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Stripping Down the Subprime Crisis

Whitney Travis*

I. Introduction

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

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

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* Whitney Travis serves as a law clerk to the Honorable Judge St. John, Bankruptcy Court, Federal District Court for the Eastern District of Virginia; Washington and Lee University School of Law, May 2008; B.S. Florida State University, 2005.

2. See 11 U.S.C. § 1322(b)(2) ("[T]he plan may . . . modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor’s principal residence."); DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 63 (4th ed., 2006) ("Section 1322(b)(2) prevents a plan from altering any of the terms of the original loan, even if they are not strictly speaking part of the secured claim.").
3. See 11 U.S.C. § 1322(b)(2) ("[T]he plan may . . . modify the rights of holders of secured claims.").
While the Court’s holding may be "faithful to the intent of Congress," this Article argues Congress should reevaluate and amend the Bankruptcy Code. The Bankruptcy Code no longer reflects an accurate picture of the mortgage industry. Traditionally, mortgage loans were available to only those borrowers deemed creditworthy. Further, the loans that were extended to these select individuals were priced at just above market; the lender would make a profit because very few loans defaulted. However, a new type of loan—called subprime loans—changed the traditional business model of the mortgage lender by increasing the number of people who could qualify for mortgage loans, and shifting the risk of default onto investors while shifting the risk of market fluctuation onto borrowers.

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

Part IV applies bankruptcy’s justifications to the proposed amendment. Part IV.A looks to the internal goals of bankruptcy, specifically the goal of equitable distribution among creditors and the goal of providing a fresh start to the debtor. Part IV.B looks to the external goals of bankruptcy—the maintenance of an "open credit economy." Part V concludes by advocating for the amendment’s adoption.
II. The Current Financial Crisis

A. Factors That Paved the Way for the Housing Boom

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

Despite low interest rates and rising incomes, however, many people could still not qualify for a mortgage loan. The traditional mortgage lender, typically local banks, had a simple business model, one of low risk and low return. The lender would closely scrutinize loan applicants to identify those that were least likely to default.\(^8\) Once identified, the lender would sell those individuals "a relatively static product," such as a thirty year, fixed rate, fully amortizing loan.\(^9\) Although the lender would make only a small profit on each loan, "[t]he

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\(^7\) Id.

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

\(^9\) Id. at 384.
model work[ed] because the number of loans paid in full in accordance with their terms was perhaps fifty times the number of loans that default."

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

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

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10 Id. at 384–85.
11 See Leonhardt, supra note 5 (“[Wall Street] was transforming the mortgage business from a local one, centered around banks, to a global one, in which investors from almost anywhere could pool money to lend.”).
12 Kenneth Johnson et. al, The Subprime Morass: Past, Present, and Future, 12 N.C. BANKING INST. 125, 125 (2008); see also Henry v. Lehman Commercial Paper, Inc., 471 F.3d 977, 984 (9th Cir. 2006) (“A typical borrower in the subprime mortgage market is ‘house-rich’ but ‘cash-poor,’ having built up equity in his home but in little else, and has a lower net income than the average borrower.”).
13 Johnson et. al, supra note 12, at 126.
14 Id.
Third, the majority of subprime loans are adjustable rate mortgages (ARM).\textsuperscript{15} ARMs change the traditional business model by shifting the risk of interest rate fluctuations from lenders to borrowers.\textsuperscript{16} Instead of having a steady interest rate—called a fixed rate—throughout the entire life of the loan, the ARM adjusts after a certain period of time to reflect the market.\textsuperscript{17} As explained on Wells Fargo’s website, because of the lower initial interest rate, an ARM can help you:

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

However, "ARMs present the risk that an increase in interest rates will lead to a significantly higher monthly payment."\textsuperscript{19} Further expounding this risk, a subprime ARM often begins with a

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

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

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


\textsuperscript{19} Johnson et. al, supra note 12, at 126.
lower than market "teaser" rate and then adjusts to interest rates that far exceed the market.\textsuperscript{20}

When the interest rate is increased, the borrower’s mortgage payment also increases.

Another way the mortgage industry has changed is with the securitization of the mortgage loan. Traditionally, mortgage lenders "bore the risks of their loans and therefore had incentive to ensure loan security and repayment."\textsuperscript{21} Today, however, mortgages are sold and packaged into mortgage backed securities (MBS).\textsuperscript{22} MBS are then sold to investors who are issued "claims to the expected interest and principle payments owed by the mortgagees."\textsuperscript{23} This shifts the risk of default from mortgage lenders to investors.\textsuperscript{24} MBS allow low quality loans—like subprime mortgages—to be pooled with high quality loans—like those issued under the traditional business model, which make the MBS less risky for the investor; basically, one individual’s "ability to make payments becomes of marginal significance to the pools performance."\textsuperscript{25}

\textsuperscript{20} See id. (stating that, when teaser rates are involved, "the initial interest rate will be lower-than-market and will later adjust to a substantially higher prevailing market rate").

\textsuperscript{21} Unterman, \textit{supra} note 15, at 84.

\textsuperscript{22} See id. (stating that "[t]oday most mortgages are sold and packages in MBS").

\textsuperscript{23} \textit{Id.} at 86.

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

\textsuperscript{25} Unterman, \textit{supra} note 15, at 86.
B. Effect of Housing Boom – Domestically and Internationally

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

Homebuilding also made an "oversized contribution to the growth of real domestic product and employment."\(^{28}\) From 2002 to 2005, residential construction accounted for twelve percent of economic growth, as compared to its historical average of five percent.\(^{29}\) And, from 2003 to 2005, construction jobs accounted for over sixteen percent of all new jobs, as compared to its historical average of five percent.\(^{30}\)

The subprime mortgage market was further fueled by overconfidence in MBS.\(^{31}\) "The [securitization] industry marketed MBS as stable instruments insulated from the risks of a housing downturn,"\(^{32}\) thus encouraging the misconception "that the pooling of mortgage loans

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\(^{26}\) Kathleen Madigan, After the Housing Boom, Business Week (April 11, 2005), available at http://www.businessweek.com/magazine/content/05_15/b3928001_mz001.htm (last visited March 23, 3008).

\(^{27}\) Donna Walter, As Mortgage Crisis Deepens, Some Seek Aid—or Lawsuits, 12/4/07 Daily Record (Kansas City, MO) (December 4, 2007). This was done by appraisers overstating the condition or size of a house and classifying neighborhoods as improving when they were really deteriorating. Id.

\(^{28}\) Id.

\(^{29}\) Id.

\(^{30}\) Id.

\(^{31}\) Unterman, supra note 15, at 86–87 ("MBS enjoyed a great deal of market confidence during the U.S. housing boom, with some even thought of as an alternative to the security of U.S. Government Treasury Bonds.").

\(^{32}\) Id. at 87.
automatically reduces risk through diversification." However, diversification only reduces risk if high quality loans are added to the pool; risk is not reduced by adding more low quality loans. "[B]y fooling investors to believe that bad loans could be transformed through the sophistication of the investment industry," the MBS market was artificially inflated. According to the Department of Housing and Urban Development (HUD), the subprime lending industry grew from a $35 billion industry in 1994 to $650 billion in 2007.

C. The Housing Bust

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

[This] new reality will have a big impact on homeowners who have begun to look at 10% annual gains in home values as a birthright. Consumers who made a habit of tapping into their home equity will find that their home is no longer a personal ATM. Anyone counting on continued home appreciation to fund their retirement or pay for their children’s education may face a big shortfall when the bills come due. The new ways that housing is financed also shift the risk of rate changes from banks to homeowners. That could squeeze some families who have adjustable-rate mortgages.

33 Id. at 86.
34 Id. at 86–87 (stating that the "risks of a MBS are determined by the quality of mortgage loans that are accumulated").
35 Id. at 87.
36 See Johnson et. al, supra note 12, at 125.
37 Kathleen Madigan, After the Housing Boom, BUSINESS WEEK (April 11, 2005), available at http://www.businessweek.com/print/magazine/content/05_15/b3928001_mz001.htm?chan=gl.
38 Id.
Key to avoiding the bust were "housing prices [that rose] in tandem with economic indicators like job growth, GDP, and household income." However, these economic indicators were all inextricably linked to the housing industry; when housing prices stagnated, job growth, GDP, and household income all stagnated. A report from the United States Government Accountability Office (GAO) found that "the rapid decline in the rate of home price appreciation through much of the nation beginning in 2005 may have reduced incentives for borrowers to keep current on their mortgages and made it more difficult for borrowers to refinance or sell their homes to avoid default or foreclosure."  

The international crisis began in late 2006 and early 2007 as the housing bubble was bursting. As subprime borrowers began to default on the payment of their mortgage loans, MBS began losing some or all of their value. The pressure of credit risks and illiquidity forced many high profile banks, corporations, and hedge funds to take enormous write downs and, in some cases, resulted in bankruptcy.

III. Can A Solution be Found in Bankruptcy?

A. Background on the Bankruptcy Code

An individual files for bankruptcy when he, for whatever reason, is insolvent, meaning he is unable to satisfy creditors or discharge liabilities, either because his liabilities exceed his assets

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39 Clark, supra note 6.
40 Johnson et. al, supra note 12, at 130.
41 See id. at 130–31 (describing the current crisis).
or because of his inability to pay debts as they mature. The Bankruptcy Code provides two mechanisms under which an insolvent individual—a debtor—may discharge certain unpaid debts. First, under Chapter 7 of the Code, a debtor can "discharge prepetition debts following the liquidation of the debtor’s assets by a bankruptcy trustee, who then distributes the proceeds to creditors." Therefore, the amount of money creditors in a Chapter 7 will receive is, with some exceptions, limited to those proceeds generated by the bankruptcy estate, which consists of all of the debtor’s existing assets.

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

To determine how much each creditor will receive—under Chapter 7 or Chapter 13—requires a discussion of priorities. For purposes of this Article, the priorities of two creditors will be discussed: those of secured creditors and unsecured creditors. A secured creditor is a creditor

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44 WEBSTER’S UNABRIDGED DICTIONARY (Random House 2001).
46 Id.
48 Marrama, 127 S.Ct at 1107.
49 See GROSS, supra note 47, at 56 ("All plans of reorganization . . . must pay creditors at least as much as they would receive in a liquidation case.").
50 Id. at 29–34 (describing bankruptcy’s reorganization option).
with a claim that is protected by specific assets.\textsuperscript{51} A unsecured creditor, on the other hand, is an individual or institution that lends money without obtaining specified assets as collateral.\textsuperscript{52} This poses a higher risk to the unsecured creditor because the secured creditor is preferred in bankruptcy.\textsuperscript{53}

Consider the following example. A debtor files for Chapter 7. The debtor has one asset, a painting that is sold by the Trustee for $100,000. Three creditors have claims against the bankruptcy estate: a bank has a claim for $90,000 that is secured by the painting, and two unsecured creditors each have claims for $20,000. The trustee will distribute $90,000 to the bank secured by the painting. The remaining $10,000 will be distributed to the two unsecured creditors, each receiving $5,000. Therefore, the two unsecured creditors will be compensated twenty-five cents for every dollar they are owed.

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

\textbf{B. Strip Down in Bankruptcy}

Section 506(a) of the Bankruptcy Code, which applies to both Chapter 7 and Chapter 13 filings, "provides that an allowed claim secured by a lien on the debtor’s property ‘is a secured claim to the extent of the value of [the] property; to the extent the claim exceeds the value of the

\textsuperscript{51} WEBSTER’S UNABRIDGED DICTIONARY (Random House 2001).

\textsuperscript{52} WEBSTER’S UNABRIDGED DICTIONARY (Random House 2001).

\textsuperscript{53}
property, it ‘is an unsecured claim.’”\footnote{See Gross, supra note 47, at 328; see also 11 U.S.C. § 506(a).}

Therefore, § 506(a) allows a debtor to "strip down" the creditor’s claim, guaranteeing the creditor full payment for only that portion that is secured.

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

If, however, instead of a painting, the asset at issue was the debtor’s primary residence, the secured creditor would be treated very different. In \textit{Nobelman v. American Savings Bank},\footnote{Nobelman v. American Savings Bank, 508 U.S. 324 (1993) (holding that the debtor could not modify the rights of a creditor secured by the debtor’s primary residence).} the debtor fell behind on his mortgage payments and sought relief under Chapter 13 of the \textbf{Bankruptcy Code}.\footnote{\textit{Id.} at 326.} The debtor’s mortgage lender filed a proof of claim for $71,335, representing the principal loan amount of $68,250 plus interest and fees.\footnote{\textit{Id.}} At the time of filing, however, the debtor’s home was worth only $23,500.\footnote{\textit{Id.}} Relying on § 506(a), the debtor’s plan

\begin{itemize}
\item \footnote{See Gross, supra note 47, at 328; see also 11 U.S.C. § 506(a).}
\item \footnote{Nobelman v. American Savings Bank, 508 U.S. 324 (1993) (holding that the debtor could not modify the rights of a creditor secured by the debtor’s primary residence).}
\item \footnote{\textit{Id.} at 326.}
\item \footnote{\textit{Id.}}
\item \footnote{\textit{Id.}}
\end{itemize}
proposed to strip the lien to an amount equal to the value of the property.\textsuperscript{59} Under the plan, the debtor would make payments pursuant to the mortgage contract up to the amount of the secured claim.\textsuperscript{60} The remaining portion of the loan would be treated as an unsecured claim, and, under the plan, the lender would receive nothing.\textsuperscript{61}

The lender and the Chapter 13 trustee objected to the petitioner’s claim, arguing that the proposed bifurcation of the lender’s claim violated § 1322(b)(2) of the Bankruptcy Code.\textsuperscript{62} Section 1322(b)(2) of the Code provides that a debtor may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is a debtor’s principal residence."\textsuperscript{63} The Court found that giving effect to § 506(a)’s bifurcation of the loan would require a modification of the rights of the holder of the security interest.\textsuperscript{64} Therefore, the Court held that § 1322(b)(2) prohibited “such modification where . . . the lender’s claim [was] secured only by a lien on the debtor’s principal residence.”\textsuperscript{65}

\textit{C. Proposed Solution – Amending Chapter 13 to Allow Strip Down of Loans Secured by Debtor’s Primary Residence}

The financial crisis described in Part II is far from over. At the root of the crisis is the subprime loan, the majority of which are ARMs.\textsuperscript{66} "According to Federal Reserve Chairman

\textsuperscript{59} Nobelman, 508 U.S. at 326.
\textsuperscript{60} Id.
\textsuperscript{61} Id.
\textsuperscript{62} Id.
\textsuperscript{63} 28 U.S.C. § 1332(b)(2).
\textsuperscript{64} Nobelman, 508 U.S. at 329–32.
\textsuperscript{65} Id. at 332.
\textsuperscript{66} See supra Part II.A (describing ARMs).
Ben Bernanke, the rate of serious delinquencies for ARMs has increased significantly, reaching nearly sixteen percent as of August 2007.\textsuperscript{67} Further, it is estimated that nearly one trillion in ARMs will reset within the next three years.\textsuperscript{68} As these ARMs reset, more and more borrowers will become unable to make their mortgage payments. This will result in foreclosure for many borrowers,\textsuperscript{69} as well as a continued liquidity crisis for MBS investors and the underwriting financial institution.\textsuperscript{70}

The White House’s initial reaction to the increasing rate of foreclosures came in July 2007, when Treasury Secretary Henry Paulson unveiled Hope Now.\textsuperscript{71} Hope Now is an alliance

\begin{footnotesize}
\textsuperscript{67}Johnson et. al, \textit{supra} note 12, at 138.

\textsuperscript{68}See, e.g., Jane Birnbaum, The Affluent, Too, Couldn’t Resist Adjustable Rates, \textit{The N.Y. Times} (March 20, 2008), \textit{available at} http://www.nytimes.com/2008/03/20/business/20mortgage/html?_r=1&pagewanted=print (describing the foreclosure situation with jumbo ARMs). The article states:

\begin{quote}
[A]bout 870,000 borrowers took jumbo ARMs—mortgages of $417,000 or more—from 2005 to 2007. In the fourth quarter of 2007, 8.10 percent were two payments late . . . while 2.62 percent were in the foreclosure process and 1.35 percent have been foreclosed. . . . [Further, it is] predicted that eventually 8 percent of these jumbo ARMs will be foreclosed.
\end{quote}

\textit{Id.}.

\textsuperscript{69}Johnson et. al, \textit{supra} note 12, at 138 ("ARM resets combined with a weak housing market will fuel a continued liquidity crisis for the homeowner, the subprime investor, and the underwriting financial institutional alike.").

\textsuperscript{70}Hope Now, press release, \textit{Alliance Created to Help Distressed Homeowners} (October 10, 2007). The project was expanded in February 2008 with the addition of Project Lifeline, a program under which six major lenders agreed to halt foreclosures for some delinquent borrowers. However, a moratorium only puts off the problem. This could actually benefit the sex participating lenders: Bank of America Corp., Citigroup Inc., Countrywide Financial Corp., J.P. Morgan Chase and Co., Washington Mutual Inc., and Wells Fargo & Co. Together the lenders make up over 50 percent of the credit card industry. \textit{See} Mann, \textit{supra} note 8, at 385 n.50
\end{footnotesize}
between counselors, mortgage market participants, and mortgage servicers to create a unified, coordinated plan to reach and help as many homeowners as possible." While Hope Now claims it is succeeding, others argue it has "done little to keep the housing crisis from deepening."

The main problem cited is that the program is voluntary, and "the financial powers behind Hope Now—mortgage lenders, loan servicers and big investors—are reluctant to change loan terms substantially if doing so hurts them." In sum, the government’s solution allows the fox to guard the hen house. One solution to this problem would allow another, more neutral entity to decide whether loan modification is appropriate for any given borrower. This could be achieved by amending Chapter 13 of the Bankruptcy Code to allow for the modification of mortgages on a debtor’s primary residence. This would enable Chapter 13 plans to strip down (commenting on the concentration of the credit card industry). If debtors are struggling to stave off foreclosure, it is likely that all income is going to that purpose. Therefore, credit cards are likely being used to pay for other necessities like food, utility bills, and gas. See, e.g., Jason Hidalgo, Credit Card Debt Related to Housing Crash, Reno Gazette-Journal (February 10, 2008), available at http://www.new.rgj.com/apps/pbcs/dll/article?AID=/20080210/NEWS18/80210031&template=(telling the story of one couple who accumulated $30,000 in credit card debt paying for "daily expenses").

72 Hope Now, Press Release.


74 Id.

75 Id.

76 Four bills were proposed, two by the House of Representatives and two by the Senate; S.B. 2136 (Helping Families Save Their Homes in Bankruptcy Act of 2007) is similar to H.R. 3609 (Emergency Home Ownership and Mortgage Equity Protection Act of 2007), and S.B. 2133 (Homeowners’ Mortgage and Equity Savings Act) is
a mortgage loan to the home’s current value, rather than the indebtedness on the home. It would also allow bankruptcy judges to adjust the interest rate of the loan to better reflect the ability of the borrower to make payments.

**IV. Application of Bankruptcy’s Purposes to the Proposed Solution**

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

According to "time-worn bankruptcy lore," the bankruptcy system serves two purposes: first, the fair and equal distribution of assets among the creditors; and second, "to aid the unfortunate debtor by giving him a fresh start in life." In 1970, the Commission on the similar to H.R. 3778 (Homeowners’ Mortgage and Equity Savings Act). In general, the bills seek to limit or delete § 1322(b)(2)’s prohibition on modification of mortgages on a debtor’s principal residence. The bills would allow a bankruptcy judge to strip down a mortgage loan on a primary residence to the home’s current value rather than the indebtedness on the home. While S.B. 2136 and H.R. 3609 would allow bankruptcy judge’s the right to eliminate the prohibition without restriction, S.B. 2133 and H.R. 3778 permit strip down under certain circumstances.

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77 See, e.g., Stellwagen v. Clum, 245 U.S. 605, 617 (1918) ("[The Court’s] decision lay great stress upon this feature of the law—as one not only of private but of great public interest."); Jackson, 98 HARV. L. REV. 1393, 1447 (1985) (noting that discussions of bankruptcy policy ordinarily proceed without a grounding in a "normative theory of discharge’s functions, goals, and justifications").


79 See, e.g., Stellwagen, 245 U.S. at 617 ("The federal system of bankruptcy is designed . . . to distribute the property of the debtor, not by law exempted, fairly and equally among his creditors.").

80 Id.
Bankruptcy Laws of the United States added to these two purposes. The Commission was formed "to study, analyze, evaluate, and recommend changes in the substance and administration of the bankruptcy laws of the United States."\textsuperscript{81} The Commission submitted to Congress a report in 1973, which became a helpful tool employed in the Congressional sessions leading up to the passage of the 1978 Bankruptcy Code.\textsuperscript{82}

The report identified both external and internal goals of the bankruptcy process and considered the relationship between the external and internal goals.\textsuperscript{83} The internal goals included:

1. Open access of both debtor and creditor to the bankruptcy process;
2. Fair and equitable treatment of creditors’ claims;
3. Rehabilitation of debtors;
4. Efficient and economical case administration;
5. Deterrence and sanctions against fraud and other dishonest conduct; and
6. Production of information concerning the outcomes and effects of bankruptcy cases.\textsuperscript{84}

The external goals in question are the values involved in the "open credit economy."\textsuperscript{85} The report stated that the primary function of the bankruptcy system was said to be to continue the law-based orderliness of the open-credit economy in the event of a debtor’s inability or unwillingness to pay his or her debts.\textsuperscript{86} However, the internal goals should prevail in instances of conflict with external goals.\textsuperscript{87}

\textsuperscript{81} Kenneth N. Klee, \textit{Legislative History of the New Bankruptcy Code}, 54 AM. BANKR. L.J. 275, 277 (1980);

\textsuperscript{82} see also Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 (creating the nine person commission).

\textsuperscript{83} Id. at 68–83

\textsuperscript{84} Id. at 75, 76, 79, 81, 82, 83.

\textsuperscript{85} Id. at 68.

\textsuperscript{86} Id. at 69.
In 2005, the 1978 Bankruptcy Code was reformed by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCA). The reform came in response to perceived abuse in bankruptcy filings. As stated by the House, Congress believed (1) that bankruptcy relief was too readily available and was "used as a first resort, rather than a last resort;" (2) that loopholes and incentives present in the 1978 Code that allowed "and—sometimes—even encourage[d] opportunistic personal filings and abuse;" and that this abuse led to (3) higher costs being passed onto consumers who lived up to their financial obligations.

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

A. Fair and Equitable Treatment of Creditor’s Claims

One of the tenets of bankruptcy is that similarly situated claimants should be treated equally. In Nathanson v. NLRB, the Supreme Court stated "[t]he theme of the Bankruptcy Act is

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87 Id. at 75.
90 Id. at 3.
91 Id. at 5.
92 Id. at 4.
'equality of distribution' . . . and if one claimant is to be preferred over others, the purpose should be clear from the statute."  

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

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

However, due to the changes in the mortgage industry, many mortgage lenders no longer deserve this special protection. No longer are mortgage lenders local banks that extend "stable, long-term" loans to only those consumers least likely to default. Rather, mortgage lenders now extend subprime loans to those consumers who are most likely to default because those are the consumers who are willing to pay the highest interest rates. The risk of default, which traditionally acted as a check on the mortgage lenders’ selection process, now falls on MBS investors. Therefore, while it is clear after Nobelman that mortgage lenders are preferred over

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94 See 11 U.S.C. § 1322(b)(2) (2002) ("[T]he plan may modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor’s principal residence.") (emphasis added).
96 See supra notes 12 & 13 and accompanying text.
97 See supra notes 21–25 and accompanying text.
other creditors in bankruptcy, it is not clear why this is the case; the risks that once justified preferring mortgage lenders no longer seem relevant—at least, not in all cases.

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

B. Fresh Start of the Debtor

In 2007, providing a fresh start to the "honest but unfortunate debtor" was reaffirmed by the Supreme Court as the "primary goal" of bankruptcy. However, while the phrase comes with a pedigreed endorsement, it is argued that the phrase has lost its bite. "[A]s is the case with many widely employed truisms, common acceptance of the phrase tends to obscure the elusiveness of its content. Indeed, as used most frequently in judicial and legislative analysis, the ‘debtor’s fresh start’ is simply a synonym for the existing set of debtor-protection devices.”

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98 See Nobelman v. American Savings Bank, 508 U.S. 324 (1993) (holding that the debtor could not modify the rights of a creditor secured by the debtor’s primary residence).


100 Marrama, 127 S.Ct. at 1107.

101 See Hallinan, supra note 78, at 51.
It is important to note that the bankruptcy law’s commitment to providing a debtor a fresh start "is a decidedly modern and peculiarly American phenomenon."102 Two explanations for the American approach are typically put forth. The more common explanation is "framed in terms of socioeconomic policy and social utility."103

In large part, this approach was founded on a perception of insolvent debtors as potentially valuable contributors to the nation’s economic development, whose participation in the economy was impeded by the hopelessness of their financial conditions. Relief measures, the argument ran, were an appropriate means of restoring to the public at large the benefits of these debtors’ entrepreneurial skills and energies, and of doing so with minimal impact on their creditors’ realistic expectations of repayment.104

Although this policy was meant to encourage the American entrepreneur,105 its implication—that it is difficult to remain a productive member of society when your finances are in ruin—remains true as applied to the current financial crisis. According to the Census Bureau, more than one third of homeowners spend over 30 percent on housing costs, defined as mortgage costs.

102 Id. at 53.
103 Id.
104 Id.
105 Another segment of the population harmed in the subprime crisis is, what is commonly known as, the "flipper." These are individuals who purchased homes, with the intention to turn around and sell, or "flip," them for a profit. Often times, these individuals took out ARMs, with the mindset that the home would be out of their hands by the time the loan reset to a higher interest rate. These individuals are now stuck with homes they cannot sell, and interest rates they cannot pay. Although not limited by § 1322(b)(2)’s prohibition because, often times, the homes are not the debtor’s primary residence, how these individuals should be and are treated in bankruptcy is interesting. It could be argued that these people are entrepreneurs, and that activity should be encouraged, rather than discouraged.
payments, taxes, insurance, and utilities.\textsuperscript{106} The situation, referred to as being "house poor,"\textsuperscript{107} not only means that homeowners have less disposable income,\textsuperscript{108} but it also jeopardizes the family’s overall financial security.\textsuperscript{109}

The second explanation for the American policy of fresh start is "framed in moral terms."\textsuperscript{110}

Building on a characterization of the insolvent’s default as a matter of misfortune rather than blameworthiness, this approach focused on mercy or forbearance as the morally correct response to financial failure and depicted collection efforts as a morally repugnant effort to inflict suffering for greedy motives. From this perspective, relief legislation was, if not precisely an enforcement of a creditor’s obligation to forbear and forgive, at least a refusal to involve the state in his morally questionable pursuit of repayment.\textsuperscript{111}

Again, this explanation falls in line with the current financial crisis. The underlying conditions that led to the current financial crisis was based on misconceptions about the market: borrowers were fooled into believing they could refinance at any time.\textsuperscript{112} However, "[t]oday’s ARMs were

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\textsuperscript{107} See, e.g., Warren, supra note 95, at 33 (describing house poor). However, "the label is misleading. Many of the house poor are not poor at all. They are middle-class families that overextended themselves in a desperate effort to find a home in a safe neighborhood with decent schools." Id.

\textsuperscript{108} See, e.g., Peter S. Goodman, Slump Moves From Wall St. to Main St., The N.Y. Times (March 21, 2008), available at http://www.nytimes.com/2008/03/21/business/21econ.html?pagewanted=print (discussing how the credit crisis is being felt by retail stores and "couples planning their wedding are demonstrating uncustomary thrift").

\textsuperscript{109} Warren, supra note 95, at 34 ("The date are unmistakeable: commitment to a huge mortgage is threatening the economic survival of millions of families.").

\textsuperscript{110} Hallinan, supra note 78, at 57.

\textsuperscript{111} Id.

\textsuperscript{112} See Birnbaum, supra note 69 (stating "that lenders assured [homeowners] they could always refinance").
}
‘designed to fail, so you have to refinance . . . It should [not] be surprising that values go up and down in this kind of situation. And when you most need to refinance you can[not]—the crux of the crunch.’”

"The determination [to make certain debts nondischargeable is] made, at least in part, because the need for and importance of payment to the recipient outweighs the need for and importance of rehabilitation of the debtor.” Here, there are both socioeconomic and moral reasons to rehabilitate the debtor by allowing strip down of his mortgage debt. The debtor, once relieved of his overwhelming mortgage debt, will have more disposable income and better able to handle his other financial obligation. Therefore, instead of having his money tied up in his house, he could be investing in other aspects of society. Further, the amendment would allow a bankruptcy judge to determine whether the mortgage lender precipitated a known misconception, thereby allowing the judge to access whether this is a "morally questionable pursuit of repayment.”

C. External Goals of Bankruptcy

According to the Commission on Bankruptcy Laws of the United States "credit furthers economic growth and increases individuals’ well-being, and both goals are better served if

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

114 Hallinan, supra note 78, at 57.
consumers are inclined to take risks." Therefore, a basic function of bankruptcy is to serve the credit markets. 

While the amendment would support the two purposes of bankruptcy—equitable distribution of assets and a fresh start to debtors—some question whether it is "wise to remove the anti-modification governmental incentive that encourages the lender side of the transaction at a time when other factors, such as depressed home values, have already chilled the market[.]

According to the Mortgage Bankers Association and the American Bankers Association, any bill which allows homeowners to modify their mortgages in bankruptcy would cause mortgage interest rates to jump significantly. Further, the measure will cause lenders to tighten their lending requirements, making it harder for potential borrowers to qualify for a home loan.

\footnote{Johanna Niemi-Kiesiläinen, Consumer Bankruptcy: Market Failure or Social Problem?, 37 OSGOODE HALL L.J. 473, 476 (1999).}

\footnote{Niemi-Kiesiläinen, supra note 115, at 476.}


\footnote{Statement of David G. Kittle, CMB, Chairman-Elect, Mortgage Bankers Association, Before the Subcommittee on Commercial and Administrative Law, Committee on Judiciary, United States House of Representatives, Oct. 30, 2007, Hearing on "Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?—Part II," available at http://judiciary.house.gov/media/pdfs/Kittle071030.pdf, at 3 (claiming that permitting modification of mortgages in bankruptcy will result in an effective 200 basis point increase in interest rates on single-family owner-occupied properties).}

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

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

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

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121 Id.

122 Levitin & Goodman, supra note 120, at 40.

123 Benton & Fly, supra note 117.


V. Conclusion

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

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