188.

secured claim be paid off over no more than five years,[193] which usually would not be possible. Thus, if the "other than" clause does not apply, so that *Nobelman* does not prohibit strip down, and even if the *Bellamy* approach to § 1322(b)(5) is accepted rather than the *Enewally/Rash* approach, debtors who want to strip down their mortgages generally will have to pay their full regular monthly mortgage payments.[194] They also usually will have to pay something extra each month during the plan period to cure their pre-bankruptcy mortgage defaults as required under § 1322(b)(5).[195] They also will be forced to continue to pay interest at the contract rate, though on a reduced principal balance if they succeed in stripping down the mortgage.[196]

Mortgage holders who are not entitled to the protection of the "other than" clause thus are not likely to suffer immediate cash flow loss due to the lack of that protection, even if the debtor manages to strip down the mortgage. Such mortgage holders are likely to continue to receive the contractually-agreed interest rate, at least on the value of their mortgage lien. In addition, debtors who could strip down their mortgages under current law—because, for example, the collateral for the mortgage included more than just the debtor's principal residence—would be a fairly creditworthy group. Note that for such a plan to be feasible under current law—a requirement for confirmation[197]—the debtor must have (1) high enough income to be able to pay off the stripped down mortgage in full with interest over no more than five years, if the *Enewally/Rash* approach is used,[198] or (2) at least high enough income to be able to make the full contractual monthly mortgage payment each month, together with an additional required amount to cure arrearages, if the Second Circuit's *Bellamy* approach is accepted and if the debtor uses § 1322(b)(5) to stretch out the payments beyond five years.[199] Such debtors, as a group, seem likely to be able to make substantial payments, even if ultimately some of them might not complete their Chapter 13 plans. This provides some protection for mortgage holders. Again we see that the extra protection against strip down provided by the "other than" clause may not be as financially valuable as it might seem because, even without it, the home mortgage holder has real and valuable protection.

Debtors who are permitted, at least in theory, to strip down mortgages

193. *See supra* text accompanying notes 159–64.

194. *See supra* text accompanying notes 111–25, 162.

195. *See* 11 U.S.C. § 1322(b)(5) (2006); *supra* text accompanying notes 166–75.

196. *See supra* text accompanying notes 176, 178.

197. *See* § 1325(a)(6).

198. *See supra* text accompanying notes 113–19.

199. *See supra* text accompanying notes 121–22, 166–83.

under current law thus certainly seem more likely on average to be able to make substantial payments than the debtors who would be permitted to strip down their home mortgages under the proposed congressional legislation. The legislation is designed to help debtors who cannot afford their current mortgage payments.[200] At least in some versions of the proposed legislation, debtors who can afford to make their current mortgage payments are prohibited from stripping down their mortgages.[201] The population of debtors who can use strip down, at least theoretically, under current law and the population of debtors who could use it under the proposed legislation seem to be opposite, or at least quite different, in terms of creditworthiness.

### *D. Protection Against a Declining Market: Of Compensation, Adequate Protection, Balanced Risk, and Unintended Consequences*

Finally, current law provides some protection for mortgage holders against market declines, including expected market declines[202] in a declining market. A debtor in default on an undersecured home mortgage who files a Chapter 7 petition is unlikely to be able to stop foreclosure more than briefly.[203] Thus, the mortgage holder will be able to foreclose in the short

200. *See infra* text accompanying notes 234–310 (explaining provisions of current proposals designed to (1) encourage mortgage holders or servicers to offer consensual modifications that would lower mortgage payments to affordable level, and (2) limit or prohibit mortgage modification in bankruptcy by debtors who did not take advantage of such offers); *see, e.g.*, 155 CONG. REC. S4915–17 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin) (supporting an amendment that would have allowed strip down of home mortgages, and emphasizing the need to provide relief for homeowners who cannot afford their contractual mortgage payments); *The Looming Foreclosure Crisis Hearing*, *supra* note 7, at 1–3 (statement of Sen. Durbin) (supporting a bill in the 110th Congress that would have allowed home mortgage strip down in Chapter 13).

201. The current proposals are unclear on this point. The good faith requirements in the current proposals do not seem to require that the mortgage payment be highly unaffordable relative to the debtor's income, but only that the debtor not be able to pay all the debtor's debts without difficulty, including large credit card debts the debtor may have built up. *See infra* text accompanying note 316. Under Senator Durbin's proposal, a mortgage holder or servicer could in theory limit a debtor's use of Chapter 13 to modify a home mortgage by making an offer to modify the mortgage payments to what the proposal treats as an affordable level. *See infra* text accompanying notes 238–310. If the payments already are affordable, it would seem that an offer of a very minor modification could serve to limit the debtor's use of Chapter 13 to modify the home mortgage. Some of the proposals in the previous Congress had stronger limits. *See* Scarberry, *supra* note 4.

202. *See supra* note 1 and accompanying text.

203. The § 362(a) automatic stay initially will prevent the mortgage holder from foreclosing. *See* 11 U.S.C. § 362(a)(5) (2006). But, under § 362(d)(2), the mortgage holder is entitled to relief from the automatic stay—and thus entitled to a bankruptcy court order permitting it to use non-bankruptcy foreclosure rights—if *both* (1) the debtor lacks equity in the property, *and* (2) the property is "not

term and obtain whatever value may be available. The mortgage holder will not be required to wait while the market declines and while even the value available in foreclosure diminishes.[204]

Suppose the debtor instead files a Chapter 13 petition, in an attempt to keep the home. Suppose also that the value of the home is less than the mortgage debt, but that, for one or more of the reasons discussed above, the debtor is unable to strip down the mortgage. The debtor will have to pay the full monthly mortgage payments going forward and also something each month toward the mortgage arrearages.[205] These payments will help to compensate for the likelihood that the foreclosure value of the home will decline in the declining market. The debtor's willingness to make such payments may also indicate that the debtor does not believe the value of the home will fall too steeply—or perhaps that the debtor believes the home's value is likely to increase over the longer term—and may also indicate that the debtor is committed to paying off the mortgage despite the likelihood in a declining market that the home's value will decrease over the shorter term. Thus, there may be a kind of selection process in which the risk to the mortgage holder from a market decline is mitigated. Of course, should the declining market end and the value of the home begin to increase, the mortgage holder will benefit both from a higher likely recovery in foreclosure if the debtor's plan fails and from an increased incentive for the debtor to make all of the payments in order to keep the home. Most importantly, that increased incentive would be likely to result in the mortgage holder obtaining the full value called for by the mortgage agreement. All of these factors help to balance the risk that the home's value will decline further, that the debtor's plan will fail, and that the mortgage holder's recovery in foreclosure will be less than it would have been had the debtor not delayed foreclosure by use of Chapter 13.

By contrast, under the proposed congressional legislation, a Chapter 13 debtor would not have to make the full contractually-required monthly mortgage payments.[206] Instead, the debtor could make lower payments due to strip down of the mortgage's principal balance, adjustment in the

necessary to an effective reorganization." § 362(d)(2). If the mortgage is undersecured, the debtor will have no equity in the home. A Chapter 7 case is not a reorganization, and thus, the property cannot be "necessary to an effective reorganization." As a result, both requirements will be met, and the mortgage holder will be entitled to relief from the automatic stay. If the debtor is in default and cannot cure the default in whatever manner may be required by non-bankruptcy law, the mortgage holder will be entitled to foreclose once it obtains relief from the automatic stay.

204. The value available in foreclosure is unlikely to drop dollar-for-dollar with a drop in the fair market value of a home, because distress sales are at a discount to fair market values. If a foreclosure sale would bring seventy percent of the fair market value of a property, then the value available in foreclosure would drop seventy cents for each dollar drop in market value.

205. *See supra* text accompanying notes 121–22, 166–83.

206. *See supra* note 10 and accompanying text.

mortgage's interest rate, and, quite likely, a lengthening of the mortgage's term, resulting in a lower required monthly payment due to the longer amortization period.[207] The mortgage holder, thus, would not receive the payments required under current law that help to compensate for the risk of a decline in the home's value, and the benefit of the selection process noted in the prior paragraph would be eliminated or much reduced. Further, the mortgage holder's potential benefit from a recovery in the home's value would be greatly reduced: the debtor's incentive to make payments still would be increased by a recovery in the home's value—perhaps increased even more than under current law because the appreciation would accrue to the debtor—but that incentive would not result in the mortgage holder obtaining the benefit of its original contractual rights. Instead, with exceptions that are so limited as to be illusory or easily side-stepped, the proposed legislation would give the benefit of future appreciation to the debtor by fixing the amount of the mortgage at the low stripped down amount.[208]

In effect, the debtor would be given a free option on the future appreciation of the home. If the home appreciates, the debtor still will owe only the stripped down amount of the mortgage and will own the resulting equity. If the home declines in value, the debtor can convert the Chapter 13 case to Chapter 7[209] and obtain a discharge of any personal liability on the mortgage[210]—or perhaps simply dismiss the Chapter 13 case[211]—and then walk away from the home.

There is an additional protection against a declining market that is provided, at least in theory, by current law.[212] Mortgage holders, like other holders of secured claims, are entitled to "adequate protection" of the value of their liens against loss caused by the delay in foreclosure imposed by the automatic stay.[213] It would seem that in a declining market the Chapter 13 debtor would be required in some way to prevent a decline in the foreclosure

207. *See infra* text accompanying notes 228–32.

208. *See infra* text accompanying notes 321–29.

209. A Chapter 13 debtor has a non-waivable right to convert the Chapter 13 case to Chapter 7 at any time. *See* 11 U.S.C. § 1307(a) (2006).

210. *See* § 727(a)–(b).

211. If the mortgage debt is nonrecourse, the debtor will have no need for a discharge of personal liability, because there will be no personal liability for the mortgage debt. In such a case, if the debtor does not have other debts that the debtor wishes to discharge, a simple dismissal of the Chapter 13 case will suffice.

212. *See* § 362(d)(1).

213. *See id.*

value of the home or to compensate for any such decline, but there seems to be no practical way for the debtor to do either. If, in the absence of action by the debtor, a decline of ten percent in market prices would reduce the foreclosure value of a home from $300,000 to $270,000, how could the debtor prevent such a decline other than by making costly improvements to the home—improvements that would probably have to cost much more than $30,000 in order to have a positive effect of $30,000 on the foreclosure value? It would be less expensive for the debtor to pay the mortgage holder $30,000 to compensate for the decline in value or to give the mortgage holder a lien on $30,000 set aside in an account. But where would the debtor find $30,000 to provide compensation? Very few debtors in bankruptcy could come up with the required funds.

The impracticability of requiring debtors to provide such adequate protection suggests that Congress would not have intended to create such a requirement. Thus, courts generally have held that no additional adequate protection is required in a Chapter 13 case beyond the debtor's making of the payments required by the plan.[214] This renders particularly hollow the assurance given in the section-by-section summary of Senator Durbin's home mortgage strip down bill in the last Congress, that, "[l]ike any secured creditor, the mortgage holder would be entitled to adequate protection of its property interest during the Chapter 13 case."[215]

With respect to claims secured by personal property—which often depreciates in value rapidly and predictably and which usually is purchased on shorter term credit—the 2005 amendments to the Code specifically added the requirement that plan payments be sufficient to provide adequate protection to the secured claim holder during the plan.[216] Congress added no such requirement for claims secured by real property and, thus, likely did not intend for courts to require debtors to provide any particular form of adequate protection of a mortgagee's lien in Chapter 13. Nevertheless, the impracticability of providing real adequate protection to home mortgage holders against a declining market counsels against reduction of the other forms of protection given to home mortgage holders.

214. *See, e.g.*, *In re* Perez, 339 B.R. 385, 401 n.18, 401–02 (Bank. S.D. Tex. 2006); *In re* Smith, 104 B.R. 695 (Bankr. E.D. Pa. 1989); *cf.* Americredit Fin. Servs., Inc. v. Nichols (*In re* Nichols), 440 F.3d 850, 857–58 n.6, 861 (6th Cir. 2006) (failing to apply 2005 amendments to Bankruptcy Code because relevant proceedings below occurred before effective date of amendments) (confusing concept of regulatory taking with concept of adequate protection and allowing modification of Chapter 13 plan because the modification would not render the lien totally valueless, even though the modification would result in the collateral—a truck—depreciating faster than principal would be amortized, thus rendering the creditor undersecured); *see also infra* note 216.

215. SENATE JUDICIARY COMMITTEE, *supra* note 137, at 1.

216. § 1325(a)(5)(B)(iii)(II). Thus, the payments would need to be sufficient to pay not only interest but also sufficient principal to cover the expected depreciation in value of the personal property collateral—such as an automobile—due to wear and tear and passage of time.

In particular, under current law there is a balanced risk approach that might be thought to provide adequate protection against general market declines.[217] As we have seen, a home mortgage holder may be harmed by a market decline, but the mortgage holder also stands to gain from a rising market.[218] Elimination of the mortgage holder's ability to gain from a rising market, with a free option on future appreciation being given to the debtor, very substantially upsets the balance of the current approach. Whether the result would violate the Fifth Amendment's Takings Clause by taking the mortgage holder's property without providing "just compensation" is beyond the scope of this Article.[219] But the Bankruptcy Code's provisions for adequate protection of property interests, including liens, flow from Fifth Amendment Takings Clause concerns.[220] The adequate protection provisions "reconcile" the needs of debtors with "the secured creditor's entitlement to constitutional protection of its bargained-for property interests."[221] Should Congress upset the current balanced risk approach without explicitly addressing the need for adequate protection, Congress would invite the Supreme Court to give teeth, in the Chapter 13 context, to the provisions of the Code requiring adequate protection, in order to avoid

217. *See supra* notes 202–10 and accompanying text.

218. *See supra* notes 202–10 and accompanying text.

219. *See* Zinman & Petrovski, *supra* note 41, at 149–53 (discussing potential takings issues with regard to proposed legislation).

220. *See* H.R. REP. NO. 95-595, at 338–39 (1977). The requirements of adequate protection are based both on the constitutional right of secured creditors to protection of the value of their liens and on a policy judgment that secured creditors should receive, at least to some extent, the benefits for which they bargained:

> The concept is derived from the fifth amendment [sic] protection of property interests. It is not intended to be confined strictly to the constitutional protection required, however. [Section 361], and the concept of adequate protection, is based as much on policy grounds as on constitutional grounds. Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.

*Id.* at 339 (citations omitted); *see also* United Sav. Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 793 F.2d 1380 (5th Cir. 1986), *aff'd*, 484 U.S. 365 (1988) (discussing this portion of the House Report).

221. Lend Lease v. Briggs Transp. Co. (*In re* Briggs Transp. Co.), 780 F.2d 1339, 1342 (8th Cir. 1985). *Accord* Chrysler Credit Corp. v. Ruggiere (*In re* George Ruggiere Chrysler-Plymouth, Inc.), 727 F.2d 1017, 1019 (11th Cir. 1984) (noting that requirement of adequate protection of cash collateral resolves the tension between the debtor's need to use cash collateral and the secured creditor's right under the Fifth Amendment's Takings Clause to have its lien protected).

the difficult constitutional issues under the Fifth Amendment.[222] The adequate protection measures the Court might determine to be statutorily required—such as setting aside $30,000 in the example above—could make Chapter 13 much harder for the typical debtor to use to save his or her home. The unintended consequences of upsetting the current balanced risk approach could be quite substantial.

## III. THE SEVERE EFFECT OF THE PROPOSED LEGISLATION ON THE RIGHTS OF HOME MORTGAGE HOLDERS—A SEVERE EFFECT THAT WOULD CAUSE HOME MORTGAGE HOLDERS TO BE TREATED VERY UNFAVORABLY IN COMPARISON TO OTHER SECURED CREDITORS

It is worth considering the details of the proposed legislation to see how severely it would affect the protections available to home mortgage holders under current law, and to see whether the proposed legislation would treat home mortgage holders unfavorably as compared to other secured creditors.[223] The House of Representatives passed its version of the legislation, House Bill 1106, on March 5, 2009.[224] The Senate has, as of yet, taken no action on House Bill 1106. The version of the legislation that home mortgage strip down proponents in the Senate most recently attempted to pass is contained in Senator Richard J. Durbin's proposed amendment (the Durbin Amendment) to Senate Bill 896.[225] The Durbin Amendment was defeated on April 30, 2009 by a vote of forty-five in favor to fifty-one opposed,[226] but press reports suggest that Democratic congressional leaders nevertheless are preparing to try to move forward in the near future on strip down legislation.[227]

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222. For a recent application of the constitutional avoidance canon of statutory construction in the bankruptcy context, see *In re* Clemente, 409 B.R. 288 (Bankr. D.N.J. 2009) (avoiding interpretation of Code that would require court to consider whether Code subjected individual, who was a Chapter 11 debtor, to involuntary servitude contrary to the Thirteenth Amendment). For a suggestion that enactment of the legislative proposals might similarly lead to the Supreme Court requiring that interest rates paid on secured claims in Chapter 13 be much higher than presently required, making Chapter 13 much less useful for debtors, see Zinman & Petrovski, *supra* note 41, at 158–60.

223. Information with regard to past legislative proposals—as of December 13, 2007—is available in a chart prepared by the author. *See* Scarberry, *supra* note 4. The text of this Article focuses on House Bill 1106, as passed by the House of Representatives on March 5, 2009, and on Senator Durbin's proposed amendment to Senate Bill 896, which was rejected by the Senate on April 30, 2009.

224. *See supra* note 4.

225. *See* Durbin Amendment, *supra* note 4.

226. *See* 155 CONG. REC. S4937–38 (daily ed. Apr. 30, 2009); *supra* note 22 and accompanying text.

227. *See* Jessica Holzer, *Barney Frank Threatens to Revive Mortgage Bankruptcy Plan*, WALL ST. J., Sept. 9, 2009, http://online.wsj.com/article/SB125251560012096255.html; Theo Francis, *Washington Revives the Mortgage Cramdown*, BUS. WK., Oct. 8, 2009,

## A. *Treatment of Home Mortgage Holders Under the Proposed Legislation*

### 1. General Provisions: Strip Down, Stretch Out, and Interest Rate Modification

Both House Bill 1106, as passed by the House, and the language of the failed Durbin Amendment to Senate Bill 896 would enact a new § 1322(b)(11) that would allow strip down and other kinds of modification of some home mortgages by creating an exception to the "other than" clause of § 1322(b)(2), and by allowing the modified mortgage to be paid off over a time much longer than the three to five years of the plan.[228] The new

http://www.businessweek.com/magazine/content/09_42/b4151052063508.htm.

228. House Bill 1106 would enact the "Helping Families Save Their Homes Act of 2009." After the Durbin Amendment failed, Senate Bill 896—as amended in various other ways—passed the Senate and House, was signed by the President on May 20, 2009, and became Public Law 111-22. Curiously, Division A of Public Law 111-22 carries a short title, the "Helping Families Save Their Homes Act of 2009," identical to the title of the Act that would be enacted by House Bill 1106. Section 103 of House Bill 1106 and § 503 of the Durbin Amendment each would amend Bankruptcy Code § 1322 similarly by adding new subsections (b)(11), (g), and (h). *See* H.R. 1106, 111th Cong. § 103 (2009); Durbin Amendment, *supra* note 4, § 503, at S4981. New subsection (b)(11) would specify how a mortgage could be modified; it would allow strip down of the mortgage, adjustment of the mortgage interest rate, and payoff of the stripped down mortgage over a lengthy period—as noted below in this footnote. Section 503 of the Durbin Amendment would also add a new subsection (i) to § 1322 providing options to the debtor depending on the debtor's income level, a provision not paralleled in House Bill 1106. *See id.* Both § 103 of House Bill 1106 and § 503 of the Durbin Amendment would amend Bankruptcy Code § 1322 by providing—in a new subsection (i) under House Bill 1106 and a new subsection (j) under the Durbin Amendment—that homes would be valued at their fair market value for purposes of strip down, with disputes to be resolved using FHA appraisal rules. H.R. 1106, § 103; Durbin Amendment, *supra* note 4, § 503, at S4981. Finally, § 503 of the Durbin Amendment would add a new § 1322(k) prohibiting use of the home as collateral for additional loans during the Chapter 13 case if the mortgage holder's rights were modified under the new § 1322(b)(11). *See* Durbin Amendment, *supra* note 4, § 503, at S4981.

The new § 1322(b)(11) would explicitly provide an exception to the § 1322(b)(2) "other than" clause to allow Chapter 13 plans, in various ways, to modify mortgages on debtors' principal residences that were originated before the effective date of the section under House Bill 1106, or before January 1, 2009 under the Durbin Amendment. H.R. 1106, § 103; Durbin Amendment, *supra* note 4, § 503, at S4981. Under the proposed § 1322(b)(11), a plan could modify a mortgage by providing for payment of the stripped down § 506(a) secured claim over a term as long as forty years minus the "period for which such loan has been outstanding," or even longer in the unusual event that the remaining term of the mortgage was longer. H.R. 1106, § 103; Durbin Amendment, *supra* note 4, § 503, at S4981. Thus, if a thirty-year mortgage had been outstanding for three years as of the bankruptcy petition filing date, the modified mortgage could be paid off over a period of thirty-seven years, which would extend the mortgage's maturity by ten years.

If the mortgage carried a variable interest rate, House Bill 1106, but not the Durbin Amendment, would allow the plan to modify the mortgage "by prohibiting, reducing, or delaying adjustments to such rate of interest applicable on and after the date of filing of the plan." H.R. 1106,

§ 1322(b)(11) would allow the § 506(a)(1) secured claim to be paid off over a period that could be as long as forty years from the bankruptcy petition filing date.[229]

The interest rate on the modified mortgage would be set at the average rate on prime mortgages plus a risk premium.[230] House Bill 1106, but not the Durbin Amendment, apparently would allow the debtor the option of fixing the interest rate at whatever interest rate the mortgage carried at the time of the bankruptcy petition filing.[231] For purposes of strip down, the home would be valued at its "fair market value," with disputes resolved using Federal Housing Administration (FHA) appraisal rules.[232]

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§ 103. It seems that under House Bill 1106, the plan could lock in whatever interest rate was applicable on the petition filing date, even if it were a low introductory or "teaser" rate. Such an approach could create constitutional problems, because the mortgage holder would not receive payments with a present value equal to the value of its lien, even if all of the payments are made. *Cf.* Zinman & Petrovski, *supra* note 41, at 149–60 (discussing constitutional issues that may arise even if interest rates are set at higher levels than introductory or teaser rates). Under the Durbin Amendment (and apparently as an alternative that the debtor could choose under House Bill 1106 if the debtor chose not to lock in the current interest rate or not to leave a variable interest rate provision unchanged), the plan could modify the interest rate to the average rate offered for prime mortgages—as published by a federal agency—"plus a reasonable premium for risk." Durbin Amendment, *supra* note 4, § 503, at S4981; H.R. 1106, § 103. Thus a fifteen-year mortgage originated in 2007, four years before a 2011 bankruptcy petition filing, with $400,000 still owing, secured by a home determined by the court to be worth $300,000, could be modified to become, in effect, a new thirty-six year $300,000 mortgage payable at a court-determined interest rate over thirty-six years from 2011—thus maturing in 2047 instead of 2022. If interest rates remain the same as they currently are—in late September, 2009—the average prime mortgage rate for a thirty-six year mortgage would be 5.09%. *See* Fed. Fin. Inst. Examination Council, FFIEC Rate Spread Data, http://www.ffiec.gov/ratespread/YieldTableFixed.csv (last visited Nov. 13, 2009) (showing 5.09% average prime mortgage rate for thirty-six year mortgages originated around September 28, 2009). The Durbin Amendment, but not House Bill 1106, would round that 5.09% figure "to the nearest 0.125 percent," thus raising it to 5.125%. In a typical case the court likely would add about 150 to 200 basis points, thus raising the rate to perhaps 6.5% or 7% under either House Bill 1106 or the Durbin Amendment, a rate that then would be in effect for the next thirty-six years, even if the mortgage originally carried an adjustable rate or a higher rate.

229. *See* H.R. 1106, § 103; Durbin Amendment, *supra* note 4, § 503, at S4981. Under other provisions that would be added to the Bankruptcy Code by House Bill 1106 and the Durbin Amendment, there would be limits on the charging of fees related to a mortgage on the debtor's principal residence during the Chapter 13 case. H.R. 1106, § 104; Durbin Amendment, *supra* note 4, § 504, at S4981–82. House Bill 1106, but not the Durbin Amendment, would prohibit any such fees from being charged if the mortgage holder were undersecured. Under both House Bill 1106 and the Durbin Amendment, the debtor's Chapter 13 plan could, in any event, utilize a proposed § 1322(c)(5) to waive any prepayment penalty on the home mortgage. H.R. 1106, § 104; Durbin Amendment, *supra* note 4, § 504, at S4981–82.

230. *See* H.R. 1106, § 103; Durbin Amendment, *supra* note 4, § 503, at S4981.

231. *See* H.R. 1106, § 103.

232. *See id.*; Durbin Amendment, *supra* note 4, § 503, at S4981.

2. Qualification for Use of the Proposed New § 1322(b)(11)

Both House Bill 1106 and the Durbin Amendment include requirements that would have to be met before the new § 1322(b)(11) could be used to modify a mortgage.[233] The requirements under the Durbin Amendment are stricter and rather complex.

Under House Bill 1106, to be entitled to modify his or her mortgage using the new § 1322(b)(11), the debtor would have to have provided the mortgage holder or servicer substantial financial information at least thirty days before filing the bankruptcy petition.[234] The debtor also would have to have "*considered* any qualified loan modification offered" by the mortgage holder or servicer.[235] Those requirements would not apply if the debtor filed the bankruptcy petition thirty days or less before a scheduled foreclosure sale. Finally, only mortgages originated before the effective date of the new § 1322(b)(11) could be modified using its provisions;[236] that is the only substantive limitation on use of the new § 1322(b)(11) under House Bill 1106. Bankruptcy provisions with such temporal limitations tend to be expanded at least if there is no clear rationale for the limitation,[237] and thus

233. H.R. 1106, § 103; Durbin Amendment, *supra* note 4, § 503, at S4981.

234. H.R. 1106, § 103.

235. *Id.* (emphasis added). If House Bill 1106 became law, there would be a short time after its enactment—the first thirty days after its enactment—during which different requirements would apply. *Id.*

The term "qualified loan modification" is defined in the new § 101(43A) that would be added by section 100 of House Bill 1106. H.R. 1106, § 100. A "qualified loan modification" must be made without the charging of any fees to the debtor, must be "made in accordance with" the March 4, 2009 Homeowner Affordability and Stability Plan guidelines; must reduce principal, interest, property taxes, insurance, and any homeowners' association fees or condominium fees (PITIA) to the thirty-one percent of gross income target figure under the guidelines, *see infra* text accompanying note 279; and must "permit[] the debtor to continue to make payments under the modification agreement, notwithstanding the filing of a [bankruptcy] case." H.R. 1106, § 100; March 4 Treasury Guidelines, *supra* note 8.

236. H.R. 1106, § 103.

237. Chapter 12 of the Bankruptcy Code, 11 U.S.C. §§ 1201–1231 (2006), provides a case in point. It was enacted in 1986 with a 1993 sunset date to assist family farmers during a farm crisis. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, §§ 255, 302(f), 100 Stat. 3088, 3105, 3124; *see* JEROME M. STAM & BRUCE L. DIXON, U.S. DEP'T OF AGRIC., FARMER BANKRUPTCIES AND FARM EXITS IN THE UNITED STATES, 1899–2002, at 8 (2004), *available at* http://www.ers.usda.gov/publications/aib788/aib788.pdf. Chapter 12 refused to die when the crisis was over. Chapter 12 was extended in 1993 with a new 1998 sunset date. *Id.* at 31 (providing a legislative history of the Bankruptcy Code's Chapter 12). Six months after it had expired, it was renewed retroactively and then given six additional months of life. *Id.* Subsequently, Chapter 12 would sunset multiple times but be renewed retroactively with extensions provided by eight different statutes before it sunsetted again on January 1, 2004. *Id.* It was extended

this limitation would provide little comfort for lenders considering making mortgage loans after the effective date of the new § 1322(b)(11).

The Durbin Amendment's stricter rules would allow modification of a mortgage holder's rights by use of the new § 1322(b)(11) only if the mortgage was originated prior to January 1, 2009, and only if the "unpaid principal balance . . . is not greater than the maximum loan amount provided for in the Homeowner Affordability and Stability Plan . . . ."[238] Thus mortgages exceeding $729,750 or originated after 2008 would not be subject to modification under the new section.[239] In addition, the new § 1322(b)(11) could only be used if the mortgage was "at least 60 days delinquent,"[240] and, for a first mortgage, only if there was "written notice that a foreclosure may be commenced."[241] The debtor could not use the new § 1322(b)(11) to modify a first mortgage absent certification "that the debtor sought a qualified loan modification offer or a qualified loan refinancing offer . . . and submitted the required information . . . ."[242] The Durbin Amendment does not make clear that the debtor must seek such a modification offer or refinancing offer, *and* provide the information sufficiently in advance of a bankruptcy filing for the person from whom the offer is sought to have a reasonable opportunity to respond, but such a requirement easily could be implied.[243] If the debtor received such a modification offer or refinancing

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retroactively again in 2004, with a new sunset date of July 1, 2005. Family Farmer Bankruptcy Relief Act of 2004, Pub. L. 108-369, § 2, 118 Stat. 1749, 1749. Chapter 12 was then made a permanent part of the Bankruptcy Code, with no sunset date, by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, § 1001, 119 Stat. 23, 185–86.

238. Durbin Amendment, *supra* note 4, § 503, at S4981.

239. *See* March 4 Treasury Guidelines, *supra* note 8.

240. Durbin Amendment, *supra* note 4, § 503, at S4981.

241. *Id.*

242. *See id.*; *id.* § 501, at S4980 (defining "qualified loan modification offer" (proposed § 101(43A(A))), "qualified loan refinancing offer" (proposed § 101(43B)), and "required information" (proposed § 101(43A(G)))).

243. *See infra* text accompanying note 250 (quoting Senator Durbin's statement to the effect that under his amendment the debtor must make the request and provide the needed information at least forty-five days before filing the bankruptcy petition). For an offer to be a "qualified loan modification offer" under the definition in the Durbin Amendment, the offer must be made "not later than 45 days after the date on which the debtor provided to the servicer of such loan, in good faith, all required information." Durbin Amendment, *supra* note 4, § 503, at S4981. Where protection of the mortgage holder's rights depends on whether a "qualified loan modification offer" had been made, it would be reasonable to interpret the statutory scheme to give the mortgage servicer the forty-five days contemplated by the definition of that term. If the Durbin Amendment's version of § 1322(b)(11) were to become effective after the debtor's petition filing date or less than forty-five days prior to the debtor's petition filing date, the Durbin Amendment would provide specifically for the servicer—from whom the debtor seeks a modification or whoever the debtor might seek a refinancing from the mortgage holder—to have at least forty-five days to respond to the debtor's request. *See id.* However, even that provision does not make clear that the servicer or whoever else might be involved must be given forty-five days after receiving the needed information to consider the debtor's request.

offer, and if the debtor's income equaled or exceeded eighty percent of the "area median income," then the debtor could not use the new § 1322(b)(11) to modify the rights of a first mortgage holder,[244] and thus would need to accept the offer in order to obtain help with regard to the mortgage beyond that available under current law. If the debtor's income was less than eighty percent of the area median, and if the modification offer or refinancing offer did not reduce the "monthly housing payment" to twenty-five percent or less of the debtor's "monthly gross income,"[245] then the debtor could use the new § 1322(b)(11)—*though not its strip down provision*[246]—if the resulting monthly payments would be less than the modification offer or refinancing offer.[247] Thus the debtor could reject the offer from the mortgage holder and instead choose to modify the mortgage in Chapter 13 by changing the interest rate or stretching out the payments, but not by stripping down the principal owed on the mortgage.

The key question then becomes whether the mortgage holder's opportunity to make a modification offer—and, under the Durbin Amendment, to make a refinancing offer—provides substantial protection for the mortgage holder. Under House Bill 1106 the debtor merely must *consider* a modification offer.[248] Thus, the debtor may refuse to accept the offer without being disqualified from using the new § 1322(b)(11) to modify the mortgage, unless such refusal amounts to a lack of good faith, which would not likely be the case under House Bill 1106, as noted below.[249] The answer then to this key question is a clear "no" under the provisions of House Bill 1106.

The answer is not so clear under the Durbin Amendment, because the making of such an offer will preclude the debtor from using the new § 1322(b)(11) or at least prevent use of that section to strip down the mortgage. Senator Durbin argued that his amendment would

> literally give to the banks control over whether a family in foreclosure can go into bankruptcy. We say that anybody facing foreclosure—who is delinquent for at least 60 days on a home that

244. Durbin Amendment, *supra* note 4, § 503, at S4981.

245. *See* Durbin Amendment, *supra* note 4, § 503, at S4981 (referring to "monthly housing payment" and "monthly gross income"). Note that "monthly housing payment" seems to be essentially identical to the HAMP "PITIA." *See infra* note 279-80 and accompanying text.

246. *See* Durbin Amendment, *supra* note 4, § 503, at S4981.

247. *Id.*

248. H.R. 1106, 111th Cong. § 103 (2009) (proposed § 1322(h)(1)(A)(iii)).

249. *See infra* text accompanying notes 315–20.

> is valued at no more than $729,000, with a mortgage that was written no later than 2008—has to show up at the bank at least 45 days before they file bankruptcy and present all the economic information, all the financial documents the bank would need for a mortgage—proof of income, indication of net worth. If the bank at that point offers them a renegotiated mortgage—a mortgage which will basically allow them to stay in the home, that reduces the borrower's mortgage debt-to-income ratio to 31 percent, which is the standard the administration is talking about, or offers hope for home refinancing—another program—and the person facing foreclosure does not take that offer, then that same family in foreclosure cannot use the bankruptcy court to rewrite the mortgage. So in other words, the banks ultimately have the key to the courthouse. If they make the offer and it is turned down, that is the end of the story.[250]

Senator Durbin's statement does not appear to be completely accurate. As noted above, the Durbin Amendment does not explicitly require that the debtor request modification or refinancing *and also* provide the needed information forty-five days before filing the bankruptcy petition.[251] Also as noted above, not all debtors would be completely precluded under the Durbin Amendment from using the new § 1322(b)(11) to modify a mortgage where the mortgage holder made such a qualified offer. Though they would be precluded from using it to strip down their mortgages, some debtors still could use it to modify the mortgage's duration and interest rate.[252]

Then there is the question whether it is reasonable to require mortgage holders to make such offers in order to obtain at least some protection against modification of their rights. A full answer to that question would require a complete analysis of loan modifications under the Obama Administration's Homeowner Affordability and Stability Plan,[253] which is beyond the scope of this Article, and of mortgage refinancing under the HOPE for Homeowners program,[254] which also is beyond the scope of this

250. 155 CONG. REC. S4917 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin).

251. *See supra* note 243 and accompanying text.

252. Durbin Amendment, *supra* note 4, § 503, at S4981.

253. *See* U.S. Department of the Treasury, Homeowner Affordability and Stability Plan Fact Sheet, http://www.treasury.gov/initiatives/eesa/homeowner-affordability-plan/FactSheet.pdf (last visited Nov. 13, 2009).

254. *See* 12 U.S.C.A. § 1715z-23 (West 2009) (enacted as section 257 of the National Housing Act by section 1402 of the Housing and Economic Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654, 2800–09, and establishing the Hope for Homeowners Program in the FHA).

> The HOPE for Homeowners Program is a temporary program authorized by section 257 of the National Housing Act, established within the Federal Housing Administration (FHA) of the Department of Housing and Urban Development (HUD) that offers

Article.

Note, however, that the new § 1322(h)(2) under the Durbin Amendment would require only that the debtor seek *either* a qualified loan modification offer *or* a qualified loan refinancing offer.[255] The definition of "qualified loan refinancing offer" in the new § 101(43B)(A) under the Durbin Amendment includes only a "loan offered in accordance with the HOPE for Homeowners program."[256] Such loans may not exceed 90%, or in some cases 96.5%, of the home's appraised value,[257] and they may be sought from lenders other than the existing mortgage holder.[258] For such a refinancing loan to be made, existing mortgagees must agree that their existing mortgages will be considered paid in full and that their mortgage liens will be eliminated,[259] leaving the home encumbered only by the lien securing the new loan.

Thus, it seems that for the mortgage holder itself to make a "qualified loan refinancing offer," the mortgage holder would have to agree to refinance its own mortgage with a mortgage in an amount *less than the appraised value of the property*. The mortgage holder would be left with a

> homeowners and existing loan holders (or servicers acting on their behalf) FHA insurance on refinanced loans for distressed borrowers to support long-term sustainable homeownership by, among other things, allowing homeowners to avoid foreclosure. The HOPE for Homeowners Program is administered by HUD through FHA.

24 C.F.R. § 4001.01 (2009).

255. Durbin Amendment, *supra* note 4, § 503, at S4981.

256. *Id.* § 501, at S4980.

257. 12 U.S.C.A. § 1715z-23(e)(2) ("The principal obligation amount of the refinanced eligible mortgage to be insured shall . . . not exceed 90 percent of the appraised value of the property to which such mortgage relates (or such higher percentage as the Secretary determines, in the discretion of the Secretary)."); 24 C.F.R. § 4001.110(a)(2) (allowing 96.5% ratio in certain cases); Letter from U.S. Department of Housing and Development to All Approved Mortgagees and Appraisers (Oct. 1, 2008) [hereinafter Mortgagee Letter 2008-29], http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/08-29ml.doc (setting forth requirements for lenders to originate HOPE for Homeowners refinance loans); Letter from U.S. Department of Housing and Development to All Approved Mortgagees (Jan. 6, 2009), http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-03ml.doc (setting forth requirements for lenders to originate HOPE for Homeowners refinance loans).

258. *See* 24 C.F.R. § 4001.05(b) ("A mortgagee holding or servicing an eligible mortgage to be refinanced and insured under section 257 of the National Housing Act is not required to be an approved mortgagee as required in paragraph (a) of this section, unless it seeks to be the originator of the refinanced mortgage to be insured by FHA.").

259. *See* 12 U.S.C.A. § 1715z-23(e)(4) ("All holders of outstanding mortgage liens on the property to which the eligible mortgage relates shall agree to accept the proceeds of the insured loan and any payments made under this paragraph, as payment in full of all indebtedness under the eligible mortgage, and all encumbrances related to such eligible mortgage shall be removed."); Mortgagee Letter 2008-29, *supra* note 257.

smaller mortgage than would be created by strip down. Further, the mortgage holder would have to treat the original mortgage as having been paid in full. By contrast, if a mortgage were stripped down in a Chapter 13 case, the mortgage holder, at least one who whose mortgage was not a nonrecourse mortgage,[260] would have an unsecured claim that it could assert in the case, and it might receive some payment on account of that claim.

In addition, it is not clear that the debtor would have to seek the "qualified loan refinancing offer" from the existing mortgage holder, either directly, or through whoever else might be servicing the mortgage on the mortgage holder's behalf. The HOPE for Homeowners program explicitly contemplates that the refinancing loan may be made by a different lender,[261] and the Durbin Amendment seems to contemplate that as well.[262] On the other hand, Senator Durbin's statement[263] suggests that the debtor would have to seek a modification or refinancing from the existing mortgage holder. And the requirement of the proposed § 1322(h)(1) that the debtor have "submitted the required information, as that term is defined in § 101(43A)(G)," may also suggest that; note that the definition of required information refers to requirements under various government programs with regard to information "required to be provided *to the servicer*."[264]

If the debtor is permitted to seek such a refinancing offer from another lender, the other lender might turn the debtor down for any number of reasons, with the result that the debtor would not have received a "qualified loan refinancing offer." Thus, the debtor would be free under the Durbin Amendment to use the new § 1322(b)(11) to modify the mortgage, including by way of strip down.[265] It seems certain that the other lender would reject the debtor's request for such an offer if the existing home mortgage holder refused to accept the proceeds of the refinancing loan as payment in full of the mortgage, as is required for a refinancing under the HOPE for Homeowners program. It also must be remembered that the refinancing loan could not exceed 90%, or in some cases 96.5%, of the appraised value of the home.[266]

In the end, the mortgage holder would be penalized for refusing to accept less than the appraised value of the home in full payment of the

260. *See supra* note 93.

261. *See supra* note 258.

262. *See* Durbin Amendment, *supra* note 4, § 501, at S4980 (referring to approval of the refinancing loan by "a person or entity authorized by the Secretary of the Department of Housing and Urban Development to serve as a mortgagee" rather than referring to approval of the refinancing loan by the existing mortgage holder).

263. *See supra* text accompanying note 250.

264. *See* Durbin Amendment, *supra* note 4, § 501, at S4980 (emphasis added).

265. *See* Durbin Amendment, *supra* note 4, § 503, at S4981.

266. *See supra* note 257.

mortgage. The penalty would be that, because the debtor would not have received a "qualified loan refinancing offer," the debtor would be free under the Durbin Amendment to use the new § 1322(b)(11) to strip down and otherwise modify the mortgage.

A mortgage holder might be willing to accept ninety percent of the value of the home instead of having to foreclose or continue to deal with the debtor. That might be a good deal for the mortgage holder. Alternatively, the mortgage holder might be willing to replace its existing mortgage with a smaller one equal to ninety percent of the home's value and to treat its existing mortgage as paid, because the smaller mortgage then would be guaranteed by the FHA.[267] There would be nothing wrong with the debtor suggesting that the mortgage holder should take one or the other of those deals.

However, a provision coercing the mortgage holder into accepting less than the value of its collateral fails a test of fundamental fairness. This is especially the case when we consider who would take the remaining ten percent of the home's value if the mortgage holder gave in to the coercion and made a "qualified loan refinancing offer" or consented to one made by another lender. Who would take that ten percent, or at least half of it? The answer is the federal government, with the debtor being given any part not taken by the federal government.[268] Now it may be true that the ten percent, along with the other fees charged by the FHA and the future appreciation taken by the FHA as noted below, might not exceed the value of the benefit to the mortgage holder of the mortgage insurance provided by the FHA. Nevertheless, it is unseemly and perhaps an unconstitutional taking for the federal government to coerce the mortgage holder into transferring ten percent of the value of its collateral to the federal government.

Consider also that the FHA would then claim an entitlement to divide with the debtor the subsequent appreciation of the home upon any sale or

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267. "Under this Program, an eligible mortgagor may obtain a refinancing of his or her existing mortgage(s) with a new mortgage loan insured by FHA, subject to conditions and restrictions specified in section 257 of the National Housing Act and requirements established by the Board." 24 C.F.R. § 4001.03(b)(2) (2009).

268. *See* 12 U.S.C.A. § 1715z-23(k)(1) (West 2009). This section provides for the federal government and the mortgage debtor to split the equity created by the FHA-insured refinancing. The government's share, called an "exit fee," begins at one hundred percent if the home is sold or refinanced in the first year after the FHA-insured refinancing and drops gradually to fifty percent if the home is sold or refinanced more than five years after the FHA-insured refinancing. The fifty percent figure is not further reduced, no matter how much time passes. Even if the debtor were to sell or refinance the home forty years later, the federal government still would be entitled to receive half of the equity initially created by the FHA-insured refinancing.

other disposition of the home, no matter how long in the future, with the FHA likely entitled to half of the appreciation.[269] Thus federal law would have coerced the mortgage holder not only into giving up ten percent of the value of its collateral, but also the value of the future appreciation of the collateral, with that value being divided between the debtor, the federal government, and possibly junior mortgage holders.[270]

Quite possibly all of this was inadvertent. It would be easy to amend the Durbin Amendment to deny the debtor the unfettered choice of seeking either a "qualified loan refinancing offer" or a "qualified loan modification offer." Suppose the debtor was required to seek a "qualified loan modification offer" from the mortgage holder if the debtor wanted to use the new § 1322(b)(11). If the mortgage holder made such an offer, the debtor would be forced to accept or decline the mortgage holder's offer. The debtor would not be allowed to use the new § 1322(b)(11) to seek an alternative loan provider. This arrangement would more fully align the Durbin Amendment with Senator Durbin's own description of its intended purpose.

However, would such an approach provide substantial protection to the mortgage holder? The Durbin Amendment is not perfectly clear on this point, but it appears that the requirements for a "qualified loan modification offer" differ for mortgages in each of three categories: (1) mortgages for which the debtor would qualify for loan modification under the Obama Administration's HAMP because the mortgage servicer is a HAMP participant or for another reason;[271] (2) mortgages insured or guaranteed by the FHA, the Department of Veterans Affairs, or the Department of

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269. *See* § 1715z-23(k)(2) ("For each eligible mortgage insured under this section, the Secretary may, upon any sale or disposition of the property to which the mortgage relates, be entitled to up to 50 percent of appreciation, up to the appraised value of the home at the time when the mortgage being refinanced under this section was originally made. The Secretary may share any amounts received under this paragraph with or assign the rights of any amounts due to the Secretary to the holder of the existing senior mortgage on the eligible mortgage, the holder of any existing subordinate mortgage on the eligible mortgage, or both."); 24 C.F.R. § 4001.120(b) ("Upon sale or disposition of a property securing a Program mortgage, FHA shall be entitled to receive an amount equal to 50 percent of the appreciation in value of the property calculated in accordance with paragraph (a) of this section."). Pursuant to 12 U.S.C.A. § 1715z-23(k)(2), a portion of this appreciation claimed by the FHA may be used to induce junior mortgage holders to release their liens so that the FHA-insured refinancing can be accomplished. Junior mortgage holders may be given a share of the appreciation or an up-front payment instead. *See* 24 C.F.R. § 4001.120(c)–(e). The reference in § 1715z-23(k)(2) to possible sharing of appreciation with "the holder of the existing senior mortgage" was added by section 202 of Public Law 111-22, Senate Bill 896 as enacted, but does not yet seem to be implemented by the regulations. *See* Helping Families Save Their Homes Act of 2009, Div. A of Pub. L. No. 111-22, § 202, 123 Stat. 1632, 1640–43 (codified in scattered sections of U.S.C.).

270. *See supra* note 269.

271. *See* Home Affordable Modification Program: Overview, https://www.hmpadmin.com/portal/programs/hamp.html (last visited Oct. 21, 2009).

Agriculture; and (3) other mortgages, including mortgages that would not qualify for modification under HAMP even though serviced by HAMP participating mortgage servicers.[272]

A large majority of home mortgages are serviced by HAMP participating servicers.[273] Thus, the first category of mortgages is potentially large. With respect to this category, under the Durbin Amendment a "qualified loan modification offer" would need to be made "in accordance with the guidelines" of HAMP.[274] It would also need to be made within forty-five days after the debtor provided the required information[275] and would have to be "presented to the debtor as a firm written offer in a form that can be accepted by the debtor by signing the offer and returning it to the servicer of such loan."[276] These requirements create a seeming disconnect with the HAMP guidelines. The HAMP loan modification guidelines call for a ninety-day trial modification period, during which the debtor must successfully make his or her modified payments, with the modification becoming effective the following calendar month.[277] Perhaps an offer to permit the debtor to start such a trial period—with the modification becoming effective if the debtor successfully makes the required payments during the trial period—could be considered a firm offer to modify the loan, but that is not at all clear. Note that none of the incentives offered under HAMP will be available if there is no such trial period.[278]

The substantive requirements for modifications under the HAMP

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272. *See* Durbin Amendment, *supra* note 4, § 501, at S4980.

273. Seth Wheeler, Stabilizing the Housing Market 4 (Sept. 24, 2009) (written testimony before the Congressional Oversight Panel), http://cop.senate.gov/documents/testimony-092409-wheeler.pdf (stating that "[f]ifty-seven servicers have signed up for the HAMP program" and that "[m]ore than 85% of loans in the country are now covered by the HAMP program").

274. Durbin Amendment, *supra* note 4, § 501, at S4980.

275. *Id.*

276. *Id.*

277. *See* March 4 Treasury Guidelines, *supra* note 8; Fannie Mae, Reissuance of the Introduction of the Home Affordable Modification Program, HomeSaver Forbearance™, and New Workout Hierarchy (Apr. 21, 2009) [hereinafter Revised Fannie Mae Guidelines], *available at* https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2009/0905.pdf (reissuing and modifying Fannie Mae guidelines originally introduced by Announcement 09-05 on March 4, 2009).

278. The guidelines state:

> Successful completion of the trial modification period . . . [is a] prerequisite[] for any payments to the lender/investor, servicer, or borrower. . . . No payments under the program to the lender/investor, servicer, or borrower will be made during the Trial Period. No payments under the program to the lender/investor, servicer, or borrower will be made if the Trial Period is not completed successfully.

March 4 Treasury Guidelines, *supra* note 8, at 9.

guidelines are complex, centering on a "Standard Waterfall" approach. Under this method, qualifying debtors generally would be entitled to have their mortgages modified in several ways, in step order, until the debtor's monthly payment—for principal, interest, property taxes, insurance, and any homeowners' association fees or condominium fees (PITIA)—are reduced for at least five years to no more than thirty-one percent of the debtor's "Monthly Gross Income," as defined in the guidelines.[279] If the PITIA is thirty-one percent or less of Monthly Gross Income even before any modification, then the debtor does not qualify for a HAMP modification.[280]

Suppose that the debtor's Monthly Gross Income is $4,000, and the PITIA is $1,800. The "Debt-To-Income" (DTI) ratio then would be forty-five percent, well above the thirty-one percent DTI target.[281] Under the Standard Waterfall approach, the first step toward reaching the thirty-one percent target is interest rate reduction.[282] The interest rate on the mortgage would be reduced until the thirty-one percent target is reached or until the interest rate is two percent, which is the interest rate floor below which the interest rate will not be reduced.[283] The reduction in the interest rate would be effective for at least five years.[284] Suppose a reduction of the interest rate to two percent would reduce the debtor's PITIA to $1,400. The DTI ratio would be thirty-five percent, still above the thirty-one percent target.[285]

Thus, the next step under the Standard Waterfall would need to be taken: extension of either the term of the mortgage or of its amortization for up to forty years, if necessary, beginning at the end of the ninety-day trial period.[286] Suppose an extension to thirty-eight years would reduce PITIA to $1,240. This would yield a DTI ratio of thirty-one percent, which would meet the target; thus an extension to forty years would not be needed. But suppose even an extension to the full forty years would reduce PITIA only to $1,300. Then the DTI ratio would be 32.5%, still above the 31% target, necessitating a move to the next step under the Standard Waterfall: forbearance of principal.[287]

279. *Id.*

280. *See* Revised Fannie Mae Guidelines, *supra* note 277, at 3.

281. *See* March 4 Treasury Guidelines, *supra* note 8, at 1, 3.

282. *Id.* at 7.

283. *Id.*

284. *See id.* The interest rate would then increase by one percent per year, but it would not increase above the contractual rate, nor would it increase above the prevailing rate for thirty-year conforming fixed rate mortgages "as of the date that the modification document is prepared." *Id.* at 8. In the event that the rate as modified is already above that prevailing rate, then the rate as modified becomes the fixed rate for the entire remaining term of the mortgage. *Id.*

285. *Id.* at 3.

286. *Id.* at 7, 9.

287. *See id.* at 7, 9.

PITIA would be reduced further by a forbearance of principal, under which neither interest nor principal payments would be due on the portion of the principal subject to forbearance.[288] That portion would be payable, without interest, at the earliest of (1) the end of the mortgage's term (its maturity date), (2) the date the home is sold, or (3) the date the mortgage is paid off—presumably by a refinancing.[289] Forbearance of principal can reduce the principal and interest payment portion of PITIA as much as is needed to reduce the DTI ratio to the thirty-one percent target.[290] Because PITIA in our example has already been reduced to $1,300, there would need to be sufficient principal forbearance to reduce PITIA by $60 per month, to $1,240, which would meet the thirty-one percent DTI target.[291] Principal forbearance of about $36,000 would likely be sufficient.[292]

The servicer may include "principal forgiveness," a permanent reduction in the principal balance, at any point in this process, but is not required to do so.[293] Thus, for example, in a given case a reduction in the mortgage interest rate from 7% to 5.5%, together with a permanent reduction in principal of $40,000, might reduce PITIA sufficiently to meet the 31% target even with no change in the duration of the mortgage.[294] If so, that would be a sufficient modification to meet the requirements of the guidelines.[295]

Note that under this approach, the servicer, acting for the mortgage holder or holders, need not agree to any reduction of principal.[296] Even if forbearance of the principal is required, the principal must eventually be paid, though without interest, and perhaps only after many years.[297] This approach is somewhat similar to the § 1111(b)(2) election that undersecured

288. *Id.* at 7.

289. *Id.* at 7, 9.

290. *See id.* at 7.

291. *See id.*

292. Note that, at the modified two percent interest rate, a reduction of $36,000 in the principal on which interest is payable would yield yearly savings of $720, and thus a monthly reduction of PITIA of $60 on account of lower interest payments. The actual reduction in PITIA would be a little higher because the debtor also would not be making monthly principal payments on the $36,000 subject to forbearance. The monthly reduction in PITIA due to lower principal repayment would be small on a loan amortized over forty years, but the savings would mean that the modification could provide for a little less than $36,000 in principal to be subject to forbearance and still meet the thirty-one percent DTI target. *See id.* at 3.

293. *Id.* at 8.

294. *See id.* at 7.

295. *See id.* at 8.

296. *Id.*

297. *Id.* at 7.

creditors usually are entitled to make in Chapter 11 cases.[298]

The HAMP guidelines contain one additional, crucial test that must be met for the debtor to be *entitled* to a modification from a HAMP-participating servicer: the Net Present Value (NPV) test.[299] The NPV test attempts to determine whether the value of the mortgage to its owners will be increased by a modification from what they otherwise likely would receive, given the likelihood of a foreclosure in which there would be losses if the mortgage is not modified.[300] The test

> compare[s] the net present value . . . of cash flows expected from a modification to the net present value of cash flows expected . . . in the absence of modification. If the NPV of the modification scenario is greater, the NPV result is deemed positive, and the servicer must modify the loan (absent fraud, etc.). However, an "NPV positive" result is not necessary to qualify a loan for a Home Affordable Modification and the associated lender/investor, servicer, and borrower payments.[301]

It is not clear whether, under the Durbin Amendment, a positive result on the NPV test is necessary for a debtor to "qualify for the Homeowner Affordability and Stability Plan."[302] A positive result is not necessary under the guidelines for the debtor to receive a HAMP modification, if the servicer chooses to offer one.[303] However, a positive result is necessary for the debtor to be entitled to receive such an offer.[304] It is not clear whether a debtor who could receive a HAMP modification only if the servicer chooses to offer one should be considered to "qualify" for such a modification.[305]

Suppose a positive NPV test result is not necessary for the debtor to "qualify," so that under the Durbin Amendment a mortgage holder would in any event have to make a modification offer in order to preclude or limit the debtor's use of the new § 1322(b)(11).[306] The Durbin Amendment then could coerce a mortgage holder into making a modification offer even where the NPV test is negative—that is, even where the HAMP guidelines recognize that such a modification could cause a loss of value of the

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298. *See* 11 U.S.C. § 1111(b)(2) (2006).
299. *See* March 4 Treasury Guidelines, *supra* note 8, at 16–17.
300. *See id.* at 16.
301. *Id.*
302. *See* Durbin Amendment, *supra* note 4, § 503, at S4981.
303. March 4 Treasury Guidelines, *supra* note 8, at 16.
304. *Id.*
305. *See id.*
306. *See generally* Durbin Amendment, *supra* note 4, § 503, at S4981.

mortgage holder's property interest.[307]

Even if a positive result is necessary for the debtor to "qualify," the Durbin Amendment could in effect still coerce the mortgage holder into making such an offer where the NPV test result is negative. It seems that, if the NPV test result were negative, the mortgage would fall into the third category of mortgages noted above: the "other mortgages" category.[308] Note that mortgage holders whose mortgages fall into that "other mortgages category" because of failure of the NPV test would be coerced under the Durbin Amendment to make a modification offer very much like the one that, under the HAMP guidelines, would only be required where the NPV test was positive.[309] The mortgage holder could only prevent or limit use of the new § 1322(b)(11) by making a modification offer that would reduce the debtor's DTI ratio to thirty-one percent for at least five years, and that would limit interest rates after that five year period in the same way the guidelines would limit them for a HAMP modification.[310]

3. Provisions in the Proposed Legislation that Might Slightly Soften the Effect of Allowing Strip Down

House Bill 1106 and the Durbin Amendment both contain further provisions that might slightly soften the effect of their authorization of the strip down of home mortgages. One provision that could be useful is found only in House Bill 1106. One that has little real value is found in both in essentially the same form. Another, dealing with recapture of appreciation, is mostly illusory under the approach taken in House Bill 1106, and also mostly illusory under the somewhat different approach taken in the Durbin Amendment.

The first provision—the one found only in House Bill 1106—would appear in some cases to allow the mortgage holder to require that the debtor's Chapter 13 plan reduce the mortgage interest rate instead of reducing the mortgage principal.[311] The mortgage holder would have to be willing to have the interest rate on the mortgage reduced sufficiently so that the monthly payments (1) would not exceed thirty-one percent of the

307. *See id.*

308. *See supra* text accompanying notes 271–72.

309. *See* March 4 Treasury Guidelines, *supra* note 8, at 6.

310. *See* Durbin Amendment, *supra* note 4, § 501, at S4981 (proposed § 101(43A)(C)(ii)); *see also* March 4 Treasury Guidelines, *supra* note 8, at 7.

311. *See* H.R. 1106, 111th Cong. § 103 (2009) (adding a proposed § 1325(d)).

debtor's gross monthly income, the limit set in the Obama Administration's March 4, 2009 HAMP guidelines,[312] (2) would be affordable for the debtor so that the debtor could avoid foreclosure, and (3) would nevertheless be sufficient to fully amortize the unreduced mortgage principal—at the reduced interest rate—over thirty years.[313] This provision has some resemblance to the § 1111(b)(2) election available to most undersecured creditors in Chapter 11 cases, which allows them to avoid a reduction in principal.[314]

The second provision—the one found in essentially the same form in both House Bill 1106 and the Durbin Amendment—would add a new § 1325(a)(11) requiring that the debtor meet a good faith test in order to utilize the proposed § 1322(b)(11) to modify a mortgage.[315] Section 1325(a)(11) would specifically preclude a finding of good faith where the debtor has no need to modify the mortgage because the debtor can pay all debts, including future increases, "without difficulty for the foreseeable future, including the positive amortization of mortgage debt."[316] Most such debtors who are so little in need of bankruptcy relief presumably would fail the requirement already in the Bankruptcy Code that the debtor propose the Chapter 13 plan in good faith;[317] thus, this specific preclusion does not seem to provide substantial additional protection to mortgage holders.

It is true that courts could find that debtors using § 1322(b)(11) lacked

312. *See id.*; March 4 Treasury Guidelines, *supra* note 8, at 3.

313. *See* March 4 Treasury Guidelines, *supra* note 8, at 3.

314. *See* 11 U.S.C. § 1111(b)(2) (2006).

315. *See* H.R. 1106, § 105; Durbin Amendment, *supra* note 4, § 505, at S4982.

316. *See* Durbin Amendment, *supra* note 4, § 505, at S4982; *see also* H.R. 1106, § 105. Both proposals would add a new § 1325(a)(11) to the Bankruptcy Code. Debtors convicted of mortgage fraud in connection with the mortgage that the debtor seeks to modify would be prohibited under the Durbin Amendment's proposed § 1325(a)(11)(B) from modifying their mortgages under the proposed § 1322(b)(11). Durbin Amendment, *supra* note 4, § 505, at S4982. Such debtors apparently would be found to lack good faith under House Bill 1106's version of the proposed § 1325(a)(11). H.R. 1106, § 105.

317. *See* 11 U.S.C. § 1325(a)(3) (2006). A few debtors might meet the existing § 1325(a)(3) good faith requirement but yet be within the new § 1325(a)(11)'s specific preclusion. Debtors might have such ample current income and such bright economic prospects that they could pay all their debts (including possible future increases in such debts) "without difficulty for the foreseeable future, including the positive amortization of mortgage debt," in the words of the proposed § 1325(a)(11), yet face foreclosure and have a legitimate need to use Chapter 13. They might have missed several mortgage payments during a prior time of financial distress. They might lack the lump sum of cash needed to cure the arrearages and prevent foreclosure; or the mortgage holder might already have accelerated the mortgage debt. But only a very few Chapter 13 debtors are likely to have such limited financial difficulties. Note that a debtor who now has, or might realistically in the foreseeable future have, difficulty in paying unsecured credit card debt would not be covered by the new § 1325(a)(11)'s specific preclusion. In effect the provision conditions the mortgage holder's protections on the debtor's ability to pay unsecured credit card debt.

good faith even in cases in which the specific preclusion did not apply; perhaps courts would develop the proposed § 1325(a)(11) good faith requirement so that it would be meaningful, but that is doubtful. The only guidance provided by the proposed § 1325(a)(11) for a case in which the preclusion does not apply—guidance provided only in the version contained in House Bill 1106—is that, in deciding whether a mortgage strip down is proposed in good faith, the court is to "consider whether the holder of such claim (or the entity collecting payments on behalf of such holder) has offered to the debtor a qualified loan modification[318] that would enable the debtor to pay [the debtor's other] debts and [the mortgage] loan without reducing such principal amount."[319] This approach essentially would require the home mortgage holder to subsidize the debtor's payment in full of other debts such as the large credit card debts that many debtors have built up. To prevent use of § 1322(b)(11) under this good faith requirement the mortgage holder would have to offer a modification that would reduce its contractual rights enough to allow the debtor to meet the debtor's full contractual obligations to other creditors, including obligations on credit cards.[320]

The third provision—the one dealing with recapture of appreciation—would provide for a limited right of the mortgage holder to share in future "appreciation" of the home where the mortgage has been stripped down but later is sold for more than the court-determined value of the home—with that value adjusted, as discussed below, in important ways.[321] Unfortunately, the right would be so limited as to be largely illusory. Under House Bill 1106, the mortgage holder would only be entitled to share in "appreciation" if the debtor sells the home during the five years after the plan goes into effect.[322] A debtor could avoid sharing any future "appreciation" at all by waiting five years before selling.

Further, under the Durbin Amendment, the debtor is entitled to keep half of the "appreciation" even if the debtor sells the home within the first year.[323] Such first-year "appreciation" is more likely to be the result of an undervaluation by the court than any upturn in the market, especially given the adjustment noted below in which costs of sale are subtracted from any

318. *See supra* note 235.

319. *See* H.R. 1106, § 105 (footnote added).

320. It is not clear why the proponents of the legislation would thus seek to favor unsecured claims such as claims for credit card debt. *See also supra* note 317.

321. *See infra* text accompanying notes 326–29.

322. *See* H.R. 1106, § 103.

323. Durbin Amendment, *supra* note 4, § 503, at S4981.

real appreciation under both the Durbin Amendment and House Bill 1106.

Under the version contained in House Bill 1106, the percentage of "appreciation" that the debtor would have to agree to pay over to the mortgage holder would drop quickly over the five years, from ninety percent, if the home is sold in the first year, to seventy, fifty, thirty, and ten percent, respectively, if the home is sold in the second, third, fourth, or fifth year. By waiting three years to sell, the debtor could limit the mortgage holder's share to thirty percent and thus obtain seventy percent of the "appreciation;" by waiting four years to sell, the debtor could obtain ninety percent; and by waiting five years, the debtor could receive it all. The current depressed market is not expected to recover substantially for several years.[324] By the time it might recover, the mortgage holder whose mortgage was stripped down in 2009 or 2010 would be entitled to very little benefit from the recovery.

To make matters worse, "appreciation" would be determined under a new § 1322(g)[325] that would mask at least some of the real appreciation that might occur. "Appreciation" would be determined by comparing the eventual sale price with the value as determined by the court at the time of strip down, with two important adjustments to that court-determined valuation.

The first adjustment would adjust the court-determined strip down value upward by the amount of the costs of sale.[326] Thus the home would have to appreciate by more than the costs of sale for any "appreciation" to exist. This reduces the benefit to mortgage holders of valuing homes at the time of strip down at their fair market value, without deduction of costs of sale.[327]

The second adjustment would be to add the cost of improvements made by the debtor to the court-determined strip down value. Quite often improvements add much less to the value of a home than the cost of the

324. *See, e.g.*, Koeppen, *supra* note 1.

325. *See* Durbin Amendment, *supra* note 4, § 503, at S4981; H.R. 1106, § 103.

326. Durbin Amendment, *supra* note 4, § 503, at S4981; H.R. 1106, § 103.

327. *See* Durbin Amendment, *supra* note 4, § 503, at S4981 (providing for valuation at fair market value); H.R. 1106, § 103 (same). Such a valuation at fair market value would by definition not include a deduction for costs of sale and would be consistent with the approach currently required by the Supreme Court for valuation in Chapter 13 where the debtor is retaining property. *See* Assocs. Commercial Corp. v. Rash, 520 U.S. 953, 960 (1997) ("In such a 'cram down' case, we hold, the value of the property (and thus the amount of the secured claim under § 506(a)) is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller."). Thus property that the debtor will retain is to be valued at what it would cost the debtor to replace it, not at the net amount that would be obtained by the debtor or the secured creditor on its sale. When an adjustment is made for costs of sale in the calculation of "appreciation," the mortgage holder is denied a portion of the real appreciation that may have occurred. Perhaps such an adjustment is appropriate, inasmuch as the debtor then will not be retaining the property, but it does mask real appreciation that occurred while the debtor retained and occupied the property.

improvements; thus, if improvements costing $20,000 were made to the home, and if those improvements added $8,000 to the value of the home, the home could appreciate $12,000 due to a market upturn without there being any "appreciation" under the proposed § 1322(g).[328]

For example, suppose the debtor's plan stripped down a $300,000 mortgage to the $230,000 court-determined value of the home. If the debtor were to sell the home for $310,000 three years and a day after the plan went into effect, the mortgage holder's share of "appreciation" would be thirty percent under the approach taken in House Bill 1106 and fifty percent under the approach taken in the Durbin Amendment. If costs of sale were $15,000, and if improvements costing the debtor $20,000 had added $8,000 to the value of the home, the "appreciation" would be $310,000 minus $265,000—the sum of the $230,000 court valuation of the home, the $15,000 costs of sale, and the $20,000 cost of improvements—which comes out to $45,000. The home's actual appreciation over the amount of the court's valuation, not including the $8,000 increase in market value due to improvements made by the debtor, would have been $72,000, but that amount would be trimmed to $45,000 by the operation of the proposed § 1322(g). And then the mortgage holder would be entitled under the approach taken in House Bill 1106 only to thirty percent of the $45,000, or $13,500, which is less than twenty percent of the actual appreciation. Under the approach taken by the Durbin Amendment, the mortgage holder would be entitled to fifty percent of the $45,000, which is $22,500, only a little over thirty-one percent of the actual appreciation. Of course, by waiting an additional year to sell the home, the debtor could cut the mortgage holder's share of the "appreciation" by two thirds, from thirty percent of "appreciation" to ten percent, under the approach taken in House Bill 1106, and by waiting a further year the debtor could deny the mortgage holder any share of the appreciation under either approach.[329]

We thus see that under the proposed legislation a home mortgage holder

328. Note that the FHA makes the optimistic assumption under the HOPE for Homeowners Program that improvements yield appreciation equal to seventy-five percent of their cost. *See* 24 C.F.R. § 4001.120(a)(3) (2009). The assumption made by both the Durbin Amendment and House Bill 1106 that improvements yield appreciation equal to one hundred percent of their cost is completely unrealistic and in effect would allow homeowners to make improvements partly at the expense of the mortgage holder.

329. Compare this approach with the approach taken by the government in demanding a share of appreciation of homes refinanced under the HOPE for Homeowners Program, in which the government's share is fifty percent no matter how long it takes for the debtor to sell the property. *See supra* note 269 and accompanying text.

could have its rights modified, including in many cases by way of a strip down of the mortgage to the court-determined value of the home in a depressed market, with very limited opportunity of benefitting from a recovery of the market. The mortgage holder could be required to accept payment of the stripped down mortgage over a period of up to forty years at a court-determined interest rate that is highly unlikely to provide a market return, given the risk of non-payment and given that the stripped down mortgage is, if the court's valuation is correct, a one hundred percent loan-to-value mortgage. The debtor is given a free option on most or all of the future appreciation of the home, with the mortgage holder required, as noted above and further explained in the next section of this Article, to bear the burden of future depreciation.

### B. *An Example of the Risk of Future Depreciation that the Proposed Legislation Would Impose on the Mortgage Holder*

The author testified on this subject before the Senate Judiciary Committee on December 5, 2007, and argued against amendment of the Bankruptcy Code to allow home mortgage strip down in Chapter 13. At the same hearing, Dr. Mark Zandi, Chief Economist at Moody's Economy.com, who testified in favor of strip down, noted in his written testimony that "[t]he housing market downturn is intensifying."[330] According to Dr. Zandi:

> Further significant declines in housing construction and prices are likely into 2009 as a record amount of unsold housing inventory continues to mount, given the impact of the recent subprime financial shock and its impact on the mortgage securities market and thus mortgage lenders. There is now a broad consensus that national house prices will fall by between 10% and 15% from their peak to their eventual trough. Even this disconcerting outlook assumes that the broader economy will avoid recession and that the Federal Reserve will continue to lower interest rates.[331]

In fact, the widely-respected S&P/Case-Shiller U.S. National Home Price Index dropped from 170.61 for the fourth quarter of 2007 to 132.64 for the second quarter of 2009,[332] a decline of over twenty-two percent.

330. *The Looming Foreclosure Crisis Hearing*, *supra* note 7, at 238 (statement of Dr. Mark Zandi).

331. *Id.* at 233–34 (footnote omitted).

332. *See* S&P/Case-Shiller U.S. National Home Price Index 1987–2009, http://www2.standardandpoors.com/spf/pdf/index/csnational_values_082562.xls (last visited Nov. 13, 2009).

Suppose Congress had enacted legislation permitting strip down shortly after that hearing. Suppose then that a homeowner who owed $500,000 on a home determined accurately by a bankruptcy court to be worth $400,000 had been permitted to strip the mortgage down to a $400,000 principal balance in a Chapter 13 case filed in the fourth quarter of 2007, with the $400,000 to be paid over thirty or more years. If the home's value followed the national average trend, the home would have been worth twenty-two percent less by the second quarter of 2009, which would have made it worth $312,000. The debtor would have paid very little principal during that time on a loan amortized over thirty years, and thus would have over $80,000 in negative equity. Would a reasonable debtor continue to make payments on a nearly $400,000 mortgage to keep a $312,000 home? Perhaps, perhaps not, but in any event, there would be a substantial chance in such a case that the debtor would default, either because of a lack of incentive to make payments or because of the further financial difficulties that cause many Chapter 13 plans to fail. And then the mortgage holder—who had been prevented by the § 362 automatic stay and by confirmation of the plan from foreclosing—would find that it now was foreclosing on a home worth substantially less than it would have been worth had foreclosure gone forward in the fourth quarter of 2007.

If we suppose that homes are worth in foreclosure perhaps seventy percent of their fair market value, the foreclosure value of the home would have dropped from $280,000 to less than $219,000, a drop of over $61,000. The result of the failed Chapter 13 would have been a loss to the mortgage holder of $61,000 in foreclosure value, only slightly counterbalanced by the very small amount of principal the debtor may have paid under the failed plan. The $61,000 loss would mean that more than a fifth of the foreclosure value, twenty-two percent to be exact, had been lost due to the pendency of the bankruptcy case.

Even under Dr. Zandi's prediction of only a ten to fifteen percent drop, the loss in such a case would have been substantial. Yet there was no recognition by strip down proponents that their proposal would impose this loss on mortgage holders. Instead, strip down proponents such as Professor Levitin argued that a mortgage holder whose mortgage would be stripped down under the proposed legislation would be guaranteed to receive the court-determined value of the home.[333] It is true that under the various

333. *See supra* note 144. Professor Lawless argued in congressional testimony that "[t]he mortgage lender benefits by getting a promise to pay equal to the value of the house, which is what it would have had if it sold the house outside of bankruptcy." *Credit Cards and Bankruptcy:*

proposals a Chapter 13 plan could be confirmed only if it provided that the debtor would pay—at least during the three-to-five-year term of the plan—payments that would, if continued over thirty or forty years, pay off the court-determined value of the home at a court-determined rate of interest. But it is quite wrong to say that this would guarantee that the mortgage holder would receive the court-determined value of the home.

As noted above, the debtor has a nonwaivable right to dismiss the Chapter 13 case or to convert it to Chapter 7 at any time;[334] thus the debtor is not bound to make the payments provided for under the plan. Of course, even if the debtor made all the payments at the court-determined rate of interest, the mortgage holder would only receive value equal to the court-determined value of the home if the court-determined interest rate were a fair market rate, a very unlikely state of affairs.[335] But, the key point is that there is absolutely no guarantee the debtor will make the payments provided for by the plan. Many Chapter 13 plans fail.[336] Despite the statements made

*Opportunities for Reform: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 32 (2008) (statement of Robert M. Lawless), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110shrg769/pdf/CHRG-110shrg769.pdf. The assumption that a Chapter 13 plan embodies a promise to pay that is equal to the value of the house ignores (1) the debtor's right to dismiss the Chapter 13 case or to convert it to Chapter 7, either of which will eliminate any obligation imposed by the plan to make payments, (2) the high failure rate of Chapter 13 plans, and (3) the extremely low likelihood that the interest rate imposed by the court would be a market rate for such a risky, one hundred percent loan-to-value mortgage—with a resulting extremely low likelihood that the supposed promise to pay would have a value equal to the value of the home.

334. *See supra* notes 73, 209.

335. Consider the following questions from Senator Sessions and answers from Bankruptcy Judge Thomas Bennett:

> Senator SESSIONS. Now, I supported cram-down for automobiles. I think it makes sense. I think we came pretty close. Senator Durbin was articulate on that issue, I know, when we discussed it, and Senator Feingold. I think we came close to the right amount there. But it does appear to me that since homes tend to be generally upward and you can have periods of decline, that it is less appropriate.
>
> Judge Bennett, you've been at this a while. Would you agree, whether you should or not, it's less appropriate than in an automobile?
>
> Judge BENNETT. I'm going to leave the policy decisions to those that make those. I will tell you what I think from an economic point of view. The answer is, the risk and the uncertainty is far greater than on what are shorter term and smaller dollar amounts. So, from that point of view I think I would tell you that by pushing these out at longer terms with bigger dollar volumes and with interest rates, that really—and I could tell you the experience of interest rates on cars is, it's prime plus 1, 2 or 3. Realistically, in the real market, the credit quality of the people who get prime or prime plus 1, 2, or 3 are not bankrupts. So, the idea that the interest rate on the cram-down really reflects the market rate misses the point in the real world.

*The Looming Foreclosure Crisis Hearing*, *supra* note 7, at 29.

336. *See, e.g.*, Ed Flynn & Gordon Bermant, *A Day in Bankruptcy*, 22 AM. BANKR. INST. J. 20 (2003) (noting that about two-thirds of Chapter 13 cases are dismissed or converted to Chapter 7); Eggum, Porter & Twomey, *supra* note 44, at 1144 ("Prior research has shown that only about one in three Chapter 13 bankruptcy cases ends in successful plan completion and a discharge."). Of course, some of these failures are due to the requirement that debtors who wish to keep their homes must

by strip down proponents, there is no effective way to provide adequate protection of the value of the mortgage holder's property in such a case.[337]

Under current law, a debtor could keep the home in a Chapter 13 case only by making the full payments required by the mortgage contract going forward, and by making additional payments to cure any past missed payments. A debtor who can afford to do that is a better credit risk on average than the debtors who could use strip down under the congressional proposals and shows a greater commitment to fulfilling his or her financial obligations. Of course, even such debtors often fail to complete their Chapter 13 plans, and the mortgage holder may end up foreclosing. The mortgage holder runs the risk that foreclosure value will have dropped during the Chapter 13 case, but under current law, as noted above,[338] there are substantial positive factors that help to balance this risk. Removal of those positive factors and the allowance of strip down would cause a substantial imbalance, significantly changing the risk characteristics of the mortgage.

The likelihood that such losses will occur, especially in a declining market, is recognized not only by the author, and not only by lenders with a financial interest in preventing amendment of the Bankruptcy Code. The Treasury's HAMP guidelines note that "[t]o encourage lenders/investors to modify more mortgages, compensation will be provided to partially offset probable losses from home price declines."[339] The Treasury's executive summary for its Homeowner Affordability and Stability Plan—of which HAMP is a part—states that

> [t]o encourage lenders to modify more mortgages and enable more families to keep their homes, the Administration—together with the FDIC—has developed an innovative partial guarantee initiative. The insurance fund—to be created by the Treasury Department at a size of up to $10 billion—will be designed to discourage lenders

make their full monthly mortgage payments and pay something in addition toward past missed payments. In their report on their empirical study of bankruptcy debtors and bankruptcy cases, Mr. Eggum, Professor Porter, and Ms. Twomey make the important points that a high percentage of Chapter 13 debtors have unaffordable mortgage payments and that a reduction in monthly mortgage payments could help some Chapter 13 debtors succeed in completing their plans, thus lowering the current high failure rate for Chapter 13 cases. *See id.* at 1125, 1129–30, 1144–54, 1163–64, 1167–68.

337. *See supra* text accompanying notes 212–22.

338. *See supra* text accompanying notes 202–22.

339. March 4 Treasury Guidelines, *supra* note 8, at 14.

from opting to foreclose on mortgages that could be viable now out of fear that home prices will fall even further later on. Holders of mortgages modified under the program would be provided with an additional insurance payment on each modified loan, linked to declines in the home price index.[340]

The Treasury's executive summary provides a link to the *Homeowner Affordability and Stability Plan Fact Sheet*,[341] which goes on to explain that

> [t]his initiative provides lenders with the security to undertake more mortgage modifications by assuring that if home price declines are worse than expected, they have reserves to fall back on.[342] These payments could be set aside as reserves, providing a partial guarantee in the event that home price declines—and therefore losses in cases of default—are higher than expected.[343]

The Obama Administration recognizes that such losses may be suffered, and that mortgage holders should be protected against such losses. That is why the President's program calls for setting up a multi-billion dollar fund to compensate lenders for such losses that may occur while the lenders try to work with borrowers to avoid foreclosure. Yet neither House Bill 1106 nor the Durbin Amendment takes such losses into account, and, of course, debtors typically have no resources to compensate for such losses.

### C. *Why the Argument that the Proposed Congressional Legislation Would Simply Treat Home Mortgage Holders the Same as Other Secured Creditors in Chapter 13 Is Incorrect*

Proponents of the legislative proposals to allow home mortgage strip down have argued vehemently that allowing such strip down would simply treat home mortgages the same as other secured debt in Chapter 13 cases. How could it be fair to allow debtors a greater ability to protect other assets

340. Press Release, U.S. Dep't of the Treasury, Homeowner Affordability and Stability Plan: Executive Summary (Feb. 18, 2009), http://www.treas.gov/press/releases/tg33.htm.

341. Homeowner Affordability and Stability Plan Fact Sheet, http://www.treasury.gov/initiatives/eesa/homeowner-affordability-plan/FactSheet.pdf (last visited Nov. 22, 2009) [hereinafter *Homeowner Affordability and Stability Plan Fact Sheet*].

342. In fact, the Home Price Decline Protection incentives provided under the Obama Administration's program are based on anticipated declines in home values, not on whether declines in home values turn out to be steeper than expected. *See* U.S. DEPT. OF THE TREASURY, SUPPLEMENTAL DIRECTIVE 09-04: HOME AFFORDABLE MODIFICATION PROGRAM – HOME PRICE DECLINE PROTECTION INCENTIVES (2009), http://www.financialstability.gov/docs/press/SupplementalDirective7-31-09.pdf.

343. *Homeowner Affordability and Stability Plan Fact Sheet*, *supra* note 341 (footnote added).

in Chapter 13 than to protect their homes? That has been the argument. It has been argued that debtors are permitted to modify secured debts so as to keep vacation homes and yachts, but not permitted to modify the mortgage on their principal residence so as not to be kicked out of their homes.

As the current 111th Congress began, Senator Richard J. Durbin introduced a bill that would allow home mortgage modification in Chapter 13[344] and continued to sound that theme, a theme that would be repeated again and again in the current Congress: "So what does this bill do? This bill would allow mortgages on primary residences to be modified in bankruptcy *just like other debts*—including vacation homes, family farms, and yachts."[345]

That statement, of course, was far from correct. Substantial first mortgages on vacation homes cannot, as a practical matter, be modified in Chapter 13 under current law, except for the same kind of curing of defaults permitted with respect to a mortgage secured by a debtor's principal residence. As even strip down proponents are forced to admit, Chapter 13 debtors seldom would be able to retain vacation homes at all.[346] Cases in which Chapter 13 debtors modify security interests on yachts in order to keep them are rare enough that the author cannot recall one. Current law certainly would not permit, with respect to liens on vacation homes and yachts, the kind of Chapter 13 modification that Senator Durbin has championed, in which monthly payment amounts are reduced, interest rates are changed, the principal amount of the lien is stripped down, and the modified mortgage is paid off over a period extending many years beyond the three-to-five-year duration of a Chapter 13 plan.[347]

Other members of Congress picked up the theme. For example, Senate Majority Leader Harry Reid argued in favor of the Durbin Amendment[348] by saying:

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344. S. 61, 111th Cong. (2009); *see* 155 CONG. REC. S64–66 (daily ed. Jan. 6, 2009) (statement of Sen. Durbin) (describing the proposed amendments to the Bankruptcy Code).

345. 155 CONG. REC. S65 (daily ed. Jan 6, 2009) (statement of Sen. Durbin) (emphasis added).

346. For example, Professor Levitin notes that

> [a]rguably neither vacation-home nor investor-property mortgages reflect a premium for bankruptcy modification because neither is likely to be modified in bankruptcy. A mortgage-loan modification in bankruptcy can occur only as part of a plan. The automatic stay would likely be lifted on an investment property (or vacation home) before a plan could be confirmed.

Levitin, *supra* note 6, at 589–90 (footnote omitted).

347. *See supra* text accompanying notes 111–27.

348. *See supra* note 4.

> It is unbelievable to me that people can have their primary residence in Las Vegas and have a beach house in Laguna, CA, and a ski chalet in Brian Head, UT, or some other ski area in Utah, and they come upon hard times. The resorts they have at the beach and up in the mountains, they can go to bankruptcy court and get that readjusted. Their primary residence, they cannot. But a person who has a home in Las Vegas or some other place in Nevada who comes upon hard times, they cannot do a thing with their home. They cannot go to bankruptcy court.[349]

Senator Durbin followed up by arguing:

> Under the current bankruptcy law, if you are deep in debt and facing foreclosure, and you own several pieces of real estate—your home, a vacation condo in Florida, a vacation condo in Aspen, CO, and you are facing foreclosure on all three properties because of economic problems—you can walk into that bankruptcy court and the judge can say we will renegotiate the terms of the mortgage on the Aspen, CO, property—we will reduce the principal of the mortgage to the fair market value, the interest rate will be the current interest rate, we will add a little to it, and so forth and so on. The bankruptcy judge has that power for the Florida property and for the Colorado property. But the law prohibits the bankruptcy court from rewriting the terms of the mortgage of a person's home. Why? Why does that make any sense? If the bankruptcy court can rewrite the mortgage on your vacation condos, your farm, or your ranch, why can't they do it for your home? That is what this bill does. It gives the bankruptcy court that power.[350]

Senator Jeff Merkley argued in favor of the Durbin Amendment by asking the Senate to

> [r]emember that this bankruptcy power is not extraordinary. A Federal bankruptcy judge already has the power to modify debt on a vacation home, an investment property, a credit card, a car loan, even a yacht. Why can't the court make any modification to a

349. 155 CONG. REC. S4902 (daily ed. Apr. 29, 2009) (statement of Sen. Reid).

350. 155 CONG. REC. S4917 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin). Note that a Chapter 13 plan need not be negotiated, and that the bankruptcy judge does not ordinarily act as a mediator to obtain a negotiated settlement. Rather, if the plan drafted by the debtor's attorney meets the requirements of the Bankruptcy Code, it will be confirmed, regardless of whether the mortgage holder consents. *See* 11 U.S.C. § 1325(a) (2006). The mortgage holder's consent is only needed if the plan does not meet the requirements of § 1325(a)(5)(B) or (C). *See* § 1325(a)(5).

> family's primary assets, the important piece of the American dream known as home ownership? I can think of no good reason.[351]

Senator Thomas S. Udall similarly argued that current law unfairly favors vacation homeowners: "I have yet to hear a good reason why that working American should not have the *same rights* as every real estate speculator and vacation homeowner in this country. My constituents do not think that is fair. And you know they are right."[352]

Senator Christopher J. Dodd continued to pound the point home:

> [F]or those who have not followed the debate, let me explain.
>
> There is *no restriction* in a bankruptcy court for a bankruptcy judge to modify—or at least to negotiate—the modification of your mortgage if you have a vacation home or if you have a pleasure boat and have a mortgage on that. The bankruptcy judge can modify the mortgage on that beach house, that mountain cabin, that yacht you may have. That is perfectly legitimate under bankruptcy laws. What you are not allowed to do, if you are a bankruptcy judge, is to modify the mortgage on a principal residence.
>
> I don't know if statistically what I am about to say is accurate. I suspect that most Americans who have a principal residence don't have vacation homes. I know some do, and that is perfectly legitimate. I am not arguing that you shouldn't have one. But explain to me, if someone will, the distinction on why a vacation home, a yacht, a mountain cabin—as nice as it is to have one—ought to be able to be subjected to a workout with the mortgage involved, and yet, for the person who only owns one home, as most do—you own one house—a bankruptcy judge is prohibited from engaging in a workout between the lender and the borrower on that principal place of residence. For the life of me, over the last number of months we have been involved in this debate and discussion, I have failed to hear an adequate explanation of why there is a distinction on a principal place of residence where a mortgage is involved and there is *no hesitation, no restriction whatsoever*, on whatever other number of homes you may have. Some have a lot more than two; some have three, four, and five. All of those can be subject to a workout, but not a principal place of

351. 155 CONG. REC. S4919 (daily ed. Apr. 30, 2009) (statement of Sen. Merkley).
352. *Id.* at S4921 (statement of Sen. Udall) (emphasis added).

residence. That is all we are trying to do here.[353]

The Chairman of the House Committee on the Judiciary, Representative John Conyers, Jr., made the same argument in the House in favor of House Bill 1106 by saying that it would "limit an anomaly in the Bankruptcy Code which prohibits judicial modifications of principal residences, even though every other class of asset, from second homes to yachts, airplanes, investment properties, family farm, hotels, and even office buildings, is eligible for such treatment."[354]

Academics who support home mortgage strip down have sounded a similar theme.[355] Professor Robert M. Lawless testified before the Senate Judiciary Committee and argued in favor of a home mortgage strip down bill[356] on the basis that "[i]n chapter 13, bankruptcy judges already have these powers with respect to mortgages on vacation homes or secured loans on a debtor's boat. This bill would only extend that power to mortgage loans on a debtor's house."[357]

Professor Adam J. Levitin does not explicitly claim that the kind of modification he supports for home mortgages in Chapter 13 is the same kind of modification currently permitted in Chapter 13 for debts secured by vacation homes and yachts. But he makes the comparison repeatedly, both in congressional testimony and in scholarly papers, as the following excerpts show, beginning with testimony from July 2009:

> A consumer debtor can modify car loans, credit card debt, student

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353. *Id.* at S4922 (statement of Sen. Dodd) (emphasis added). As this Article shows, it is simply incorrect to say that as a practical matter a first mortgage on a substantial vacation home can be modified in Chapter 13 under current law, because payments required to pay off the claim during the three-to-five-year plan would be too high, and because a plan calling for such payments would not be proposed in good faith—and thus would not be confirmable. It is simply not correct to say that there is "no restriction" on such modifications.

354. 155 CONG. REC. H2848 (daily ed. Feb. 26, 2009) (statement of Rep. Conyers).

355. *See, e.g.*, Michelle J. White, *Bankruptcy: Past Puzzles, Recent Reforms, and the Mortgage Crisis*, 11 AM. L. & ECON. REV. 1 (2009). Professor White states:

> Under current law, bankruptcy judges have the power to change the terms of mortgages if they are secured by vacation homes, multifamily homes, or boats, but not if they are secured by the debtor's principal residence. So the proposed reform would make the treatment in bankruptcy of mortgages secured by a debtor's primary residence the same as the treatment in bankruptcy of other secured loans.

*Id.* at 19 (citing Levitin & Goodman, *Mortgage Market Sensitivity*, *supra* note 18). Professor White's article is "an expanded version of the talk that [she] gave as President of the American Law and Economics Association, which took place at the 18th Annual ALEA Meeting on May 16–17, 2008." *Id.* at 1.

356. S. 2136, 110th Cong. (2008).

357. *Credit Cards and Bankruptcy: Opportunities for Reform: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 32 (2008) (statement of Robert M. Lawless), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110shrg769/pdf/CHRG-110shrg769.pdf.

> loans, yacht loans, jet-ski loans, snowmobile loans, airplane loans, computer loans, jewelry loans, and appliance loans, as well as investment property mortgages and vacation home mortgages. A consumer debtor can also modify a principal residence mortgage if it is a multifamily property. This means that a consumer who rents out the basement or the attic can modify the mortgage on her house in bankruptcy. The only type of debt that a consumer cannot modify in bankruptcy is debt on a single-family principal residence.[358]

In January 2009, Professor Levitin testified that

> [t]he bankruptcy system, however, is incapable of handling the current home foreclosure crisis because of the special protection it gives to most residential mortgage claims. Debtors may generally modify all types of debts in bankruptcy—reducing interest rates, stretching out loan tenors, changing amortization schedules, and limiting secured claims to the value of collateral ("strip down" or "cram down"). Under current law, debtors can modify mortgages on vacation homes, investor properties, and multifamily residences in which the owner occupies a unit. Debtors can also currently modify wholly unsecured second mortgages on their principal residences, as well as loans secured by yachts, jet-skis, snowmobiles, jewelry, household appliances, furniture, cars, trucks, or any other type of personalty.
>
> The Bankruptcy Code, however, forbids the modification of mortgage loans secured solely by the debtor's principal residence.[359]

358. *July 2009 Levitin Testimony*, *supra* note 20, at 9; Levitin, *Helping Homeowners*, *supra* note 18, at 6 (including identical or nearly identical statement). Professor Levitin does preface this particular statement, both in his testimony and in *Helping Homeowners*, with language that might indicate—to a person knowledgeable about bankruptcy and about the proposed legislation allowing home mortgage modification—that the kinds of modifications permitted under current law for debts secured by cars, yachts, jet-skis and the other kinds of property in his list are limited in ways that home mortgage modifications would not be limited under the proposed legislation. *See July 2009 Levitin Testimony*, *supra* note 20, at 8; *Helping Homeowners*, *supra* note 18, at 6. The implication of his comparison, however, is misleadingly to the contrary.

359. Adam J. Levitin, Hearing: On H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009," and H.R. 225, the "Emergency Homeownership and Equity Protection Act" 14–15 (Jan. 22, 2009) (written testimony before the House of Representatives Committee on the Judiciary) [hereinafter *January 2009 Levitin Testimony*] (footnotes omitted), *available at* http://judiciary.house.gov/hearings/pdf/Levitin090122.pdf (showing incorrect date of January 22,

Professor Levitin also argues, in his 2009 *Wisconsin Law Review* article, that

> [u]nder current law, debtors can modify mortgages on vacation homes, investor properties, and multifamily residences in which the owner occupies a unit. Debtors can also currently modify wholly unsecured second mortgages on their principal residences, as well as loans secured by yachts, aircraft, jewelry, household appliances, furniture, vehicles, or any other type of personalty. The Bankruptcy Code, however, forbids the modification of mortgage loans secured solely by the debtor's principal residence.[360]

Such comparisons would be pointless, or nearly so, were the kinds of modifications very different. The making of the comparisons and the failure to point out differences amounts to an implicit and incorrect claim that the kinds of modifications are at least very similar.

Professor Levitin also claims that his empirical studies comparing interest rates on vacation homes and multi-family residences with interest rates on single-family principal residences can tell us what the effect would be of allowing modification of single-family principal residence mortgages under the legislative proposals.[361] That is necessarily an implicit claim that the kinds of modifications are the same or at least so similar as to have the same effects. Again, that implicit claim is incorrect.

All of these claims and arguments suffer from the same fatal flaw: the kind of Chapter 13 modification of home mortgages that would be permitted under the proposed legislation is very, very different from the kind of Chapter 13 modification currently permitted, in theory, with respect to mortgages on vacation homes and security interests in yachts. Some of the most prominent proponents of strip down are now recognizing that current law requires a stripped down claim to be paid off during the life of the

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2008).

360. Levitin, *supra* note 6, at 581–82 (footnotes omitted). Similar statements are made in Levitin & Goodman, *Mortgage Market Sensitivity*, *supra* note 18, at 4–5, and Levitin & Goodman, *Effect on Markets*, *supra* note 18, at 3.

361. *See supra* text accompanying notes 20–21. Professor Levitin does state that a comparison of interest rates on vacation home mortgages and investment property mortgages, on the one hand, with interest rates on single-family owner-occupied homes, on the other hand, may not be "particularly meaningful," because debtors are unlikely to be able to strip down mortgages on vacation homes and investment properties. Levitin, *supra* note 6, at 590. As a result, he notes, lenders are not likely to charge a risk premium to cover possible losses from strip down on vacation home mortgages and investment property mortgages. *See supra* note 346; Levitin, *supra* note 6, at 589–90. Thus, he is left only with the claim that there is a "valid comparison" to be made between multiple-unit mortgages—where the debtor occupies one of the units so that the property is not just an investment property—and single-family owner-occupied home mortgages. Levitin, *supra* note 6, at 590. This limitation on his claims has not been adequately appreciated by home mortgage strip down proponents.

Chapter 13 plan, over a period of no more than five years—a limitation that makes strip down of first mortgages on substantial properties usually impossible—whereas the proposed legislation would allow, in some cases, up to nearly forty years, making strip down quite feasible and likely to be used.[362] Thus, while arguing for Chapter 13 home mortgage strip down, the Congressional Oversight Panel, chaired by Harvard Law Professor Elizabeth Warren, now admits that

> [t]he type of bankruptcy modifications proposed for mortgages on principal residences differs from the debt restructurings that are currently permitted for vacation homes or rental property, if they are modified in Chapter 13. In Chapter 13, all debts, including the reduced principal amount, must be repaid within the three-to-five years duration of the bankruptcy plan.[363]

The authors of a recent and impressive empirical study, including Professor Katherine Porter, argue in favor of strip down, but yet recognize that where current law allows strip down or other modification of a secured claim, the stripped down amount of the claim must be paid off during the Chapter 13 plan:

> Under current law, a secured claim that is subject to strip down must be paid in full within the three- to five-year duration of a Chapter 13 plan. While this feat often can be accomplished for claims secured by personal property, few debtors are able to pay the entire amount of their mortgages in that short time period.[364]

Requiring the home mortgage holder to take payments at a court-

362. Congressional opponents of the legislative proposals also have now begun to argue that the proposed legislation would not simply extend to home mortgages the same kind of treatment currently applicable to vacation homes. In arguing against the Durbin Amendment, Senator Jon Kyl noted that proponents of home mortgage strip down

> argue it should be allowed because, after all, bankruptcy law already allows a version of this for vacation homes. Big difference. What proponents do not mention is that to qualify for cram-down on a vacation home mortgage, the debtor is required to pay off the entire amount of the secured claim within the 5-year length of the chapter 13 plan. The Durbin amendment, of course, does not include the requirement that the debtor must pay off the security claim within 5 years. He does not purport to treat cram-down on primary homes the same way the Bankruptcy Code treats them on secondary homes.

155 CONG. REC. S4925 (daily ed. Apr. 30, 2009) (statement of Sen. Kyl).

363. WORKING TOWARD A SOLUTION, *supra* note 137, at 52.

364. Eggum, Porter & Twomey, *supra* note 44, at 1163 (footnote omitted).

determined interest rate over a period of up to forty years does indeed differ greatly from what Chapter 13 now permits, at least in theory, with regard to other secured debt.[365] But, does Chapter 13 currently permit strip down of first mortgages at all as a practical matter with respect to vacation homes and investment real property of substantial value? The general answer is a clear "no" because, as Professor Porter and her coauthors note and as the author has been noting since 1993,[366] the debtor could not afford to pay the value of the property with interest over a period of no more than five years and would not be permitted to do so by the court even if he or she were able to make such high payments.[367]

It is true that Chapter 13 allows debtors in some cases to strip down secured claims secured by automobiles. It might be thought wrong that the bankruptcy laws would be more concerned with helping a debtor keep a car than with helping a debtor keep a home. But consider that many debtors would be unable to earn the money to feed their families or fund their Chapter 13 plans if they could not use their automobiles to get to work. Note also that automobiles are not ordinarily the kind of property that is subject to wide market swings. Allowing strip down of a car loan does not give the debtor the kind of free option on future market appreciation that strip down would give the debtor with respect to real property. Additionally, strip down of car loans has in fact been substantially restricted by recent amendments to the Bankruptcy Code, amendments that provide auto lenders much more protection than home mortgage holders would have under the proposed home mortgage strip down legislation.[368]

Auto loans can now only be stripped down in Chapter 13 if the auto loan has been outstanding for 910 days, or two and a half years, prior to the filing of the bankruptcy petition.[369] For most auto loans, that will be half or more of the expected life of the loan. The car lender thus will have received much of the promised performance and probably substantial amounts of principal repayment. If the Chapter 13 plan strips down an older car loan, the plan will have to provide for payments that are high enough to amortize the stripped down claim at least as fast as the expected depreciation on the car, thus providing a real form of adequate protection of the car lender's security interest.[370]

None of those protections is contemplated under the proposed home mortgage strip down legislation. There is no requirement that homeowners

365. *See supra* text accompanying notes 128–37.

366. *See supra* text accompanying note 128.

367. *See supra* text accompanying note 128.

368. *See infra* notes text accompanying notes 369–70.

369. *See supra* note 64.

370. *See* 11 U.S.C. § 1325(a)(5)(B)(iii)(II) (2006).

have made payments for any particular period of time before filing a Chapter 13 petition and invoking strip down, nor is there any realistic protection of the value of the mortgage against future decline. Of course, the auto lender will be subjected to a court-determined interest rate for no more than five years, with a relatively fast pay-down of principal that it can lend elsewhere at market rates. The auto lender is not subjected to a court-determined interest rate for up to forty years, with very slow amortization of principal, in a declining market—or in one that may, as real property markets sometimes do, go into decline.

It has been argued, particularly by Professor Robert Lawless, that current law—in particular § 1322(b)(5)—would allow payment of a stripped down secured claim secured by collateral other than the debtor's principal residence over more than the three to five years of the Chapter 13 plan.[371] This argument treats the *Bellamy* approach, discussed above, as if it were generally accepted. But as noted above, the strong weight of authority, and nearly all recent authority outside the First Circuit, rejects the *Bellamy* approach in favor of the *Enewally/Rash* approach.[372] The Ninth Circuit—the circuit that was in the vanguard of allowing home mortgage strip down before *Nobelman*—has now, post-*Nobelman*, in its *Enewally* decision, rejected such use of § 1322(b)(5).[373] It is critical to see, however, that even under the *Bellamy* approach, any change in the amount of the monthly payment or in the interest rate would trigger the requirement that the stripped down claim be paid off during the three to five years of the plan. Professor Lawless seems (or at least seemed in 2007) to agree on that point.[374]

Thus, even if the *Enewally/Rash* approach is rejected in favor of the *Bellamy* approach, the kinds of modifications that the proposed home mortgage strip down legislation would permit—lowering of monthly payments and lowering of interest rates—would trigger the requirement under current law that the stripped down claim be paid off with interest over

371. *See* Blog Post of Robert Lawless on Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2007/12/equal-footings.html#more (Dec. 17, 2007, 12:21 WST) [hereinafter Equal Footings] (post entitled "Equal Footings").

372. *See supra* text accompanying notes 115–20, 123–25.

373. Enewally v. Wash. Mutual Bank (*In re* Enewally), 368 F.3d 1165, 1172 (9th Cir. 2004), *cert. denied*, 534 U.S. 1021 (2004).

374. *See* Equal Footings, *supra* note 371 (noting that in order to maintain payments under § 1322(b)(5) the plan must change neither the amount of the contractual monthly payment nor the contractual interest rate); *supra* note 132 (noting alternative approach suggested more recently by Professor Lawless).

the three-to-five-year life of the plan.[375] It simply cannot be maintained that the proposed legislation would treat home mortgages the same as other secured debt in Chapter 13.

Accordingly, some proponents of home mortgage strip down now argue that debtors should be permitted to treat their home mortgages in Chapter 13 in the same way that debts secured by vacation homes and investment real property can be treated in Chapter 11 bankruptcy. Thus, the Congressional Oversight Panel now argues that in Chapter 11

> vacation homes, rental property and mortgages on all business property can be stretched over decades. The proposed bankruptcy modification would permit the modified loan on the principal residence to be held to maturity and repaid over as much as thirty years [sic]. The length of the anticipated repayment period in the proposed bankruptcy modification would be more like the treatment of mortgages on vacation homes, rental property and all business property in Chapter 11.[376]

It is not clear why Chapter 11 is thought to provide a good comparison. In Chapter 11, unlike Chapter 13, creditors are permitted to vote on the plan of reorganization,[377] are entitled to have nonrecourse claims treated as if they were recourse,[378] alternatively are allowed to prevent strip down in most cases by making the § 1111(b)(2) election,[379] are sometimes permitted to file their own plans of reorganization for the debtor,[380] and often have the benefit of the absolute priority rule under which the business owners cannot retain any of the value of the business—except for exempt property in cases involving debtors who are natural persons and except for certain kinds of property, including personal services earnings, obtained postpetition[381]—absent full payment of creditors.[382] Undersecured creditors often have the power to block plans of reorganization by voting their deficiency claims against the plans.[383] Chapter 11 debtors do not have the unlimited right to

375. See *supra* note 132, for discussion of an alternative understanding of § 1325(a)(5)(B) that, if accepted, could in effect allow the debtor to satisfy the requirement of § 1325(a)(5)(B) and also pay off the secured claim over a longer period than the three to five years of the plan. As discussed in note 132, this alternative, under which the debtor would "distribute" a new long-term mortgage to the mortgage holder, must be rejected.

376. WORKING TOWARD A SOLUTION, *supra* note 137, at 52, 54.

377. *See* 11 U.S.C. § 1126 (2006).

378. *See* § 1111(b).

379. *Id.*

380. *See* § 1121(c).

381. *See* §§ 552(b), 1129(b)(2)(B)(ii).

382. *See* § 1129(b).

383. *See, e.g.*, Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. Lasalle St. P'ship, 526 U.S. 434

dismiss their cases that Chapter 13 debtors have.[384] Furthermore, cases in which debtors use Chapter 11 to retain vacation homes for personal use seem rare.[385]

## IV. WHY THE EMPIRICAL STUDIES RELIED ON BY STRIP DOWN PROPONENTS DO NOT PROVIDE A SOUND BASIS FOR THE MAKING OF PUBLIC POLICY

Strip down proponents rely heavily on Professor Adam J. Levitin's empirical studies for the proposition that the proposed home mortgage strip down legislation would not cause interest rates to be higher than they otherwise would be and would not make mortgages more difficult to obtain than they otherwise would be.[386] Professor Levitin must be credited for coming up with thoughtful and creative ways to attempt to study these questions empirically. Unfortunately, his studies do not provide a sound basis for the making of public policy. As noted above, his studies in effect compare apples with oranges—or perhaps a bumper crop of apples with a frost-ravaged crop of oranges—by comparing the effects of the kind of strip down that would be widely available under the legislation now before Congress with the effects of the very, very different kinds of strip down that, in limited circumstances, are currently available or were at one time available.[387]

Professor Levitin suggests that the matter can be studied empirically with a type-of-property comparison and a temporal/geographical comparison.[388] The insight involved in conceiving of such empirical studies is impressive.

The type-of-property comparison is possible, according to Professor Levitin, because under current law strip down is possible only for home

(1999); Barakat v. Life Ins. Co. of Va. (*In re* Barakat), 99 F.3d 1520 (9th Cir. 1996).

384. *Compare* § 1112(b) (requiring showing of cause for dismissal), *with* § 1307(b) (providing debtor who filed a Chapter 13 petition—and whose Chapter 13 case therefore was not converted to Chapter 13 from another Chapter—with nonwaivable right to dismiss).

385. If a debtor that is a business entity—a corporation, limited liability company, or partnership—were to retain a vacation home, perhaps a hunting lodge used to entertain business clients, under its Chapter 11 plan, it is likely that the value of the vacation home would then in effect be owned by the creditors, because they likely would end up owning the debtor's equity interests. More likely, the vacation home would be sold as the debtor sought to generate cash for its continuing business operations or to generate cash to make needed payments to holders of claims.

386. *See supra* text accompanying notes 22–24.

387. *See supra* text accompanying notes 22–24.

388. *See* Levitin, *supra* note 6.

mortgages on certain kinds of property, such as multiple unit properties (for example, a duplex or triplex, only one of which would be the debtor's principal residence) and vacation or second homes.[389] Thus, a comparison of current mortgage interest rates and current mortgage availability for home mortgages that can be stripped down with those that cannot be stripped down could help us to tease out the effect on interest rates of allowing or not allowing strip down.[390]

Private mortgage insurance (PMI) premiums can be used to confirm this analysis, according to Professor Levitin, because PMI ordinarily does not cover any bankruptcy strip down risk.[391] Thus, to the extent the differences in PMI premiums for different kinds of properties track the differences in mortgage interest rates for those different kinds of properties, we can determine, he argues, that the differences in mortgage interest rates are not due to strip down risk but rather to other risk factors.[392]

Prices that Freddie Mac and Fannie Mae pay when they buy mortgages also can be used to confirm the results, according to Professor Levitin. If Freddie Mac and Fannie Mae do not discount the price they will pay for mortgages that are subject to strip down risk, then it appears that they do not think the availability of strip down creates extra risk that needs to be priced.[393]

The temporal/geographical comparison is possible, according to Professor Levitin, because strip down of mortgages on principal residences was permitted only by some courts at some times and in some places prior to the Supreme Court's decision in *Nobelman* prohibiting such strip down.[394] By analyzing mortgage interest rates and mortgage availability in light of exactly when and where strip down was permitted, it should be possible, according to Professor Levitin, to determine whether availability of strip down affected mortgage interest rates and availability.[395] Professor Levitin and Professor Joshua Goodman undertook such an empirical study.[396]

Unfortunately, each of these attempts to obtain empirical answers suffers from a very basic flaw. It may be possible to determine the differences in interest rates and mortgage availability caused by the availability of mortgage strip down in bankruptcy under current law by

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389. *Id.* at 578.
390. *Id.* at 586–93.
391. *Id.* at 593.
392. *Id.* at 593–96.
393. *Id.* at 597–98.
394. *Id.* at 598.
395. *Id.* at 599.
396. *Id.* at 598–99; Levitin & Goodman, *Mortgage Market Sensitivity*, *supra* note 18; Levitin & Goodman, *Effect on Markets*, *supra* note 18.

comparing interest rates and availability for mortgages that can, in theory, be stripped down, with interest rates and availability for mortgages that cannot be stripped down. But that will tell us little or nothing that is reliable about the effect that the proposed legislation would have on mortgage interest rates and mortgage availability unless two conditions are established: (1) the kind of Chapter 13 strip down permitted under the proposed legislation must be the same kind as the kind currently available, or at least very similar to the kind currently available, and (2) the likelihood of such a Chapter 13 strip down actually being accomplished under current law must be the same, or at least very similar, to the likelihood of strip down being accomplished under the proposed legislation. Unless both those conditions can be established, we cannot say that the risk imposed on lenders will be the same, and we thus cannot say that their response in terms of higher interest rates or reduced mortgage availability will be the same. Because Professor Levitin asserts that his empirical studies provide strong evidence of the effect, or lack of effect, that enactment of the proposed legislation would have,[397] he is implicitly claiming that both conditions (1) and (2) hold.

Conditions (1) and (2) must hold if useful data is to be obtained, but neither can be established as being even remotely correct. The proposed legislation would allow a strip down in which the stripped down amount of the mortgage could be paid by reduced monthly mortgage payments, at a reduced interest rate, over a very long period of up to nearly forty years.[398] If the Ninth Circuit's *Enewally* decision is accepted, so that the *Enewally/Rash* approach is applied,[399] current law requires the stripped down mortgage to be paid off with interest over no more than five years.[400] Even if the Second Circuit's *Bellamy* decision is accepted, so that the *Bellamy* approach is applied,[401] current law requires the stripped down mortgage to be paid off with interest over no more than five years unless both the monthly mortgage payment and the mortgage interest rate are kept at their contractual levels.[402] The kind of strip down currently permitted is thus not even remotely the same—even under the *Bellamy* approach—as the kind that would be permitted by the proposed legislation. The likelihood of strip down being accomplished is also not even remotely the same. Debtors

397. *See supra* text accompanying notes 20–21.
398. *See supra* notes 228–29 and accompanying text.
399. *See supra* text accompanying notes 111–17.
400. *See supra* text accompanying notes 94–144.
401. *See supra* text accompanying notes 121–22.
402. *See supra* text accompanying notes 121–22, 176–83, 374.

who cannot afford their contractual monthly mortgage payment cannot accomplish a strip down under current law even under the *Bellamy* approach.[403] Under the *Enewally/Rash* approach, almost no one could accomplish a strip down under current law because the needed payments would be very large.[404] Thus, neither the kind of strip down nor its availability is remotely the same under current law as under the proposed legislation.

It also appears to be clearer and clearer as time passes that the *Enewally/Rash* approach is considered by most courts to be correct.[405] If the *Enewally/Rash* approach is followed, then there is currently no serious risk of strip down of first mortgages on multiple unit properties or on vacation or second homes, at least not where the property has substantial value, because of the high payments that would be required. It is thus not surprising that neither the type of property comparison, nor the PMI premium study, nor the Freddie Mac/Fannie Mae pricing study showed a strip down risk in Professor Levitin's studies;[406] there essentially is none under current law.

Note that the quotes Professor Levitin obtained for his study were for quite substantial mortgages.[407] No debtor could afford to pay off such a mortgage, even stripped down somewhat, with interest during a three-to-five-year plan. It is therefore not surprising that Professor Levitin found that lenders do not currently price for such a nonexistent or nearly nonexistent risk.[408] Of course strip down of first mortgages on substantial properties would be quite feasible under the proposed legislation;[409] the proposed legislation thus would create a risk far different from the essentially nonexistent risk under current law.

A similar analysis holds for the temporal/geographical comparison. It can yield reliable results only if conditions (3) and (4) hold: (3) the kind of strip down of mortgages secured only by principal residences that was available at some times and in some places before *Nobelman* must be the same kind as, or at least very similar to, the kind that would be available

403. *See supra* text accompanying note 402 (noting that *Bellamy* approach requires that full contractual amount of monthly payment not be reduced if plan strips down mortgage and provides for stripped down mortgage to be paid off over more than five years). If the stripped down mortgage must be paid off instead over no more than five years, the payments would be even larger; if the contractual monthly mortgage payment is unaffordable, a larger monthly payment certainly would also be unaffordable.

404. *See supra* text accompanying notes 128–36.

405. *See supra* text accompanying notes 113–25.

406. *See* Levitin, *supra* note 6, at 599 ("Taken together, the historical data and current market-pricing data indicate that mortgage markets are largely indifferent to bankruptcy-modification outcomes. The current market data suggest almost complete indifference . . . .").

407. *See id.* at 651–53 (showing quotes for $320,000 mortgages).

408. *See supra* note 406 and accompanying text.

409. *See supra* text accompanying notes 362–64.

under the proposed legislation, and (4) the likelihood of strip down at the times and in the places where it was permitted pre-*Nobelman* must be the same as, or at least very similar to, the likelihood of strip down under the proposed legislation. Again, Professor Levitin must be claiming implicitly that conditions (3) and (4) hold.[410] But again neither the kind of strip down nor its availability is remotely the same. The courts that allowed such pre-*Nobelman* strip downs did not permit alteration of the contractual monthly payment or the contractual interest rate.[411] Only debtors who could afford the full contractual monthly payment could accomplish a strip down.[412] The proposed legislation is designed to allow strip down by debtors who cannot afford their full contractual monthly mortgage payments.

It is interesting to note that Professor Levitin did detect an increase in interest rates—though only a small increase—due to the availability of strip down at some times and places pre-*Nobelman*.[413] Mortgage holders were subject to a real, though limited, risk of losses from strip down before the *Nobelman* decision, and it is possible that Professor Levitin's empirical studies captured the effect, or some of the effect, of that risk. The much greater risks that would be created by the proposed legislation presumably would cause a substantially greater increase in interest rates.

It may also be worth noting that the persons who could use home mortgage strip down at some times and in some places pre-*Nobelman* and the persons who, in theory, can use it today with regard to multiple unit properties or vacation homes have, as a general matter, relatively strong creditworthiness as compared to those who could use home mortgage strip down under the proposed legislation. Again, it should be stressed that only those who could afford to make the full contractual monthly payment, plus something each month to make up for arrearages, could use home mortgage strip down where it was permitted pre-*Nobelman*, or, under the *Bellamy* approach, where it is permitted currently. Under the *Enewally/Rash* approach, only those who can afford to pay off the entire stripped down mortgage with interest over no more than five years can use strip down currently where it is permitted.[414] By contrast, the proposed legislation is targeted at debtors who cannot afford their current monthly payments and

410. *See supra* text accompanying note 397.

411. *See supra* text accompanying notes 121–22, 176–83, 374.

412. *See supra* text accompanying note 403.

413. *See infra* text accompanying notes 418–21.

414. *See* Enewally v. Wash. Mutual Bank (*In re* Enewally), 368 F.3d 1165, 1172 (9th Cir. 2004), *cert. denied*, 534 U.S. 1021 (2004).

who need to have those payments reduced.[415] And far from requiring payoff of the stripped down mortgage over no more than five years, the proposed legislation would allow extension of the term of the mortgage, in some cases to nearly forty years.[416] Thus, the creditworthiness and ability to pay of those intended to benefit from the proposed legislation is quite different.

Interest rates and mortgage availability are sensitive to expected losses. Expected losses from strip down would seem undoubtedly to be higher where strip down is used by debtors who cannot afford to pay their current contractual monthly mortgage payments as compared to those who can afford to make that payment and more, or even afford to pay off the entire mortgage in five years. This additional flaw makes it even less likely that Professor Levitin's empirical studies could provide reliable evidence that enactment of the proposed legislation would have little effect on mortgage interest rates and mortgage availability.

To sum up, the proposed legislation would allow a kind of strip down that modifies the mortgage holders' rights much more severely than was permitted, only by some courts, pre-*Nobelman* and much more severely than what is currently theoretically permitted for mortgages on multiple unit or vacation properties. It would make strip down much more easily accessible than it was in the courts that permitted it pre-*Nobelman* and much more easily accessible than it is currently for multiple unit or vacation properties. Further, strip down would be available to debtors who are likely, as a group, to be much less capable of making substantial payments on their mortgages and substantially less creditworthy than (1) the debtors who were permitted to use strip down pre-*Nobelman* and (2) the debtors who currently are, in theory, permitted to use strip down. Thus, there is simply no reason to think that Professor Levitin's empirical study can provide us with reliable evidence that there will be no substantial effect on mortgage interest rates or mortgage availability if the legislative proposals allowing home mortgage strip down become law.[417]

## V. THE LIKELY EFFECTS ON HOME MORTGAGE INTEREST RATES AND HOME MORTGAGE AVAILABILITY OF THE PROPOSED HOME MORTGAGE STRIP DOWN LEGISLATION

Unfortunately, the conclusion that Professor Levitin's empirical studies cannot provide us with reliable evidence of the likely effect of the proposed

415. *See supra* note 126 and accompanying text.

416. *See* H.R. 1106, 111th Cong. § 103 (2009); Durbin Amendment, *supra* note 4, § 503, at S4981.

417. For an argument that the empirical studies suggest that there would be a substantial effect, see *infra* text accompanying notes 418–22.

strip down legislation may leave us with little more than common sense approaches to estimate the likely effect. On the other hand, Professor Levitin and his co-researcher Professor Goodman did find that availability of home mortgage strip down pre-*Nobelman* was associated with "a statistically significant increase of twelve to sixteen basis points"—.12% to .16%—for median-risk borrowers and a "marginally statistically significant impact of thirty-two to sixty-two basis points"—.32% to .62%—for "high risk borrowers."[418] They also found that availability of home mortgage strip down pre-*Nobelman* seemed to make lenders require somewhat higher down payments: "Under our most conservative assumption, we find that permitting strip-down results in a reduction of loan to value ratios for all mortgages."[419] They found that loan-to-value ratios were affected for higher risk borrowers by almost 2.8%, as measured six months after a ruling in an area permitting strip down;[420] reduction in loan-to-value ratios for other borrowers may not have been statistically significant.[421]

The reader will reach his or her own conclusion about how much more severe the risks and costs would be under the proposed congressional legislation than under the very different and much more restricted pre-*Nobelman* strip down that was available in certain geographic areas, but the author would suggest a factor of at least five times the severity. If that estimate is correct, and if the empirical studies of Professor Levitin and Professor Goodman are reliable in this respect, then it would be reasonable to expect that, due to enactment of the proposed congressional legislation, the typical borrower would be forced to pay at least a half percent and perhaps a full one percent higher mortgage interest rate, and the higher risk borrower would pay an interest rate two or three percent higher than the rates that otherwise would be charged. Borrowers likely would be asked to make higher down payments in lieu of which even higher interest rates might be charged, if the lender were willing to proceed with the loan. Higher risk borrowers might be required to provide substantially higher down payments—perhaps an additional ten to fifteen percent—or else face even higher interest rates, if the lender were willing to go forward.

Of course, extrapolation is dangerous and does not always yield reliable results.[422] At least, however, it may be said that Professor Levitin's

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418. Levitin, *supra* note 6, at 599.

419. Levitin & Goodman, *Mortgage Market Sensitivity*, *supra* note 18, at 23.

420. Levitin, *supra* note 6, at 598.

421. Levitin & Goodman, *Mortgage Market Sensitivity*, *supra* note 18, at 23.

422. *See, e.g.*, R. LYMAN OTT & MICHAEL LONGNECKER, AN INTRODUCTION TO STATISTICAL

empirical research, far from providing reliable evidence that the proposed congressional legislation would not cause home mortgage interest rates to rise and would not restrict home mortgage availability, in fact suggests just the opposite.

In any event, it seems clear that the proposed legislation would substantially affect the risk characteristics of mortgages by imposing on the mortgage holder the risk of future declines in home values while giving the debtor essentially a free option on future increases.[423] The prospect of the extension of what perhaps would have been a fifteen year mortgage to a mortgage payable over up to forty years would also seem unfavorable, especially when the court-determined interest rate that the debtor would pay on the court-determined stripped down amount of the mortgage would be in place for that entire period of up to forty years. The failure of mortgage strip down proponents to address the major risk of redefault—even though that is a key factor in the HAMP Net Present Value test—creates legitimate doubt that their sunny views of the effect of the proposed legislation would come true.[424] Their similar failure to consider the self-cure rate—the percentage of debtors who would cure and pay off their mortgages under current law, either outside of bankruptcy or in Chapter 13, but who could, if the proposed legislation passes, instead modify and strip down their mortgages—creates similar doubt, especially given that the cure rate also is a key factor in the NPV test.[425] And the sunny conclusion that a mortgage holder would be guaranteed to receive at least as much under a Chapter 13 modification and strip down as the mortgage holder would receive in a prompt foreclosure cannot be accepted.[426]

The first of only two countervailing factors would seem to be the hope that some mortgage holders who, for one reason or another, chose not to enter into voluntary mortgage modifications allowing debtors to stay in their homes would come out ahead under Chapter 13 modifications forced on the mortgage holders under the proposed legislation. Some structural obstacles to voluntary modifications have already been addressed,[427] and it is usually not sensible to assume that sophisticated financial entities are unable to determine what is in their financial interest.

METHODS AND DATA ANALYSIS 596 (6th ed. 2010); SUNNY BAKER, THE COMPLETE IDIOT'S GUIDE TO BUSINESS STATISTICS 234 (2001).

423. *See supra* Part III.

424. *See supra* notes 6–9, 299–310 and accompanying text.

425. *See supra* notes 6–8 and accompanying text.

426. *See supra* text accompanying notes 144, 333–43.

427. *See, e.g.*, *supra* note 8 (describing the Obama Administration's Home Affordable Modification Program); Helping Families Save Their Homes Act of 2009, Div. A of Pub. L. No. 111-22, § 201, 123 Stat. 1632, 1638–40 (codified as amended at 15 U.S.C.A. § 1639a (2009)) (entitled "Servicer Safe Harbor for Mortgage Loan Modifications").

The second countervailing factor would be the hope that the availability of Chapter 13 mortgage modifications under the proposed legislation would help to end the cycle of more foreclosures leading to lower home values leading to more foreclosures, and so on, with greater and greater losses to mortgage holders as a group, as well as to homeowners.[428] Of course first-time home buyers are happy to see home prices drop from their inflated levels, and it is not clear that such a cycle would take home prices below a level that somehow could be thought to be optimal.

What does seem clear is that higher risks will be accounted for in mortgage pricing and availability. What also seems clear is that the greatest effect will be (1) on mortgages where the home buyer cannot make a large down payment, or wants to refinance despite having relatively little equity, (2) on mortgages made during what appear to be times of declining home prices, and (3) on mortgages made when market interest rates are higher than they are expected to be in the future. Both mortgage interest rates and mortgage availability are likely to be affected.

To consider points (1) and (2), perhaps as a society we wish to make it more difficult for persons with small down payments to buy homes and for persons with little home equity to refinance. It would be refreshing, but not politically palatable, for members of Congress to admit that the proposed legislation would likely have that effect. Strip down obviously is more costly to a mortgage holder the lower the court-determined value of the home is as compared to the principal balance of the mortgage; a small down payment, or a small amount of equity at the time of refinancing, or an expectation of declines in home values, will make the anticipated strip down losses greater and thus have a greater effect on mortgage pricing and

428. *See, e.g.*, 155 CONG. REC. H2848 (daily ed. Feb. 26, 2009) (statement of Rep. Conyers) (discussing the need to "limit the downward cycle of foreclosures that are now damaging our neighborhoods"); March 4 Treasury Guidelines, *supra* note 8, at 1 ("[I]n the absence of decisive action, we risk an intensifying spiral in which lenders foreclose, pushing area home prices lower, reducing the value of household savings, and making it harder for all families to refinance."); Opening Statement of Damon Silvers Before Congressional Oversight Panel: Philadelphia Field Hearing on Mortgage Foreclosures 2 (Sept. 24, 2009), http://cop.senate.gov/documents/statement-092409-silvers.pdf ("This very tidal wave of mortgages threatens a vicious cycle—in which foreclosures exert downward pressure on housing prices, falling real estate values and defaulted mortgages push down on bank capital, weakened banks pull back on lending, causing business activity to decline and unemployment to rise, feeding more defaults."); *July 2009 Levitin Testimony*, *supra* note 20, at 7 ("We know that foreclosures place downward pressure on home prices and beget more foreclosures, creating a negative feedback loop or death spiral in the housing market."). *But see* Mason, *supra* note 7, at 6–7 (suggesting that home prices are affected much more by macroeconomic circumstances than by the level of foreclosures).

availability.

In addition, to consider point (3), mortgages made when interest rates are higher than they are expected to be in the future may be subject to being modified to a lower interest rate under the proposed legislation. That may cause mortgage originators to charge even higher rates or restrict availability. High mortgage interest rates have a negative effect on home prices because the buyers cannot afford as large a mortgage as they could with lower rates. Thus, declining values and high interest rates may go together, compounding the cost to mortgage holders of the proposed legislation, and increasing the likely effect on mortgage pricing and availability.[429]

## VI. CONCLUSION

The proposed home mortgage strip down legislation is likely to increase mortgage costs and decrease mortgage availability. There simply is no way to know with any confidence just how substantial those effects will be. Professor Levitin's empirical studies do not provide a sound basis for an optimistic view that the proposed legislation will not have a substantial effect on home mortgage interest rates and availability; in fact, his studies may suggest just the opposite. In any event, the proposed legislation would substantially alter the risk characteristics of home mortgages, and thus the effect could easily be quite substantial. Again unfortunately, if the proposed legislation is enacted, there likely will be no way to ever tell what its effect was. If interest rates go up, and availability drops, we would not know the extent to which the legislation might have been the cause of such changes. If interest rates go down and mortgage availability increases, we would not know whether rates would have gone down even more and availability increased even more had the legislation not been enacted.

It also would be difficult to measure the effect that enactment of such legislation might have on public cynicism about debt-relief initiatives and the "bailouts" with which those initiatives may be connected in the public's mind. But where a prudent homeowner—one who waited to buy a home until he or she had a substantial down payment, who waited to buy until interest rates were reasonable, and who did not engage in cash-out refinancing to finance consumption—sees the major benefit of the legislation going to those who took the opposite course, resentment or

429. Note, for example, that a one percent increase in the interest rate on a thirty-year $300,000 mortgage from a seven percent rate to an eight percent rate would increase monthly payments by about $205, from about $1,996 per month to about $2,201 per month. *See, e.g.*, The Washington Post, Mortgage Calculator, http://www.washingtonpost.com/real-estate/tools-calculators/mortgage-calculator.html (last visited Nov. 21, 2009).

cynicism is a likely reaction.

One key problem with the proposed legislation is its grant to the debtor of, in effect, a free option on future appreciation. A provision giving the mortgage holder a real and substantial right to recapture most of the future appreciation[430] 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. Such a provision should not depend on whether the debtor chooses to sell or refinance the home. If the debtor does not do so before the end of five years, the mortgage holder should nonetheless be able to obtain a share of the appreciation by seeking a new valuation of the home. The stripped down principal then would be restored by perhaps two-thirds of any appreciation revealed by the new valuation.

It might also make sense to focus the legislation on providing help for the debtor over the shorter term during which financial distress is likely to persist. Something like the steps in the HAMP waterfall,[431] though perhaps in reverse order, could be implemented on a temporary basis by the plan, with (1) a temporary change in the amortization schedule to a longer period, (2) a temporary forbearance of payment of principal and interest and of accrual of interest on the portion of the principal that exceeds the value of the home, and (3) a temporary interest rate reduction. Such changes could be put in place for the five years of a Chapter 13 plan; or perhaps even for five years in a process that might be set up during a Chapter 7 bankruptcy that would eliminate most unsecured debts and make the debtor more able to make mortgage payments.[432] The original terms of the mortgage—in particular the contractual interest rate and the contractually required amount of monthly payments—then could be reinstated after that period.[433] Debtors thus could be helped to keep their homes despite temporary financial distress

430. The 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. A realistic measure of the added value due to improvements—probably something less than the optimistic seventy-five percent of cost figure used by FHA in its recapture provisions, *see supra* note 328—could also be used to give the debtor an additional share of appreciation very roughly equivalent to the appreciation likely caused by the improvements.

431. *See supra* text accompanying notes 279–95.

432. It is not clear why a debtor in need of help with his or her mortgage should be required to go through a Chapter 13 plan, with all of its complexities, unless the goal is to make the relief less appealing and thus less quickly sought.

433. Reinstatement of the terms of the mortgage under this suggested approach would not involve capitalizing the amount by which interest payments were reduced during the five years; that is,the principal balance of the mortgage would not be increased by the amount of the reduction in interest payments nor would the debtor otherwise be required to pay that amount.

and without changing, for up to forty years, the rights of mortgage holders. So long as such an approach would provide the mortgage holder a reasonable return during the five-year period on the value of the home, it could provide an appropriate balance.

Strong limits on the availability of even these limited forms of home mortgage modification might also minimize the negative effects. Such limits should be designed to avoid the worst problems with moral hazard, self-cure risk, redefault risk, and creation of resentment. One approach would be to allow a debtor to modify the home mortgage only if:

1. The mortgage was originated prior to January 1, 2008;[434] and
2. Either

(a) since the date of origination of the mortgage the debtor has unexpectedly suffered a serious and likely persistent reduction in income (for reasons beyond his or her reasonable control); or

(b) since the date of origination of the mortgage the debtor has unexpectedly suffered large and likely continuing medical expenses; or

(c) sharp or fraudulent practices were used to lead the debtor to believe that the mortgage would be affordable; or

(d)(i) since the date of origination of the mortgage the value of the home has dropped by at least 25% (not taking into account any reduction in value caused by waste or by any other unreasonable action on the part of the debtor) and (ii) the amount of the mortgage is at least 125% of the value of the collateral to which the mortgage holder is entitled to look (again not taking into account any reduction of the value of the home due to waste or other unreasonable action on the part of the debtor); and

3. The debtor's income is less than 150% of the state median income; and
4. The court finds that there is a very high likelihood (or if requirement 2(c) is satisfied, that there is a likelihood) that the debtor will make the payments required by the mortgage as modified.[435]

For these purposes, the debtor's income would not be determined under the flawed "current monthly income" definition contained in the Bankruptcy

434. Perhaps a clear statement of the rationale either in the statute or in the legislative history—that by this date debtors must have known of the mortgage crisis and should have been careful with their borrowing, *see supra* text accompanying note 44—could give this date more sticking power than temporal limitations generally have in bankruptcy. *See supra* note 237.

435. *See infra* text accompanying note 439.

Code,[436] but rather based on the debtor's tax returns, preferably using adjusted gross income for the year ended before the relevant date. Thus the 2005 tax return would be used to determine income as of the date of origination of a mortgage originated during 2006, and current income would be based on the most recently filed tax return. Although the choice of any particular percentage level would be somewhat arbitrary, perhaps a fifteen percent reduction in income could be set as the level of serious reduction, and perhaps medical expenses equal to ten percent of income could be considered to be large for these purposes. Reductions in income could likely be considered to be persistent if they are likely to continue for at least two years; similarly, medical expenses could be considered to be "continuing" if they are likely to continue for two years.

Why these limitations? To deal with moral hazard concerns, it would make sense to limit use of home mortgage modification to debtors who obtained their mortgages before it became clear that there was a serious mortgage crisis and to debtors whose inability to make their mortgage payments is to a great degree beyond their reasonable control. Debtors who obtained mortgages after it was clear that there was a mortgage crisis should be considered to have assumed the risk of financial difficulties even more clearly than debtors who obtained mortgages at an earlier date; thus a limitation of home mortgage modification to mortgages originated prior to January 1, 2008,[437] or perhaps even an earlier date, would make sense. Debtors who have suffered neither an unexpected substantial and persistent decrease in income nor an unexpected substantial and continuing increase in medical expenses may seem to be opportunistic in their claim that they cannot afford to pay the mortgage, absent sharp practices that led them to believe that they would be able to pay the mortgage. Note that current law allows debtors who suffered temporary income reduction to save their homes by filing in Chapter 13 if their income level has sufficiently recovered so that they are able to cure defaults and continuing regular payments during a Chapter 13 plan. Debtors with a relatively high level of current ability to pay may be thought to be acting opportunistically by attempting to modify their mortgages rather than fulfilling their contractual obligations or using the existing cure and maintain provisions of Chapter 13. But debtors whose homes have dropped very substantially in value so that the mortgage is substantially undersecured may be thought to act reasonably

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436. *See* § 101(10A).

437. *See supra* text accompanying note 44.

in deciding that that they should not continue paying the mortgage in full; thus the alternative of modifying the mortgage and then paying it as modified may be thought to be reasonable rather than opportunistic.

Debtors who have suffered neither a substantial and persistent unexpected reduction in income nor substantial and continuing unexpected medical expenses may be thought to be able in many instances to engage in self-cure.[438] The same is true of debtors with relatively high income. Excluding such debtors from home mortgage modification will tend to reduce the costs imposed on lenders due to the self-cure risk. However, a debtor who has suffered such a loss of income or such medical expenses is not likely to be able to engage in self-cure unless the resulting financial difficulty is relatively short-lived; hence, the choice of a two-year term to represent the difference between relatively short-lived financial difficulties and relatively long-term financial difficulties. Once again, though, if the value of the home has dropped substantially so that the mortgage is substantially undersecured, the likelihood of self-cure will be reduced, and the costs imposed on mortgage holders by permitting modification will be small.

A requirement of a heightened likelihood that the debtor will be able to make payments under the mortgage as modified will help to reduce the redefault risk.[439] But debtors who were led by sharp or fraudulent practices to believe that they would be able to afford what turned out to be an unaffordable mortgage should be given a wider opportunity to try to meet their obligations under a mortgage as modified in Chapter 13; thus the current standard for feasibility should be retained for such debtors.

Resentment is likely to be minimized by exclusion of relatively high income debtors. It also is likely to be minimized by exclusion of debtors whose failure to make contractually required payments occurs without unexpected financial reverses and despite their knowing acceptance of the risks—either because they obtained their mortgages after the existence of a mortgage crisis was common knowledge or because no sharp or fraudulent practices were used to convince them that they could afford the mortgages. But where the mortgage is substantially undersecured due to a substantial drop in the value of the home, people will understand that it may not be reasonable to expect the debtor to meet the contractual obligation; the reasonable debtor might simply walk away from the home.

Debtors who are not excluded by these limitations could be allowed to modify their mortgages in the limited ways described in this Conclusion. It is unlikely that permitting such modest modifications would create

438. *See supra* notes 7–8, 425 and accompanying text.

439. *See supra* notes 7–8, 424 and accompanying text.

substantial resentment. It is also unlikely that permitting such modifications would create unreasonable risks that would impose large costs on mortgage holders, either due to self-cure risk or redefault risk. Thus, future interest rates and future availability of home mortgages would not likely be substantially affected. Finally, permitting such modest modifications in limited circumstances would not set a precedent that would likely create expectations on the part of future home mortgage borrowers or lenders that the borrowers would be relieved of their mortgage obligations at substantial cost to mortgage holders. Thus, permitting such modifications would not seem to create a serious moral hazard problem going forward.

Instead, to the extent bankruptcy law can contribute to breaking the downward cycle of foreclosures begetting lower home prices begetting more foreclosures, permitting such modifications might be to the benefit of all homeowners and of most mortgage holders as well. Given the modest nature of the permitted modifications and the limited availability of such modifications under the author's proposals, the author does not believe the proposals would likely result in home prices being artificially propped up to the serious detriment of first time home buyers or would likely result in an unnecessary and damaging prolongation of the mortgage crisis. But there can be no confident assurance on either of those points.