STRIPPING DOWN THE SUBPRIME CRISIS

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INTRODUCTION

In *Nobelman v. American Savings Bank*, the Supreme Court held that a literal reading of the Bankruptcy Code prohibits a Chapter 13 debtor from modifying the rights of a mortgage lender's claim secured only by a primary residence.[1] The decision requires a Chapter 13 debtor to pay the entire amount of the mortgage lender's claim in order to retain possession of his home.[2] Given that a debtor can modify the rights of nearly every other creditor in bankruptcy,[3] one might wonder why mortgage lenders hold such an elite status. In his concurring opinion, Justice Stevens stated:

> At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market. It therefore seems quite clear that the Court's literal reading of the text of the statute is faithful to the intent of Congress.[4]

While the Court's holding may be "faithful to the intent of Congress," this article argues that Congress should revaluate and amend the Bankruptcy Code because it no longer reflects an accurate picture of the mortgage industry. Traditionally, mortgage loans were available to only those borrowers deemed creditworthy. Further, the loans that were extended to those select individuals were

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1 Nobelman v. Am. Sav. Bank, 508 U.S. 324, 332 (1993).

2 *See id. See generally* 11 U.S.C. § 1322(b)(2) (2007) ("[T]he plan may . . . modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence. . . .").

3 *See* 11 U.S.C. § 1322(b)(2) ("[T]he plan may . . . modify the rights of holders of secured claims . . . .").

4 *Nobelman*, 508 U.S. at 332 (Stevens, J., concurring) (citation omitted).

priced at just above market, and lenders profited because very few loans defaulted. However, the introduction of subprime loans changed the traditional business model of the mortgage lender by increasing the number of people who could qualify for mortgage loans and shifting the risk of default to investors, while shifting the risk of market fluctuation to borrowers.

Part I of this article examines the current financial crisis and concludes that the subprime mortgage loan is at the root of the crisis. Part II presents a brief overview of the Bankruptcy Code and discusses pertinent sections of the Code: Section 506(a), which allows a debtor to bifurcate claims into secured and unsecured parts, and § 1322(b)(2), which prohibits a debtor from changing the "rights" of mortgage lenders. Part II offers an amendment to § 1322(b)(2) that would allow certain debtors to modify the terms of their mortgage loan.

Part III applies bankruptcy's justifications to the proposed amendment. Part III A & B considers internal goals of bankruptcy, specifically the goals of equitable distribution among creditors and providing a fresh start to the debtor. Part III C looks to the external goals of bankruptcy, such as the maintenance of an "open credit economy." This article concludes by advocating for the amendment's adoption.

I. THE CURRENT FINANCIAL CRISIS

A. Factors That Paved the Way for the Housing Boom

The U.S. housing boom started in 1998, "when large numbers of people decided that real estate, which still [had not] recovered from the early 1990s slump, had become a bargain."[5] At the time, low interest rates allowed a homeowner to make monthly mortgage payments that were, on average, ten percent less than those made in 1990.[6] Further, as compared to earlier in the decade, incomes had risen thirty percent.[7]

Despite low interest rates and rising incomes, many people could still not qualify for a mortgage loan. The traditional mortgage lender, typically local banks,

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[5] David Leonhardt, *Can't Grasp Credit Crisis? Join the Club*, THE N.Y. TIMES, March 19, 2008, www.nytimes.com/2008/03/19/business/19leonhardt.html?_r=1&ei=5087&em=&en.

[6] *See* Kim Clark, *Can the Housing Boom Last?*, FORTUNE MAGAZINE, February 2, 1998, http://money.cnn.com/magazines/fortune/fortune_archive/1998/02/02/237209/index.htm.

[7] *Id.*

had a simple business model, one of low risk and low return. The lender would closely scrutinize loan applicants to identify those that were least likely to default.[8] Once identified, the lender would sell those individuals "a relatively static product," such as a thirty year, fixed rate, fully amortizing loan.[9] Although the lender would make only a small profit on each loan, "[t]he model work[ed] because the number of loans paid in full in accordance with their terms [was] perhaps fifty times the number of loans that default[ed]."[10]

Wall Street, however, saw potential profit in the many turned away by traditional mortgage lenders and transformed the mortgage industry with an innovation known as subprime loans.[11] Subprime loans change the traditional mortgage lender's business model in at least three ways. First, a subprime loan is, by definition, "a mortgage loan to a borrower with sub-standard credit."[12] By extending loans to borrowers who cannot qualify for traditional prime loans, subprime loans greatly increase the number of people who can borrow.

Second, to compensate for being sold to riskier borrowers, subprime loans come with higher interest rates.[13] For example, from 1995 to 2004, "the average interest rate of a fixed-rate subprime loan at origination was over two percent higher than the rate of prime loans at origination."[14] When paid in accordance with loan terms, the higher interest rates means higher rates of return for the lender.

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[8] *See* Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 385 (stating that profitability depends on "limiting bad loans through the exercise of judgment about the quality of potential borrowers").

[9] *Id.* at 384.

[10] *Id.* at 384-85.

[11] *See* Leonhardt*, supra* note 5 ("[Wall Street] was transforming the mortgage business from a local one, centered around banks, to a global one, in which investors from almost anywhere could pool money to lend.").

[12] Kenneth Johnston et. al, *The Subprime Morass: Past, Present, and Future*, 12 N.C. BANKING INST. 125, 125 (2008); *see also In Re* First Alliance Mortgage Co., 471 F.3d 977, 984 (9th Cir. 2006) ("A typical borrower in the subprime mortgage market is 'house-rich' but 'cash-poor,' having built up equity in his home but in little else, and has a lower net income than the average borrower.").

[13] Johnston et. al, *supra* note 12, at 126.

[14] *Id.*

Third, the majority of subprime loans are adjustable rate mortgages (ARMs).[15] ARMs change the traditional business model by shifting the risk of interest rate fluctuations from lenders to borrowers.[16] Instead of having a fixed interest rate throughout the entire life of the loan, an ARM adjusts after a certain period of time to reflect the market.[17] As explained by Wells Fargo, because of the lower initial interest rate, an ARM can help consumers:

- Buy a more expensive home. Because your maximum loan amount is based on the initial monthly payments, you may be able to borrow more.
- Save money if you expect to move or refinance. If you plan to move or refinance before the end of the loan's initial fixed period, you can take advantage of an ARMs lower payments without worrying about future rate increases.[18]

However, "ARMs present the risk that an increase in interest rates will lead to a significantly higher monthly payment."[19] Further compounding this risk, subprime ARMs often begin with a low "teaser" rate and then adjust to charge significantly higher interest rates.[20] When the interest rate is increased, the borrower's mortgage payment also increases.

The securitization of the mortgage loan also changed the mortgage industry. Traditionally, mortgage lenders "bore the risks of their loans and therefore had

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[15] *Id.* ("[T]he majority of subprime loans tend to be [ARMs]."); *see also* Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 84-85 (2008) (stating that ARMs "have become a major form of lending at the sub-prime level").

[16] Johnston et. al, *supra* note 12, at 126 ("ARMs shift the risk of rate fluctuation from the lender to the borrower, which can present risks for consumer borrowers who may be forced to incur higher rates and greater payment obligations in the future.").

[17] *See* Federal Reserve Board, Consumer Handbook on Adjustable-Rate Mortgages (2007), *available at* http://www.federalreserve.gov/pubs/arms/arms_english.htm (stating that ARMs are loans with interest rates that change, typically in relationship to an index like the Cost of Funds Index or the London Interbank Offered Rate).

[18] *See* Wells Fargo, http://www.wellsfargo.com/mortgage/buy/loans/descriptions/adjustable (last visited March 22, 2008).

[19] Johnston et. al, *supra* note 12, at 126.

[20] *Id.* (stating that, when teaser rates are involved, "the initial interest rate will be lower-than-market and will later adjust to a substantially higher prevailing market rate").

incentive to ensure loan security and repayment."[21] Today, however, mortgages are sold and packaged into mortgage backed securities (MBS).[22] MBS are then sold to investors who are issued "claims to the expected interest and principle payments owed by the mortgagees."[23] This shifts the risk of default from mortgage lenders to investors.[24] MBS allow low quality loans, such as subprime mortgages, to be pooled with high quality loans, like those issued under the traditional business model. This practice makes MBS less risky for the investor. One individual's "ability to make payments becomes of marginal significance to the pools [sic] performance."[25]

B. Effects of the Housing Boom

Between 1998 and 2005, the housing market exploded. "Frenzied demand caused home prices to jump . . . and generated [ten percent] gains each year in housing wealth for many Americans, who quickly used refinancings or home-equity loans to convert some of the windfall into cash."[26] The demand was so great that some houses were being "appraised at more than 1,000 percent their real value."[27]

Homebuilding also "made an oversize[d] contribution to the growth of real gross domestic product and employment."[28] From 2002 to 2005, residential construction accounted for more than twelve percent of economic growth, as compared to its historical average of five percent.[29] Additionally, from 2003 to 2005, construction jobs accounted for over sixteen percent of all new jobs, as compared to its historical average of five percent.[30]

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[21] Unterman, *supra* note 15, at 84.

[22] *Id.* (stating that "[t]oday most mortgages are sold and packages in MBS").

[23] *Id.* at 86.

[24] *See id.* at 84 ("Today most mortgages are sold and packaged into MBS and therefore mortgage risk is assumed by investors, not the originators."); *see also* Johnston et. al, *supra* note 12, at 128 ("MBSs can take a variety of structures, but their principal purpose is to transfer the right to receive 'the cash flow from pools of mortgage loans,' as well as to transfer the related default risks, to third-party investors.").

[25] Unterman, *supra* note 15, at 86.

[26] Kathleen Madigan, *After the Housing Boom*, BUS. WK., Apr. 11, 2005, at 79.

[27] Donna Walter, *As Mortgage Crisis Deepens, Some Seek Aid—or Lawsuits*, THE DAILY RECORD, Dec. 4, 2007, at 3.

[28] Madigan, *supra* note 26, at 81.

[29] *Id.*

[30] *Id.*

Overconfidence in MBS further fueled the subprime mortgage market.[31] "The [securitization] industry marketed MBS as stable instruments insulated from the risks of a housing downturn,"[32] thus encouraging the misconception "that the pooling of mortgage loans automatically reduces risk through diversification." [33] However, diversification only reduces risk if high quality loans are added to the pool; risk is not reduced by adding more low quality loans.[34] "[B]y fooling investors to believe that bad loans could be transformed through the sophistication of the investment industry," the MBS market was artificially inflated.[35] According to Federal Reserve Chairman Ben Bernanke, subprime lending grew from $35 billion in 1994 to $600 billion in 2006.[36]

C. The Housing Bust

In 2005, the housing market began to show signs of slowing down.[37] According to Richard Berner, chief United States economist for Morgan Stanley, "Home prices [would] rust, not bust, for the next few years."[38] Still, some were concerned about how the market would react:

> [This] new reality will have a big impact on homeowners who have begun to look at [ten percent] annual gains in home values as a birthright. Consumers who made a habit of tapping into their home equity will find that their home is no longer a personal ATM. Anyone counting on continued home appreciation to fund their retirement or pay for their children's education may face a big shortfall when the bills come due. The new ways that housing is

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[31] Unterman, *supra* note 15, at 86 ("MBS enjoyed a great deal of market confidence during the U.S. housing boom, with some even thought of as an alternative to the security of U.S. Government Treasury Bonds.").

[32] *Id.* at 87.

[33] *Id.* at 86.

[34] *Id.* at 86-87 (stating that the "risks of a MBS are determined by the quality of mortgage loans which are accumulated").

[35] *Id.* at 87.

[36] Ben Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve, Remarks at the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm.

[37] Madigan, *supra* note 26, at 80.

[38] *Id.*

> financed also shift the risk of rate changes from banks to homeowners. That could squeeze some families who have adjustable-rate mortgages.[39]

Key to avoiding the bust were "housing prices [that rose] in tandem with economic indicators like job growth, GDP, and household income . . . ."[40] However, these economic indicators were all inextricably linked to the housing industry; when housing prices stagnated, job growth, GDP, and household income all stagnated. In fact, the United States Government Accountability Office (GAO) reported that "the rapid decline in the rate of home price appreciation throughout much of the nation beginning in 2005 may have reduced incentives for borrowers to keep current on their mortgages and made it more difficult for borrowers to refinance or sell their homes to avoid default or foreclosure."[41]

An international crisis began in late 2006 and early 2007 when the housing bubble burst.[42] As subprime borrowers defaulted on their mortgage loans, MBS began "losing some or all of their worth . . . ."[43] "The pressure of credit risks and illiquidity has forced many high profile banks, corporations, and hedge funds to take enormous write downs and, in some cases, has resulted in bankruptcy."[44]

II. CAN A SOLUTION BE FOUND IN BANKRUPTCY?

A. Background on the Bankruptcy Code

An individual generally files for bankruptcy when he is insolvent, meaning that he is "unable to satisfy creditors or discharge liabilities, either because [his] liabilities exceed [his] assets or because of [his] inability to pay debts as they mature."[45] The Bankruptcy Code provides two mechanisms for insolvent individuals or debtors to discharge unpaid debts.[46] First, under Chapter 7 of the Code, a debtor

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39 *Id.*

40 Clark, *supra* note 6, at 48.

41 Johnston et. al, *supra* note 12, at 130 (citing U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE HOUSE COMM. ON FIN. SERVS., GAO DOC. NO. 08-78R, at 4 (Oct. 16, 2007)).

42 *See id.* at 130-31 (describing the economic crisis).

43 *Id.* at 131.

44 *Id.*

45 WEBSTER'S UNABRIDGED DICTIONARY 987 (2d ed. 2001).

46 Marrama v. Citizens Bank of Mass., 127 S. Ct. 1105, 1107 (2007).

can "discharge prepetition debts following the liquidation of the debtor's assets by a bankruptcy trustee, who then distributes the proceeds to creditors."[47] Therefore, the amount of money creditors in a Chapter 7 will receive is, with some exceptions, limited to those proceeds generated by the bankruptcy estate, which consists of all of the debtor's existing assets.[48]

Under Chapter 13 of the Code, which provides the second mechanism, a debtor "with regular income [may] obtain a discharge after the successful completion of a payment plan approved by the bankruptcy court."[49] However, a creditor must receive in Chapter 13 what the creditor would have received in Chapter 7.[50] Thus, while Chapter 13 allows the debtor to retain possession of his assets, the debtor's assets will still form the basis of the debtor's payment plan.[51]

Determining how much each creditor will receive under either option requires a discussion of priorities. For purposes of this article, the priorities of two creditors will be discussed: those of secured creditors and unsecured creditors. A secured creditor is a creditor with a claim that is protected by specific assets.[52] An unsecured creditor, on the other hand, is an individual or institution that lends money without obtaining specified assets as collateral.[53] This poses a higher risk to the unsecured creditor because the secured creditor is preferred in bankruptcy.[54]

Consider the following example: A debtor files for Chapter 7. The debtor has one asset, a painting that is sold by the Trustee for $100,000. Three creditors have claims against the bankruptcy estate: a bank has a claim for $90,000 secured by the painting, and two unsecured creditors each have claims for $20,000. Under Chapter 7, the trustee will distribute $90,000 to the bank secured by the painting. The remaining $10,000 will be distributed to the two unsecured creditors, each

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47 *Id.*

48 *See* KAREN GROSS, FAILURE AND FORGIVENESS 25-29 (Yale University Press 1997) (describing bankruptcy's liquidation option).

49 *Marrama*, 127 S. Ct. at 1107.

50 *See* GROSS, *supra* note 48, at 56 ("All plans of reorganization . . . must pay creditors at least as much as they would receive in a liquidation case.").

51 *Id.* at 29-34 (describing bankruptcy's reorganization option).

52 WEBSTER'S UNABRIDGED DICTIONARY 1731 (2d ed. 2001).

53 *Id.* at 2086.

54 GEORGE W. KUNEY, MASTERING BANKRUPTCY 123-26 (2008).

receiving $5,000. Therefore, the two unsecured creditors will be compensated twenty-five cents for every dollar they are owed.

If the debtor has a steady income and wants to retain possession of the painting, he may enter into Chapter 13. Chapter 13 requires the debtor to propose a plan that will allow his creditors to receive at least what they would have received in Chapter 7. Therefore, over the term of the plan, the debtor will have to pay the secured creditor $90,000 and pay each unsecured creditor at least $5,000.

B. Strip Down in Bankruptcy

Section 506(a) of the Bankruptcy Code, which applies to both Chapter 7 and Chapter 13 filings, "provides that an allowed claim secured by a lien on the debtor's property 'is a secured claim to the extent of the value of [the] property'; to the extent the claim exceeds the value of the property, it 'is an unsecured claim.'"[55] Therefore, § 506(a) allows a debtor to "strip down" the creditor's claim, guaranteeing the creditor full payment for only that portion that is secured.[56]

To illustrate strip down, let us amend the facts from the example in Part III A by valuing the painting at $50,000 instead of $100,000. Because the collateral is now worth less than the amount of the claim, the debtor can use § 506(a) to strip down the bank's $90,000 secured claim to $50,000. The remaining $40,000 the bank is owed will become an unsecured claim, and the bank will have to get in line with the other unsecured creditors to be compensated for that portion. Given that the painting is the debtor's only asset, the unsecured claims will probably not be paid. Again, if the debtor entered into Chapter 13 in order to retain possession of the painting, the debtor would have to propose a plan that would give the creditors at least what they would have received in Chapter 7.[57] Therefore, over the term of the plan, the debtor would have to pay the bank at least $50,000.

If instead of a painting the asset at issue was the debtor's primary residence, the secured creditor would be treated differently.[58] In *Nobelman v. American Savings Bank*, the debtor fell behind on his mortgage payments and sought relief under

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[55] *Nobelman*, 508 U.S. at 328 (citation omitted); *see also* 11 U.S.C. § 506(a).

[56] 11 U.S.C. § 506(a).

[57] *See* GROSS, *supra* note 48, at 56 ("All plans of reorganization . . . must pay creditors at least as much as they would receive in a liquidation case.").

[58] *Nobelman*, 508 U.S. at 332 (holding that the debtor could not modify the rights of a creditor secured by the debtor's primary residence).

Chapter 13 of the Bankruptcy Code.[59] The mortgage lender filed a proof of claim for $71,335, representing the principal loan amount of $68,250 plus interest and fees.[60] At the time of filing, however, the debtor's home was worth only $23,500.[61] Relying on § 506(a), the debtor's Chapter 13 plan proposed to strip the lien to an amount equal to the value of the property.[62] Under the plan, the debtor would make payments pursuant to the mortgage contract up to the amount of the secured claim.[63] The remaining portion of the loan would be treated as an unsecured claim, and the lender would receive nothing under the plan.[64]

The lender and the Chapter 13 trustee objected to the petitioner's claim, arguing that the proposed bifurcation of the lender's claim violated § 1322(b)(2) of the Bankruptcy Code.[65] Section 1322(b)(2) of the Code provides that a debtor may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is a debtor's principal residence . . . ."[66] The Court found that giving effect to § 506(a)'s bifurcation of the loan would require a modification of the rights of the holder of the security interest.[67] Therefore, the Court held that § 1322(b)(2) prohibited "such a modification where . . . the lender's claim [was] secured only by a lien on the debtor's principal residence."[68]

C. Proposed Solution—Amending Chapter 13 to Allow Strip Down of Loans Secured by Debtor's Primary Residence

The financial crisis described in Part II is far from over. At the root of the crisis is the subprime loan, the majority of which are ARMs.[69] "According to Federal Reserve Chairman Ben Bernanke, the rate of serious delinquencies for ARMs has

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[59] *Id.* at 326.

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] 28 U.S.C. § 1322(b)(2).

[67] *Nobelman*, 508 U.S. at 332.

[68] *Id.*

[69] *See supra* Part II A (describing ARMs).

increased significantly, reaching nearly sixteen percent as of August 2007."[70] Further, it is estimated that nearly one trillion dollars in ARMs will reset within the next three years.[71] As these ARMs reset, more and more borrowers will be unable to make their mortgage payments resulting in foreclosure for many borrowers,[72] as well as a continued liquidity crisis for MBS investors and the underwriting financial institutions.[73]

The White House's initial reaction to the increasing rate of foreclosures came in October 2007, when Treasury Secretary Henry Paulson unveiled Hope Now.[74] "Hope Now is an alliance between counselors, mortgage market participants, and mortgage servicers to create a unified, coordinated plan to reach and help as many homeowners as possible."[75] While Hope Now claims it is succeeding,[76] others argue it has "done little to keep the housing crisis from deepening."[77]

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[70] Bernanke, *supra* note 36.

[71] Johnston et. al, *supra* note 12, at 138.

[72] *See, e.g.*, Jane Birnbaum, *A Break for Freddie and Fannie*, N.Y. TIMES, Mar. 20, 2008, at C1 (describing the foreclosure situation with jumbo ARMs). The article states: "[A]bout 870,000 borrowers took jumbo ARMs—mortgages of $417,000 or more—from 2005 to 2007. In the fourth quarter of 2007, 8.10 percent were two payments late . . . while 2.62 percent were in the foreclosure process and 1.35 percent have been foreclosed. . . . [Further, it is] predicted that eventually 8 percent of these jumbo ARMs will be foreclosed." *Id.*

[73] Johnston et. al, *supra* note 12, at 138 ("ARM resets combined with a weak housing market will fuel a continued liquidity crisis for the homeowner, the subprime investor, and the underwriting financial institution alike.").

[74] Press Release, Hope Now, Alliance Created to Help Distressed Homeowners (October 10, 2007) (available at http://www.fsround.org/hope_now/pdfs/AllianceRelease.pdf). The project was expanded in February 2008 with the addition of Project Lifeline, a program under which six major lenders agreed to halt foreclosures for some delinquent borrowers. However, a moratorium only puts off the problem. This could actually benefit the six participating lenders: Bank of America Corp., Citigroup Inc., Countrywide Financial Corp., J.P. Morgan Chase and Co., Washington Mutual Inc., and Wells Fargo & Co. Together the lenders make up over 50 percent of the credit card industry. *See* Mann, *supra* note 8, at 385 n.50 (commenting on the concentration of the credit card industry). If debtors are struggling to stave of foreclosure, it is likely that all income is going to that purpose. Therefore, credit cards are likely being used to pay for other necessities like food, utility bills, and gas. *See, e.g.*, Jason Hidalgo, *Housing Crunch Adds to Credit Card Troubles*, RENO GAZETTE-JOURNAL, Feb. 11, 2008, at 1A. (telling the story of one couple who accumulated $30,000 in credit card debt paying for "daily expenses").

[75] Alliance Created to Help Distressed Homeowners, *supra* note 75.

[76] Lynnley Browning, *SOS Unanswered*, N.Y. TIMES, Apr. 2, 2008, at C1.

[77] *Id.*

One problem cited is that "the financial powers behind Hope Now—mortgage lenders, loan servicers and big investors—are reluctant to change loan terms substantially if doing so hurts them."[78] One solution to this problem is to allow another, more neutral entity to decide whether loan modification is appropriate for any given borrower. This could be achieved by amending Chapter 13 of the Bankruptcy Code to allow for the modification of mortgages on a debtor's primary residence.[79] This would enable Chapter 13 plans to strip down a mortgage loan to the home's current value, rather than the indebtedness on the home. It would also allow bankruptcy judges to adjust the interest rate of the loan to better reflect the ability of the borrower to make payments.

III. APPLICATION OF BANKRUPTCY'S PURPOSES TO THE PROPOSED SOLUTION

Bankruptcy law has existed in this country for over a century. Throughout that time, the purposes of bankruptcy law have prevailed as a commonly cited and valid reason on which to ground a court's decision.[80] Therefore, in order to determine whether the proposed solution is an appropriate one, this Part will analyze the solution in view of the purposes of bankruptcy law.

According to "time-worn bankruptcy lore,"[81] the bankruptcy system serves two purposes: first, the fair and equal distribution of assets among the creditors;[82]

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[78] *Id.*

[79] Four bills were proposed, two by the House of Representatives and two by the Senate. S.B. 2136 (Helping Families Save Their Homes in Bankruptcy Act of 2007) is similar to H.R. 3609 (Emergency Home Ownership and Mortgage Equity Protection Act of 2007), and S.B. 2133 (Homeowners' Mortgage and Equity Savings Act) is similar to H.R. 3778 (Homeowners' Mortgage and Equity Savings Act). In general, the bills seek to limit or delete § 1322(b)(2)'s prohibition on modification of mortgages on a debtor's principal residence. The bills would allow a bankruptcy judge to strip down a mortgage loan on a primary residence to the home's current value rather than the indebtedness on the home. While S.B. 2136 and H.R. 3609 would allow bankruptcy judge's the right to eliminate the prohibition without restriction, S.B. 2133 and H.R. 3778 permit strip down under certain circumstances.

[80] *See, e.g.*, Stellwagen v. Clum, 245 U.S. 605, 617 (1918) (discussing the main purposes of the federal system of bankruptcy). *See generally* Jackson, 98 HARV. L. REV. 1393, 1447 (1985) (noting that discussions of bankruptcy policy ordinarily proceed without a "grounding in a normative theory of discharge's functions, goals, and justifications").

[81] Charles G. Hallinan, *The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 50 (1986).

[82] *See, e.g.*, Stellwagen, 245 U.S. at 617 ("The federal system of bankruptcy is designed . . . to distribute the property of the debtor . . . fairly and equally among his creditors . . . .").

and second, "to aid the unfortunate debtor by giving him a fresh start in life."[83] In 1970, the Commission on the Bankruptcy Laws of the United States added to these two purposes. The Commission was formed "to study, analyze, evaluate, and recommend changes in the substance and administration of the bankruptcy laws of the United States."[84] The Commission submitted to Congress a report in 1973, which became a helpful tool employed in the congressional sessions leading up to the passage of the 1978 Bankruptcy Code.[85]

The report identified both external and internal goals of the bankruptcy process and considered the relationship between the external and internal goals.[86] The internal goals included:

(1) Open access of both debtor and creditor to the bankruptcy process;
(2) Fair and equitable treatment of creditors' claims;
(3) Rehabilitation of debtors;
(4) Efficient and economical case administration;
(5) Deterrence and sanctions against fraud and other dishonest conduct; and
(6) Production of information concerning the outcomes and effects of bankruptcy cases.[87]

The external goals in question are the values involved in the "open credit economy."[88] The report stated that the primary function of the bankruptcy system was to continue the law-based orderliness of the open-credit economy in the event of a debtor's inability or unwillingness to pay his or her debts.[89] However, the internal goals should prevail in instances of conflict with external goals.[90]

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83 *Id.*

84 Kenneth N. Klee, *Legislative History of the New Bankruptcy Code*, 54 AM. BANKR. L.J. 275, 277 (1980); *see also* Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 (creating the nine person commission).

85 Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137 (1st. Sess. 1973).

86 *Id.* at 68-83

87 *Id.* at 75-76, 79, 81-83.

88 *Id.* at 68.

89 *Id.* at 69.

90 *Id.* at 75.

In 2005, the 1978 Bankruptcy Code was reformed by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[91] The reform came in response to perceived abuse in bankruptcy filings.[92] As stated by the House, Congress believed (1) that bankruptcy relief was "too readily available and [was] sometimes used as a first resort, rather than a last resort;"[93] (2) that loopholes and incentives present in the 1978 Code allowed "and—sometimes—even encourage[d] opportunistic personal filings and abuse;"[94] and that this abuse led to (3) higher costs being passed onto consumers who lived up to their financial obligations.[95]

This article argues that Congress's stated intent in passing BAPCPA does not override those goals set forth in the Commission's report. Rather, BAPCPA's intent only modifies and enhances certain goals laid out by the Commission, namely bolstering the fifth stated goal: to deter and sanction fraud and other misconduct.

A. Fair and Equitable Treatment of Creditors' Claims

One of the tenets of bankruptcy is that similarly situated claimants should be treated the equally. In *Nathanson v. NLRB*, the Supreme Court stated "[t]he theme of the Bankruptcy Act is 'equality of distribution' and if one claimant is to be preferred over others, the purpose should be clear from the statute."[96]

As demonstrated in Part III, § 1322(b)(2) treats mortgage lenders secured by the debtor's primary residence differently from lenders secured by other assets. Mortgage lenders get the best possible deal in bankruptcy. They are paid in full, regardless of the current value of the asset, and paid according to the original terms of the contract.[97] As Professor Elizabeth Warren explains:

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[91] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

[92] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, H.R. REP. No. 109-31(I), at 3-5 (1st Sess. April 8, 2005).

[93] *Id.* at 4.

[94] *Id.* at 5.

[95] *Id.* at 4.

[96] Nathanson v. Nat'l Labor Relations Bd., 344 U.S. 25, 29 (1952) (citation omitted).

[97] *See* 11 U.S.C. § 1322(b)(2) (2002) ("[T]he plan may . . . modify the rights of holders of secured claims, *other than* a claim secured only by a security interest in real property that is the debtor's principal residence . . . .") (emphasis added).

> At the time the 1978 Code was adopted, such deference may have been entirely appropriate. After all, mortgage lending was stable, long-term lending, with interest rates pegged only modestly above anticipated inflation. To require that these long-term lenders subject themselves to the vagaries of contract-rewriting that is the norm for bankruptcy risked de-stabilizing an entire industry.[98]

However, due to the changes in the mortgage industry, many mortgage lenders no longer deserve this special protection. No longer are mortgage lenders local banks that extend "stable, long-term" loans to only those consumers least likely to default. Rather, mortgage lenders now extend subprime loans to those consumers who are most likely to default because those consumers are willing to pay the highest interest rates.[99] The risk of default, which traditionally acted as a check on the mortgage lenders' selection process, now falls on MBS investors.[100] Therefore, while it is clear after *Nobelman* that mortgage lenders are preferred over other creditors in bankruptcy,[101] it is not clear why this is the case; the risks that once justified preferring mortgage lenders no longer seem relevant—at least, not in all cases.

The amendment to § 1322(b)(2) would not require bankruptcy judges to modify the debtor's mortgage loan. Mortgage lenders that continue to operate under the traditional business model explored in Part II.A may very well deserve to maintain their elite status. Rather, the amendment would dispose of §1322(b)(2)'s bright line rule. Currently, a bankruptcy judge may not, under any condition, modify the terms of a mortgage loan secured by the debtor's primary residence. The amendment to § 1322(b)(2) would allow the judge to look at the circumstances of the case to determine whether the mortgage lender deserves to be preferred over all other secured creditors.

B. Fresh Start of the Debtor

In 2007, providing a fresh start to the "honest but unfortunate debtor" was reaffirmed by the Supreme Court as the "principal purpose" of bankruptcy. [102]

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[98] Elizabeth Warren, *The New Economics of the American Family*, 12 AM. BANKR. INST. L. REV. 1, 32 (2004).

[99] *See supra* notes 12-13 and accompanying text.

[100] *See supra* notes 21-25 and accompanying text.

[101] *See* Nobelman v. Am. Sav. Bank, 508 U.S. 324, 325-326 (1993) (holding that the debtor could not modify the rights of a creditor secured by the debtor's primary residence).

[102] Marrama v. Citizens Bank of Mass., 127 S. Ct. 1105, 1107 (2007) (citing Grogan v. Garner, 498 U.S. 279, 286-87 (1991).

However, while this phrase comes with a pedigreed endorsement, it is argued that the phrase has lost its bite: "[A]s is the case with many widely employed truisms, common acceptance of the phrase tends to obscure the elusiveness of its content. Indeed, as used most frequently in judicial and legislative analysis, the 'debtor's fresh start' is simply a synonym for the existing set of debtor-protection devices . . . ."[103]

It is important to note that the bankruptcy law's commitment to providing a debtor a fresh start "is a decidedly modern and peculiarly American phenomenon."[104] Two explanations for the American approach are typically put forth. The more common explanation is "framed in terms of socioeconomic policy and social utility."[105]

> In large part, this approach was founded on a perception of insolvent debtors as potentially valuable contributors to the nation's economic development, whose participation in the economy was impeded by the hopelessness of their financial conditions. Relief measures, the argument ran, were an appropriate means of restoring to the public at large the benefits of these debtors' entrepreneurial skills and energies, and of doing so with minimal impact on their creditors' realistic expectations of repayment.[106]

Although this policy was meant to encourage the American entrepreneur,[107] its implication—that it is difficult for individuals to remain productive members of society when their finances are in ruin—remains true as applied to the current financial crisis. According to the Census Bureau, in 2005 more than one third of homeowners spend over 30 percent on housing costs, defined as mortgage payments, taxes, insurance, and utilities.[108] The situation, referred to as being "house

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[103] *See* Hallinan, *supra* note 82, at 51.

[104] *See id.* at 53.

[105] *See id.* at 57.

[106] *Id.*

[107] Another segment of the population harmed by the subprime crisis is the "flipper." These are individuals who purchased homes with the intention of selling or "flipping" them for a profit. These individuals often took out ARMs with the mindset that the home would be out of their hands by the time the loan reset to a higher interest rate. These individuals are now stuck with homes they cannot sell and interest rates they cannot pay. It could be argued that flippers are entrepreneurs that should be encouraged, rather than discouraged.

[108] Americans Becoming Increasingly House Poor (Oct. 3, 2007), http://www.msnbc.msn.com/id/15107993/.

poor,"[109] not only means that homeowners have less disposable income,[110] but it also jeopardizes the family's overall financial security.[111]

The second explanation for the American policy of fresh start is "framed in moral terms."[112]

> Building on a characterization of the insolvent's default as a matter of misfortune rather than blameworthiness, this approach focused on mercy or forbearance as the morally correct response to financial failure and depicted collection efforts as a morally repugnant effort to inflict suffering for greedy motives. From this perspective, relief legislation was, if not precisely an enforcement of a creditor's obligation to forbear and forgive, at least a refusal to involve the state in his morally questionable pursuit of repayment.[113]

Again, this explanation falls in line with the current financial crisis. The underlying conditions that led to the current financial crisis were based on misconceptions about the market; borrowers were fooled into believing they could refinance at any time.[114] However, "[t]oday's ARMs were 'designed to fail, so you have to refinance . . . It should [not] be surprising that values go up and down in this kind of situation. And when you most need to refinance you can[not]—the crux of the crunch.'"[115]

"The determination [to make certain debts nondischargeable is] made, at least in part, because the need for and importance of payment to the recipient outweighs the need for and importance of rehabilitation of the debtor."[116] Here,

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[109] *See, e.g.*, Warren, *supra* note 99, at 33 (describing "house poor"). However, "the label is misleading. Many of the 'house poor' are not poor at all. They are middle-class families that overextended themselves in a desperate effort to find a home in a safe neighborhood with decent schools." *Id.*

[110] *See, e.g.*, Peter S. Goodman, *Slump Moves from Wall St. to Main St.*, N.Y. TIMES, Mar. 21, 2008, at A1 (discussing how the credit crisis is being felt by retail stores).

[111] Warren, *supra* note 99, at 34 ("The data are unmistakable: commitment to a huge mortgage is threatening the economic survival of millions of families.").

[112] Hallinan, *supra* note 82, at 57.

[113] *Id.*

[114] *See* Birnbaum, *supra* note 73 (stating "that lenders assured [homeowners] they could always refinance").

[115] *Id.* (quoting Professor Susan M. Wachter, professor of business and real estate specialist at the Wharton School of the University of Pennsylvania).

[116] GROSS, *supra* note 48, at 111.

there are both socioeconomic and moral reasons to rehabilitate the debtor by allowing strip down of his mortgage debt. The debtor, once relieved of his overwhelming mortgage debt, will have more disposable income and will be better able to handle his other financial obligations. Therefore, instead of having his money tied up in his house, he could be investing in other aspects of society. Further, the amendment would allow a bankruptcy judge to determine whether the mortgage lender precipitated a known misconception, thereby allowing the judge to assess whether this is a "morally questionable pursuit of repayment."[117]

C. External Goals of Bankruptcy

According to the Commission on Bankruptcy Laws of the United States "credit furthers economic growth and increases individuals' well-being, and both goals are better served if consumers are inclined to take risks. A basic function of bankruptcy is therefore to serve the credit markets."[118]

While the amendment would support the two purposes of bankruptcy, equitable distribution of assets and a fresh start to debtors, some question whether it is "wise to remove the anti-modification governmental incentive that encourages the lender side of the transaction at a time when other factors, such as depressed home values, have already chilled the market[.]"[119] According to the Mortgage Bankers Association and the American Bankers Association, any bill which allows homeowners to modify their mortgages in bankruptcy would cause mortgage interest rates to jump significantly.[120] Further, the measure will cause lenders to tighten their

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[117] Hallinan, *supra* note 82, at 57.

[118] Johanna Niemi-Kiesiläinen, *Consumer Bankruptcy in Comparison: Do We Cure a Market Failure or a Social Problem?*, 37 OSGOODE HALL L.J. 473, 476 (1999).

[119] Alvin Fletcher Benton & James L. Fly, *Home Foreclosure Crisis: Will Proposed Amendments to the Bankruptcy Code Be Helpful or Hurtful?*, Bankruptcy and Creditors Rights Newsletter (Dec. 10, 2007), *available at* http://www.hklaw.com/id24660/PublicationId2317/ReturnId31/contentid49748/.

[120] Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?: Hearing Before the Subcomm. On Commercial and Administrative Law of the H. Comm. of the Judiciary, 110th Cong. 3 (2007) (statement of David G. Kittle, Chairman-Elect, Mortgage Banker's Association) (claiming that permitting modification of mortgages in bankruptcy will result in an effective 200 basis point increase in interest rates on single-family owner-occupied properties with a 5-10 percent down payment).

lending requirements, making it harder for potential borrowers to qualify for a home loan.[121]

However, according to a study by two Georgetown professors, these fears seem unfounded.[122] The study tested the impact of mortgage strip-down and modification on principal home residence mortgage rates, loan origination volumes, loan-to-value ratios, and bankruptcy filing rates.[123] The study found that "permitting bankruptcy modification of mortgages would have no or little impact on mortgage markets."[124] Further, the study stated that the Mortgage Bankers Association figure that resulted in a higher interest rate was "the result of a cherry-picked comparison."[125]

The Mortgage Bankers Association further argues that such a measure would give bankruptcy courts too much leeway to rewrite loans without legal or economic restraints.[126] Section 1322(b)(2) allows bankruptcy judges to modify the rights of all creditors except those of a holder of a "claim secured only by a security interest in real property that is debtor's principal residence."[127] Speaking on the topic, Bankruptcy Judge Jacqueline P. Cox stated:

> I quote the Supreme Court to emphasize that interest rates are adjusted in our proceedings routinely. In fact, since the 2004 *Till* decision, I have held only two or three hearings involving disputes over interest rate adjustments. The bar and the financial services community have very little trouble in this regard.[128]

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121 Posting of Rhonda McMillan, http://blog.goallpro.com/mortgage-adjustments-by-bankruptcy-judges/ (Mar. 17, 2008, 14:28 EST).

122 Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets*, (Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper No. 1087816, 2008), *available at* http://ssrn.com/abstract=1087816.

123 *Id.*

124 *Id.* at 1.

125 *Id.* at 40.

126 Benton & Fly, *supra* note 119.

127 11 U.S.C. § 1322(b)(2).

128 United States Senate Committee on the Judiciary, *The Looming Foreclosure Crisis: How to Help Families Save Their* Homes, Before the S. Comm. On the Judiciary (Dec. 5, 2007) (Testimony of the Honorable Jacqueline P. Cox), *available at* http://judiciary.senate.gov/print_testimony.cfm?id-3046&wit_id-6809 (italics added).

CONCLUSION

In *Nobelman v. American Savings Bank*, the Supreme Court held that a Chapter 13 debtor could not use strip down to modify the rights of a mortgage lender secured by the debtor's primary residence.[129] This article argues that, in light of the current and continuing financial crisis in the United States, the Bankruptcy Code should be amended to reverse the Supreme Court's decision. The amendment would allow debtors to adjust a mortgage lender's claim secured by the debtor's primary residence to the amount of the collateral's worth. Further, the amendment would allow a bankruptcy judge to adjust the interest rate of the mortgage loan to reflect a rate the borrower would be able to bear.

The amendment is supported by the purposes of the Bankruptcy Code: fair and equitable treatment of creditors' claims and a fresh start for the debtor. Mortgage lenders no longer deserve to be preferred over other secured creditors. Moreover, both socioeconomic and moral concerns call for the rehabilitation of the debtor over the repayment of the mortgage lender.

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[129] 508 U.S. 324, 332 (1993).