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The Chapter 13 Alternative: A Legislative Solution to Undersecured Home Mortgages

Hon. Samuel L. Bufford
Dickinson School of Law, Pennsylvania State University

ARTICLES

THE CHAPTER 13 ALTERNATIVE: A LEGISLATIVE SOLUTION TO UNDERSECURED HOME MORTGAGES

The Honorable Samuel L. Bufford *

I. INTRODUCTION

The Great Recession that began in approximately 2008 brought severe financial difficulties to a large number of homeowners in the United States. With a rise in the unemployment rate from 4.6% to 10%,[1] many lost their jobs and their ability to make their home payments. At the same time, with an average 30.3% reduction in housing values[2] (which in some places has approached nearly 60%),[3] many homes are now worth substantially less than

* Judge Bufford served as a U.S. Bankruptcy Judge in Los Angeles for twenty-five years until his retirement in 2010. He is now a Distinguished Scholar in Residence at Dickinson School of Law, Pennsylvania State University.

1. According to the United States Department of Labor, Bureau of Labor Statistics, unemployment rates rose from 4.6% in January 2007 to a peak of 10% in December 2009. *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, USDL 07-0159, THE EMPLOYMENT SITUATION: JANUARY 2007, at 1 (2007), *available at* http://www.bls.gov/news.release/archives/empsit_02022007.pdf (noting an unemployment rate of 4.6% in January 2007); BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, USDL 09-1583, THE EMPLOYMENT SITUATION—DECEMBER 2009, at 1 (2010), *available at* http://www.bls.gov/news.release/archives/empsit_01082010.pdf (noting an unemployment rate of 10% in December 2009).

2. Press Release, Standard & Poor's, U.S. Home Prices Keep Weakening as Nine Cities Reach New Lows According to the S&P/Case-Shiller Home Price Indices (Jan. 25, 2011), *available at* http://standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p--us (explaining that the 30.3% value reflects the reduction in housing values from their peak value in 2006 through November 2010).

3. *Id.* (noting that Las Vegas has seen the greatest decline in housing values since 2006).

the debt owed on mortgages secured by the homes.[4] Some 5 million homeowners are at least two months behind in their mortgage payments, and RealtyTrac predicts that some 1.2 million homes will be foreclosed on in 2011.[5] The housing crisis continues to get worse, not better.[6]

Large amounts of public funds, through a variety of programs, have been expended to try to ameliorate this problem, with disappointing results.[7] The federal Home Affordable Modification Program ("HAMP") alone, for example, has been allocated $50 billion of U.S. government funds, of which $652.4 million has been expended to produce a meager 520,000 permanent modifications.[8] However, none of these government programs has made a substantial dent in the backlog of 11.1 million homes that are under water where homeowners cannot make their mortgage pay-

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4. *See* Nick Timiraos, *U.S. News: Home-Purchasing Power Increases*, WALL ST. J., Feb. 9, 2011, at A4. As of the end of 2009, nearly 27% of all U.S. homeowners owed more on their mortgages than their homes were worth. *Id.*

5. Janna Herron, *Banks Repossessed 1 Million Homes Last Year—and 2011 Will Be Worse*, MSNBC.COM, Jan. 13, 2011, http://www.msnbc.msn.com/id/41051419/ns/business-real_estate/.

6. Residential foreclosures are predicted to increase by 20% in 2011. Dan Levy & Prashant Gopal, *Foreclosure Filings in U.S. May Jump 20% from Record 2010 as Crisis Peaks*, BLOOMBERG, Jan. 13, 2011, http://www.bloomberg.com/news/2011-01-13u-s-foreclosure-filings-may-jump-20-this-year-ds-crisis-peaks.html.

7. Created during the second Bush administration, the Hope for Homeowners Program and FHASecure (discontinued Dec. 31, 2008), as well as President Obama's Making Homes Affordable Program, were meant to encourage lenders to voluntarily modify mortgages held by certain qualified debtors. HOPE for Homeowners Program, 24 C.F.R. § 257 (2010); Press Release, U.S. Dep't of Hous. & Urban Dev., Bush Admin. to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes; FHA to implement new "FHASecure" refinancing product (Aug. 31, 2007), *available at* http://archives.hud.gov/news/2007/pr07-123.cfm; Press Release, Making Homes Affordable Program, U.S. Dep't of the Treasury, U.S. Dep't Of Hous. & Urban Dev. & The Ad Council Unveil Nat'l PSA Campaign To Raise Awareness Of Making Home Affordable Program (July 28, 2010), *available at* http://www.makinghomeaffordable.gov/news/latest/Pages/pr_07282010.aspx. HOPE NOW is a prominent non-governmental modification program administered by the mortgage industry. Press Release, HOPE NOW, HOPE NOW: Mortgage Servicers Completed 101,000 Loan Mods for Homeowners in January (Mar. 10, 2011), *available at* http://www.hopenow.com/press-releases.php.

8. *See* CONG. OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT: A REVIEW OF TREASURY'S FORECLOSURE PREVENTION PROGRAMS, 16 n.23, 18, 44 n.114 (2010) ("To date, HAMP has processed 519,648 permanent modifications.").

ments.[9] Home prices are expected to decline another 5–10% before they reach bottom near the end of 2011.[10]

In addition, interest rates for secured credit have lowered dramatically, making home ownership much more affordable for a given income level and debt service capacity.[11] However, a homeowner whose property value is less than the outstanding mortgage loans (or if the property value is near this demarcation line) has typically been shut out of the opportunity to refinance to reduce home mortgage costs.[12] In many such cases, the refinancing of the mortgage debt would make the mortgage payments affordable instead of putting them beyond an owner's reach.

Nonetheless, there are a substantial number of homes where the owners could make the payments with appropriate mortgage payment modifications. Such a modification would (a) reduce the amount of the secured debt to the reduced value of the house, (b) reduce the interest rate to the current interest rate, (c) change any adjustable rate to a fixed rate, and (d) adjust the monthly payments correspondingly.

This article discusses minor changes to the U.S. Bankruptcy Code that would make these changes possible.[13] These changes would make avoiding foreclosure possible for a homeowner who (a) is presently not able to make the mortgage service payments but (b) could make payments for a mortgage that is reduced to the market value of the property and to a fixed market mortgage rate. The article does not address the political issue of what pro-

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9. *See* Ruth Simon & Nick Timiraos, *Mortgage Faceoff Looms for Lenders*, WALL ST. J., Mar. 28, 2011, at C1.

10. Timiraos, *supra* note 4 (stating that many economists expect that home prices will decline by 5% to 10% before bottoming out in late 2011 or early 2012).

11. *See Primary Mortgage Market Survey: 30-year Fixed-Rate Mortgages Since 1971*, FREDDIE MAC, http://www.freddiemac.com/pmms/pmms30.htm (last visited Apr. 15, 2011) (displaying that interest rates on thirty-year fixed-rate mortgages have fallen from an annual average of 6.03% in 2008 to an annual average of 4.69% in 2010).

12. *See, e.g.*, Gregory Scott Crespi, *The Trillion Dollar Problem of Underwater Homeowners: Avoiding a New Surge of Foreclosures by Encouraging Principal-Reducing Loan Modifications*, 51 SANTA CLARA L. REV. 153, 168–69 (2011); Eric A. Posner & Luigi Zingales, *A Loan Modification Approach to the Housing Crisis*, 11 AM. L. & ECON. R. 575, 577 (2009); Manuel Adelino et al., *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Boston, No. 09-4, 2009).

13. *See* 11 U.S.C. §§ 101–1532 (2006).

tections Congress might decide to provide to mortgage owners and servicers as a part of such legislation.[14]

A highly important advantage of such legislation is that it would preserve the principle embodied in bankruptcy law—that the private sector should bear the economic losses resulting from financial adversity. Through and through, bankruptcy law sits on the solid rock that private economic losses should be kept private: government money should not be used to bail out private economic adversities. As the experience of the last few years has demonstrated, a breach of this principle can lead (as it has led) to a vast depletion of public resources to support private investment, at the cost of creating a scarcity of funds for other public purposes (or alternatively, a vast impairment of the public credit of the government).

Other advantages of adopting this revision to the Bankruptcy Code would also arise. The main advantage is that it would permit the clearing of a substantial segment of the market of nonperforming mortgage loans and the resulting processes of foreclosure and resale. These processes are very cumbersome and inefficient. They result in the realization of prices substantially lower than could be achieved in a market where a private (usually resident) owner of a home sells it to a buyer who also expects to reside in it.[15] Further, this proposal could substantially ameliorate the now depressed housing market that is dominated by the sale of foreclosed homes by institutions at prices substantially lower than the prices of private home sales.[16] At the same time, as Professor Adam Levitin has shown, this change in Chapter 13 will have little or no impact on mortgage credit cost or availability.[17]

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14. For draft legislation of this type, *see, e.g.*, Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103 (1st Sess. 2009). While several bills have included such a proposal, none is a clean bill that would enact only this proposal. Further, none has been enacted.

15. *See* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 603–06 (2009).

16. *See* Press Release, RealtyTrac, Foreclosure Homes Account for 25 Percent of All Q3 2010 Residential Sales (Dec. 1, 2010), *available at* http://www.realtytrac.com/content/press-releases/foreclosure-homes-account-for-25-percent-of-all-q3-2010-residential-sales-6194.

17. *See* Levitin, *supra* note 15, at 599, 601–02.

II. CHAPTER 13

Chapter 13 of the Bankruptcy Code was enacted in 1978 as part of a thoroughgoing revision to the U.S. bankruptcy law.[18] Generally, Chapter 7 provides for the orderly liquidation of debtors with insufficient assets to pay their creditors in full.[19] Chapter 11 provides for the reorganization of individuals and businesses pursuant to a plan voted on by the creditors.[20] Chapter 9 provides for the reorganization of certain municipalities.[21] Chapter 12 was added in 1986 to provide for the adjustment of debts of family farmers[22] (and, beginning in 2005, for family fishermen).[23] Chapter 15 was added in 2005 to provide for the coordination of international insolvency cases.[24] Chapters 1, 3, and 5 of the Bankruptcy Code contain general provisions applicable to all kinds of bankruptcy cases (with certain exceptions).[25]

A. *The General Scope of Chapter 13*

Chapter 13, which provides generally for the adjustment of debts of individuals with regular income, is best understood as an alternative to a consumer Chapter 7 case.

The basic structure of a consumer Chapter 7 case is that an "honest but unfortunate" debtor gives up all non-exempt property[26] (if any)[27] in which the debtor has an interest on the date of

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18. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, ch. 13, 92 Stat. 2549, 2645–51 (codified in scattered sectiosn of 11 U.S.C. and 28 U.S.C.). The 1978 amendments went into force on October 1, 1979. *See* Martin I. Klein, *The Bankruptcy Reform Act of 1978*, 53 AM. BANKR. L.J. 1, 3 (1979). The prior law had a Chapter 13 that had similarities to the present Chapter 13, but it was different in many material respects. *Id.* at 17–18.

19. *See* 11 U.S.C. §§ 701–784 (2006).

20. *See id.* §§ 1101–1174.

21. *See id.* §§ 901–946.

22. *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 255, 100 Stat. 3088, 3105–14 (codified as amended at 11 U.S.C. §§ 1201-1231 (2006)).

23. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1007, 119 Stat. 23, 187–88 (codified in scattered sections of 11 U.S.C.).

24. *See id.* § 801, 119 Stat. 23, 134–45 (codified at 11 U.S.C. §§ 1501-1532 (2006)).

25. *See* 11 U.S.C. §§ 101-562. There is no Chapter 2, 4, 6, 8, 10, or 14. These chapters are saved for use, if needed, in subsequent bankruptcy legislation.

26. For property exemptions applicable to individuals, see *id.* § 522. Alternatively, in § 522(b)(2), Congress authorized any state to opt out of the federal exemption provisions and to substitute its own state law exemptions. Some thirty-three states have exercised this

the bankruptcy filing in exchange for a discharge[28] of all unsecured debts[29] and a fresh start in economic life.[30] In a Chapter 7 case, the debtor is permitted to keep all postpetition earnings and other postpetition property.[31]

By contrast, in a Chapter 13 case, the debtor keeps all of her[32] prepetition property and in exchange makes monthly payments through a Chapter 13 plan for three to five years, which must total at least as much as the creditors would receive in a Chapter 7 case.[33] These payments go to a Chapter 13 trustee, who distributes them to the creditors according to the Chapter 13 plan approved by the court.[34]

Chapter 13 is inspired by Chapter 11, which provides for the reorganization of a business and the payment of its debts pur-

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option. *See* WILLIAM HOUSTON BROWN, LAWRENCE R. AHERN, III & NANCY FRAAS MACLEAN, BANKR. EXEMPTION MANUAL § 4:2 (2010 ed.).

27. In fact, approximately 93% of Chapter 7 cases are "no asset" cases where the trustee finds no property to administer for the benefit of creditors. *See* Dalié Jiménez, *The Distribution of Assets in Consumer Chapter 7 Bankruptcy Cases*, 83 AM. BANKR. L.J. 795, 797 (2009).

28. The Chapter 7 discharge is provided by § 727. *See* 11 U.S.C. § 727(a). This section provides for the denial of a discharge for a Chapter 7 debtor for certain misconduct, chiefly within the bankruptcy case itself. *See id.* In addition, certain prepetition debts are not subject to the discharge. *See id.* § 523.

29. *See id.* §§ 523, 727(b). While Chapter 7 provides for the discharge of all debts, the collateral for any secured debt (typically a house or a car) remains liable for the debt. *See id.* § 524(e). In consequence, as a practical matter a Chapter 7 discharge discharges all unsecured debt and the debtor remains liable for house and car payments.

30. *See, e.g.*, Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367, 381 (2007) (quoting Grogan v. Garner, 488 U.S. 279, 286, 287 (1991)) (internal quotations omitted) (stating that the basic purpose of bankruptcy is to give "a fresh start to the honest but unfortunate debtor.").

31. *See* 11 U.S.C. § 541(a)(1), (6). There is a minor exception that, in a Chapter 7 case, any inheritance, life insurance proceeds (from a decedent), or marital property settlement received by the debtor within 180 days after filing also becomes property of the estate and available for liquidation and distribution to creditors. *See id.* § 541(a)(5). It is very uncommon for a Chapter 7 debtor to receive property of this type.

32. While the pronoun "her" is used as a convention in legal scholarship, in fact a majority of Chapter 13 debtors are women. *See, e.g.*, Elizabeth Warren, *What Is a Women's Issue? Bankruptcy, Commercial Law, and Other Gender-Neutral Topics*, 25 HARV. WOMEN'S L.J. 19, 27 n.40 (2002) (giving data to show that, in 2001, 71% of individual consumer (and all Chapter 13) bankruptcy cases were filed either by women alone (39%) or as joint petitions (32%)). It is a fair inference that women were debtors in a majority of the Chapter 13 cases included in that sample.

33. *See* 11 U.S.C. § 1325(a)(4); Levitin, *supra* note 15, at 579.

34. 11 U.S.C. § 1322(a)(1); *see id.* § 1302 (describing the appointment and tasks of the trustee).

suant to a plan over a course of years.[35] A Chapter 13 debtor must have regular income.[36] The debtor must propose a feasible plan for the adjustment of debts within fourteen days after the filing of the case.[37] A Chapter 13 plan deals with unsecured debt by providing for the debtor to make such payments as the debtor can afford and discharging any unpaid balance at the end of the plan after the debtor makes the plan payments ("unsecured creditor treatment").[38] The unsecured creditors receive payments from the trustee (who passes them on from the debtor) as provided in the Chapter 13 plan.[39] In due course, a Chapter 13 debtor receives a discharge of all unsecured debts (unless the plan provides otherwise).[40]

Secured creditors are treated quite differently from unsecured creditors under a Chapter 13 plan. A Chapter 13 plan typically has two separate provisions for secured debt. First, the plan typically provides for the cure of any arrearages (i.e., missed payments) on a secured debt and the payment of the regular monthly (or other periodic) payments for the life of the plan and thereafter until the debt is paid in full[41] ("secured creditor treatment").[42]

Second, if the secured creditor is undersecured (i.e., the value of the collateral is less than the unpaid amount on the debt), the debt is divided into two parts.[43] The secured portion is given secured creditor treatment (i.e., arrearages are cured and regular monthly payments are made for the life of the plan and until the debt is retired).[44] The unsecured portion is given unsecured creditor treatment, which usually means that it is paid a much lower percentage (and perhaps nothing at all).[45]

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35. *See id.* § 1123; *see also Chapter 11: Reorganization Under the Bankruptcy Code*, U.S. COURTS, http://www.uscourts.gov/federalcourts/bankruptcy/bankruptcybasics/chapter11.aspx (last visited Apr. 15, 2011)).

36. *See* 11 U.S.C.A. § 109(e) (West 2011).

37. *See* FED. R. BANKR. P. 3015(b).

38. *See* 11 U.S.C. § 1328(a) (2006).

39. *See id.* § 1326(a)(2).

40. *See id.* § 1328(a).

41. In certain cases the secured debt (such as a car loan) may be paid in full according to its terms before the end of the Chapter 13 plan. *See id.* § 1322(b)(5).

42. *See id.*

43. *See id.* § 506(a)(1).

44. *Id.*

45. *Id.*

Chapter 13 secured debt modifications are limited by federal bankruptcy common law. A modified loan must provide a reasonable risk premium for the debtor,[46] and the plan must provide for the secured creditor to receive the present value of its collateral.[47] Only a debtor who can afford a loan within these limits can qualify for the modification of a loan under Chapter 13.[48] In addition, a debtor must undertake a plan requiring the debtor to live at or near the poverty level for three to five years (mostly five years in the present economic environment) to qualify for a Chapter 13 discharge that would accomplish the changes described.[49]

It is likely that a substantial number of homeowners whose property is undersecured and who cannot afford their present payment schedules would qualify for such a Chapter 13 plan. There are no estimates as to how many undersecured debtors would qualify for Chapter 13 treatment. This figure likely includes a substantial portion of those with undersecured mortgages who are presently unable to make their payments, but probably far less than half. Nonetheless, this group would have substantial size.

B. *Chapter 13 Treatment of Debts Secured by Automobiles*

The most common kind of secured debt in a Chapter 13 case is a debt secured by an automobile.[50] In virtually every case where the debtor has such a loan, the collateral is worth less than the amount owing on the debt.[51] Until 2005, the foregoing description of the treatment of an undersecured creditor was the typical pattern for the treatment of automobile loans in Chapter 13 cases: the secured debt was written down to the value of the automobile and paid over the life of the plan until the debt was paid in full (whether before or after the completion of the plan), and the un-

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46. *See* Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004) (discussing the factors used to determine the size of a risk adjustment).

47. *See* 11 U.S.C. § 1325(a)(5).

48. *See* 11 U.S.C.A. § 109(e) (West 2011).

49. *See* 11 U.S.C. § 1325(b).

50. *See generally* David Gray Carlson, *Cars and Homes in Chapter 13 After the 2005 Amendments to the Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 301, 302 (2006) (discussing secured car lenders and home mortgage lenders in Chapter 13 bankruptcy cases).

51. *See id.*

secured portion of the debt was paid at the same rate as other unsecured creditors.[52]

In 2005, Congress changed Chapter 13 so that it now prohibits the bifurcation of a debt secured by an automobile if the debtor has not owned the vehicle for at least 910 days before the date of filing the bankruptcy petition.[53] Under Chapter 13 as modified, a vehicle owned no more than 910 days is treated as fully secured and must be given secured creditor treatment under the plan.[54] Other vehicles are treated the same as all other secured debt (except for principal home mortgages) described above.[55]

C. *Chapter 13 Treatment of Debt Secured by the Debtor's Principal Residence*

Chapter 13 singles out home mortgages for special treatment.[56] Unlike all other secured debt held by a Chapter 13 debtor (except for certain automobiles since 2005), a Chapter 13 plan may not modify the rights of a holder of a secured claim "secured only by a security interest in real property that is the debtor's principal residence."[57] Notwithstanding this prohibition, the plan may provide for the curing of any default "within a reasonable time" and maintenance of payments during the life of the plan.[58]

Thus a Chapter 13 plan may provide for the payment of secured debts owing by the debtor according to the following pattern. The debtor may pay arrearages over the life of the plan (up to five years), except that arrearages on a mortgage secured by

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52. *Id.* Other secured debt in a Chapter 13 case may be collateralized with appliances, jewelry, investment property, a vacation home, or electronic equipment. *See* 11 U.S.C. § 1325(a); Wilson v. Commonwealth Mortg. Co., 895 F.2d 123, 128–29 (3d Cir. 1990) (appliances and furniture). All such debts are subject to the same treatment in a Chapter 13 case as a car loan before 2005; Carlson, *supra* note 50, at 302–04.

53. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 306(b), 119 Stat. 23, 80 (codified at 11 U.S.C. § 1325(a)).

54. *See* 11 U.S.C. § 1325(a).

55. *Id.*

56. *See id.* § 1322(b)(2). In 1994 Congress added § 1123(b)(5) to prohibit the modification of a mortgage secured by a debtor's principal residence in a Chapter 11 case. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 206, 108 Stat. 4106, 4123 (codified at 11 U.S.C. § 1123(b)(5)).

57. 11 U.S.C. § 1322(b)(2).

58. *Id.* § 1322(b)(5).

the debtor's principal residence must be paid within "a reasonable time" (which is typically less than five years).[59]

III. THE CHAPTER 13 PROPOSAL

Given this description of the treatment of undersecured debts in a Chapter 13 plan, we now turn to the proposal to permit a debtor to use a Chapter 13 case to modify an undersecured home loan to make it affordable. The main purpose of this article is to describe in detail how Chapter 13 would need to be changed to accomplish such a modification and to specify exact language that would accomplish such a change.

A. *Chapter 13 Background*

Until recently, there was relatively little pressure to change the special treatment of home mortgages in Chapter 13 cases. Apart from specific markets, the value of personal residences had never depreciated more than 10% since the Great Depression.[60] At the same time, until the 1990s, it was customary for residential mortgages to require a down payment of at least 10%.[61] Thus, it was unusual for a home mortgage holder to become undersecured. While the recent advent of mortgages with lower down payments produced an occasional Chapter 13 case with an undersecured home mortgage holder, this was relatively uncommon. Even junior mortgage holders were typically "in the money" in Chapter 13 cases.[62]

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59. *See, e.g.*, United Ca. Sav. Bank v. Martin (*In re* Martin), 156 B.R. 47, 50 (B.A.P. 9th Cir. 1999) (stating that while "reasonable time . . . is a flexible concept, determined on a case-by-case basis," "reasonable time" is limited to three years "unless the court approves a longer period not to exceed five years."); *In re* Harmon, 72 B.R. 458, 462 (Bankr. E.D. Pa. 1987).

60. *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 967 (2009); *see also* David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons from the Great Depression*, 90 FED. RESERVE BANK OF ST. LOUIS REV. 133, 145 (2008), *available at* http://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf.

61. Jerry W. Markham, *The Subprime Crisis—Some Thoughts on a "Sustainable" and "Organic" Regulatory System*, 4 FLA. INT'L U.L. REV. 381, 385 n.22 (2009).

62. *See* Dennis Cauchon, *Why Home Values May Take Decades to Recover*, USA TODAY, Dec. 12, 2008, http://iusatoday.net/news/graphics/housing_prices/home_prices.pdf.

The advent of the Great Recession, beginning in 2008, changed this picture dramatically. Since that date, U.S. homes have depreciated by an average of 30.3%.[63] In some markets, the reduction in home values has approached 60%.[64] This change has made a large number of mortgages undersecured. In addition, the unemployment rate rose from 4.6% to 10%, which left many homeowners unable to pay their mortgages.[65]

At the same time, the average interest rate for home mortgages dropped drastically. In 2008, the average rate for a home mortgage was 6.03%.[66] At the end of 2010, it had fallen to 4.69%.[67] However, a very large number of homeowners have been unable to refinance their homes to take advantage of the lower rates, because they cannot provide an equity cushion for a new mortgage.[68]

The development of the securitization market for home mortgages has added to this problem. Securitization has stratified the home mortgage market so that mortgage holders are contractually prohibited from making substantial modifications to home mortgages, and their counterparties are too numerous and dispersed to make any efficient modification.[69] This securitization has created a collective action problem that bankruptcy law is uniquely designed to solve in ordinary circumstances.

B. *The Chapter 13 Proposal*

In light of these problems, this article describes a Chapter 13 modification that provides an alternative procedure for modifying an undersecured consumer mortgage.[70] The mortgage would be

63. *See supra* note 2 and accompanying text.

64. *See supra* note 3 and accompanying text.

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

66. *See supra* note 11.

67. *See supra* note 11.

68. *See* Crespi, *supra* note 12, at 169–70.

69. *See* Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 HARV. L. & POL'Y REV. *ONLINE*, Jan. 19, 2009, at 1, 3–5, http://hlpronline.com/Levitin_HLPR_011909.pdf.

70. Several bills have been introduced in Congress that would, *inter alia*, adopt some of the recommendations made here. *See, e.g.*, Helping Families Save Their Homes in Bankruptcy Act of 2008, S. 2136, 110th Cong. § 102 (2007); Home Owners' Mortgage and Equity Savings (HOMES) Act, S. 2133, 110th Cong. § 2 (2007); Emergency Home Owner-

written down to the fair market value of the property (the debtor's home) serving as collateral for the loan. The unsecured portion of the loan would be given the same treatment as other unsecured debt in the Chapter 13 plan. The interest rate would be reduced to the present market rate (for a borrower with the credit standing of the Chapter 13 debtor).[71] If the debtor completes the payments under the plan, the unsecured portion of the debt (the portion not supported with collateral) would be discharged through the Chapter 13 discharge. The collective action problem is solved by requiring all parties in interest to negotiate their interests in a bankruptcy forum.[72]

To permit a Chapter 13 debtor to make such a change in her mortgage, three alterations in the language of § 1322(b), plus one in § 1322(c), are required.

1. First Change: Amend the Language of § 1322(b)(2)

The first change is to amend subsection (b)(2) as follows:

(b) Subject to subsections (a) and (c) of this section, the plan may—

. . .

(2) modify the rights of holders of secured claims~~, other than a claim secured only be a security interest in real property that is the debtor's principal residence,~~ or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims. . . .

2. Second Change: Add New Provision § 1322(b)(6)

To make the change to § 1322(b)(2) effective and to assure that the intention of this change is realized (and to overrule contrary

ship and Mortgage Equity Protection of 2007, H.R. 3609, 110th Cong. None has been enacted.

71. For an explanation of the calculation of an appropriate interest rate in the bankruptcy context, see *Till v. SCS Credit Corp.*, 541 U.S. 465, 478–81 (2004).

72. *See, e.g.*, Susan E. Hauser, *Cutting the Gordian Knot: The Case for Allowing Modification of Home Mortgages in Bankruptcy*, 5 J. BUS. & TECH. L. 207, 225 (2010).

case law), it is necessary to add a new provision inspired by Chapter 11:

> (6) provide for the extension of the maturity date beyond the date when the final payment on the plan is due or change the interest rate or other terms of a secured claim. . . .

The remaining subparagraphs of § 1322(b) should be renumbered to provide for the insertion of subparagraph (6).

3. Third Change: Two Technical Amendments

As a result of the change in subparagraph (2), two references in § 1322 to the deleted clause need to be removed. Thus subparagraph (5) should be amended as follows:

> (5) ~~notwithstanding paragraph (2) of this subsection,~~ provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due . . . .

Similarly, subparagraph (c) should be amended as follows:

> (c) Notwithstanding ~~subsection (b)(2) and~~ applicable nonbankruptcy law. . . .

Pursuant to amended § 1322, as described above, a debtor would be authorized to bifurcate an undersecured mortgage claim. In consequence, the debtor would become responsible only for the value of the allowed secured claim (the value of the collateral), and would pay the remainder at the rate provided in the plan for unsecured creditors.[73] The plan of reorganization would then be required to provide at least for the payment of the present value of the allowed secured claim, not the entire under-

73. While a number of Chapter 13 plans provide that general unsecured creditors be paid little or nothing, a substantial number of Chapter 13 plans provide for the payment of all unsecured creditors in full over the life of the plan. *See* William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 405 (1994). Another substantial segment provides for the payment of 70% of unsecured debts (so that the debtor can qualify for a hardship discharge under § 1328(b), if it becomes applicable during the life of the plan). *See* 11 U.S.C. § 1328(b) (2006) (discussing when a court may grant a hardship discharge to a debtor).

lying lien, taking into account the length of the mortgage agreement and adjusting payments to reflect an interest rate determined by the national prime rate adjusted by the risk of a debtor default under the plan.[74] The amount of the underlying lien exceeding the value of the collateral (the allowed unsecured claim) would be treated like any other general unsecured claim.[75] Because present law permits debtors to offer plans—and courts to confirm plans—that cram down undersecured claims (except those secured by the debtor's principal residence or a recently purchased automobile), amending § 1322 will not fundamentally change or affect the administration of the Bankruptcy Code.

C. *Explanation of the Proposal*

The first change is the substantive change in Chapter 13. It deletes the provision prohibiting a Chapter 13 plan from modifying a claim secured only by a security interest in the debtor's principal residence and permits a Chapter 13 plan to include such a modification.[76]

The second change, the addition of a new § 1322(b)(6), is required to reverse case law interpreting § 1322. None of the congressional bills has addressed this issue. The leading opinion needing reversal to implement this proposal is *Enewally v. Washington National Bank (In re Enewally)* from the Ninth Circuit.[77] In that case, the debtor owned two rental properties, and the secured creditor was undersecured as to each.[78] The Chapter 13

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74. *See id.* § 1325(a)(5)(B)(ii); *Till*, 541 U.S. at 478–81.

75. *See* 11 U.S.C. § 1325(a)(4). Unsecured creditors in Chapter 7 frequently receive payment on a very small percentage of their claim, or nothing at all. *Id.* §§ 507(a), 726(a), 727(a). As a practical result of this provision, it is quite possible that a Chapter 13 debtor will have to devote very few or no funds to the repayment of general unsecured claims that are not entitled to priority. *Id.* §§ 507, 1322(a)(2).

76. It could be argued that § 1123(b)(5), which is identical to § 1322(b)(2), should also be amended to delete the same phrase. *Compare id.* § 1123(b)(5) (providing that a Chapter 11 bankruptcy plan may not modify a claim secured by a security interest in real property), *with id.* § 1322(b)(2) (providing that a Chapter 13 bankruptcy plan may not modify a claim secured by a security interest in real property). Section 1123(b)(5) was borrowed from Chapter 13 when it was added to the Bankruptcy Code in 1994. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 206, 108 Stat. 4106, 4123 (codified at 11 U.S.C. § 1123(b)(5)). This issue is beyond the scope of this article.

77. 368 F.3d 1165 (9th Cir. 2004).

78. *Id.* at 1167. The debtor also had a principal residence, as to which the plan proposed to cure the arrearages over the life of the plan as provided in § 1322(b)(5). Enewally

plan (as modified) proposed to strip off the unsecured claims on the two rental properties, but not to change either the duration of each loan or the interest rates.[79] The bankruptcy court (pursuant to an opinion written by the author herein) held that Chapter 13 permitted such a plan proposal for rental property because it did not come within the exception of § 1322(b)(2).[80] The Ninth Circuit upheld a reversal by the district court and found that Chapter 13 requires that all changes in a claim must include the payment in full of the claim as changed over the life of the plan.[81]

New § 1322(b)(6) is inspired by § 1123(a)(5)(H) in Chapter 11.[82] Because Chapter 11 now includes the language of § 1322(b)(2),[83] § 1123(a)(5)(H) is needed in Chapter 11[84] to support the common practice in Chapter 11 cases of modifying the duration, amount and interest rate of a secured claim.[85] Chapter 11 also authorizes stripping the unsecured claim of an undersecured creditor in a

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v. Wash. Nat. Bank (*In re* Enewally), 276 B.R. 643, 647–48 (Bankr. C.D. Cal. 2002), *aff'd in part, rev'd in part*, No. SA CV 02-459-GLT, 2002 WL 34178495 (C.D. Cal. Nov. 26, 2002), *aff'd*, 368 F.3d 1165 (9th Cir. 2004).

79. *In re* Enewally, 276 B.R. at 645–46. Pursuant to the plan, the unsecured overage claims in the rental properties would be discharged at the end of the plan, provided that such a discharge was entered. *Id.* at 645.

80. *See id.* at 652–53.

81. *See In re* Enewally, 368 F.3d at 1172.

82. *See* 11 U.S.C. § 1122(a)(5)(H) (2006).

83. *Compare id.* § 1322(b)(2), *with id.* § 1123(b)(5) (same language in each provision).

84. Professor Mark Scarberry argues that *Enewally* prohibits stripping down a lien in a Chapter 13 case even without the language in § 1322(b)(2). *See* Mark S. Scarberry, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13 Bankruptcy*, 37 PEPP. L. REV. 635, 661–65 (2010). Professor Adam Levitin contends, in his response to Professor Scarberry, that *Enewally* is a decision from only one circuit court (albeit from the largest United States federal circuit) that does not establish national case law, particularly since it has not been followed much. *See* Adam J. Levitin, *Back to the Future with Chapter 13: A Response to Professor Scarberry*, 37 PEPP. L. REV. 1261, 1267–69 (2010). This paper proposes the legislative overruling of *Enewally* to make clear that it will no longer be good law anywhere after the Chapter 13 change proposed herein is legislatively adopted.

85. *See* Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495, 1496 (1993). Stripping down the unsecured portion of an undersecured creditor's claim is not permitted in a Chapter 7 case. *See* Dewsnup v. Timm, 502 U.S. 410, 417 (1992). Section 1322(b)(2) has prohibited such an action in a Chapter 13 case since it went into force in 1979. *See In re* Enewally, 368 F.3d at 1171–72. However, the practice has always been different in Chapter 11 cases.

Chapter 11 plan.[86] It will have the same effect in a Chapter 13 case pursuant to the proposed change.[87]

In order to avoid the strict time constraints for repayment required by *Enewally*, the best solution is the addition of a new provision to Chapter 13 permitting the modification of the duration, amount, and interest rate of all secured claims.

The third change involves two technical amendments to § 1322, both of which simply remove the extraneous references to the repealed antimodification provision in § 1322(b)(2). Since amended § 1322(b)(2) will permit the modification of all contract rights, including those resulting in the cure and reinstatement of a claim secured by a principal residence, it is not necessary to include language in § 1322(b)(5) to ensure that result. For that same reason, § 1322(c) should also be identically amended.

D. *Who Will Qualify to Use This Change*

To qualify for mortgage modification under the amended Chapter 13, a debtor would have to file a Chapter 13 bankruptcy case. Chapter 13 has entry requirements that such a debtor must satisfy. First, there are debt ceilings that exclude creditors with too much debt: a Chapter 13 debtor is disqualified if the debtor has more than $1,081,400 in "noncontingent, liquidated, secured

86. *See, e.g.*, First Fed. Bank of Ca. v. Weinstein (*In re* Weinstein), 227 B.R. 284, 290 n.4 (B.A.P. 9th Cir. 1998) (recognizing an established pre-1994 practice to permit a Chapter 11 individual debtor to strip down an undersecured mortgage on the debtor's principal residence); Wade v. Bradford, 39 F.3d 1126, 1129 (10th Cir. 1994) (noting that Chapter 11 debtors could strip down lien on residence notwithstanding *Dewsnup*); *In re* Jones, 152 B.R. 155, 173 (Bankr. E.D. Mich. 1993) (stating that a categorical prohibition on lien stripping in Chapter 11 cases "would disrupt established pre-Code law"); *cf.* Harmon v. United States *ex rel.* Farmers Home Admin., 101 F.3d 574, 581 (8th Cir. 1996) (allowing lien stripping in a Chapter 12 case).

87. It could be argued that § 1123(b)(5) should also be repealed. However, there are rather few Chapter 11 cases where a debtor seeks to strip down the unsecured portion of an undersecured home loan. In the fiscal year ending September 30, 2010, only 14,191 Chapter 11 cases were filed nationwide. *See Bankruptcy Filings Up Nearly 14 Percent Over Last Fiscal Year*, U.S. COURTS (Nov. 8, 2010), http://www.uscourts.gov/News/Newsview/10-11-08/Bankruptcy_Filings_Up_Nearly_14_Percent_Over_Last_Fiscal_Year.aspx. However, only a small proportion of these cases involved individual debtors, *id.* tbl. F-2 (12-Month Period), and only a small portion of the individual debtor Chapter 11 cases involved an issue of stripping down an undersecured home mortgage. Thus, this change in Chapter 11 would have little impact on the existing home mortgage crisis.

debts" and more than $360,475 in similar unsecured debts.[88] Second, a Chapter 13 debtor must propose a plan that meets the statutory requirements for confirmation.[89] Third, and most important, the plan must be supported by a budget showing that the debtor plans to live (with certain qualifications) within the spartan restrictions that the Internal Revenue Service attempts to impose on taxpayers to qualify for a plan to pay tax arrearages over a period of time.[90] This would require that the debtor and the debtor's family live at or near the poverty level for the life of the plan.

Notably, this strip-down would not be available to debtors filing their cases under Chapter 7,[91] the most popular chapter for consumer debtors.[92] Thus a debtor opting under Chapter 7 for a clean slate and a fresh start as of the date of filing the bankruptcy petition (after turning over all non-exempt property to the trustee for liquidation for the benefit of creditors)[93] would not be eligible for this treatment for her home.[94]

E. *The Benefits of this Change in Chapter 13*

The most important benefit of such a change in Chapter 13, for our discussion here, is that it restricts the losses in the consumer real estate market to the private sector and insulates the government purse from these losses. The government does not contribute any funding to achieving this result. The costs of the Chapter 13 system are carried by the U.S. court system, supple-

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88. 11 U.S.C.A. § 109(e) (West 2011). These statutory ceilings are adjusted for inflation every three years. 11 U.S.C. § 104(a) (Supp. III 2009). The last such adjustment was made effective April 1, 2010. *See id.*

89. *See* 11 U.S.C. § 1325 (2006).

90. *See id.* § 1325(b)(3); *see also id.* § 707(b)(2)(A)–(B) (discussing when granting relief by dismissing a case under Chapters 11 or 13 would constitute abuse).

91. *See* Dewsnup v. Timm, 502 U.S. 410, 417, 420 (1992) (holding that a Chapter 7 debtor cannot strip down an undersecured claim that "is secured by a lien and has been fully allowed pursuant to § 502").

92. Chapter 7 accounts for approximately 70% of consumer bankruptcies. Robert J. Landry, III, *An Empirical Analysis of the Causes of Consumer Bankruptcy: Will Bankruptcy Reform Really Change Anything?*, 3 RUTGERS BUS. L.J. 2, 8 (2006).

93. *See supra* text accompanying notes 26–31.

94. A Chapter 7 trustee would not sell a debtor's home if the secured creditor was undersecured, because the creditor would be entitled to all of the value in the house and there would be no benefit for the unsecured creditors. Instead, in due course the trustee would abandon the property back to the debtor. *See* FED. R. BANKR. P. 6007.

mented by filing fees (court costs) and a percentage payment to the Chapter 13 trustee who administers the case (administration costs). Private losses in the residential real estate market, if any, remain private and do not drain the public treasury.

This proposal has two additional important features. First, for a Chapter 13 debtor who can afford the payments under the restructured loan, the debtor can keep the home and make affordable payments to the lender (or its successor). The debtor does not incur the loss of the home or the impact of a foreclosure on the debtor's credit report, and the debtor can get on with her life.[95]

At the same time, Chapter 13 is cheaper for the lender.[96] The lender is much more likely to be paid.[97] A court-approved repayment plan providing for the payment of reduced mortgage payments is likely to result in payments to the secured creditor. The present value of the stream of payments under the plan will most likely substantially exceed the amount that a bank can realize from reselling the property after foreclosure (which must be discounted for the delay in the foreclosure process and in the resale process).[98] The lender likely receives no payments during the foreclosure process and certainly receives none during the delay between foreclosure and resale of the residence.[99] In addition, the lender does not incur the costs and administrative burden of owning and marketing the property, almost surely at a loss, or of recognizing this loss on its balance sheet.[100]

This change in bankruptcy law also solves the contractual, practical, and economic problems resulting from the securitization of the vast majority of home mortgages. The bankruptcy solution solves the collective action problem that prevents mortgage owners from finding an economic solution to a mortgage affordability problem. In addition, under mortgage securitization, mortgage servicers are typically the only parties who have any author-

95. The costs to a debtor of foreclosure are usually substantial. The debtor suffers a loss of community ties, friendships, religious affiliation, "schooling, childcare, medical care, transportation, and even employment." Levitin, *supra* note 15, at 569.

96. *See id.* at 610–11.

97. *See id.* at 607.

98. *See id.* at 606–07.

99. *See id.* at 629.

100. *See id.* at 606. Foreclosure imposes larger losses on lenders, on the average, than bankruptcy modification of their loans. *See id.* at 618; *see also* Levitin, *supra* note 69, at 7.

ity to act on behalf of mortgage holders, and the servicers are typically prohibited by contract from making loan modifications, or their right to make such modifications is severely limited.[101] The servicers lack sufficient personnel to handle a large number of consumer contacts and lack the financial resources to hire such personnel. In addition, in many cases, foreclosure is more profitable to loan servicers than modification of a loan.[102] All of these problems disappear immediately for loans modified pursuant to the proposed Chapter 13 change.

Furthermore, such a program makes good politics. Because such a program would reduce the incentives for a homeowner to abandon the property, the community bears a smaller burden of vacant houses, loss of property taxes, and the failure of the residents to maintain their properties and to support and contribute to community life.[103]

IV. CONCLUSION

The principal purpose of this article is to specify the changes needed in Chapter 13 of the U.S. Bankruptcy Code to put into place a Chapter 13 solution for the home ownership problem in the United States. This solution is both simple and elegant: delete from § 1322(b)(2) the phrase "other than a claim secured only by a security interest in real property that is the debtor's principal residence." A second change incorporates language from § 1123(a)(5)(H) to make it explicit that a Chapter 13 plan may extend the maturity date and change the interest rate and other terms of a debt instrument. Third, some minor technical changes would implement these alterations.

As the foreclosure crisis continues to deepen, modification of certain underwater mortgages under Chapter 13 of the Bankruptcy Code can make a substantial contribution to the stabilization of the housing market. Unlike any other existing or proposed solutions to the problem, "bankruptcy modification offers immediate relief, solves the market problems created by securitization,

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101. *See, e.g.*, Levitin, *supra* note 69, at 5.

102. *See id.*

103. *See* Levitin, *supra* note 15, at 569 (discussing the costs foreclosure can have for third parties).

addresses both problems of payment-reset shock and negative equity, screens out speculators, spreads burdens between borrowers and lenders, and avoids both the costs and moral hazard of a government bailout."[104] Thus, while the bankruptcy solution is not a magic bullet, "it is a quick, fair, efficient, and administrable response that would help stabilize the housing market and prevent the deadweight social and economic losses of foreclosure."[105]

Most importantly, this solution can be accomplished at no cost to the federal government or any other governmental agency. Like all bankruptcy law, the costs of this solution rest entirely on the private sector (and rest principally on those responsible for bringing on the housing crisis).

104. *Id.* at 647–48.
105. Levitin, *supra* note 69, at 9.