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January 19, 2010

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THE CASE FOR "CRAMDOWN": ELIMINATING THE PRACTICAL AND IDEOLOGICAL BARRIERS TO PURE MORTGAGE MODIFICATION

*Peter J. Leo**

"The [P]resident's plan largely relies on reduction in interest rates as opposed to reduction in principal and that makes a lot of sense. We should let the [P]resident's plan, other than the bankruptcy part, go forward and see how it works."[1]

"When we allowed mortgage securitization, we created this hole, and we are obliged to fill it. Only a judge can cut through the nightmare of bureaucracy that a homeowner faces trying to sort through this mess. Securitized mortgages caused it, and there is only one practical way to clear it up . . . ."[2]

I. INTRODUCTION

Our country currently finds itself embroiled in the most serious economic crisis since the Great Depression. Experts agree that the current economic situation arose out of various indiscretions in the housing market—particularly, the aggressive behavior of both lenders and investors in the subprime lending industry.[3] As a result, millions of Americans have lost their

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[1] Marcia Coyle, *Bankruptcy Judges May Be Enlisted to Combat Soaring Home Foreclosures*, N.Y.L.J. (Feb. 26, 2009).

[2] 155 CONG. REC. S4926 (daily ed. Apr. 30, 2009) (statement of Sen. Whitehouse).

[3] *See, e.g.*, *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 3–4 (2008) (written testimony of Eric Stein, Senior Vice-President, Center for Responsible Lending) ("To increase loan volume, lenders adopted even riskier practices and products . . . . The fact that Wall Street paid the most for the most dangerous mortgages meant that originators provided these loans, often regardless of their ultimate sustainability."); *Regulatory Restructuring:*

homes to foreclosure—a trend that is certain to continue if the government does not act swiftly and decisively to stop it.[4] Earlier this year, a bill was introduced in the newly elected Congress that proposed a simple, common-sense solution to the rising tide of foreclosures.[5] This bill—the Helping Families Save Their Homes in Bankruptcy Act of 2009 (Cramdown Bill)—would have allowed Chapter 13 bankruptcy judges to modify the terms of mortgage loans secured by a bankrupt's principal residence.[6]

Enhancing Consumer Financial Products Regulation: Hearing Before the H. Comm. on Financial Services, 111th Cong. 3 (2009) (written testimony of Kathleen E. Keest, Senior Policy Counsel, Center for Responsible Lending) ("[S]ubprime lenders pushed homeowners into more expensive, more volatile loans because of the higher fees they generated and because there would likely be another new loan in fairly short order.").

[4] *See* Nina Liao, Note, *Cramming Down the Housing Crisis: Amending 11 U.S.C. § 1322(b) to Protect Homeowners and Create a Sustainable Bankruptcy System*, 93 MINN. L. REV. 2240, 2241 (2009) ("In the first quarter of 2008 alone, foreclosure filings increased by more than 100 percent from the same period a year prior, and foreclosures for the entire year will run at about 2.25 million. Moreover, economists predict that ten million more homeowners will foreclose over the next five years.").

[5] *See, e.g.*, Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 200, 111th Cong. (as reported by H. Comm. on the Judiciary, Feb. 24, 2009). An identical version of the House bill was introduced in the Senate on January 6, 2009. *See* S. 61, 111th Cong. (2009).

[6] H.R. 200, 111th Cong. § 4 (2009); *see also* S. 61, 111th Cong. § 4 (2009).

While the concept of mortgage modification—also known as "cramdown"—is not a new tool for bankruptcy judges, the proposal to apply cramdown to principal residences was met with a great deal of resistance from within Congress and from without.[7] According to Alabama Senator Jeff Sessions, "[w]hen people borrow money to buy a house, . . . they must realize 'the money didn't come from nowhere.' The money was lent to them and lenders have to know they are going to be repaid. . . . 'There's no free lunch here.'"[8] However, Chapter 13 bankruptcy judges are allowed to use cramdown as a "free lunch" for, essentially, all other claims for secured debt.[9] Given this inconsistency in bankruptcy law, why are some members of Congress

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[7] *See, e.g.*, *Bankruptcy Reform: Senate Judiciary Panel Revisits Cramdown Option to Stem Tide of U.S. Foreclosures*, BANKR. L. DAILY, July 24, 2009 [hereinafter *Bankruptcy Reform*] ("Sen. Jeff Sessions (R-Ala.), the ranking member of the committee, expressed skepticism that allowing bankruptcy judges to cram down mortgage loans on primary residences would resolve the foreclosure crisis."); *see also* American Bankruptcy Institute, *Legislative Highlights*, AM. BANKR. INST. J., Sept. 28, 2009, at 95 [hereinafter ABI] (noting that the Cramdown Bill, sponsored by Illinois Senator Dick Durbin, "is bitterly opposed by the mortgage-lending industry"); Coyle, *supra* note 1 ("[T]he lending industry's arguments [are] that the legislation will result in higher mortgage interest rates, increased down payments and higher closing costs and encourage people to go into bankruptcy.").

[8] *Bankruptcy Reform*, *supra* note 7.

[9] *See* 11 U.S.C. § 1322(b)(2) (2006) (stating that the debtor's Chapter 13 repayment "plan may . . . modify the rights of holders of secured claims"); *see also* Liao, *supra* note 4, at 2249 ("[T]he

and the lending industry so adamantly opposed to using cramdown on a bankrupt's primary residence?

The answer to this question is rooted not only in the practical limitations on cramdown, but in the ideologies held by some in government—as well as the palpable self-interest of the mortgage lending industry. While it is true that "[t]he debtor's gain from cram-down equals the creditor's loss,"[10] the losses ought to fall on those who took the risk—lenders and investors—rather than the homeowners whose lives will be forever altered by a home foreclosure. To date, the government has invested billions of dollars for the purpose of stabilizing the housing market.[11] Accordingly, the time has now come for a solution that, if implemented, would eliminate the continued use of tax dollars to mitigate the losses of the mortgage lenders and mortgage-backed security investors.

Unfortunately, President Obama's plan—the Home Affordable Modification Program (HAMP)—does not go far enough. Consumers have had difficulty obtaining voluntary mortgage modifications under HAMP, and those lucky enough to receive a voluntary mortgage

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Code allows bankruptcy judges to cram down various types of secured debt, except for mortgages secured by the debtor's primary residence.").

[10] Liao, *supra* note 4, at 2249.

[11] *See generally* Edmund L. Andrews & David E. Sanger, *U.S. Is Finding Its Role in Business Hard to Unwind*, N.Y. TIMES, Sept. 13, 2009, http://www.nytimes.com/2009/09/14/business/14big.html?_r=1&pagewanted=2 ("The scale of the Fed's intervention has been staggering. . . . [T]he government is propping up almost the entire mortgage market, and by extension, the housing industry.").

modification from their lender often end up with a loan that fails to meet HAMP guidelines.[12] Additionally, many servicers of securitized mortgages are unwilling to enter into voluntary loan modifications.[13] Meanwhile, more and more homeowners are headed for foreclosure without an effective remedy to protect them from their lenders, who possess the financial capability to pursue a foreclosure that far outweighs a homeowner's ability to resist.[14]

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[12] *See Bankruptcy Reform*, *supra* note 7; *see also The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform? Hearing Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary*, 111th Cong. 23–27 (2009) [hereinafter *Hearings*] (written testimony of Alys Cohen, National Consumer Law Center). According to Cohen, some participating servicers are: (1) requiring borrowers to execute waivers of their legal rights in exchange for modifications; (2) offering modification plans that do not conform to HAMP guidelines, despite the servicer's assurances to the contrary; (3) simply refusing to perform HAMP modifications entirely despite an eligible borrower's right to a HAMP review; and (4) charging fees for loan modifications under the program—all of which is prohibited by HAMP. *Id.*

[13] *Bankruptcy Reform*, *supra* note 7; *see also Hearings*, *supra* note 12, at 23 (written testimony of Alys Cohen, National Consumer Law Center) ("[T]he [HAMP] program has significant limitations both in design and implementation. HAMP's ability to guarantee an increase in sustainable modifications is dependent on voluntary servicer participation in the program. Several large servicers are still not participating . . . .").

[14] *See, e.g.*, Binyamin Appelbaum, *Rescued Banks Post Big Profits, Drawing Ire*, Wash. Post, July 18, 2009, http://www.washingtonpost.com/wp-

This paper will argue that the most effective remedy for the foreclosure crisis is to amend § 1322(b) of the Bankruptcy Code to allow for modification of mortgage loans, with no exceptions. Hereinafter, I will refer to this remedy for the foreclosure crisis as "pure mortgage modification." In Part II, this paper will summarize various other proposals offered to reduce foreclosures—some of which argue that pure mortgage modification is impractical and costly. In Part III, this paper will identify the ideological bases for the opposition to pure mortgage modification—mainly, that pure mortgage modification is unfair treatment to lenders. After addressing these ideological concerns, this paper will ultimately conclude that pure mortgage modification should be an option open not only to homeowners involved in Chapter 13 bankruptcy proceedings, but should be available by way of state or federal law to all homeowners against whom a mortgage lender or servicer is pursuing foreclosure. Mortgage lenders, servicers, and Wall Street mortgage-backed securities investors have had their proverbial "carrot." It is time for Congress to prod them with the "stick."[15]

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dyn/content/article/2009/07/17/AR2009071700885.html (noting the combined $13.6 billion in second-quarter earnings for Citigroup, Bank of America, Goldman Sachs, and J.P. Morgan Chase); Robin Sidel, *J.P. Morgan Sees Earnings Soar*, WALL ST. J., Oct. 15, 2009, http://online.wsj.com/article/SB125551544966884573.html (detailing the "sevenfold" increase in third-quarter earnings of J.P. Morgan Chase & Co., and citing its ability to "pour[] another $2 billion into reserves for soured loans in its consumer businesses").

[15] *See* 155 CONG. REC. S4920 (daily ed. Apr. 30, 2009) (statement of Sen. Schumer) ("We have been pushing banks to do loan modifications for more than 2 years now and, frankly, we don't have much to show for it. . . . We have offered lenders and servicers plenty of carrots, but it is

II. Practical Alternatives to Pure Mortgage Modification

A. *The Columbia Authors' Approach*

One alternative proposal to pure mortgage modification is grounded in the complex incentive structures of the market for mortgage-backed securities. In 2008, "[s]ecuritized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts."[16] While this fact may fail to surprise given the aforementioned increase in foreclosures,[17] what is truly startling is that these same securitized loans also represented a mere fifteen percent of all mortgages outstanding in 2008.[18] Based on the assumptions that mortgage servicers are "not compensated appropriately to handle the current volume of delinquencies[,]" subject to "explicit and implicit legal barriers to modifying mortgages successfully[;]" and that the existence of second liens on many homes discourages modification of first-lien mortgages, Christopher Mayer, Edward Morrison, and Tomasz Piskorski—hereinafter referred to as the Columbia authors—propose a three-pronged approach to solving the foreclosure crisis.[19] Generally, the Columbia authors argue that the following proposals will lead to a resolution of the foreclosure crisis in the United State: (1) creating additional incentive fees for servicers to

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unfortunately clear we also need a stick. The reason the programs in the past have largely not worked is it was just carrots and no stick. We need both.").

[16] Christopher Mayer, Edward Morrison & Tomasz Piskorski, *A New Proposal for Loan Modification*, 26 Yale J. on Reg. 417, 417 (2009).

[17] *See supra* note 4 and accompanying text.

[18] Mayer et al., *supra* note 16, at 417–18.

[19] *Id.* at 418–19.

perform mortgage modifications, (2) establishing incentive payments for second lenders who voluntarily forfeit their liens, and (3) creating a "litigation safe harbor" to "insulate[] servicers from costly litigation" on the part of angry investors whose returns have diminished.[20] This plan will, according to the Columbia authors, cost the government a mere $12.35 billion, and will purportedly "avoid between 675,000 and one million foreclosures" of the aforementioned privately securitized mortgages—in addition to "facilitat[ing] hundreds of thousands of modifications among mortgages controlled by GSEs or portfolio lenders."[21]

While the Columbia authors do not completely repudiate pure mortgage modification as a means of stopping foreclosures, they argue that it is far less advantageous than its proponents make it sound.[22] First, the Columbia authors argue that pure mortgage modification would apply to too many mortgages, setting up a system that would "pit federal judges against the GSEs"—entities that guarantee nearly seventy percent of all outstanding mortgages and "can already ensure fair modifications."[23] Next, the Columbia authors argue that "cramdown would likely impose excessive losses on lenders," and that applying cramdown uniformly to all residential mortgages in bankruptcy would ignore the need for balancing foreclosure prevention with

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[20] *See generally id.* at 420–23.

[21] *Id.* at 424, 429.

[22] *See id.* at 426 (2009) ("Proponents of [cramdown] believe it would impose no . . . costs on taxpayers. That is untrue. Cramdown may be no more costly than doing nothing about the foreclosure crisis, but doing nothing is not the only alternative. Relative to our proposal, cramdown exposes taxpayers to significant losses.").

[23] *Id.*

minimizing lenders' losses.[24] If cramdown were applied so liberally, they argue, borrowers would have very little incentive to accept a mortgage modification offer from a lender, and would thus "eliminate[] the possibility that a lender can ever recover its losses on borrowing."[25] Finally, the Columbia authors assert that such a permissive cramdown policy would flood the courts with bankruptcy filings—a circumstance that would "delay a resolution of the crisis" and lead to a rise in the future cost of credit for other borrowers.[26]

While certainly not frivolous, none of the arguments advanced by the Columbia authors against pure mortgage modification conclusively proves that pure mortgage modification is a fool's errand. Taking the Columbia authors' arguments in reverse order, the assertion that pure mortgage modification would lead to an untenable rise in the number of bankruptcy filings is tempered somewhat by the fact that, to foreclose, lenders in many states must proceed via judicial foreclosure is allowed in every state, and is required in many others.[27] Given the staggering increase in foreclosures, it follows logically that a similar "flood" of foreclosure filings must already be happening in state courts of general jurisdiction. If every single homeowner in those foreclosure actions had the option to enter bankruptcy and obtain a pure mortgage modification, the amount of litigation would not necessarily increase. Rather, the

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[24] *Id.*

[25] *Id.*

[26] *Id.* at 426–27.

[27] *See* GEORGE LEFCOE, REAL ESTATE TRANSACTIONS, FINANCE, AND DEVELOPMENT 440 (6th ed. 2009) ("All states allow judicial foreclosure. . . . A majority of states also permit power of sale (nonjudicial) foreclosure.").

major effect on foreclosure litigation would be a change in the identity of the petitioner, the availability of the federal forum as an alternative to state courts, and the remedies available to both parties—none of which indicate, on their face, a precipitous increase in the amount of foreclosure cases that will end up in bankruptcy court.

As for discouraging borrowers' acceptance of voluntary mortgage modifications offered by lenders outside of bankruptcy, there is already a major reason for homeowners to refrain from accepting a mortgage modification offered by a lender, and instead proceed to bankruptcy court. Under current law, the Internal Revenue Code treats acceptance of mortgage modifications that reduce the amount of the borrower's principal balance as income to the borrower, unless the borrower is insolvent or is involved in a bankruptcy proceeding.[28] While the tax consequences of pure mortgage modification are beyond the scope of this paper, it is important to note that most lenders do not offer principal reductions as part of their mortgage modification plans.[29] Therefore, the specter of increased income tax liability is less of a risk to borrowers whose lenders are not actually cancelling any of their outstanding indebtedness. However, a principal reduction is exactly what some borrowers need to make their home loans affordable again.[30]

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[28] *See generally* I.R.C. § 108 (2006).

[29] *See* Mayer et al., *supra* note 16, at 426 ("[Pure] mortgage modification is far more aggressive than the strategies now being employed by lenders. Some strategies, such as forbearance, do not involve principal write-downs at all. . . . [Others] provide[] for reductions in interest rates and forbearance on principal payments.").

[30] *See* Guy Loranger, *North Carolina's Bankruptcy Bar Is Cramming for the Cramdowns*, N.C. Lawyers Weekly, Mar. 16, 2009 ("The proposed legislation would particularly help homeowners

Allowing a bankruptcy judge to reduce the principal amount owed in bankruptcy would, at the very least, encourage mortgage lenders to voluntarily offer principal reductions to their borrowers, which would, in turn, require a separate debate on federal tax policy, which we must leave for another day.

The Columbia authors' arguments that pure mortgage modification would be available to too many mortgages and would ignore the lender's interest in recovering its investment are simply incorrect. When the Helping Families Save Their Homes Act of 2009[31]—the eventual bill passed by Congress to curb the foreclosure crisis—came to a vote in the Senate, Illinois Senator Dick Durbin offered a nearly identical version of his original Cramdown Bill as an amendment, and described in detail the various limitations on a borrower's right to pure mortgage modification included in his amendment:

> What we offer today is significantly different than what we offered a year ago. We literally give to the banks control over whether a family in foreclosure can go into bankruptcy. We say that anybody facing foreclosure—who is delinquent for at least 60 days on a home that is valued at no more than $729,000, with a mortgage that was written no later than 2008—has to show up at the bank at least 45 days before they file bankruptcy and present all the economic information, all the financial documents the bank would need for a mortgage—proof of income, indication of net worth. If the bank at that point offers them a renegotiated mortgage—a mortgage which will basically allow them to stay in the home, that reduces the borrower's mortgage debt-to-income ratio to 31 percent, which is the standard the administration is talking about, or offers hope for home refinancing . . . and the person facing foreclosure does not take that offer, then that same family in foreclosure cannot use the bankruptcy court to rewrite the mortgage. So in

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who are 'underwater,' meaning they owe more on their mortgages than their property's fair market value. The Washington Post reported March 4 that more than 8.3 million homeowners across the country were in that situation.").

[31] *See generally* Helping Families Save Their Homes Act of 2009, S. 896, 111th Cong. (2009).

> other words, the banks ultimately have the key to the courthouse. If they make the offer and it is turned down, that is the end of the story.[32]

Under Senator Durbin's cramdown plan, lenders are more than adequately protected—despite the Columbia authors' assertion that pure mortgage modification does not serve a lender's best interests.[33] Rather than restate the various terms of the amendment which limit the class of homeowners who are eligible for pure mortgage modification, the author would like to emphasize once more that if a lender offers a voluntary modification to the borrower, and it is rejected, cramdown is *not available* to the borrower.[34] Thereafter, the lender's remedies—foreclosure, offering a second voluntary modification, or attempting to refinance the home with an entirely new loan—remain undisturbed. In this form, pure mortgage modification can hardly be considered harmful to the interest of mortgage lenders, and may incentivize lenders to engage in voluntary modifications in the future.

Finally, the entire focus of the Columbia authors' plan is misplaced. Its insistence on further financial incentives for the holders and servicers of securitized loans fails to identify the

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[32] 155 CONG. REC. S4917 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin). The Durbin Amendment was eventually defeated by a vote of 45–51. *Id.* at S4938; *see generally* S. Amdt 1014, 111th Cong. (2009). Earlier that week, the amendment's seemingly imminent defeat prompted Senator Durbin—speaking to the media about Congress—to state unequivocally that the banking lobby "frankly own[s] the place." Glenn Greenwald, Op-Ed, *Top Senate Democrat: Bankers "Own" the U.S. Congress*, SALON, Apr. 30, 2009, http://www.salon.com/opinion/greenwald/2009/04/30/ownership/.

[33] *See generally* Mayer et al., *supra* note 16, at 426.

[34] 155 CONG. REC. S4917 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin).

real losers in the foreclosure crisis—homeowners.[35] Despite their belief in the power of these economic incentives to encourage modifications by servicers and second-lien lenders, the Columbia authors undermine their own argument by admitting that "the government should remove legal constraints that now inhibit modification and will continue to inhibit it *even if* servicers and second-lien lenders are given appropriate financial incentives."[36] While the Columbia authors undoubtedly refer to the third prong of their proposal—a legislatively-enacted litigation safe harbor for servicers who modify mortgages based on a good-faith belief they are acting in the best interest of their investors[37]—their reference to the necessity of government action is a tacit admission that financial incentives alone will not lead to a reduction in foreclosures.

Ultimately, additional financial incentives and a litigation safe harbor are merely more carrots for the subprime lending industry. Simply put, the Columbia authors' proposal asks the government to once again intervene on the side of the risk-takers, rather than stand up for relatively powerless homeowners on the brink of losing their most valuable asset—all because

[35] *See* Mayer et al., *supra* note 16, at 417, 420–23 (acknowledging the "2.25 million foreclosures started last year and 1.7 million foreclosures projected to start in 2009," but proposing a plan focused on adding small incentives for servicers rather than expanding the rights of homeowners facing foreclosure).

[36] *Id.* at 429 (emphasis added).

[37] *See id.* at 423 ("Our Legislative Proposal (1) clarifies that servicers' primary duty is to act in the economic interest of investors as a group and (2) provides protection against lawsuits when the servicer can show that its actions were consistent with this duty.").

the investors are unwilling to accept ultimate responsibility for the losses associated with today's toxic real estate market.[38] Such an argument cannot plausibly be advanced as a better alternative to pure mortgage modification.

B. *The Liao Two-Step Approach*

Another practical alternative to pure mortgage modification, proposed earlier this year, much more closely resembles Senator Durbin's proposal in his original Cramdown Bill. In contrast to the Columbia authors' focus on increasing the incentives for servicers who modify mortgages, this second proposed solution to the foreclosure crisis—advanced by student author Nina Liao of University of Minnesota Law School—focuses on amendments to the Bankruptcy

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[38] Once again, in spite of their overall proposal to continue subsidizing and protecting investors, the Columbia authors make another more explicit admission:

> The[] barriers [preventing voluntary mortgage modification] could be overcome if investors agreed to rewrite their PSAs. A rewrite typically requires unanimous investor consent, especially if it would give servicers freedom to reduce principal or interest rates. . . . The number of investors is so large—and their interests so divergent—that consensus is a near impossibility. Put differently, mortgage securitization has dramatically increased the number of creditors to whom a homeowner is indebted. . . . [T]here is no way (at a reasonable cost) to reach a consensus among creditors. Homeowners bear the consequences of this standstill.

See id. at 419. It is this kind of investment environment that prompted Rhode Island Senator Sheldon Whitehouse to make his emphatic statement on the Senate floor about the government's responsibility for, and obligation to fix, the foreclosure crisis. *See supra* note 2 and accompanying text.

Code.[39] Liao's proposal contains two steps: (1) a "temporary relief measure" that would allow bankruptcy judges to engage in pure mortgage modification for qualifying homeowners for a period of seven years, and (2) a retention of pure mortgage modification as a discretionary tool for bankruptcy judges, so long as homeowners satisfy strict eligibility requirements.[40] To qualify for Liao's temporary form of cramdown, a homeowner must pass a test analogous to the general Chapter 13 means test, and must also hold a nontraditional loan—that is, a loan "with outlandish terms"—or a subprime loan.[41]

The Chapter 13 "means test" appears in section 1325(b)(3) of the Bankruptcy Code.[42] That section sets up a general framework in which a debtor's disposable income is compared to that of the "median family income of the applicable State," assuming the debtor is the only person living in her household.[43] Generally, "the means test compels debtors with surpluses of income over living expenses to pay unsecured creditors over the life of the [Chapter 13] plan."[44] Presumably, Liao's approach will apply an analogous test to homeowners seeking cramdown—if

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[39] *See* Liao, *supra* note 4, at 2242–43 ("This Note advocates that Congress pass a temporary cram-down relief measure[.] . . . Congress should then implement a permanent system that entrusts bankruptcy judges with discretion to modify loans in a manner consistent with jurisdictional Chapter 13 practices and needs.").

[40] *See id.* at 2265–72.

[41] *Id.* at 2268.

[42] 11 U.S.C. § 1325(b)(3) (2006).

[43] *Id.* § 1325(b)(3)(A).

[44] Liao, *supra* note 4, at 2267.

a homeowner earns a surplus of income over living expenses, cramdown would not be an available remedy for the debtor's bankruptcy judge.[45] According to Liao, this expanded "[use of] the means test to determine cram-down eligibility will assure that debtors entitled to relief are debtors who cannot pay" their monthly mortgage payment.[46]

Liao's temporary-relief measure would expire after seven years.[47] After the seven-year temporary cramdown period has elapsed, homeowners seeking cramdown would be required to negotiate with their lenders.[48] Furthermore, to encourage homeowners to bargain with their lenders during negotiations, bankruptcy judges would be required to consider several objective, jurisdiction-specific factors before cramming down a homeowner's mortgage, such as "the success rate of crammed-down plans, the prevalence of bankruptcy abuses, fluctuations of real estate values, conditions of the financial markets, and the history of predatory lending."[49] While this approach is well-intentioned, its requirements are ultimately too deferential to the giants of the mortgage-lending industry.[50] It does not go so far as to explicitly provide another "carrot" to mortgage-lenders, but instead of handing homeowners a sturdy and reliable "stick," it gives bankruptcy judges a relative twig.

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[45] *See id.*

[46] *Id.*

[47] *Id.* at 2269.

[48] *Id.* at 2270–71.

[49] *Id.* at 2271–73.

[50] *See supra* notes 14–15 and accompanying text.

Liao's primary objection to pure mortgage modification is that allowing cramdown for all undersecured mortgages—prime or subprime, traditional or nontraditional—is "too risky."[51] The Mortgage Bankers Association predicts that rising interest rates and higher credit costs are the inevitable results of unchecked pure mortgage modification, which Liao contends would undermine the established federal policy of encouraging lower interest rates and a low cost of credit as the means of promoting home ownership.[52] However, "[t]he empirical evidence indicates that there is unlikely to be anything more than a de minimis effect on interest rates as a result of permitting bankruptcy modification."[53] While Liao acknowledges the existence of this

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[51] Liao, *supra* note 4, at 2261.

[52] Press Release, Mortgage Bankers Ass'n, MBA's Kittle Challenges Bankruptcy Myths at Hearing (Jan. 29, 2008), http://www.mortgagebankers.org/NewsandMedia/PressCenter/59656.htm [hereinafter MBA Press Release]; *see also* Coyle, *supra* note 1 (describing the objections to cramdown advanced by the mortgage-lending industry); Liao, *supra* note 4, at 2260–61 (listing "higher interest rates and more expensive credit" as potential inhibitors to the federal policy of providing affordable housing).

[53] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. 565, 655. Interestingly, the Columbia authors cite another of Professor Levitin's works for the proposition that "the cost of future credit could rise significantly, especially for individuals with imperfect credit records. Empirical evidence suggests that borrowing costs are higher and mortgage amounts are smaller when mortgages are subject to

evidence, she maintains that pure mortgage modification is unacceptably risky "because it remains uncertain whether interest rates will rise."[54] However, Liao forgets that under current law, essentially every allowed secured claim—except mortgages on the debtor's principal residence—is subject to cramdown.[55] This includes vacation homes, second homes, investment properties, and car loans—items of property for which, Liao admits, consumers have not seen a decrease in the availability of credit or an increase in interest rates.[56] Liao also mentions that antideficiency laws—which prevent lenders from recovering the unsecured portion of a mortgage loan when a defaulting debtor's property value is not enough to cover the entire value of the mortgage—are similar in their effect to cramdown, and that credit remains freely available in states where such laws are in effect.[57] All things considered, the provisions of Liao's theory that are meant to contain rising interest rates and create a "sustainable bankruptcy system" are merely speculative in nature, and play directly into the hands of the lending industry—which does not hesitate to capitalize on the fear that the cost of credit will become prohibitive.[58]

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cramdown." Mayer et al., *supra* note 16, at 427. For portions of Professor Levitin's rebuttal, see *infra* Part III.

[54] Liao, *supra* note 4, at 2261.

[55] *See* Loranger, *supra* note 30 ("Under present law, a Chapter 13 plan allows judges to adjust the rights of secured creditors in virtually every type of loan arrangement except for those secured by a mortgage on the debtor's principal residence.").

[56] Liao, *supra* note 4, at 2255.

[57] *Id.*

[58] *See* Coyle, *supra* note 1.

Liao is also generally opposed to pure mortgage modification because of the alleged "moral hazard" that it may create—that is, it will encourage more homeowners to file for bankruptcy.[59] While this argument will be discussed in more detail in Part III.B of this paper, it is worth noting that Liao recognizes "the debtors who file for bankruptcy today are more likely to be honest homeowners rather than opportunistic planners."[60] In fact, empirical evidence indicates that since the 2005 amendments to the Bankruptcy Code introduced the means test—which was designed to force borrowers capable of paying their debts into Chapter 13—the median income of borrowers in both Chapter 7 and Chapter 13 bankruptcy proceedings has remained nearly identical.[61]

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[59] Liao, *supra* note 4, at 2258–59.

[60] *Id.* at 2259.

[61] Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 361–62 (2008). According to Lawless and his co-authors, who together participated in a Harvard University study entitled *The Consumer Bankruptcy Project*:

> The Consumer Bankruptcy Project data permit us to explore whether the income screen in the means test pushed those high-income debtors who were more able to pay over to Chapter 13. . . . Median income among Chapter 7 filers in 2001 was $23,761, while median income among Chapter 7 filers in 2007 was a virtually identical $23,136. Similarly, there is no statistically significant difference between the median incomes of Chapter 13 filers from 2001 and those from 2007, which were $33,742 and $35,688 respectively.
>
> These data indicate that by yet another measure, BAPCPA seems to have failed its announced mission. The means test has pushed a higher proportion of bankruptcy debtors into Chapter 13, but it has not pushed a targeted group of presumptively abusive high-income earners. The large sorting effects based on income that the means test was supposed to produce simply did not occur.

Finally, Liao takes issue with the current bills' lack of a sunset provision.[62] According to Liao, bills "[w]ithout sunset provisions . . . fail to account for long-term, unforeseeable consequences of cram-down, which may include negative effects on interest rates, homeownership, and other types of consumer credit."[63] While this may simply be another manifestation of the general fear that the cost of credit will increase if pure mortgage modification is allowed, Liao acknowledges that part of her rationale for including a sunset provision is to "provide creditors with an additional layer of protection."[64] Because they lack a

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> Instead, the principal effect of the new law was apparently random and arbitrary—the antithesis of what the supporters of the amendments promised.

Id. (citations omitted).

[62] Liao, *supra* note 4, at 2263; *see generally* Helping Families Save Their Homes Act of 2009, S. 896, 111th Cong. (2009); Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 200, 111th Cong. (as reported by H. Comm. on the Judiciary, Feb. 24, 2009); S. 61, 111th Cong. (2009) (as introduced in Senate, January 6, 2009). None of the bills contains a sunset provision comparable to the one advocated by Liao. However, the amendment to S. 896 offered by Senator Durbin applied retroactively from January 1, 2009—not prospectively. *See* 155 Cong. Rec. S4917 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin) ("[F]uture borrowers aren't even eligible for this bankruptcy assistance. It ends as of January 1, 2009. Future mortgages, future foreclosures aren't even affected by it. It has an ending date.").

[63] Liao, *supra* note 4, at 2263.

[64] *Id.*

sunset provision, Liao declares the bills considered by Congress too stringent at the outset, and too reckless over time.[65]

This same criticism can, unfortunately, be leveled at Liao's own proposal. By conditioning her temporary cramdown provision's availability on the debtor's qualification under the means test, Liao essentially guarantees that the vast majority of bankruptcy filers—the middle class—will likely not have access to the benefit of cramdown.[66] This restriction is arguably more detrimental than Senator Durbin's requirement that a Chapter 13 debtor present a notice of foreclosure to the bankruptcy court before being eligible for cramdown.[67] In addition, Liao's proposal fails to provide for the future as well, because it places a higher value on preventing a foreclosure today than ten years from today. Her seven-year sunset provision is meant to eliminate the availability of the first step in her plan—the means test cramdown—once the housing market has recovered.[68] While it is true that the economic needs of the country will be vastly different in seven years, the challenges faced by families on the brink of foreclosure

[65] *See id.* at 2263–64 ("In sum, the pending bills are insufficient because they set up a barrier to immediate relief, and fail to provide for the long run.").

[66] *See id.* at 2243 ("Contrary to the traditional notion that bankruptcy-filers are lower-class wage earners, debtors in bankruptcy cover a broad spectrum of the American middle class.").

[67] Helping Families Save Their Homes in Bankruptcy Act of 2009, S. 61, 111th Cong., § 2 (as introduced in the Senate, Jan. 6, 2009).

[68] *See* Liao, *supra* note 4, at 2269 ("The needs of the economy seven years from now will differ from those today, and a relief measure enacted to address particular problems of a particular recession is unsuitable for the market once it recovers.").

will not. Even if the rising tide of foreclosures eventually normalizes, it is vital that consumers have a guaranteed, powerful remedy on their side if they fall on hard times and choose to file for bankruptcy—as opposed to the mere possibility of receiving the remedy they so desperately need.[69]

Ultimately, Liao concludes that her proposal is robust enough to stem the tide of foreclosures, and yet limited enough that it mitigates the risk of detrimental, unintended consequences from polluting the nation's system of bankruptcy.[70] Despite the admirable attempt to strike a balance between the proponents and opponents of pure mortgage modification, Liao's suggested amendment to the text of section 1322(b) fails to accomplish even this moderate goal. Under present law, section 1322(b)(2) reads, in pertinent part: "the [Chapter 13 repayment] plan may . . . (2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims[.]"[71] As written, this statute is interpreted to preclude modification of a secured claim on a homeowner's principal residence, but to allow modification of secured claims on essentially all other types of

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[69] *See id.* at 2272–73 (describing the multifactor test for bankruptcy judges to apply in future cramdown cases).

[70] *See id.* at 2273 (concluding that the proposal "should provide relief quickly to distressed Chapter 13 homeowners" but "should sunset . . . to account for unforeseeable consequences of cram-down").

[71] 11 U.S.C. § 1322(b)(2) (2006).

property subject to secured claims.[72] Liao proposes that section 1322(b)(2) should be permanently amended to read as follows:

> [T]he plan may modify the rights of holders of secured claims, *including* a claim secured only by a security interest in real property that is the debtor's principal residence, *in a manner consistent with jurisdictional Chapter 13 practices and not inconsistent with this title*, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.[73]

According to Liao, "[t]his altered language will preserve cram-down and give judges leeway to modify mortgages."[74] While both of those propositions may be true in theory, Liao's proposed amendment to section 1322(b)(2) gives rise to a glaring unintended consequence—a result her theory as a whole seeks to avoid.[75] By changing the words "other than" from the original section 1322(b)(2) to read "including," Liao abrogates the distinction between home mortgage liens and other liens held by secured creditors.[76] Proponents of pure mortgage modification could hardly argue with this change. However, when Liao's second proposed amendment to the statute—the addition of "in a manner consistent with jurisdictional Chapter 13 practices and not inconsistent with this title"—is paired with the first, the new section 1322(b)(2)

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[72] Liao, *supra* note 4, at 2242; *see also, e.g.*, In re Reinhardt, 563 F.3d 558 (6th Cir. 2009) (holding that, under the Ohio definition of real property, § 1322(b)(2) did not bar a bankruptcy judge from modifying a secured creditor's lien on an unattached mobile home when the same creditor also held a security interest in the real property on which the mobile home was located).

[73] Liao, *supra* note 4, at 2270 (emphasis added).

[74] *Id.*

[75] *See supra* text accompanying note 56.

[76] *See* Liao, *supra* note 4, at 2270.

could be construed to apply the jurisdictional and discretionary language of Liao's second proposed amendment to *all* secured claims in bankruptcy. Indeed, creditors would likely object to every petition by a debtor for cramdown on any secured claim, arguing that the new language of the statute required the bankruptcy judge to engage in the aforementioned multifactor, jurisdiction-specific test, and to allow cramdown on car, boat, or vacation-home liens only after mandatory negotiations with the creditor.[77]

This is certainly not the result Liao's theory intends. Nevertheless, Liao's proposed language remains instructive of the point that, without careful drafting, a well-intentioned amendment to the Bankruptcy Code meant to provide aid to distressed homeowners could in fact lead to a drastic expansion of creditors' rights. Without undergoing a statutory face lift, Liao's proposed amendment fails to implement her wholly pragmatic, well-designed proposal—and, like the Columbia authors' proposal, creates another substantial carrot for the mortgage-lending industry. Ultimately, the proposal for which Liao advocates is based on a general fear that lenders will change their lending practices if pure mortgage modification is allowed. It is to the roots of this fear that this paper now turns.

III. IDEOLOGICAL OPPOSITION TO PURE MORTGAGE MODIFICATION

While this paper explores only two practical alternatives to pure mortgage modification, there are several other paths the government has taken in an effort to stop the rise in home

[77] *See supra* note 48 and accompanying text.

foreclosures.[78] While the government has considered adding home-mortgage cramdown to the bankruptcy courts' box of tools, it has yet to enact the proposal—despite repeated calls for a change to section 1322(b) of the Bankruptcy Code.[79] These efforts have failed not so much because of their impracticality, but because of pervasive ideological opposition to the modification of mortgage debt. Generally, the ideological arguments against cramdown may be grouped into three categories: (1) arguments based on the contract rights of lenders; (2) arguments that cramdown creates a moral hazard that will lead to a flood of bankruptcy filings; and (3) the injection of fault into the bankruptcy system as a whole. While these three categories of arguments are certainly not frivolous, they are based on principles that are either outdated or merely speculative, and serve only to bolster the false argument that lenders will somehow be treated unfairly by pure mortgage modification.[80] It is to these arguments that this paper now turns.

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[78] *See, e.g.*, ABI, *supra* note 7, at 95 (identifying alternative proposals such as "federal funds for cities that implement mandatory mediation proceedings for foreclosures" and "an Obama administration goal to have started 500,000 [voluntary] loan modifications" by November 1).

[79] *See CRS Report Analyzes Four Bills to Modify Primary Residence Exception of Section 1322*, BANKR. LAW DAILY, May 29, 2009 (identifying S. 61, H.R. 200, H.R. 1106, and H.R. 225, and S. Amdt. 1014 to S. 896 as bills to modify § 1322).

[80] *See Hearings*, *supra* note 12, at 9 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center) ("The banking industry has not presented a scintilla of evidence that permitting cramdown would affect credit prices. Instead, they have made

A. *Lenders' Contract Rights*

Mortgage lenders argue that pure mortgage modification would violate their contract rights—specifically, the term the industry uses is "sanctity of contract."[81] This *Lochner*-esque argument raises from the dead the "question of which of two powers or rights shall prevail—the power of the state to legislate or the right of the individual to liberty of person and freedom of contract."[82] Not only has the Supreme Court repudiated the theory of economic due process and the sanctity of contract in subsequent decisions,[83] but today's observers realize that a lender arguing the sanctity of its contract rights puts itself in a precariously hypocritical position. First

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declarations based on a simplistic economic view that greater access to bankruptcy necessarily results in higher costs of credit and lower credit availability.").

[81] *See* 155 CONG. REC. S4932 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin) ("If you ask [the mortgage companies] why they are opposing this effort to try to renegotiate a mortgage to keep a family in their home to avoid this mess, they say: Senator, you don't understand. It is about the sanctity of the mortgage contract."); *see also* Rich Leonard, Op-Ed, *A Win–Win Bankruptcy Reform*, WASH. POST, Nov. 28, 2008, http://www.washingtonpost.com/wp-dyn/content/article/2008/11/27/AR2008112702051.html ("I have twice participated in briefing sessions organized by the House Judiciary Committee, where I was lectured by lobbyists for the mortgage industry about the sanctity of contracts.").

[82] Lochner v. New York, 198 U.S. 45, 57 (1905).

[83] *See generally* West Coast Hotel Co. v. Parrish, 300 U.S. 379, 392 (1937) ("Liberty implies the absence of arbitrary restraint, not immunity from reasonable regulations and prohibitions imposed in the interests of the community.").

of all, the so-called sanctity of the vast majority of home loans currently in foreclosure is open to debate.[84] Senator Durbin frames his skepticism of the sanctity of subprime mortgages as follows:

> Legitimate mortgage contracts? What is so legitimate about no-doc, interest only, negative amortizing loans that had almost no chance to succeed from the day they are underwritten?
>
> The concept of bankruptcy is enshrined in the Constitution, and bankruptcy has always been a venue in which contracts are restructured.
>
> The Chamber [of Commerce] and the banking industry had no problem with applying the sweeping 2005 bankruptcy code changes to all contracts past, present, and future when those changes benefitted businesses. *They have no standing to now argue that because of the sanctity of the contract the bankruptcy laws should not be changed*.[85]

Furthermore, Judge Leonard points to the inherent hypocrisy in the lenders' opposition to using cramdown on a debtor's home mortgage.[86]

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[84] *See supra* note 16 and accompanying text.

[85] 155 CONG. REC. S4934 (daily ed. Apr. 30, 2009) (statement of Sen. Durbin) (emphasis added); *see also id.* at S4920 (statement of Sen. Schumer). Speaking on the broader concept of roadblocks to modification caused by pooling and servicing agreements, Sen. Schumer also noted the bankruptcy courts' unique power under federal law to modify contracts. "We cannot break a contract by law. But the one place in the U.S. Constitution where a contract can be modified is bankruptcy court. Bankruptcy courts are the only constitutional way to overcome the securitization contracts and restore some power to the homeowner himself or herself." *Id.*

[86] *See* Leonard, *supra* note 81. Judge Leonard is a Bankruptcy Judge for the Northern District of North Carolina.

> Homeowners are the only ones who cannot modify the terms of their secured debts in bankruptcy. *Corporate America flocks to bankruptcy courts to do precisely this—to restructure and reamortize loans whose conditions they find onerous or can no longer meet.* Airlines are still flying and auto parts makers still operating because they have used this powerful tool of the bankruptcy process. . . . But when the bankruptcy code was adopted in 1979, the mortgage industry persuaded Congress that its market was so tightly regulated and conservatively run that it should be exempted from the general bankruptcy rules permitting modification.[87]

Thus, the sanctity-of-contract argument essentially puts lenders in a position to argue that individual debtors who are about to lose their most valuable asset are also not worthy of the same protections from creditors as the institutions who do business in the subprime mortgage market—and ultimately end up taking the debtors' homes.

Even if one believes in the legitimacy of the subprime and nontraditional mortgages, there is another point that mortgage lenders overlook when they stress the sanctity of mortgage contracts. As previously mentioned, under current law, Chapter 13 bankruptcy courts are permitted to modify *any allowed secured claim*, but for mortgages on a debtor's primary residence.[88] Professor Levitin summarizes the current law best:

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

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87 *Id.* (emphasis added).

88 11 U.S.C. § 1322(b)(2) (2006).

single-family principal residence.[89]

Given the nearly unlimited number of liens that are subject to cramdown, it seems to follow that, in the eyes of the lending industry, loans on second homes, cars, vacation homes, and airplanes are somehow less sacred than their interest in a consumer's primary residence.

All things considered, the sanctity-of-contract argument is hardly a legitimate justification for the mortgage industry's opposition to cramdown. Not only are the mortgages far more dangerous to consumers than they are examples of the sacred contract between homeowner and lender, but lenders only stress such sanctity of contract with respect to primary-residence mortgages, and not when in discussion about any other liens—while simultaneously taking advantage of the Bankruptcy Code's cramdown provisions, without the same exceptions. Accordingly, sanctity of contract appears to be mere coded language for the lending industry's double standard regarding as to whom such a powerful protection from creditors should apply in bankruptcy.

B. *The Moral Hazard of Bankruptcy*

Both the Columbia authors and Liao identify the possibility that eliminating the primary-residence exception in section 1322(b) will create a moral hazard for borrowers, and thus encourage homeowners who would not ordinarily do so to declare bankruptcy as a way of

[89] *Hearings*, *supra* note 12, at 9 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center).

getting out from under a bad mortgage.[90] The lenders' fear is that a borrower will rush into bankruptcy during bad times, have the loan on his primary residence reduced to its current market value, and then reap the rewards of the eventual—and inevitable—appreciation in value once the market recovers.[91] In addition, the moral-hazard argument contemplates homeowners using the Bankruptcy Code to eliminate any losses suffered due to real-estate speculation.[92] The underlying assumption of the moral-hazard-for-borrowers argument is a simple one—too strong a consumer protection will necessarily lead to untenable abuse of bankruptcy courts.

However, the moral-hazard-for-borrowers argument falls flat on its face when one simply considers that bankruptcy is almost always a last resort for debtors. "Chapter 13 is no walk in the park. It requires public disclosure of every aspect of your life, examinations under oath by a trustee and creditors, allowing creditors to haul you into court on any objection, and relinquishment of control of your financial life for up to five years."[93] Even representatives of

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[90] *See* Mayer et al., *supra* note 16, at 426 ("[C]ramdown legislation could . . . create a massive number of bankruptcy filings."); Liao, *supra* note 4, at 2258 ("The moral hazard . . . that creditors fear [is] perhaps less ominous in an economic downturn.").

[91] *See* Mayer et al., *supra* note 16, at 426 ("When house prices rise again, as they eventually will, the borrower will enjoy all of this appreciation.").

[92] *See Hearings*, *supra* note 12, at 10 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center) (identifying speculators as individuals who the industry fears would, but in fact would not, benefit from a Cramdown Bill).

[93] Leonard, *supra* note 81.

the mortgage-lending industry admit that bankruptcy is not where a debtor wants to be.[94] In addition, the borrowers who do file for bankruptcy protection are far more likely to do so based on an increasing reliance on debt to make ends meet, as opposed to frivolous use of credit products.[95]

It is also worth noting that there is not only a potential moral hazard for borrowers, but for lenders as well:

> Lenders will lose loan value. While they will generally do better than in foreclosure, and the loss is not because of bankruptcy *per se*, there is still a high

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[94] *See* Coyle, *supra* note 1 ("[T]here is nothing good about bankruptcy. Our Congress should not be in the business of encouraging people to go into bankruptcy."); *see also* MBA Press Release, *supra* note 51 ("There are very real and severe consequences for consumers who declare bankruptcy. Bankruptcy is a long, arduous, very public and expensive process, costing thousands of dollars in legal costs. Even when people file for bankruptcy, almost two thirds of them are unable to fulfill the terms of their repayment plans. Filing bankruptcy will allow a federally appointed trustee to scrutinize the consumer's every expenditure. Additionally, bankruptcy stays on a consumers' [sic] credit report for 10 years, making it difficult to acquire future credit, buy a home, car or insurance and in some cases, even obtain employment.").

[95] Lawless et al., *supra* note 61, at 368–69 ("The cumulative effects of the growth in [consumer] debt have been staggering. In the six years from 2001 to 2007, families that filed for bankruptcy were collectively carrying 20.8% more secured debt and 43.6% more unsecured debt—all on incomes that remained static. Additionally, this deterioration in family circumstances appears to have been accelerating.") (citations omitted).

price for lenders that will discourage reckless lending. As for homeowners, Chapter 13 bankruptcy is not a "drive-by" process. In order to receive a discharge in Chapter 13, a debtor must live on a court-supervised, means tested budget for 3 or 5 years, and fully repay certain debts, including allowed secured claims, domestic support obligations, and tax liabilities. There are also limitations on how often a debtor may receive a bankruptcy discharge. Nor would bankruptcy modification give homeowners a windfall. At best, a homeowner with negative equity would end up with zero equity, not positive equity. Given the large transaction costs to a sale, debtors are unlikely to sell their properties for anything beyond a *de minimis* profit over the next few years.[96]

Based on this assessment of the miniscule benefits to borrowers—if any—of entering bankruptcy, the existence of a moral hazard that encourages borrowers to file for bankruptcy is, at best, questionable.

In addition, lenders' argument that a moral hazard should prevent the enactment of pure mortgage modification is another hypocritical position. In fact, Senator Durbin articulated as much in a speech on the Senate floor earlier this year:

> First of all, the largest players in the mortgage-lending industry received billions of taxpayer dollars from the government in exchange for underperforming and nonperforming mortgage-backed securities, and many subsequently used part of that money to pay performance bonuses.
>
> . . . .
>
> Why is it in this country, in America, that we can find hundreds of billions of taxpayers' dollars from hard-working people all over the United States to come to the rescue of bad banking decisions, rotten investments, mortgages that were fraudulent on their face, but can't summon the political will to do something about 8 million families in America who are going to face foreclosure?[97]

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[96] *Hearings*, *supra* note 12, at 11 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center).

[97] *See* 155 CONG. REC. S4916 (daily ed. Apr. 30, 2009) (Statement of Sen. Durbin) ("How many of these bankers paid for . . . their multimillion dollar bonuses, with the rescues we have

Senator Durbin's statement demonstrates that a similar and more daunting moral hazard exists for lenders—if the lenders make the loans, and the loans turn out to be bad business decisions, the taxpayers will provide lenders with a clean slate. Continued use of taxpayer money as insurance for lenders who made poor business decisions is not a sustainable solution to the foreclosure crisis. However, even if one agrees that amending the Bankruptcy Code will encourage more filings, one need only remember that compared to the moral hazard facing the lending industry, the moral hazard facing borrowers who are considering bankruptcy in order to take advantage of cramdown is a far less expensive moral hazard to tolerate.[98]

C. *Injection of Fault into the Bankruptcy Code*

Finally, a less explicit—yet equally stubborn—ideology that inhibits the passage of some version of the Cramdown Bill is the unspoken belief that a debtor's bankruptcy is somehow his or her own fault. While closely related to the previous section on the moral hazards of bankruptcy, fault finds its way into the picture through the legislative intent of the 2005 amendments to the Bankruptcy Code. For example, Liao points out that the purpose of these amendments were to "prevent bankruptcy abuses" and "to create roadblocks in the Code to

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provided from American taxpayers—hard-earned tax dollars sent their way? The fact is we have been kind to these bankers who have brought us into this crisis.").

[98] *Hearings*, *supra* note 12, at 11 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center) ("[O]ne of the greatest advantages of bankruptcy modification is that it has no cost for taxpayers. In an age of a trillion dollars in government bailouts, bankruptcy modification is a rare bargain.").

prevent reckless spenders from obtaining bankruptcy protection."[99] The aforementioned means test enforces these goals by sending debtors with too much money out of Chapter 7 and into Chapter 13 (or possibly to a dismissal of their bankruptcy petitions), and assures that debtors who voluntarily file under Chapter 13 apply their surplus income to the repayment of creditors.[100]

While this may seem like a harmless procedural mechanism, the plain language of the code sets up a scheme that "presume[s] abuse" of the Bankruptcy Code unless the debtor meets specific income requirements.[101] Given the previously discussed undesirability of filing for bankruptcy, requiring courts to presume abuse if the debtor meets a certain asset threshold smacks of intent to punish "reckless spenders," rather than provide the "fresh start" that is the ultimate policy goal of the bankruptcy code.[102] So long as the means test remains in place—and forces debtors out of Chapter 7 and into either Chapter 13 or a dismissal—the current law will be far too focused on preventing abuse than it will be on helping debtors who are on the brink of losing their homes. Prevention of abuse is no reason to deny relief to the vast majority of legitimate bankruptcy debtors.

IV. CONCLUSION

A right to pure mortgage modification in bankruptcy proceedings should not amount to merely another carrot for the mortgage-lending industry. It also should not be a mere twig given

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[99] Liao, *supra* note 4, at 2246.

[100] *See id.* at 2246–47.

[101] *See* 11 U.S.C. § 707(b)(2) (2006).

[102] *See generally* Liao, *supra* note 4, at 2244–47.

to a bankruptcy judge. Pure mortgage modification should be an aggressive, powerful remedy given to homeowners for use as a tool to bring lenders to the negotiating table and keep them there, or to expedite the time at which the lender takes the losses it would ordinarily expect to endure in a foreclosure proceeding.[103] According to Professor Levitin, "[t]he foreclosure crisis is not about to stop any time soon. Judicially-supervised restructuring of mortgages is the only tool we have left in the box. It's a tool we know can work. It's a tool that can save hundreds of thousands of families their homes and help stabilize communities, housing markets, and the economy. It's time to use it."[104] The practical alternatives discussed in Part II rely too heavily

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[103] *See Hearings*, *supra* note 12, at 13 (written testimony of Alys Cohen, National Consumer Law Center) ("[I]investors are losing mind-boggling[,] large sums of money on foreclosures. The available data suggests that investors lose ten times more on foreclosures than they do on modifications."); *see also id.* at 9 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center). Professor Levitin describes the allocation of the lender's loss thusly:

> The choice a mortgagee faces is not bankruptcy loss versus no loss, but bankruptcy loss versus foreclosure loss. So long as bankruptcy losses are smaller than foreclosure losses, permitting bankruptcy modification will not result in higher prices.
>
> Thus, it all comes down to the question of whether lenders lose more in bankruptcy than in foreclosure. The best evidence on the question says they do not, and this is not surprising; *bankruptcy law guarantees that lenders will recover at least as much as in a foreclosure*.

Id. (emphasis added).

[104] *Hearings*, *supra* note 12, at 11 (written testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center).

on incentives for lenders who have already received plenty of help from the government, and do not go far enough toward giving homeowners a powerful judicial remedy that will decrease the number of foreclosure filings, increase the number of voluntary modifications, and keep borrowers in their homes.

To this end, the government should immediately amend Section 1322(b)(2) of the Bankruptcy Code to read: ***The plan may . . . (2) modify the rights of holders of secured claims, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.*** This provision should go into effect immediately, should not be restricted to particular types of mortgages or borrowers, and should not be subject to a sunset provision. Furthermore, states should stem the tide of judicial foreclosure filings by creating a cramdown cause of action that homeowners may raise as an affirmative defense to a foreclosure action. Mere reduction of interest rates is not enough—the problem is that too many homeowners are "underwater."[105] A formidable judicial remedy like this one will be the ultimate of "sticks" for homeowners to use as protection from lenders who would rather foreclose than agree to modify primary-residence mortgage loans.

[105] *See supra* notes 1, 30, and accompanying text.