Chapman Law Review

Volume 15 | Issue 1 Article 8

2011

Fighting the Foreclosure Flu: A Proposal to Amend 11 U.S.C. § 1322(b)(2) to Authorize Residential Mortgage Modification in Bankruptcy

Liana Mikhlenko

Fighting the Foreclosure Flu: A Proposal to Amend 11 U.S.C. § 1322(b)(2) to Authorize Residential Mortgage Modification in Bankruptcy

Liana Mikhlenko[*]

INTRODUCTION

The days of soaring property values have been dislodged by the devastating collapse of the real estate market in 2007, leaving more than five million homeowners entangled in foreclosure proceedings.[1] Foreclosures in 2009 reached record-breaking heights and are forecast to increase every year.[2] Even the most conservative estimates for the next few years presume at least six million more homes will follow in the foreclosure footsteps.[3] By 2012, predictions contend that 8.1 million homes, or 16% of all residential mortgages, will go through foreclosure proceedings.[4]

Notwithstanding the idea that foreclosures are natural occurrences in a credit economy, the troubling aspect of the

* J.D. Candidate May 2012, Chapman University School of Law; B.S. Marketing 2009, San Diego State University. The author offers her sincerest appreciation to Professor Stephanie Hartley for her insightful guidance, feedback, and general mentorship. She would also like to thank David Lee and the Chapman Law Review for their valuable comments and inspiration. She is also forever indebted to her family and friends for their unwavering support, and endless encouragement.

1 *See* CREDIT SUISSE, FORECLOSURE UPDATE: OVER 8 MILLION FORECLOSURES EXPECTED 2 (2008), http://www.chapa.org/pdf/ForeclosureUpdateCreditSuisse.pdf; Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington D.C. (Dec. 4, 2008), *transcript available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm; CONG. OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 5, 7 (2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:47888.pdf (estimating 10% of residential borrowers had been involved in foreclosure proceedings with approximately 2900 homes entering foreclosure every day).

2 *See* Daren Blomquist, *A Record 2.8 Million Properties Receive Foreclosure Notices in 2009*, REALTYTRAC, http://www.realtytrac.com/landing/2009-year-end-foreclosure-report.html?a=b&accnt=233496 (last visited May 17, 2011) (finding foreclosure proceedings on 2.8 million properties in 2009, which was an increase of 21% from 2008 and 120% from 2007).

3 CREDIT SUISSE, *supra* note 1, at 2.

4 *Id.* at 1.

current round of foreclosures is its origin.[5] Whereas preceding foreclosure epidemics resulted from high unemployment and medical infirmity, the prevailing infection is derived from predatory lending practices that qualified subprime borrowers for unconventional mortgage terms without any documentation of income or affordability.[6] Such non-traditional mortgage terms were characterized by ballooned interest rates and recalculated payment obligations.[7] When placed against the backdrop of declining home prices, homeowners were left without any viable means of refinancing unaffordable terms.[8]

Such extensive and widespread foreclosures detrimentally affect borrowers, lenders, and innocent third parties.[9] Borrowers lose their biggest financial expenditure and lenders are forced to sacrifice a significant portion of their investment.[10] Surrounding neighbors and tax bases must also bear the cost of foreclosures.[11] Even adjacent communities bear the burden of depressed real estate values culminating from the lack of maintenance on

---

5 Ben Steverman & David Bogoslaw, *The Financial Crisis Blame Game*, BUSINESSWEEK.COM (Oct. 18, 2008, 12:01 AM), http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm; *see also* Lauren Hassouni, *The Nuts, Bolts, Carrots, and Sticks of the Mortgage and Foreclosure Crisis; and a Suggested Solution, in* NORTON ANNUAL BANKRUPTCY SURVEY 590, 593–97 (William L. Norton Jr. ed., 2010); CONG. OVERSIGHT PANEL, *supra* note 1, at 1.

6 *See* Hassouni, *supra* note 5, at 593–97; *see also* CONG. OVERSIGHT PANEL, *supra* note 1, at 1; *see* ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 144 (6th ed. 2009).

7 *See* Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007, at C1; *see also* Ruth Simon & James R. Hagerty, *1 in 4 Borrowers Under Water,* WALL ST. J., Nov. 24, 2009, at A1 (affirming that almost 11 million borrowers were dealing with negative equity in the 3rd quarter of 2009); *see A Snapshot of the Subprime Market,* CTR. FOR RESPONSIBLE LENDING 1 (Nov. 28, 2007), http://www.responsiblelending.org/mortgage-lending/tools-resources/snapshot-of-the-subprime-market.pdf (determining that 89–93% of subprime mortgages made from 2004–2006 had "exploding" adjustable interest rates); John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123, 1124 (2008) (noting that homeownership is now a liability rather than what was once considered an individual's most valuable asset).

8 Eggum, *supra* note 7, at 1123–24.

9 CONG. OVERSIGHT PANEL, *supra* note 1, at 6; *see also* Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEB. 57, 58 (2006), *available at* http://www.prism.gatech.edu/~di17/HPD_Cost.pdf; *see also* Lorna Fox, *Re-Possessing "Home": A Re-Analysis of Gender, Homeownership and Debtor Default for Feminist Legal Theory*, 14 WM. & MARY J. WOMEN & L. 423, 434 (2008) (noting that losing one's home has a detrimental impact on an individual occupier's quality of life, social and identity status, and personal and family relationships); *see generally* Julia Isaacs & Phillip Lovell, *The Impact of the Mortgage Crisis on Children*, FIRST FOCUS (May 1 2008), http://www.firstfocus.net/sites/default/files/r.2008-5.1.lovell.pdf.

10 *See* CONG. OVERSIGHT PANEL, *supra* note 1, at 9.

11 *Id.*; *see generally* Anthony Pennington-Cross, *The Value of Foreclosed Property*, 28 J. REAL ESTATE RES. 193, 194–95 (2006) (estimating dead-weight losses of foreclosure).

abandoned homes.[12] Local businesses hurt for commercial value while state property and government taxes deteriorate.[13]

In an effort to deal with the broad impact of foreclosures, legislators need to incorporate a federal system designed to deal with economic issues of creditors and debtors. Fortunately, bankruptcy was instituted with such a purpose.[14] Bankruptcy was enacted to provide an orderly forum, guided by the legal process, within which the economic market manages the problems arising from unaffordable debt burdens.[15] Bankruptcy encourages the reconciliation of losses by creditors and incentivizes debtors to remain productive members of society.[16]

Currently, the Bankruptcy Code permits modification and bifurcation of secured interests in personal property and secured interests in real property for vacation homes, investment properties, and multi-family residences.[17] Appallingly, the most common real property security interest—a mortgage on a principal residence—is absent from this list.[18] In fact, the only permissible effect bankruptcy may have on a residential mortgage is allowing the debtor to cure defaults through a court-supervised repayment plan.[19] This provision leaves the debtor with an effectively higher monthly obligation because the debtor is required to maintain regularly scheduled monthly payments in addition to the plan payments.[20] As such, § 1322(b)(2) undermines the legal mechanism on which the market depends for sorting through debt relationships. Rather than assisting debtors in retaining their family home, § 1322 of the Bankruptcy Code condones the unaffordable and unconventional lending

12 *See* Immergluck, *supra* note 9, at 58.

13 John Kroll, *Foreclosure Study Says Vacant Properties Cost Cleveland $35+ Million*, BLOG.CLEVELAND.COM (Feb. 19, 2008, 12:29 AM), http://blog.cleveland.com/metro/2008/02/foreclosure_study_says_vacant.html; *see also* IHS GLOBAL INSIGHT, THE MORTGAGE CRISIS: ECONOMIC AND FISCAL IMPLICATIONS FOR METRO AREAS 2 (2007), *available at* http://www.fox5vegas.com/download/2007/1128/14716194.pdf; William C. Apgar & Mark Duda, COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY'S MORTGAGE FORECLOSURE BOOM 4 (May 11, 2005), http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf.

14 *See* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 570–71 (2009).

15 *Id.*

16 *Id.*

17 11 U.S.C. § 1322(b)(2) (2006).

18 *Id.*

19 *See id.* § 1322(b); *see e.g.*, Eggum, *supra* note 7, at 1131 (showing an example of an unaffordable loan from origination by comparing the interest rate on an adjustable mortgage at origination, 7.99%, with the rate the consumer faced seven months before declaring bankruptcy, 10.99%).

20 *See* Scott F. Norberg & Andrew J. Velkey, *Debtor Discharge and Creditor Repayment in Chapter 13*, 39 CREIGHTON L. REV. 473, 477–78 (2006).

practices of financial institutions that targeted a weak subprime market.[21]

This Comment advocates amending 11 U.S.C. § 1322(b)(2) to empower bankruptcy judges with authority to modify primary residential mortgages. Amplifying bankruptcy with this power presents potentially the most helpful medication to the current foreclosure flu.[22] The revolutionary changes to the structure of the mortgage industry over the last thirty years created an entirely new lending model emphasizing mortgage securitization.[23] Lenders responded to this model by providing exotic and unaffordable loan terms to subprime borrowers.[24] As the unaffordability of their loans became clear, borrowers became unable to make their mortgage payments.[25] Facilitating the use of bankruptcy will counteract the inefficiencies and failures of previous voluntary programs and legislative proposals.[26] The infrastructure of the current bankruptcy system is well suited to provide relief: it could provide a decrease in losses to creditors, tackle the disincentives of voluntary modifications, and actually address the non-traditional mortgage terms that directly caused the current foreclosure epidemic.[27] This approach would be effective, equitable, and immediate without using taxpayer funds.[28]

Part I will discuss the history and purpose of bankruptcy law in relation to secured interests and will set forth the modern

---

21 *See* Nandinee K. Kutty, *A New Measure of Housing Affordability: Estimates and Analytical Results*, 16 HOUSING POL'Y DEB. 113, 123–24 (2005) (defining the term "house-induced poverty" and determining that 4.3% of American households not in poverty were living in house-induced poverty which means that after paying necessary housing costs, they were unable to afford even the poverty basket of non-housing goods delineated by the Department of Health and Human Services' standards); *see also* Levitin, *supra* note 14, at 572.

22 J. Peter Byrne & Michael Diamond, *Affordable Housing, Land Tenure, and Urban Policy: The Matrix Revealed*, 34 FORDHAM URB. L.J. 527, 543–44 (2007).

23 *See* Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown,* 41 CONN. L. REV. 1257, 1259 (2009).

24 *See id.* at 1272–73.

25 *See id.* at 1273.

26 *See* 11 U.S.C. § 707 (2006); 11 U.S.C. § 1325 (2006); U.S. DEP'T OF JUSTICE, U.S. TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS FISCAL YEAR 2005, at 9 (2005), *available at* http://www.justice.gov/ust/eo/public_affairs/annualreport/docs/ar2005.pdf.

27 *See generally* OFF. OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT: ANALYSIS AND DISCLOSURE OF NATIONAL BANK MORTGAGE LOAN DATA (2008), *available at* http://www.occ.gov/publications/publications-by-type/other-publications/mortgage-metrics-q1-2008/mortgage-metrics-q1-2008-pdf.pdf; Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: The Workout Prohibition in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1088–89 (2009); CONG. OVERSIGHT PANEL, *supra* note 1, at 37–44; *see* Michelle J. White, *Bankruptcy: Past Puzzles, Recent Reforms, and the Mortgage Crisis*, 11 AM. L. & ECON. REV. 1, 20–21 (2009).

28 Levitin, *supra* note 14, at 647.

mechanisms available to debtors hoping to modify secured debt. Part II will explain how the development of the current mortgage industry revolutionized lending practices through unconventional mortgage terms and weak underwriting standards and their effect on the current financial crisis. Part III will outline the federal and legislative efforts introduced to deal with the foreclosure crisis and explanations of why they have all proven to be ineffectual. Part IV will highlight the benefits of using bankruptcy as a means of dealing with the current crisis. Part V will propose an addition to current legislative proposals that would require a recalculation of affordability and mandatory lender mediation.

I. THE PURPOSE OF BANKRUPTCY AND ITS CURRENT UTILITY

Bankruptcy is the most useful mechanism for dealing with competing credit interests and is regarded as a prime factor in helping the U.S. economy grow into one of the leading economies in the world.[29] Presently, secured interests are regarded with priority and are protected to the extent that the value of their collateral is equal or greater than the amount of the loan. Within a Chapter 13 bankruptcy, many other types of secured interests are permitted to be modified, but the financial institutions have limited the ability for a homeowner to substantially change any terms on a principal residence mortgage.

A. History and Purpose of Bankruptcy in Relation to Secured Interests

Following the codification of the Bankruptcy Code in 1978, bankruptcy has become the leading device for solving financial hardships.[30] The federal system formulates a legal process that enables the market to manage problems created when borrowers are encumbered with insurmountable debt.[31] While the

29 *See* WARREN & WESTBROOK, *supra* note 6, at 339. "[B]y the early 2000s, in a single year more people filed for bankruptcy than were diagnosed with cancer. More declared bankruptcy than graduated from college. And, as a reminder of the fallout from these bankruptcy decisions, we note that more children lived through their parents' bankruptcy than their parents' divorce." *Id.* at 144; s*ee also id.* at 338 (calling bankruptcy a "form of social safety net, supplementing unemployment insurance, public medical care, and the rest").

30 Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 101 et seq. (2006)); *see* White, *supra* note 27, at 2–3; *see* S. Rep. No. 95-989, at 141 (1978) ("Chapter 13 is designed to serve as a flexible vehicle for the repayment of part or all of the allowed claims of the debtor."); H.R. Rep. No. 95-595, at 118 (1977) ("The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets.").

31 Levitin, *supra* note 14, at 570–71.

bankruptcy process is indubitably a trying ordeal for every party involved, the bankruptcy framework authorizes creditors to collectively manage their portion of loss and encourages the debtor to be socially and economically productive.[32] Otherwise, a debtor buried by debt has disincentives to work since all possible income would be dispersed to creditors.[33] Furthermore, the existence of the federal bankruptcy system offers a venue where collective reformulations of debt may take place.[34]

Homeowners in jeopardy of losing their homes or becoming delinquent on mortgage payments have turned to bankruptcy to save their residences from impending foreclosures.[35] The utility of bankruptcy in this regard has been the automatic stay trigger afforded upon filing a voluntary petition.[36] A foreclosure proceeding, by definition, is a direct attempt to collect the mortgage deficiency through a forced sale, the proceeds of which pay off a portion of the loan balance for the benefit of the lender.[37] Therefore, the filing of a bankruptcy petition would halt the foreclosure proceeding and enable debtors to stay in their home.[38]

The Bankruptcy Code affords debtors various means of dealing with indebtedness.[39] Bankruptcies essentially fall into two categories: liquidations and payout plans.[40] Consumer debtors, however, are generally drawn toward two specific chapters. Chapter 7 provides the path for liquidation by requiring debtors to relinquish all non-exempt assets to a court-appointed Trustee.[41] Chapter 7 debtors

---

32 *Id.*; *see also* WARREN & WESTBROOK, *supra* note 6, at 141 (stating that"[t]he debtor gets back to work or starts a new business, flat broke and without much in the way of assets, but knowing that the benefits of tomorrow's hard work can be used to put groceries on the table instead of ending up in the pockets of old creditors").

33 *See* WARREN & WESTBROOK, *supra* note 6, at 141.

34 *Id.* at 102 (reflecting that creditors recognized "that a workable bankruptcy system, providing orderliness to the collection process and encouraging debtors to make some payments, even at the cost of permitting debtors a discharge, was in their interest as well").

35 *See id.* at 301 (indicating that "[f]or more than half the debtors . . . their single biggest asset is their home.").

36 11 U.S.C. § 362 (2006).

37 *Foreclosure,* BUSINESS DICTIONARY.COM, http://www.businessdictionary.com/definition/foreclosure.html (last visited May. 18, 2011).

38 *See* 11 U.S.C. § 362(a); *c.f.* 11 U.S.C. § 1322(b)(5) (2006).

39 Individuals may file under Chapter 7 liquidation, Chapter 11 reorganization, Chapter 12 for family farmers and fisherman, and Chapter 13 reorganization. 11 U.S.C. § 109(d)–(f) (2006). Chapter 9 is for municipalities. § 109(c). Chapter 11 requires more expensive filing and attorney fees, but can be beneficial if debtors exceed the debt limits of Chapter 13. § 109(e); *See Bankruptcy Filing Fees,* U.S. COURTS, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyResources/BankruptcyFilingFees.aspx (last visited May 18, 2011).

40 WARREN & WESTBROOK, *supra* note 6, at 115.

41 *See generally* 11 U.S.C. § 704 (2006) (discussing the duties of trustees);

> essentially freeze their assets and debts when they file for bankruptcy. Their assets become the property of the bankruptcy estate" and "[i]n return for liquidating all non-exempt assets, the debtor is relieved of any future obligations to pay dischargeable, pre-bankruptcy debts, and all the debtor's subsequent earnings are free from the reach of pre-petition creditors.[42]

As such, debtors filing under Chapter 7 accomplish the fundamental objectives of any bankruptcy: "fair distribution of the debtor's assets for the benefit of all creditors and a 'fresh start' for the debtor."[43]

Unlike Chapter 7, Chapter 13 "focuses on using [the debtors'] future earnings, rather than accumulated assets, to pay creditors."[44] As such, Chapter 13 presents the payout plan option, which gives the debtor an opportunity to reorganize debts into a feasible repayment plan.[45] Chapter 13 debtors are permitted to remain in possession of their property.[46] In exchange for the privilege of keeping the property, the debtor promises to devote all disposable future income to the payment of debt obligations.[47] The Trustee administers this repayment according to the specific court-approved repayment plan for a duration of three-to-five years.[48] Therefore, this chapter is more suited to debtors desiring to keep their home.[49]

Under the Chapter 13 plan, a debtor may cure arrearages on a mortgage through the court-approved repayment plan.[50] This innovation in the 1978 Code was an intentional and significant departure from the Bankruptcy Act of 1898, which expressly prohibited interests secured by real and personal property to be

---

11 U.S.C. § 726 (2006) (discussing distribution of property of the estate).

42 WARREN & WESTBROOK, *supra* note 6, at 275.

43 *Id.* at 115.

44 *Id.* at 275.

45 *Id.* at 115.

46 11 U.S.C. § 1303 (2006).

47 WARREN & WESTBROOK, *supra* note 6, at 115; 11 U.S.C. § 1322 (2006) (discussing the requirements of the contents of the plan); 11 U.S.C. § 1325 (2006) (explaining confirmation of the plan).

48 11 U.S.C. § 1325(b)(4).

49 Because a Chapter 7 debtor must surrender all non-exempt assets in order to be distributed to creditors, a Chapter 7 debtor generally will not be able to retain their home. Conversely, since a Chapter 13 debtor is not required to surrender property, but is instead required to devote all disposable income over the life of the plan, Chapter 13 typically provides a means of keeping residential property. Levitin, *supra* note 14, at 579; WARREN & WESTBROOK, *supra* note 6, at 143 (stating that "Chapter 13 provide[s] a unique opportunity to get current on a home mortgage that was in arrears, a chance to keep more property, and a discharge that covered certain debts that could not be discharged in Chapter 7").

50 11 U.S.C. § 1322(b)(5) (enabling debtors to cure defaults on secured claims through the repayment of loan arrearages over time).

considered as a claim in bankruptcy.[51] Congress sought to improve a debtor's ability to repay mortgage creditors and increase the likelihood of continued home ownership.[52] The provision also benefitted creditors by enabling lenders to retain secured interests in the property.[53]

B. General Rules and Restrictions Regarding Modification of Secured Interests Within the Current Bankruptcy Framework

Secured claims are afforded greater protection in Chapter 13 cases due to the extensive duration of the reorganization plan.[54] A secured claim is guaranteed protection up to the value of the collateral securing the creditor's interest.[55] While modification of some mortgages is permitted, the current Bankruptcy Code prohibits the modification of a mortgage secured by a principal residence.[56]

i. Valuation of Secured Claims within Bankruptcy

Notwithstanding the particular chapter under which a debtor may choose to file, secured creditors maintain superior protection against their unsecured counterparts.[57] Pursuant to § 541 of the Bankruptcy Code, non-exempt unsecured assets become part of the bankruptcy estate, are sold, and the proceeds distributed pro-rata to unsecured creditors.[58] Secured interests, on the other hand, are protected and may survive the bankruptcy untouched.[59] According to § 506, however, an interest is secured only to the extent of the collateral's value.[60] The deficiency is

---

51 Eggum, *supra* note 7, at 1154–55.

52 *Id.* at 1155 (indicating that "[t]he new chapter 13 bankruptcy system was designed to provide individuals with the opportunity to repay debts, in full or in part, while retaining assets").

53 *See* Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 97 (2005) (observing that while fixed rate mortgages paid between 5–6%, yields for short-term Treasury bills never exceeded 4% from 1945 to 1966).

54 *See Secured Claims and Liens in Bankruptcy,* LAWYERS.COM, http://bankruptcy.lawyers.com/consumer-bankruptcy/Secured-Claims-and-Liens-in-Bankruptcy.html (last visited May 18, 2011).

55 11 U.S.C. § 506 (2006).

56 11 U.S.C. § 1322(b)(5).

57 *See* 11 U.S.C. § 541; *compare* 11 U.S.C. § 506 (dealing with secured claims), *with* 11 U.S.C. § 507 (dealing with unsecured claims).

58 *See* 11 U.S.C § 541 (keeping in mind that even exempt assets are considered estate property).

59 Susan E. Hauser, *Cutting the Gordian Knot: The Case for Allowing Modification of Home Mortgages in Bankruptcy,* 5. J. BUS. & TECH L. 207, 212 (2010).

60 "An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less that the amount of such allowed claim." 11 U.S.C § 506(a)(1).

treated as an unsecured claim and is subject to the pro-rata distribution afforded to general unsecured creditors.[61] Taken together, § 506 and § 541 state that undersecured interests are to be "stripped down" to the value of the collateral resulting in a bifurcation of claims: a secured interest to the extent of the collateral's value and an unsecured claim for the deficiency.[62] These provisions further the policy that a creditor should not receive better treatment within bankruptcy than it would outside bankruptcy.[63]

ii. Chapter 13 Provides Permissible Modifications of Secured Claims

Chapter 13 creditors are afforded increased protection because debtors are entitled to retain all assets and repay the secured portion of the debt through a three-to-five year court-approved repayment schedule.[64] This payment schedule allows the debtor to keep the property regardless of current default with the ability to defer missed payments over time.[65] Chapter 13 also provides debtors with a unique opportunity to modify secured claims.[66] Section 1322(b)(2) explicitly empowers debtors to modify the rights of certain secured creditors by altering interest rates, amortizing loans, decreasing monthly payments, reducing

61 11 U.S.C. § 506(d). For example, assume that Lender gave Borrower a $10,000 auto loan secured by the vehicle. After 3 years, Borrower files bankruptcy and the vehicle is worth $5,000. Disregarding any pay down of the principal loan amount, Lender would have a $5,000 secured claim and $5,000 unsecured claim. However, stripdown is precluded under Chapter 7. Dewsnup v. Timm, 502 U.S. 410, 410 (1992).

62 11 U.S.C. § 506(d); *see also* Enewally v. Wash. Mut. Bank (*In re* Enwally), 368 F.3d 1165, 1167 (9th Cir. 2004) (referring to bifurcation of secured and unsecured claims as "lien-stripping"). A creditor's claim is undersecured when the value of the collateral is less than the amount of the debt. *See, e.g.*, Tanner v. FirstPlus Fin., Inc. (*In re* Tanner), 217 F.3d 1357, 1357 n.1 (11th Cir. 2000).

63 Outside bankruptcy, a creditor is afforded remedies through the collection process. A creditor that is undersecured would only receive proceeds from the repossessed collateral. U.C.C. § 9-601 (2005). The creditor, however, would still be entitled to pursue the borrower for a deficiency by going through the state court collection system. *Id.*

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

65 11 U.S.C. §§ 506, 109(e), 1325; *see* Dumont v. Ford Motor Credit Co. (*In re* Dumont), 581 F.3d 1104, 1108 (9th Cir. 2009) (explaining that a debtor may continue to make payments on the secured debt as if the bankruptcy never occurred, and the creditor is prohibited, by the automatic stay, from repossessing the property unless there is an event of default).

66 *Cf.* U.C.C. § 9-601 et seq. Bankruptcy provisions in Chapter 13 are implicit in every security agreement, but remain dormant until the debtor files a Chapter 13 petition. 11 U.S.C. § 1322(b); 11 U.S.C. § 542 (requiring property of the estate to be turned over to the trustee); Di Pierro v. Taddeo (*In re* Taddeo), 685 F.2d 24, 26–27 (2d Cir. 1982) (empowering debtors with the ability to cure defaults on secured debts under § 1322(b)(5), allowing borrowers to reinstate accelerated loans).

principal amounts, and extending the terms of the loan.[67] Section 1325 allows a debtor to strip-down the secured claim to the value of the collateral and bifurcate the deficiency into an unsecured claim.[68] Put into context, a borrower with a debt exceeding the value of the underlying collateral obtains the most value from this strip-down provision. By providing a reduction in the principal amount of the loan, strip-down could invariably have an effect on other terms of the loan such as interest.[69] Inversely, an undersecured creditor stands to lose a substantial portion of its security interest through the conversion from a secured to an unsecured creditor. This significant fact has resulted in tremendous limitations on its applicability to specific debts.[70]

iii. The Limited Availability of Mortgage Modification within Chapter 13

Chapter 13 is advantageous to debtors that have fallen behind on mortgage payments because debtors may utilize the plan to cure prior defaults and arrearages.[71] Unfortunately, the Bankruptcy Code is unfavorable to borrowers aspiring to modify the actual structure of the principal residence mortgage.[72]

---

67 *See* Till v. SCS Credit Corp., 541 U.S. 465, 475 (2004) (finding that with regard to secured interests in personal property, 11 U.S.C. § 1322(b)(2) clearly gives authority to the courts "to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract"). Debtors can modify wholly unsecured second mortgages on their principal residences as well as loans secured by yachts, aircraft, jewelry, household appliances, furniture, or any other type of personal property. *See* 11 U.S.C. § 1322(b)(2). One recent exception the successful effort of secured vehicle creditors, limits the applicability of this provision on vehicles. Since October 17, 2005, purchase money loans secured by motor vehicles bought for personal use may not be stripped down in their first two-and-a-half years. 11 U.S.C. § 1325(a).

68 11 U.S.C. § 1325; 11 U.S.C. § 506.

69 A borrower is "underwater" if the amount of the secured debt exceeds the value of the underlying collateral. *See* Dumont v. Ford Motor Credit Co. (*In re* Dumont), 581 F.3d 1104, 1108 (9th Cir. 2009).

70 Part of 11 U.S.C. § 1325(a) has notoriously been referred to as the "hanging paragraph" underscoring the overwhelmingly unclear amendment to the Bankruptcy Code. *See generally* Simone Jones, *Who's Left Suspended on the Line?: The Ominous Hanging Paragraph and the Seventh Circuit's Interpretation in* In re Wright, 3 SEVENTH CIRCUIT REV. 1 (2007), *available at* http://www.kentlaw.edu/7cr/v3-1/jones.pdf. The "hanging paragraph" lacks a section number but provides, "section 506 shall not apply . . . if the creditor has a purchase money security interest . . . , the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor." 11 U.S.C. § 1325(a).

71 *See* Taddeo, 685 F.2d at 26–27 (discussing the legislative purpose of § 1322(b)(5) in permitting borrowers to cure defaults and return the mortgage to pre-default conditions); Nobleman v. American Savings Bank, 508 U.S. 324, 332 (1993) (The United States Supreme Court held that § 1322(b)(2) restricts a borrower's abilities to modify a lender's claim where it is only secured by the principal residence).

72 11 U.S.C. § 1322(b)(2); WARREN & WESTBROOK, *supra* note 6, at 301 (stating that "[t]he only relief in Chapter 13 as to a home mortgage is to 'cure and maintain,' that is, to

Section 1322(b)(2), conveniently termed the "anti-modification" provision, explicitly prohibits the modification of secured claims "secured only by a security interest in real property that is the debtor's principal residence."[73] This anti-modification provision prevents debtors from using Chapter 13 strip-down methods and bifurcation to modify most mortgages.[74] Additionally, this provision creates an egregious loophole. Examining the plain language of the provision, the restriction is inapplicable to mortgages attached to vacation homes, commercial, rental, and investment property, or mortgages that are secured by collateral other than, or in addition to, the principal residence.[75]

For most Chapter 13 debtors, the opportunity to cure arrearages on home mortgages does not provide a useful means of keeping their residences because current bankruptcy law fails to address the severe unaffordability of the loan itself.[76] Not only is the absence of legislative history or empirical evidence supporting the provision disturbing, records indicate that the legislation was simply a compromise of competing versions.[77]

---

catch up on the past-due arrearage while making current payments on the mortgage as they come due").

73 11 U.S.C. § 1322(b)(2).

74 Taddeo, 685 F.2d at 26–27 (discussing the legislative purpose of § 1322(b)(5) in permitting borrowers to cure defaults and return the mortgage to pre-default conditions); *Nobleman*, 508 at 332 (The United States Supreme Court held that § 1322(b)(2) restricts a borrower's abilities to modify a lender's claim where it is only secured by the principal residence).

75 Hauser, *supra* note 59, at 215 (noting that obvious obstacles exist with actually modifying such properties, including debt limits and adequate protection); *see, e.g.*, Scarborough v. Chase Manhattan Mortg. Corp. (*In re* Scarborough), 461 F.3d 406, 408 (3d Cir. 2006) (taking an interest in other income-producing property, such as rental property, falls outside of the anti-modification provision).

76 *See* Eggert, *supra* note 23, at 1259 (explaining that the securitization of the subprime market dynamically changed the underwriting process from protection to production); OFFICE OF POLICY DEV. AND RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING, 1978–1999, at 1 (2003), *available at* http://www.huduser.org/publications/PDF/trends.pdf (defining severe housing as when housing and rental costs are in excess of 50% of gross income).

77 The Bankruptcy Reform Act of 1978 amounted to a compromise between the Senate and House bills. Senate Bill 2266 prohibited any modification of claims secured by any real estate. S. 2266, 95th Cong. (2d Sess. 1978). House Bill 8200 allowed modification of all secured claims. H.R. 8200, 95th Cong., (1st Sess. 1977). Both bills were reconciled through a variety of floor amendments and resulted in a restriction on modification of loans that were only secured by the debtor's principal residence. The Congressional record has no policy discussion behind the prohibition provision. In fact, discussion of the rationale is only evidenced in the Senate hearings. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 101 et seq. (2006)). *See also* Levitin, *supra* note 14, at 575 (finding that any economic rationale behind the legislation is misplaced because the underlying assumption of market sensitivity to impacts of modifications has been unfounded. In fact, the study presented "a variety of original empirical evidence from mortgage, origination, insurance, and resale market to show that mortgage markets are indifferent to bankruptcy-modification risk."); *see also* S. REP. NO. 95-989, at 141 (1978); *see also* H.R. REP. NO. 95-595, at 429 (1977) (explaining that the Senate bill provided that a debtor's plan could modify secured rights except

This provision merely serves to protect investments of lenders promulgating exotic loans more than thirty years after the legislation's enactment, rather than utilizing bankruptcy as an alternative forum to consolidate overwhelming debt burdens.[78]

II. SECURITIZATION AND FINANCIAL DE-REGULATION

More than three decades have passed since the enactment of the Bankruptcy Code, and the mortgage industry has developed into a securitized market, encouraging the implementation of unconventional loans and loose underwriting standards.[79] Accordingly, a corresponding change in the Bankruptcy Code is vital to the health of the economy.

A. Structure of Mortgage Industry

The conventional lending strategies that previously occupied the residential mortgage market have been supplanted by the modern originate-to-distribute model.[80] While the traditional lending model was characterized by mortgages originated and serviced by a single financial institution, the modern mortgage securitization structure involves loan originators, secondary market securitizers, government sponsored entities, mortgage backed securities, and servicers.[81]

The increasing popularity of mortgage securitization incentivized investment bankers, mortgage brokers, and even the federal government to enter the housing market by purchasing

claims by wholly secured real estate mortgages, and the House bill allowed modification of all unsecured and secured claims. This broad approach was quickly shot down by the savings and loan institutions that were dominators of the residential mortgage market in the 1970s); *see also* Barbara Randolph, *Finally, the Bill Has Come Due*, TIME, Feb. 20, 1989, at 68 (noting that savings and loan institutions were funded from federally insured deposits which created substantial liability for the federal government).

78 Levitin, *supra* note 14, at 586–93 (refuting the concept that residential mortgage modifications would affect the market). Although one would expect that if a borrower could potentially modify a mortgage, the lender would place a higher risk premium. A comparison of modifiable mortgages against non-modifiable mortgages failed to represent such a premium. This undercuts the economic rationale of the anti-modification provision. *Id.*

79 Eggum, *supra* note 7, at 1157 (stating that"[e]fforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by concerns about the growth of abusive lending practices in the late 1980s and early 1990s").

80 *See* Cynthia Angell & Clara D. Rowley, *Breaking New Ground in U.S. Mortgage Lending*, FDIC OUTLOOK, Summer 2006, at 21–24, *available at* http://www.fdic.gov/bank/analytical/regional/ro20062q/na/t2q2006.pdf.

81 Levitin, *supra* note 14, at 583; *see* Lei Ding, Janneke Ratcliffe, Michael A. Stegman & Roberto G. Quercia, *Neighborhood Patterns of High-Cost Lending: The Case of Atlanta*, 17 J. AFFORDABLE HOUS. & CMTY. DEV. L. 193, 194 (2008) (finding that the subprime securitization of "mortgage loans increased over forty-fold, from $11 billion to more than $483 billion in 2006, accounting for more than 80% of all subprime lending").

and securitizing mortgages.[82] Although the complexity inherent in the mortgage securitization market will not be extensively illuminated in this Comment, a brief overview of the process is beneficial. Following the origination of the mortgage to the homeowner, the lender typically sells the mortgage to a government sponsored entity or private investment bank.[83] These entities and banks subsequently pool mortgages originated by various lenders and undertake a multi-seller conduit securitization.[84] The securitizer keeps a relationship with the mortgages through a pooling and servicing agreement (PSA), binding all parties involved.[85] Thereafter, a servicing agent is ordained with the task of managing the account, collecting the monthly loan payments, and is responsible for all communication with borrowers regarding the loan.[86] Thus, a homeowner's mortgage may be reassigned multiple times throughout its lifetime, even though the servicer or originator remains constant.[87]

The real trouble ensues, however, because this servicer is the primary decision-maker as to whether a delinquent loan goes to foreclosure or is eligible for modification.[88] Sadly, extra fees and increased compensation, coupled with PSA restrictions, incentivizes servicers to prefer foreclosures over a mutually beneficial modification.[89] Servicers, as part of their fee structure, receive compensation for collecting default fees and collect

---

82 *See* Alan C. Weinstein, *Current and Future Challenges to Local Government Posed by Housing and Credit Crisis*, 2 ALB. GOV'T L. REV. 259, 260–61 (2009) (arguing that the availability of credit to homeowners, combined with relaxed government regulation, played a significant role in the current foreclosure crisis).

83 *See Problems in Mortgage Servicing From Modification to Foreclosure Part II: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 5–6 (2010) [hereinafter Eggert Testimony] (testimony of Kurt Eggert, Professor, Chap. Univ. Sch. of Law), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=2ab0a78e-12ee-4cf8-bb70-745d0d0372ab; *see also* Levitin, *supra* note 14, at 584 (recognizing that financial institutions may also decide to directly securitize the loan in the secondary market).

84 Levitin, *supra* note 14, at 584.

85 Eggert Testimony, *supra* note 83, at 6. For an in-depth analysis of Pooling and Service Agreements see generally Gelpern, *supra* note 27.

86 Eggert Testimony, *supra* note 83, at 6; Eggert, *supra* note 23, at 1266.

87 Levitin, *supra* note 14, at 585.

88 *See* Eggert Testimony, *supra* note 83, at 4.

89 *Foreclosure Prevention and Intervention: The Importance of Loss Mitigation Strategies in Keeping Families in Their Homes: Hearing Before the Subcomm. on Hous. and Cmty. Opportunity of the H. Comm. on Fin. Services*, 110th Cong. 168–69 (2008) [hereinafter Twomey Testimony] (written testimony of Tara Twomey, Counsel, National Consumer Law Center); *see also* Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 152–155 (discussing how servicers sneak fees into their claims against bankrupt debtors); Adam J. Levitin & Tara Twomey, *Mortgage Servicing,* 28 YALE J. ON REG 1, 69–71 (2011) (delineating the compensation of servicers for mortgage defaults).

additional payment for a successful foreclosure.[90] On the other hand, because servicers are unable to collect default fees from loan modifications, servicers are forced to incur additional costs without receiving a corresponding increase in compensation.[91]

B. Non-Traditional Loans and Weak Underwriting

In light of the modern mortgage industry structure, lenders began implementing unconventional and exotic loan terms to subprime borrowers because increased risks were externalized in the thriving securitized market.[92] Lenders were protected from defaulting and foreclosed borrowers because rising home values meant that a foreclosure proceeding would yield a sale in excess of the mortgage amount, thus allowing the lender to fully recover.[93] Some loans so predatory in nature lead critics to suggest that foreclosure was the desired goal.[94] When the real estate bubble burst, declining home prices and increased interest rates ensued, leaving borrowers obligated to pay mortgages in excess of the property value.[95] Consequently, lenders' motivations to modify were eliminated because the sale of the underlying debt had already been externalized through the secondary markets.[96]

The main culprits of the unconventional mortgage terms were adjustable rate mortgages (ARMs) and option-ARMs.[97] An ARM is characterized by an initial fixed interest rate for a specified period of time.[98] Upon the expiration of this period, the

---

90 Levitin, *supra* note 89, at 70–72 (describing the compensation of servicers for mortgage defaults).

91 *Id.*

92 Kristine M. Young, *The Aging Population and Maturing Mortgage Loans: Ensuring a Secure Financial Lifeline for the Elderly Through Mortgage Lending*, 16 ELDER L.J. 477, 483 (2008) (noting that the standardization of mortgage documents reduced transaction costs and allowed the lenders to avoid interest rate fluctuations by providing a continuous flow of cash); *see also* WARREN & WESTBROOK, *supra* note 6, at 114 (stating that "evidence is . . . clear that many credit issuers have deliberately taken big risks in lending to consumers, because of the large profits available from the difference in interest rates between what a bank has to pay to get money and what it can charge for lending it to willing consumers").

93 *Cf.* CONG. OVERSIGHT PANEL, *supra* note 1, at 1; Weinstein, *supra* note 82, at 262–63.

94 Eric C. Seitz, *U.S. Subprime Crisis: H.R. 3915—A Far-Sighted Solution to the Mortgage Crisis*, 14 LAW & BUS. REV. AM. 759, 760 (2008).

95 Weinstein, *supra* note 82, at 263; *see also* Rachel D. Godsil & David V. Simunovich, *Protecting Status: The Mortgage Crisis, Eminent Domain, and the Ethic of Homeownership*, 77 FORDHAM L. REV. 949, 959–63 (2008) (presenting an example of the impact a subprime mortgage has when a substantial down payment is not required); CONG. OVERSIGHT PANEL, *supra* note 1, at 1.

96 Norton, *supra* note 5, at 2.

97 *See* Eggum, *supra* note 7, at 1159.

98 *Id.*; *see* Beverlea (Suzy) Gardner & Dennis C. Ankenbrand, *Hybrid ARMs: Assessing the Risks, Managing the Fallout,* 5 FDIC SUPERVISORY INSIGHTS 14, 14

interest rate is adjusted every six months for the remainder of the loan.[99] Whereas the mortgage payment structured by the teaser rate is reasonable, the adjustment period results in an increase in the payment structure such that the mortgage payment becomes extremely unaffordable.[100] This drastic increase in payment, aptly referred to as "payment shock," comprised eighty-one percent of the securitized subprime market in 2006.[101]

Option-ARMs, the "ugly sister" of the ARM, present the borrower with various methods of calculating a mortgage payment for the initial period.[102] The borrower may choose a minimum monthly payment, interest-only payment, or a fully amortized principal and interest payment.[103] Amongst the façade of feasible options displayed, the minimum payment is usually the only affordable choice for most borrowers and generates the majority of option-ARMs.[104] The minimum payment option, however, is entirely misrepresentative because it fails to adequately offset the accrued monthly interest.[105] Consequently, despite making continuous payments for months or even years, unpaid interest added to the loan balance forces the borrower to create debt rather than equity.[106] This is also referred to as negative amortization.[107] Similar to ARM's payment shock at the termination of the teaser period, option-ARMs contain trigger points compelling full amortization of mortgage payments resulting in an extravagant increase in payment.[108]

Aggravating the non-traditional nature of these mortgage loan terms, weak underwriting practices barely required

(Summer 2008), *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf; *see also* Scott Frame et al., *A Snapshot of Mortgage Conditions with an Emphasis on Subprime Mortgage Performance*, FED. RES. SYS. ONLINE 2–3 (Aug. 27, 2008), http://federalreserveonline.org/pdf/MF_Knowledge_Snapshot-082708.pdf.

99 Eggum, *supra* note 7, at 1159.

100 *Id.*

101 *Id.*

102 *Id.* at 1159–60.

103 *Id.*; Adam J. Levitin, *The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform?*: *Hearing Before Subcomm. on Admin. Oversight and the Courts of the S. Comm. on the Judiciary*, 111th Cong. 135 (2009) [hereinafter Levitin Testimony] (written testimony of Adam J. Levitin, Professor, Georgetown University Law Center).

104 *See* Eggum, *supra* note 7, at 1159–60; *see also* Levitin Testimony, *supra* note 103, at 135.

105 Eggum, *supra* note 7, at 1159–60.

106 *Id.*

107 *Id.*

108 *Id.* (describing two types of trigger points: a time trigger, usually five years, recasts at a certain year interval and a loan balance trigger, usually 110%, recasts when the loan balance exceeds a certain percentage of the original loan amount).

documentation to assure payment affordability.[109] In fact, lenders solely considered the affordability of the ARMs' initial teaser rate or the selected option for the option-ARM.[110] Low documentation, no documentation, and income underwriting standards failed to require any verification of ability to repay the loan.[111] Unsurprisingly, further review found major inconsistencies when compared to actual income.[112] While a Chapter 13 bankruptcy presents the borrower with the right to repay arrearages and cure defaults on a mortgage over time, this remedy fails to address the inevitable increase in monthly payments that most homeowners face in light of the non-traditional loans originated in the last decade.[113]

III. FAILED ATTEMPTS AT CURING THE FORECLOSURE FLU

As the probability of defaulting borrowers increased and the magnitude of the housing catastrophe catapulted, lawmakers continuously proposed a variety of remedies including voluntary federal agency programs, federal funding of government and mortgage agency programs, and legislative acts.[114]

---

109 Gardner, *supra* note 98, at 14, 17; *see* Eggert, *supra* note 23, at 1263–64; *see also* WARREN & WESTBROOK, *supra* note 6, at 114 (stating that the credit industry "has expanded and grown more profitable by steadily extending credit solicitations to include people who were once considered too risky for such loans").

110 Gardner, *supra* note 98, at 17; Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007).

111 *See* CHARLES CALOMIRIS & JOSEPH MASON, HIGH LOAN-TO-VALUE MORTGAGE LENDING: PROBLEM OR CURE? 11 (The AIE Press ed., 1999), *available at* http://www.aei.org/doclib/20021130_71252.pdf (noting how HLTV lenders "turned away from traditional mortgage lending standards in favor of underwriting standards similar to those used for unsecured (primarily, credit card) loan products."); *see also* CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 38 (2007), *available at* http://seattlebubble.com/blog/wp-content/uploads/2007/10/2007-03-credit-suisse-mortgage-liquidity-du-jour.pdf (estimating that by 2006 no or low-documentation loans accounted for 49% of mortgage loans originated in the US.); Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 614–15 (noting that in 2001, almost 30% of borrowers were unable to "verify information about employment, income, or other credit-related data. This figure increased to nearly 51% in 2006. . . . [M]ortgage brokers and bankers allegedly engaged in fraudulent and/or lax practices by submitting false information to qualify borrowers or by failing to document or verify relevant information.").

112 *See* Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1.

113 *See* CALOMIRIS, *supra* note 111, at 11.

114 *See* Homeowner Assistance and Taxpayer Protection Act, S. 3690, 110th Cong. § 103 (2008); Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101 (2007); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007); Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 101 (2008); Home Owners' Mortgage and Equity Savings Act, S. 2133, 110th Cong. § 2 (2007); Home Owners' Mortgage and Equity Savings Act, H.R. 3778, 110th Cong. § 202 (2007); *see* Eggum, *supra* note 7, at 1157 ("Efforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by

A. Voluntary Programs and Federal Funding

On account of the housing collapse increasing the number of defaulting and delinquent homeowners in 2007, the Bush administration implemented HopeNow.[115] Designed for subprime borrowers current on their mortgage but facing subsequent increases in adjustable rates, HopeNow was largely a disappointment because narrow applicability requirements failed to substantially affect borrowers or the increasing rate of foreclosures.[116] Other programs enacted by the administration such as FHASecure and Hope for Homeowners were likewise ineffectual.[117] Attempting to directly respond through federal funding of local mortgage counseling programs, purchasing abandoned properties, and borrower financing, the administration enacted the Housing and Economic Recovery Act of 2008.[118] Another piece of legislation targeted at encouraging home sales was the Mortgage Forgiveness Debt Relief Act of 2007, which amended the Internal Revenue Code to permit an exclusion for taxpayers on cancelled mortgage debt on a principal residence.[119] Despite these valiant efforts, unfavorable tax

---

concerns about the growth of abusive lending practices . . . ."); *see generally* Anna T. Pinedo & Amy Moorhus Baumgardner, *Federal Mortgage Modification and Foreclosure Prevention Efforts*, 41 UCC L.J. 319 (2009) (delineating the legislative, policy and program efforts of the government); R. Travis Santos, Comment, *The Legal Way to Defeat Optimus Sub-Prime*, 25 EMORY BANKR. DEV. J. 285, 313–29 (2008) (describing Congress's efforts towards fixing the sub-prime mess).

115 Santos, *supra* note 114, at 313–14; Press Release, Hope Now, Hope Now Alliance Created to Help Distressed Homeowners (Oct. 10, 2007), *available at* http://www.fsround.org/media/pdfs/AllianceRelease.pdf.

116 Ruth Simon & Tom McGinty, *Earlier Subprime Rescue Falters: December Plan Has Done Little to Help Borrowers in Dire Circumstances*, WALL ST. J., Feb. 13, 2008, at A1.

117 Press Release, U.S. Dep't of Hous. & Urban Dev., Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes (Aug. 31, 2007), *available at* http://archives.hud.gov/news/2007/pr07-123.cfm. The guidelines were too strict, requiring at least 3.5% equity in the home and no more than two missed payments at the time of application. Karina Hernandez, *FHA Secure Program to Help Homeowners in Distress*, EHOW (Oct. 5, 2010), http://www.ehow.com/about_7293798_fha-secure-program-homeowners-distress.html. Consequently, the majority of homeowners needing help because they were already affected by plummeting home prices and interest rate adjustments were largely ineligible under FHASecure. *Id.* Additionally, Hope for Homeowners' inefficiency "was attributed to high fees, high interest rates, the need for a reduction in principal on the part of the lender, and the requirement that the federal government receive 50% of any appreciation in value of the house." *Hope for Homeowners*, FIN. RELIEF L. CTR. (June 3, 2009, 12:54 PM), http://lawcenter.com/blog/?p=31. As a result, only 451 applications had been received and 25 loans were finalized as of February 2009. This was a far cry from the estimated 400,000 homeowners originally expected to participate. *Id.*

118 Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008).

119 Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007) (amending 26 U.S.C. § 108(h) (2006)).

consequences are still in effect pertaining to securitization modifications.[120]

In an effort to manage the economic crisis on a pervasive level, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted.[121] This $700 billion legislation authorized the purchase of troubled assets from financial institutions.[122] The Troubled Asset Relief Program (TARP) was created and progressively expanded to include mortgage modification and foreclosure provisions.[123] As emphasized by Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, Christopher Dodd, the primary objective of the Act was to strengthen home ownership: "This is not an ancillary objective; it is inherent, in my view, to our efforts to resolve this economic crisis."[124] Accordingly, the Obama administration pledged at least $50 billion of TARP funds for foreclosure prevention programs with the Financial Stability Plan.[125] The funds were to be used mainly through two programs.[126] First, the Making Home Affordable program expanded the availability of modifications for government-funded mortgages.[127] Second, the Home Affordable Modification Program (HAMP) provided structured guidelines for modifying mortgages and included compensation incentives for servicers, lenders, and investors in the pursuit of modification.[128]

Regrettably, Making Home Affordable and HAMP have been mostly unsuccessful.[129] Some critics suggest that mortgage

120 Pinedo, *supra* note 114, at 334–35.

121 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

122 § 101.

123 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765, 3774-3775 (2008). See generally Cong. Budget Office, The Troubled Asset Relief Program: Report on Transactions through December 31, 2008 (2009), available at http://www.cbo.gov/ftpdocs/99xx/doc9961/01-16-TARP.pdf (explaining that the EESA created the Troubled Asset Relief Program (TARP) encouraging the Treasury Department to purchase troubled assets, while the foreclosure and modification provisions in the EESA expanded the authority to manage and modify all mortgage related assets purchased with TARP funds).

124 Peter Cockrell, *Subprime Solutions to the Housing Crisis: Constitutional Problems With the Helping Families Save Their Homes Act of 2009,* 17 GEO. MASON. L. REV. 1149, 1161 (2010).

125 *Id.*

126 *Id. See also, e.g.*, *Financial Stability Plan Fact Sheet*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/about/Documents/fact-sheet.pdf.

127 Cockrell, *supra* note 124, at 1161–62.

128 *Id.*

129 *Id.*; Peter S. Goodman, *U.S. Loan Effort Is Seen as Adding to Housing Woes*, N.Y. TIMES, Jan. 2, 2010, at A1; *see also* Jonathan Hoenig, *The Plan to Stop Foreclosures Has Failed*, SMARTMONEY (Feb. 18, 2010), *available at* http://www.smartmoney.com/investing/economy/the-plan-to-stop-foreclosures-has-failed.

servicers mislead borrowers by promising affordable modified rates.[130] Other critics fault the purely procedural nature of the program as the primary reason for its inevitable failure.[131] Indeed, no mechanism exists to reprimand mortgage servicers that refuse to conform to HAMP guidelines.[132] Instead, servicers require excessive documentation, fail to conduct modification reviews prior to foreclosure proceedings, and decline to provide substantiated reasons for modification denials or calculation methods.[133] Taking a broader approach, voluntary programs such as HAMP will continue to be ineffective because they inherently fail to address the actual problem that promulgated the housing crisis—unaffordable loans.[134]

B. Legislative Proposals

Another crucial approach to the foreclosure crisis is aimed at revising the Bankruptcy Code.[135] Since defaulting homeowners are not attenuated from possible bankruptcy, Congress recognized a potential antibiotic in Bankruptcy Code reform.[136] With the support of the Obama administration, advocates for mortgage modification proposed two bills that were originally refused by the Bush Administration.[137] House Bill 200 was introduced by John Conyers, Jr. of Michigan and House Bill 225 by Brad Miller of North Carolina.[138] Senator Richard Durbin of Illinois organized its companion, Senate Bill 61.[139] Whereas a secured claim subject to strip-down must be paid in full according to the duration of the Chapter 13 plan, the proposed bills authorized a bankruptcy court to extend mortgage payments beyond the life of the plan, provided for a freeze or a reduction in interest rates and entitled the debtor to a reduction in principal

---

130 James R. Hagerty, *Mortgage-Rescue Program Benefits More Homeowners*, WALL ST. J., Mar. 13, 2010, at A2 (stating that a large number of homeowners drop out of the program because the modified payment is still unaffordable).

131 Levitin, *supra* note 14, at 627–28.

132 *Id.*

133 *Id.*

134 *Id.* at 619–20 (explaining that while voluntary options permit the struggling homeowner to cure within a 90-day period, this is only beneficial for borrowers that were in default due to an isolated event or unexpected expense. Realistically, this type of voluntary option merely delays the inevitable foreclosure).

135 Ryan Grim, *Cramdown Is Back: Banks Against Homeowners, Round 2*, HUFFINGTON POST (Sept. 8, 2009), http://www.huffingtonpost.com/2009/09/08/cramdown-is-back-banks-v_n_280126.html.

136 Cockrell, *supra* note 124, at 1163.

137 *Id.* at 1161–63.

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

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

balance based on the fair market value of the property.[140] Accordingly, the secured claim would be based on the lowered amount, decreasing the debtor's monthly mortgage payments.[141] Such combination of an extension of the loan terms with an interest rate adjustment or a reduction in principal amount would actually allow the debtors to cure arrearages and avoid foreclosure.[142]

House Bill 200—the Helping Families Save Their Homes in Bankruptcy Act of 2009—was subsequently incorporated into House Bill 1106—the Helping Families Save Their Homes Act of 2009—and passed the House of Representatives on March 5, 2009.[143] The legislation, while permitting a modification of the residential mortgage, was subject to a few strict limitations. Instead of proposing a permanent amendment to the Bankruptcy Code, eligibility was confined to loans originated prior to the passage of legislation and currently subject to foreclosure.[144] The addition of subsection (g) to section 1322 would have entitled lenders to recapture appreciation in property value if the debtor sold the property and subsection (h) would have forced the debtors to pursue voluntary lender modifications before filing a bankruptcy petition.[145] The bill came before the Senate as part of Senate Bill 896, the Helping Families Save Their Homes Act of 2009, which included several housing initiatives of the Obama Administration.[146] Lamentably, while Senate Bill 896 was signed into law on May 20, 2009, the proposal to amend § 1322 was rejected on April 30, 2009 by a vote of 45-51 amidst forceful opposition from the financial services industry.[147]

Although the amendments and proposals were rejected, congressional backers and legislators continue to pursue the

---

140 Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101(a)(3) (2007); *see also* Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 412 (2008) (providing for waiver of counseling requirement when homes are in foreclosure); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007) (allowing for modification of claims secured by debtors' principal residence); *see* 11 U.S.C. § 1322(d). The bankruptcy court would be able to recalculate the interest rate so that it was equal to the most recent mortgage yield published by the Board of Governors of the Federal Reserve System and a reasonable premium for risk. Eggum, *supra* note 7, at 1161.

141 *Id.* at 1163.

142 *Id.* at 1164.

143 Vote results available at http://clerk.house.gov/evs/2009/roll104.xml.

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

145 *Id.*

146 Helping Families Save Their Homes Act of 2009, S. 896, 111th Cong. (2009).

147 Dierdre Keady, *Mortgage Cramdowns: With the Rainbow Gone, Is the Pot of Gold Still Attainable?*, 2009 NORTHEAST BANKRUPTCY CONFERENCE 542 (Am. Bankr. Inst., 2009), *available at* http://www.abiworld.org/committees/newsletters/consumer/vol7num5/cramdown.pdf; *see* Eggum, *supra* note 7, at 1161–64.

revision of the Bankruptcy Code to permit some sort of strip-down provision.[148] Though House Financial Services Committee Chairman Barney Frank emphasized a similar provision would be incorporated in the financial regulatory reform bill, the passage of the bill did not include such a provision, denoting the success of the financial services lobby.[149]

IV. BENEFITS OF MODIFICATION WITHIN BANKRUPTCY

As evidenced by the persistence of its supporters, the rationale bolstering a bankruptcy-based solution as an alternative remedy for managing foreclosures is deep and broad.[150] Bankruptcy presents the greatest foundation for an instantaneous and enduring means of relief for struggling homeowners;[151] the existing framework of bankruptcy fosters administrative efficiency, and court-ordered participation would override servicer disincentives and encourage more voluntary modifications.

A. Mechanism Already in Place

Modification through bankruptcy utilizes a dependable framework that already contains screening mechanisms to ensure that the system is not abused.[152] When Congress amended the Bankruptcy Code to encourage more Chapter 13 filings in 2005, a means test was put in place to administer a strict mechanical standard forcing borrowers to pay as much of their debts as possible.[153] Additionally, proposed Chapter 13 plans would be subject to the feasibility and good faith provisions on the part of the debtor in order to be confirmed.[154] On account of the screening techniques and mandatory provisions within the Bankruptcy Code as it is currently written, development of independent precepts for loan modification eligibility would be unnecessary.[155]

Administrative efficiency of a bankruptcy-based resolution would not require development of a regulatory commission or

---

148 *See*, Levitin, *supra* note 103, at 8.

149 Grim, *supra* note 135.

150 *See* Press Release, Committee on the Judiciary, Conyers and Eight Others Introduce Amendment to Provide Mortgage Modification Relief to Struggling Homeowners (Dec. 7, 2009), *available at* http://judiciary.house.gov/news/091207.html.

151 *Id.*

152 *See* Eggum, *supra* note 7, at 1165.

153 *See* 11 U.S.C. §§ 707(b)(2), 1325(b)(3); *see also* White, *supra* note 27, at 10.

154 11 U.S.C. § 1325(a)(3) (requiring that proposed plans must be submitted in good faith).

155 11 U.S.C. § 109(e) (defining the strict eligibility requirements to initially qualify as a bankruptcy debtor).

expansion of existing departments.[156] Rather, existing judges, U.S. Trustees, and panel trustees possess extensive knowledge regarding creditor and debtor disputes, and essential administrative personnel are already hired, trained, and supervised.[157]

B. Override Disincentives and Encourage Voluntary Modifications

The securitization of mortgages creates a multi-party relationship resulting in difficulty interacting with servicers, identifying authorized agents, and maintaining a reliable contact with the lender.[158] Collectively, these factors present an impervious hurdle to effective voluntary modifications.[159] Despite persistent opposition to mortgage modification, the mortgage industry concedes that voluntary loan programs lack the communication required for success.[160] The bankruptcy structures for communication and negotiation provide a much needed setting to override such systematic errors.[161] The securitization of mortgages imposes financial incentives for servicers to prefer foreclosures and pooling, and servicing agreements restrict the ability of servicers and lenders to perform voluntary modification.[162] Providing involuntary modifications pursuant to a bankruptcy proceeding and court-order would invalidate the liability potential that undoubtedly is a factor in lender and servicer reluctance.[163]

---

156 *See* Letter from the Chief Legal Officers of Twenty-Two States and the District of Columbia to Nancy Pelosi, Speaker of the House, and John Boehner, House Minority Leader (Jan. 6, 2009), *available at* http://www.mass.gov/Cago/docs/press/2009_01_06_bankruptcy_code_attachment1.pdf (recommending modification of mortgages as a cost-efficient solution). It is likely, however, that the hiring of extra staff for ease of administration might be beneficial.

157 *See* Eggum, *supra* note 7, at 1165.

158 *See* Twomey Testimony, *supra* note 89, at 168.

159 *Id.* ("From the homeowner's perspective one of the biggest obstacle[s] to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions.").

160 *Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress? Part II: Hearing Before Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 10 (2007) (statement of David G. Kittle, Chairman-Elect, Mortgage Bankers Ass'n), *available at* http://www.mortgagebankers.org/files/StoptheBankruptcyCramDown/StatementofDavidKittle.pdf (admitting the consistent failure of servicer-borrower communication amounted to more than 50% of foreclosed homeowners).

161 Eggert Testimony, *supra* note 83, at 6–10 (describing the extent of servicer abuse of borrowers).

162 *See* Levitin, *supra* note 14, at 585; *see also* Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior*, NAT'L CONSUMER L. CENTER, Oct. 2009, at 8, *available at* http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/servicer-report1009.pdf.

163 *See* Eggum, *supra* note 7, at 1167.

Bankruptcy modification will likely have the counter-intuitive effect of increasing the facilitation of voluntary modifications between lenders and borrowers.[164] While bankruptcy modification will dictate a binding workout plan determined by the judge, lender involvement and control of the modification process would be limited.[165] As such, lenders may be expected to prefer voluntary workouts with the borrower in order to maintain added control over both the process and results.[166] Concurrently, borrowers may also choose to abide by consensual workouts in order to bypass the significant current and future monetary expenses of filing bankruptcy and negative impact on credit reports which increase costs of future credit.[167] Additionally, strict scrutiny of a court-supervised budget and dealing with the consequences of financial records being a matter of public record should dissuade defaulting borrowers from filing bankruptcy when a lender is willing to participate in a workout plan.[168]

C. Makes Economic "Cents"

Bankruptcy offers unrivalled benefits to borrowers and lenders while curtailing third party externalities. Mortgage modification expedites homeowner retention and continual payments which is in the common interest of borrowers and lenders. Likewise, communities and taxpayers retain the benefits from foreclosure reduction rates, balancing neighborhood property values and tax-bases, and increasing creditor accountability.[169]

i. Assisting Borrowers in Keeping Their Homes

Mortgage modification within bankruptcy offers an expansive and concentrated mechanism of assisting homeowners with impending foreclosures.[170] Currently, a bankruptcy petition is only beneficial to a borrower in terms of halting an incomplete foreclosure or reinstating an accelerated mortgage by curing arrearages over time through the Chapter 13 plan.[171] Infusing

---

164 *See* Thompson, *supra* note 162, at 8; Eggert Testimony, *supra* note 83, at 11-12; *see also* Rod Dubitsky et al., *Bankruptcy Law Reform—A New Tool for Foreclosure Avoidance* 1 (2009), http://judiciary.house.gov/hearings/pdf/Suisse090126.pdf.

165 *Id.*

166 *Id.*

167 *Id.*

168 *See* Eggum, *supra* note 7, at 1165.

169 *See generally*, Immergluck, *supra* note 9 (describing the external costs of foreclosure on communities); *see also* White, *supra* note 27, at 14 (explaining the monetary and psychological costs of foreclosures for a homeowner).

170 Hauser, *supra* note 59, at 222.

171 11 U.S.C. § 362 (2006).

the bankruptcy court with the discretion to modify principal residence mortgages would counteract the inherent poisons of the current housing epidemic that previous programs and proposals failed to address: adjusting above rate mortgages resulting from predatory lending and deterring grossly disproportional mortgages in relation to the underlying property value.[172]

First, interest rate reductions on above-market adjustable rate mortgages would allow conversion of an unaffordable ARM to a more manageable fixed interest rate, thereby counter-acting the payment shock from non-traditional subprime loans.[173] Second, strip-down of undersecured mortgages into a bifurcated payment schedule would create an incentive to continue making mortgage payments since the accumulation of equity finally becomes a reality.[174] While some critics believe that such bifurcation is a windfall, such hesitation is misplaced.[175] Strip-down by definition merely results in zero-equity, not positive equity.[176] Most notably, bankruptcy compels the debtor to endure the severe consequences of the bankruptcy process like incurring filing and attorney fees, suffering with the negative effects on credit history, and enduring the public stigma accompanying bankruptcy.[177]

ii. Providing Substantial Economic Benefits to Lenders

Lenders will undoubtedly recover more of the outstanding balance from a defaulting borrower with a mortgage modification than a foreclosure.[178] Foreclosures are both time and cost intensive.[179] The average duration of the foreclosure process from the first delinquent payment to the actual sale of the property is almost one year.[180] Actual expenses of the foreclosure can run lenders over $50,000 per property for a mere thirty

---

172 Hauser, *supra* note 59, at 223–24.

173 *Id.*; FED. DEPOSIT INS. CORP., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS: ARE THEY FOR YOU? 1, *available at* http://www.fdic.gov/consumers/consumer/interest-only /mortgage_interestonly.pdf (defining payment shock as when "[y]our payments go up a lot—as much as double or triple—after the interest-only period or when the payments adjust.").

174 Hauser, *supra* note 59, at 224.

175 *Id.* at 233.

176 Levitin, *supra* note 14, at 642.

177 *See* Melissa B. Jacoby, *Bankruptcy Reform and Homeownership Risk,* 2007 U. ILL. L. REV. 323, 330–31 (2007).

178 *See* White, *supra* note 27, at 14 (explaining that by the time foreclosed homes are sold, lenders lose fifty percent of the original loan value).

179 Jacoby, *supra* note 177, at 330–31.

180 Andrew J. Kazakes, *Protecting Absent Stakeholders in Foreclosure Litigation: The Foreclosure Crisis, Mortgage Modification, and State Court Responses,* 43 LOY. L.A. L. REV. 1383, 1396 (2010).

percent loan recovery.[181] A lender only derives the market value of the property reduced by administrative costs and fees. Conversely, mortgage modification would add value to the lender's bottom line if aided by the bankruptcy system.[182]

The guidelines of Chapter 13 generate a larger and broader depth of recovery for lenders.[183] The plan allows the lender to receive principal and interest payments on the secured portion of the loan based on the value of the collateral plus a corresponding payment for the unsecured bifurcated fraction of the loan.[184] When a junior lien holder is deemed to have a wholly unsecured interest, the senior lenders are enriched because the subject collateral will only be used to satisfy the senior debt.[185] Moreover, this cash flow is protected because debtors are forced to comply with a strict court-ordered budget requiring formal court approval to incur new debts.[186] Allowing the debtor to retain possession of the property places the burden of maintenance and upkeep in the hands of the homeowner rather than the lender.[187] The lender can eliminate the costs associated with a foreclosure sale and resale because the bankruptcy system is funded by the debtor.[188]

An added bonus of a bankruptcy-based solution is that any subsequent default of a plan payment would result in a dismissal of the entire bankruptcy case, allowing the creditor to recapture any appreciation in value of the property.[189] For future creditors, the temporal period of eligibility for debtors to file bankruptcy is

---

181 STAFF OF JOINT ECONOMIC COMMITTEE, 110TH CONG., SHELTERING NEIGHBORHOODS FROM THE SUBPRIME FORECLOSURE STORM 14 (2007). Foreclosures incur principal loss on the loan, property maintenance, appraisal fees, legal fees, lost revenues, insurance, marketing, and clean up. FED. HOUS. ADMIN. ECONOMIC IMPACT ANALYSIS OF THE FHA REFINANCE PROGRAM FOR BORROWERS IN NEGATIVE EQUITY POSITIONS 2 (2010), *available at* http://www.hud.gov/offices/adm/hudclips/ia/ia-refinancenegativeequity.pdf.

182 Hauser, *supra* note 59, at 225–26 ("When a mortgage is undersecured, the beneficial holder of the note, whether a lender or an investor, will always realize a loss when the property is liquidated. Economically, the loss realized on cramdown should be roughly equivalent to the loss realized when the property is sold at foreclosure—indicating that the creditor's bottom line will remain similar in both procedures.").

183 *See* White, *supra* note 27, at 10–14 (detailing how the 2005 changes to the Bankruptcy Code affected Chapter 13 filings and lenders).

184 *Id.* at 13.

185 *See* Nobleman v. American Savings Bank, 508 U.S. 324, 332 (1993) (holding that the anti-modification provision of 1322(b)(2) does not affect modification of an undersecured residential mortgage).

186 *See* 11 U.S.C. § 1325.

187 *See* Immergluck, *supra* note 9, at 57 (describing the negative costs associated with foreclosed properties).

188 Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World,* 92 MICH. L. REV. 336, 365 (1993).

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

broader and longer than the time a foreclosure stays on a credit report.[190] Mortgage modification within bankruptcy generates a greater return on a lender's investment as compared to a foreclosure.[191]

iii. Alleviating the Pressure on Community and Financial Markets

Foreclosures function like a contagious virus infecting surrounding neighborhoods and community tax bases.[192] Unoccupied homes remain unimproved and unmaintained and decrease the value of adjacent properties.[193] Not only do declining home values contribute to a reduction in tax revenue for cities and counties,[194] it also presents incentives for homeowners to abandon their grossly disproportionate mortgages while having a continually detrimental effect on surrounding homes.[195]

As a matter of justice, the bankruptcy solution places the financial burden and the blame on both proponents of the housing crisis.[196] Borrowers willing to commit to a subprime loan are forced to shoulder the costs and burdens of bankruptcy filing and must promise to devote all disposable income to the repayment plan.[197] Contrarily, lenders supporting irresponsible lending practices and weak underwriting decisions that chose to ignore high risks of default in lieu of short-term profits are obligated to accept the economic consequences of their actions.[198] Enlarging bankruptcy relief to permit mortgage modifications would not necessitate any taxpayer financial support because of the self-funding nature of bankruptcy.[199]

---

190 Levitin, *supra* note 14, at 643 ("[T]he minimum time between repeat Chapter 13 filings is longer than the time a foreclosure stays on a credit report.").

191 *Id.* at 647.

192 *See generally* Immergluck, *supra* note 9 (discussing the negative impact foreclosures have on property values).

193 *Id.* at 57.

194 *Id.* at 58 ("[C]ities, counties, and school districts may lose tax revenue from abandoned homes.").

195 *Id.* at 57 (explaining how foreclosed properties "contribute to physical disorder in a community, create a haven for criminal activity, discourage the formation of social capital, and lead to further disinvestment.").

196 Hauser, *supra* note 59, at 228–29.

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

198 Hauser, *supra* note 59, at 229.

199 *See* Warren, *supra* note 188, at 365 ("While the general taxpayer obviously contributes to the costs of keeping a bankruptcy court open, the fees imposed on those who use the system minimize the taxpayer costs.").

V. A BANKRUPTCY BASED ALTERNATIVE IS BOTH NECESSARY AND TIMELY

Voluntary measures to encourage mortgage modification during this housing epidemic have turned out to be largely ineffectual and inefficient failures.[200] Every economics class recognizes that merely rewarding positive behavior fails to achieve the desired goal.[201] Rather, a countervailing punishment which acts to substitute the reward for negative behavior leads to the greatest level of cooperation.[202] When such positive and negative incentives are attached to the desired goal, intended results are more probable.[203] The proposal endorsed in this Comment is the addition of a negative incentive to mortgage lenders that may be instituted by borrowers when the positive incentives fail. This negative incentive will take the form of legislation that amends Bankruptcy Code § 1322(b)(2) to permit modification of residential mortgages within a bankruptcy proceeding. Compounding on other proposals initiated, this Comment endorses an alteration in measuring affordability to reflect the dynamic relationship between income and expenses and imposes a mandatory foreclosure and modification program prior to any mortgage modification within bankruptcy.

A. Affordability Standard

Most voluntary program configurations are based on standards of the Department of Housing and Urban Development.[204] The HUD concept of affordability reflects the percentage of income a household spends on housing costs.[205] Affordable housing costs subsume, at most, 30% of gross income.[206] Unaffordable housing commits 30%–50% of gross income.[207] Housing costs greater than 50% of gross income are deemed severely unaffordable.[208] The problem with such a static standard for measurement is its failure to consider the inherent fluctuations in income and expenses.[209] The more appropriate and realistic standard that should be taken into account is that of

200 *See* discussion *supra* Part III.
201 Hassouni, *supra* note 5, at 600.
202 *Id.*
203 *Id.*
204 *See* Eggum, *supra* note 7, at 1135–36.
205 *Id.*
206 *Id.*
207 *Id.*; *see also* U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING, 1978–1999, at 1 (2003), *available at* http://www.huduser.org/publications/PDF/trends.pdf (describing moderate housing problems as costs exceeding 30% of reported income, but less than 50% of income).
208 *See* Eggum, *supra* note 7, at 1135.
209 *Id.* at 1136–37.

residual income.[210] Residual income would factor in necessary housing costs and related expenses prior to any determination of affordability.[211] This idea of residual income can be directly intertwined with a Chapter 13 plan because of the disposable income requirement necessary for a confirmable plan.[212] This standard reflects the reality that certain objectively necessary expenses are incurred by all individuals regardless of income level and should not be sacrificed in order to make an unaffordable mortgage payment.[213]

B. Mandatory Foreclosure and Modification Programs

Upon filing a bankruptcy petition, implementing a mandatory foreclosure and modification negotiation program facilitated by the bankruptcy court would provide transparency, accountability, and judicial supervision to the modification process that is currently absent from consensual voluntary modifications.[214] A structured forum to discuss alternatives to foreclosure that are mutually beneficial to borrowers and lenders would counteract the major problems intrinsic in government programs such as HAMP.[215] Attorneys and judicial supervisors would eliminate the problems inherent with pro se and pro per homeowners tending to misunderstand obligations arising from loan modification programs.[216] Moreover, these supervisors could alleviate the lack of communication by servicers and lenders failing to attend to struggling borrowers.[217]

210 *See id.* (explaining the shortcomings of the HUD standards in accounting for changes in income and costs).

211 *See, e.g.*, Steven C. Bourassa, *Measuring the Affordability of Home-Ownership*, 33 URB. STUD. 1867, 1868–69 (1996) ("The [ratio] test, however, is unsatisfactory in that households at the bottom of the income distribution will have insufficient residual income no matter how little they spend on housing, while those at the upper parts of the distribution are likely to have more than adequate residual income even if they spend more than the specified percentage of income on housing.").

212 11 U.S.C. §§ 1322, 1325 (2006).

213 *See* Eggum, *supra* note 7, at 1139–40 (describing that regardless of income level, individuals require clothing, medicine, and food).

214 *See generally* ANDREW JAKABOVIC & ALON COHEN, CENTER FOR AM. PROGRESS, IT'S TIME WE TALKED: MANDATORY MEDIATION IN THE FORECLOSURE PROCESS 9 (2009), *available at* http://www.americanprogress.org/issues/2009/06/pdf/foreclosure_mediation.pdf. (exploring the use of mandatory foreclosure mediation between debtors and lenders).

215 *Id.*

216 *See* Grace B. Pazdan, *How Foreclosure Mediation Legislation Can Keep Vermonters In Their Homes (And Money In The Pockets of Mortgage Holders),* 36-SPG VT. B. J. 24, 26–27 (2010).

217 *Id.*

CONCLUSION

The time has come to empower bankruptcy law with the authority to cure the foreclosure flu that has infected the housing market for too long. The skyrocketing foreclosure rate threatens the fundamental concept of homeownership. Despite continuous efforts designed to remedy the downturn, the apparent inadequacy of those programs necessitate a reworking of the system to truly cure the economy of this burden. These expensive programs have cost taxpayers billions of dollars without providing a corresponding benefit. Section 1322(b)(2) was created in 1978 to preserve mortgage financing and lending models that are outdated and of no relevance to the current representation of the industry. In the face of the modern mortgage structure, the provision is misused by servicers and lenders to defend predatory lending practices that would have been inconceivable in 1978. In its current form, the Bankruptcy Code fails to address the ongoing battle with loan affordability affecting the entire economy. Amending the Bankruptcy Code to authorize treatment of residential mortgages as any other secured interest would deal neatly and cleanly with the impediments to loan modification absorbing the economy.