MAKING HOMES AFFORDABLE:

HOW THE BANKRUPTCY CODE CAN HELP HOMEOWNERS AVOID FORECLOSURE

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INTRODUCTION

As the foreclosure crisis in America shows few signs of slowing, the government has been faced with the task of implementing a solution to assist homeowners in avoiding foreclosure. Avoiding foreclosures is essential for ensuring credit availability in the housing market and maintaining economic stability. The response that has been fashioned is the Making Homes Affordable Plan run by the Treasury Department. The Plan seeks voluntary modification on monthly mortgage payments for homeowners in default or at risk of default by creating incentives for servicers willing to make these modifications. Despite the good intentions of this program, there have been numerous problems and no real change in the number of foreclosures occurring since its inception. Further, the Plan does not deal with the fundamental issues in the housing market that created the foreclosure crisis in the first place. This paper argues that in order to deal with the foreclosure crisis and provide a sustainable housing credit market in the long-term, the government should focus on legislative change to the Bankruptcy Code. Rather than pursuing a policy program to attempt to modify home mortgages, Chapter 13 of the Bankruptcy Code should be amended so that homeowners can modify the mortgage on their primary residence when the homeowner's mortgage is in the unaffordable range at the time the loan is made (30% of a homeowner's income, as defined by the U.S. Department of Housing and Urban Development ("HUD")).[1]

Currently homeowners are unable to modify primary residences in Chapter 13 and thus are unable to take advantage of the "cramdown" provision, which allows a debtor to bifurcate her lien into secured and unsecured claims based on the value of the collateral and the amount owed on the loan. By allowing homeowners who file for bankruptcy to take advantage of the modification provision in Chapter 13, these homeowners with mortgages that are underwater (where a homeowner owes more on her home than it is worth) will be able to write down the mortgage principal and create a repayment plan that allows them to make affordable monthly payments. As a result, the potential for homeowners in default or facing the risk of default to avoid foreclosure and be able to pay down their modified mortgage is high. Although there are strong policy reasons supporting the absence of this modification provision in Chapter 13, the current state of the housing market rebuts many of the presumptions underlying these policy reasons. Further, the practices leading to the housing crisis have permanently altered the mortgage lending industry. Therefore, modifications in Chapter 13 will be essential beyond the scope of the foreclosure crisis.

Part I provides a short background of the events leading to the foreclosure crisis. Part II discusses the Making Homes Affordable Plan implemented by the Treasury Department in response to the current foreclosure crisis and points out the inadequacies of the program. Part III presents an alternative to the Making Homes Affordable Plan by arguing for an amendment to the Chapter 13 Bankruptcy Code to allow for modification on a mortgage for a primary residence

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[1] DAVID A. VANDENBROUCKE, HOUSING AFFORDABILITY DATA SYSTEM 11 (2007), *available at* http://www.huduser.org/Datasets/hads/HADS_doc.pdf.

in certain circumstances. Part IV concludes that amending the Bankruptcy Code to allow for modification on primary residences in the unaffordable housing range is the best method for reducing the number of foreclosures and restoring stability to the housing market. Part IV also posits that a permanent amendment to Chapter 13 will address the changing policies supporting homeownership and credit availability in the housing market.

I. BACKGROUND OF THE HOUSING MARKET CRISIS

The American dream of homeownership has now become the American nightmare. Homeownership has been an important policy pursued by the American government since the 1930s and is seen as a major investment and status symbol for many Americans.[2] However, this drive for homeownership, inflated home values and the size of loans provided to acquire these homes, contributed to a bubble ("an economic cycle characterized by rapid expansion followed by a contraction"[3]), which, like all bubbles, eventually burst. The consequence of the bust has led to many homeowners unable to make the payments on their mortgages, resulting in a widespread foreclosure crisis.[4]

The bubble began following the terrorist attacks in 2001 and the bust of the technology bubble.[5] The Federal Reserve cut interest rates in an attempt to jumpstart the U.S. economy by

[2] Jane Kaufman Winn, *Lien Stripping After* Nobelman, 27 LOY. L.A. L. REV. 541, 579 (1994).

[3] Investopedia.com, Dictionary- Bubble, http://www.investopedia.com/terms/b/bubble.asp (last visited Nov. 30, 2009).

[4] New York Times, *Times Topics: Mortgages and the Markets*, N.Y. TIMES, updated July 29, 2009, *available at* http://topics.nytimes.com/top/reference/timestopics/subjects/m/mortgages/index.html [hereinafter *Mortgages and the Markets*].

[5] New York Times, *Credit Crisis- The Essentials*, N.Y. TIMES, Sept. 22, 2009, *available at* http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/index.html [hereinafter *Credit Crisis*].

encouraging spending and lending.[6] The lower interest rates stimulated the economy by allowing cheaper mortgage payments.[7] Cheaper mortgage payments increased the demand for homes, as more people were able to afford mortgages, causing housing prices to rise.[8] The increase in housing prices also allowed many homeowners to refinance their mortgages in order to take advantage of the availability of credit to release the equity in their homes for other purposes effectively increasing the amount of debt outstanding on their homes.[9] At the same time, new types of housing financing products were introduced, such as Adjustable Rate Mortgages (ARMs),[10] which typically had introductory "teaser" rates for the first two or three years of the loan and then ballooned to a much higher rate at the end of the first few years,[11] or "interest only" periods, which had an introductory period where no principal is paid off.[12] These new products attracted many borrowers who previously would not have qualified for financing.[13]

These borrowers, known as subprime borrowers, are more risky than other borrowers because they either had little savings, low or modest income, or unfavorable credit reports.[14] Many of these borrowers took advantage of the low interest teaser rates or interest only

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[6] Alec Klein & Zachary A. Goldfarb, *The Bubble: How Homeowners, Speculators and Wall Street Dealmakers Rode a Wave of Easy Money With Crippling Consequences*, WASH. POST, June 15, 2008, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/06/14/AR2008061401479_3.html?sid=ST2008061401569; *see also Mortgages and the Markets*, *supra* note 4.

[7] *Credit Crisis*, *supra* note 5.

[8] *Id.*

[9] Gregory A. Krohn & William R. Gruver, The Complexities of the Financial Turmoil of 2007 and 2008 4 (Oct. 7, 2008) (unpublished manuscript, *available at* http://ssrn.com/abstract=1282250).

[10] Krohn & Gruver, *supra* note 9, at 4.

[11] Klein & Goldfarb, *supra* note 6.

[12] Krohn & Gruver, *supra* note 9, at 4.

[13] *Id.* ("Rising house prices and low delinquency rates encouraged lenders to make more loans with lower underwriting standards, as seen in the rapid growth of subprime mortgages.").

[14] Klein & Goldfarb, *supra* note 6.

introductory periods to acquire homes.[15] However, when their interest rates reset or principal payments began, these borrowers were faced with much higher payments than other non-subprime borrowers, which was reflective of the risk the lending institutions were taking by lending to a borrower more likely to default.[16] Despite the risk that these subprime borrowers would not be able to afford the payments on their mortgages once their rates reset, lending to subprime borrowers did not cease on the theory that the housing market was so active and prices would continue to rise therefore borrowers would be able to sell their homes at any time to repay the loan or refinance their loan into another lower interest product.[17] Additionally, during this time lenders increasingly began to utilize complex financial products that securitized the mortgages and sliced them into tranches to be re-sold to investors on the secondary market.[18] These complex products made it difficult to distinguish the risk of the underlying mortgages such that investors would overpay for these products further stimulating the credit flows to subprime borrowers.[19]

However, problems began when the rapid expansion in the housing market ceased,[20] and the market started to contract. The Federal Reserve started raising interest rates to slow the expanding economy causing mortgage rates to increase. This led to a decline in home purchases as affordability fell and the number of unsold houses increased.[21] Around this time, ARMs

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[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Credit Crisis*, *supra* note 5.

[19] *Id.*

[20] Krohn & Gruver, *supra* note 9, at 5.

[21] *Id.*

began to reset and interest only periods ended, leaving homeowners facing large monthly payments.[22] Further, with the drop in home prices, many people were confronted with high loan to value ratios ("LTV ratios") because the amount they had borrowed was now closer to or more than the value of their home.[23] With high monthly mortgage payments, a decelerating housing market, and rising LTV ratios, homeowners had little equity left in their home to refinance or to sell their homes to repay their mortgages. Delinquency rates began to rise leading to a surge of foreclosures.[24]

Since 2006, borrower defaults and foreclosures have increased dramatically.[25] Because of exotic mortgage products such as ARMs, interest only periods, and job losses leading to financial distress many homeowners are now facing monthly mortgage payments that are 40-50% of their income.[26] As homeowners who are unable to make their mortgage payments default and foreclosures increase, home prices are being further depressed due to the additional supply of homes for sale. In neighborhoods facing a number of foreclosures, each foreclosure may reduce surrounding home values by as much as 9%.[27] To emerge from this housing slump,

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[22] *Id.*

[23] *Id.*

[24] *Mortgages and the Markets*, *supra* note 4.

[25] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM: TREASURY ACTIONS NEEDED TO MAKE THE HOME AFFORDABLE MODIFICATION PROGRAM MORE TRANSPARENT AND ACCOUNTABLE 5 (2009) [hereinafter GAO REPORT]; Raymond H. Brescia, *Beyond Balls and Strikes: Towards A Problem-Solving Ethic in Foreclosure Proceedings*, 59 CASE WESTERN L. REV. 305, 324 (2008).

[26] Press Release, U.S. Department of Treasury, Making Homes Affordable: Updated Detailed Program Description 3 (March 4, 2009), http://www.treas.gov/press/releases/reports/housing_fact_sheet.pdf [hereinafter MHA Program Description].

[27] *Homeowner Affordability and Stability Plan*, THE WASH. POST, Feb. 18, 2009.

homeowners facing unaffordable monthly payments must be helped in order to stabilize home prices and prevent the foreclosure crisis from spiraling out of control.[28]

II. Addressing the Home Mortgage & Foreclosure Crisis

A. The Obama Administration's Financial Stability Plan

In response to the increased number of foreclosures stemming from the mortgage crisis, the Obama Administration proposed the Making Homes Affordable Plan as part of the Financial Stability Plan.[29] The purpose of the program is to assist homeowners with reducing their monthly mortgage payments to a more affordable level in order to prevent foreclosures.[30] The goal of the program is to assist between seven and nine million homeowners to continue to be able to make payments on their monthly mortgage in order to avoid foreclosures and prevent further reductions in home prices.[31]

The Making Homes Affordable Plan intends to achieve its goals by partnering the government with lenders and borrowers to either modify or refinance a mortgage.[32] The refinancing program provides refinancing options during a time when many homeowners are

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[28] While it is not the focus of this paper, an important aspect of the foreclosure and subprime mortgage crisis is the financial products that resulted (mortgage backed securities, CDOs, etc) that helped the mortgage crisis lead to a financial crisis as well.

[29] MakingHomesAffordable.gov, About Making Homes Affordable, http://makinghomeaffordable.gov/about.html (last visited Oct. 8, 2009). The Making Homes Affordable Plan is one aspect of the government's Financial Stability Plan, which purports to assist the United States in recovering from the recession. FinancialStability.gov, Financial Stability Plan, http://www.financialstability.gov/roadtostability/index.html (last visited Oct. 8, 2009). The Treasury has divided the plan into four parts to assist in financial recovery through: "1) a broad program to stabilize the housing market by encouraging lower mortgage rates and making it easier for millions to refinance and avoid foreclosure; 2) a new capital program to provide banks with a safeguard against a deeper recession; 3) a major new lending program with the Federal Reserve targeted at the securitization markets critical for consumer and small business lending; 4) a program to set up funds to provide a market for the legacy loans and securities that currently burden the financial system." *Id.*

[30] Making Homes Affordable.gov, About Making Homes Affordable, http://makinghomeaffordable.gov/about.html (last visited Oct. 8, 2009).

[31] FinancialStability.gov, Financial Stability Plan, http://www.financialstability.gov/roadtostability/index.html (last visited Oct. 8, 2009).

[32] *Id.*

unable to refinance due to lack of credit availability.[33] It allows responsible homeowners (homeowners that made a downpayment and have paid their mortgage payments on time) to refinance with Freddie Mac and Fannie Mae.[34] The second aspect of the Plan, the more comprehensive modification program, is most relevant to this paper. The modification program, Home Affordable Modification Program ("HAMP"), seeks to reduce the monthly payment required by homeowners, specifically targeting homeowners that are underwater, in default or at risk for default.[35]

HAMP applies to loans originated on or before January 1, 2009 and allows modifications until December 31, 2012.[36] The substance of the modifications requires lenders to reduce the monthly mortgage payments to affordable levels, defined as no greater than 38% of the borrower's income.[37] This reduction is then matched by the Treasury, dollar-for-dollar, to further decrease monthly payments to 31% of the borrower's income ("the Front-End DTI Target").[38] HAMP also offers incentive payments to both servicers and borrowers. Servicers first receive a $1,000 payment up-front for each eligible modification under this plan and then receive a "pay for success" fee of $1,000 per year for three years if the borrower stays current on his mortgage

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[33] MHA Program Description, *supra* note 26, at 2.

[34] *Id.*

[35] *Id.* at 3. To determine if it is reasonably foreseeable a borrower will default, the borrower must contact the servicer to explain their hardship and provide supporting documentation that the borrower has had a recent change in circumstances or a recent increase in their mortgage payment. Press Release, U.S. Department of Treasury, Home Affordable Modification Program Guidelines 5 (March 4, 2009), http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf [hereinafter MHA Program Guidelines]. The servicer then determines if the borrower is in imminent default due to financial hardship. *Id.*

[36] Press Release, U.S. Department of Treasury, Making Home Affordable: Summary of Guidelines (March 4, 2009), http://www.treas.gov/press/releases/reports/guidelines_summary.pdf [hereinafter MHA Summary of Guidelines].

[37] MHA Program Description, *supra* note 26, at 4.

[38] MHA Program Guidelines, *supra* note 35, at 5; MHA Program Description, *supra* note 26, at 4. Up to $50 billion of TARP funds will be used by the Treasury in the modification program. GAO REPORT, *supra* note 25, at 9.

and is successful in the plan.[39] Furthermore, lenders and servicers[40] receive payments of $1,500 and $500 respectively for modifications made to borrowers who are at risk for imminent default but are still current on their payments.[41] To help borrowers reduce the principal on their mortgage, borrowers who stay current on their monthly payments in the program can receive a government subsidy of $1,000 a year for five years to be applied directly to the principal.[42]

Implementation of HAMP is required for financial institutions receiving assistance under the Financial Stability Plan and for Fannie Mae and Freddie Mac loans.[43] No other financial institutions will be required to implement the plan, but will be encouraged to do so by agencies such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve, the Federal Deposit Insurance Corporation and the National Credit Union Administration.[44] For institutions that are required to participate in the program, a Net Present Value ("NPV") test for borrowers delinquent for sixty days or for those considered in imminent default is required to first determine if modification is necessary.[45] The NPV test compares the net present value of cash flows expected from a modification versus without modification.[46] If

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[39] MHA Program Description, *supra* note 26, at 4.

[40] There is a subtle yet important difference between servicers and lenders. A lender is typically a bank that loans a borrower the money to purchase a house and issues a mortgage. A loan servicer is usually a financial institution that collects monthly mortgage payments and manages the loan. MakingHomesAffordable.gov, FAQs, http://makinghomeaffordable.gov/borrower-faqs.html#c1 (last visited Nov. 30, 2009). A loan servicer can also be a lender, however, this is not necessarily always the case. *Id.* If the lender sells the loan on the secondary mortgage market, the investors that purchase the loans hire servicers to interact with the borrower. *Id.* Even lenders that retain ownership of a loan will hire servicers to "service" the loan on their behalf. *Id.*

[41] MHA Program Description, *supra* note 26, at 5.

[42] *Id.* at 5.

[43] *Id.* at 7.

[44] *Id.* at 7.

[45] MHA Program Guidelines, *supra* note 35, at 5.

[46] *Id.*

the NPV in the modification program is greater than without modification, the servicer is required to offer modification to the borrower.[47] However, if the NPV is not greater in the modification program, offering a modification is optional.[48] If modification is pursued, the servicer must reduce the monthly payments to the Front-End DTI Target.[49] The Front-End DTI Target is achieved by first; reducing the interest rate on the mortgage, subject to a floor of 2%.[50] If, after reducing the interest rate, the Front-End DTI Target has not been reached, then the term of the loan is extended for up to forty years.[51] Finally, if the above two steps do not reach the Front-End DTI Target, then the servicer offers principal forbearance, which means that the forbearance amount will be due in a balloon payment on the maturity date, a sale of the property, or payment of the interest bearing balance.[52]

Once a borrower's loan had been modified to reach the Front-End DTI Target, the expectancy is that borrowers will be able to become or stay current on their mortgage payments and avoid foreclosure. The lender will also receive a stream of payments that are NPV positive compared to the non-modification alternative. The broader goal is to stabilize home prices by

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[47] *Id.* at 5-6.

[48] *Id.* at 6. If the NPV is negative and modification is not pursued, the lender is required to seek alternatives to foreclosure such as alternative modification programs, deed-in-lieu of foreclosure and short sale programs. *Id.*

[49] *Id.*

[50] *Id.* at 7. The interest rate decrease is effective for five years and then subject to annual increases of 1% per year until the rate reaches the Interest Rate Cap, where it will be fixed for the remainder of the loan term. *Id.* The Interest Rate Cap is: "the lesser of (i) the fully indexed and fully amortizing original contractual rate or (ii) the Freddie Mac Primary Mortgage Market Survey rate for 30-year fixed rate conforming mortgage loans, rounded to the nearest 0.125%, as of the date that the modification document is prepared." *Id.* at 8.

[51] *Id.* at 7.

[52] *Id.* at 7. Although it is not required, servicers may also forgive principal in order to meet the 31% Front-End DTI Target. *Id.*

avoiding the price decline associated with neighborhoods where a number of houses are facing foreclosure.[53]

B. Problems With the Making Homes Affordable Plan

Despite the Treasury's efforts, HAMP is still plagued with problems that inhibit any real moratorium on foreclosures. While many of these problems are likely inherent to implementing new policy programs, their presence is creating a roadblock to the effectiveness of the program. The need for immediate relief for many homeowners could ultimately lead this program to fail to reach its goals of being able to prevent the current foreclosure issue. The program expects to devote $50 billion of Troubled Asset Relief Program (TARP) funds to modifications.[54] With such a substantial amount of taxpayer resources being devoted, it is unconscionable that this program would fail. However, the issues facing HAMP suggest that further action is needed and the best action would be an amendment to the Bankruptcy Code.

As part of the plan, the Treasury has demanded that foreclosures for borrowers applying for modification be temporarily suspended, while borrowers are considered for the plan or alternative options are pursued.[55] Despite this suspension, mortgage foreclosures have hit a record high in the third quarter of 2009,[56] indicating that foreclosures are occurring at a more

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[53] MHA Program Description, *supra* note 26, at 3.

[54] GAO REPORT, *supra* note 25, at 9.

[55] MHA Program Guidelines, *supra* note 35, at 3.

[56] Lee Christie, *Foreclosures: 'Worst Three Months of All Time'*, CNNMONEY, Oct. 15, 2009, http://money.cnn.com/2009/10/15/real_estate/foreclosure_crisis_deepens/index.htm ("They were the worst three months of all time. [O]ne in every 136 U.S. homes were in foreclosure, which is a 5% increase from the second quarter and a 23% jump over the third quarter of 2008."); *see also* GAO REPORT, *supra* note 25, at 5. (noting that defaults and foreclosures have risen to the highest level in more than 30 years). Although foreclosure rates have dropped somewhat from September to October 2009, rates are still up 19% from last year. J.W. Elphinstone, *Foreclosures dip 3 pct. in October from September*, THE ASSOCIATED PRESS, Nov. 12, 2009, *available at* http://abcnews.go.com/Business/wireStory?id=9060678. While this dip may be due to lenders foregoing foreclosures while considering borrowers for modification, it may be only temporary due to the lack of permanent modifications. *Id.*

rapid rate than the modifications are being made. A July 2009 Government Accountability Office ("GAO") report found that only 180,000 out of 2 to 2.6 million borrowers (about 9%) identified as eligible for modifications have received modifications on their mortgages.[57] This may be because many servicers are understaffed and lack the "ability to handle a greater volume of loan modifications,"[58] or because servicers have not been given adequate time to "design, develop, test, and implement new procedures and infrastructure to properly handle cash movement and incentive disbursements."[59] Homeowners' files are often lost and the staffers hired by the servicers are largely uneducated about the program and are generally unable to adequately assist many homeowners.[60] Compounding this problem, borrowers that have begun participating in the program are faced with a cumbersome process that often takes many months just to determine their eligibility.[61] Additionally, servicers screen all borrowers to determine if a borrower is in imminent default based on standards created by the servicers themselves.[62] This creates the problem of inadequate standards for homeowners because the servicer will choose who is eligible for modification based upon their own criteria, meaning that similarly situated

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57 GAO REPORT, *supra* note 25, at 13, 15; *see also* Cynthia Riddell, *Mortgage Modification Not Working As Planned*, BRADENTONHERALD.COM (F.L.), Sept. 7, 2009, http://www.bradenton.com/business/story/1688741.html.

58 GAO REPORT, *supra* note 25, at 43.

59 GAO REPORT, *supra* note 25, at 45.

60 *Progress of the Making Homes Affordable Program: What Are the Outcomes for Homeowners and What Are the Obstacles to Success: Hearing Before the Subcomm. on Housing and Community Opportunity of the H. Comm. On Financial Services*, 111th Cong. 25-26 (2009) (written testimony of Alys Cohen, National Consumer Law Center) [hereinafter *Progress of the MHA*]; Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. TIMES, June 29, 2009, at A1.

61 Riddell, *supra* note 57 ("[Borrowers] are told to send voluminous financial documentation to their mortgage servicer and then they wait for many months to hear about a decision. When they call for an update they never speak to the same representative. Often they are told they do not qualify for a modification and may not be told why they do not qualify. Thus, they are left facing foreclosure.").

62 GAO REPORT, *supra* note 25, at 20.

homeowners may not receive similar treatment because they have different servicers with different eligibility standards.

Further complicating the problem of determining borrower eligibility is the fact that many of the loans have been securitized and thus, transparency to the investors needs to be taken into account when deciding to modify these loans.[63] The investors hold the beneficial interest in the loan and are entitled to repayment, which servicers, who handle the day-to-day operations or servicing of the loans, collect on behalf of the investors.[64] Many pooling and servicing agreements (PSAs) place restrictions on modifications of the mortgages underlying the securities, such as requiring investor approval or an outright prohibition on modification.[65] Although it may be in the interest of investors to pursue modification as opposed to foreclosure to reduce losses,[66] servicers lack the incentives to pursue modification as opposed to foreclosure.[67] First, implementing a modification program imposes costs on servicers for hiring staff and creating the infrastructure to operate the modification program.[68] While some of these costs are offset by the incentive payments offered under HAMP, servicers are also losing out on the lucrative fees they collect when a borrower defaults or when the home is sold in

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[63] GAO REPORT, *supra* note 25, at 8.

[64] *Progress of the MHA*, *supra* note 60, at 11 (written testimony of Alys Cohen, National Consumer Law Center).

[65] GAO REPORT, *supra* note 25, at 8; *see also Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before S. Judiciary Comm.*, 110th Cong. (2008) (testimony of Adam J. Levitin, Professor, Georgetown University Law Center).

[66] *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 1 (2009) (testimony of Alan M. White, Assistant Professor of Law, Valparaiso University School of Law) ("Mortgage investors lost an appalling 56% of the total mortgage debt on foreclosures in November 2008, and an even more appalling 65% in June 2009.").

[67] *Progress of the MHA*, *supra* note 60, at 11 (written testimony of Alys Cohen, National Consumer Law Center).

[68] *Id.* at 12.

foreclosure.[69] Additionally, the monthly fees servicers collect is based on a percentage of the loan balance.[70] Once the balance is modified, servicers receive a smaller portion as a fee.[71] As a result, servicers have a perverse incentive to avoid modification and force borrowers into delinquency and default, even if it would be the best interests of both the investors and the homeowners to pursue modification.[72]

Meanwhile, borrowers who are eligible for the program are required to enter into a trial period where they make temporary mortgage payments for three months to demonstrate their ability to pay.[73] There is also no guarantee that these borrowers will be granted modification and as of yet, few temporary modifications have actually become permanent.[74] Even borrowers that do successfully receive a loan modification are not guaranteed to avoid foreclosure. Not all borrowers will successfully complete the trial period,[75] and even borrowers that do complete the trial period may re-default on their loans.[76] Borrowers who are denied permanent loan modifications are also at an even greater risk of default because the modified trial payments are considered only partial payments, meaning that the unpaid portion places the borrower in delinquency unless the remaining payments can be made.[77] Loans can be modified under HAMP

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[69] Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Loans*, N.Y. TIMES, July 29, 2009, at A1.

[70] *Progress of the MHA*, *supra* note 60, at 17 (written testimony of Alys Cohen, National Consumer Law Center).

[71] *Id.*

[72] Goodman, *supra* note 69; *Progress of the MHA*, *supra* note 60, at 17 (written testimony of Alys Cohen, National Consumer Law Center).

[73] Riddell, *supra* note 57; *see also* GAO REPORT, *supra* note 25, at 20.

[74] Riddell, *supra* note 57; *see also* Ruth Simon, *Treasury Makes New Push on Mortgage Relief*, WALL ST. J., Nov. 30, 2009, at A3.

[75] Ruth Simon, *Treasury Makes New Push on Mortgage Relief*, WALL ST. J., Nov. 30, 2009, at A3 (some borrowers still cannot afford the modified payments in the trial period because they are not low enough).

[76] GAO REPORT, *supra* note 25, at 35.

[77] Simon, *supra* note 75.

only once and once a borrower re-defaults on the mortgage, that loan will be removed from the program and all further payments to the servicer will cease.[78] Thus, even borrowers targeted to be assisted by the modification program may still end up losing their homes.

Further complicating the problems with the modification program is the lack of oversight provided for the program. Although the Treasury has taken some steps to establish oversight structure, there are still areas that remain without supervision.[79] The Homeownership Preservation Office (HPO), the office responsible for the loan modification oversight still does not have finalized systems of internal control nor does it have policies and procedures for the program's activities.[80] Most importantly, it is still unclear when comprehensive procedures will be implemented to address noncompliance by servicers.[81] As a result of this lack of compliance oversight, servicers have been able to violate the existing guidelines to the detriment of borrowers. For example, the HAMP guidelines prohibit servicers from requiring homeowners to waive their legal rights as a pre-condition for modification, however, modification agreements exist requiring homeowners to waive their rights or to waive their right to a HAMP modification in favor of a non-HAMP modification.[82] Additionally, some homeowners are being forced to make up-front payments before being considered for a modification, although such payments are prohibited by HAMP.[83] Without oversight, these violations have gone largely undetected.

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[78] MHA Program Guidelines, *supra* note 35, at 3, 9.

[79] GAO REPORT, *supra* note 25, at 37.

[80] *Id.*

[81] *Id.*

[82] *Progress of the MHA*, *supra* note 60, at 21 (written testimony of Alys Cohen, National Consumer Law Center).

[83] *Id.* at 24.

Finally, the loan modification program does not resolve the issue of borrowers that are underwater.[84] Even borrowers that have already received modification may still be underwater,[85] meaning that borrowers have less incentive to try and save their homes rather than just walking away all together, so the fix is only temporary.

Given the problems with HAMP, an alternative is necessary in order to help relieve homeowners facing foreclosure and stabilize the market. Rather than attempting to implement a policy program with limited opportunity for success, the focus should be on legislative change to the Bankruptcy Code.

III. Loan Modification Proposal

In order to address the foreclosure crisis and stabilize the housing market, Chapter 13 of the Bankruptcy Code should be amended. An amendment to the Code should allow for homeowners in bankruptcy to modify the mortgage on their primary residence, therefore reducing their monthly payments and avoiding foreclosure.

A. The Law in Chapter 13 Bankruptcies

The purpose of the bankruptcy system is not only to distribute the property of the debtor equally among creditors, but also to provide the debtor with a fresh start.[86] The structure of a Chapter 13 reorganization allows the debtor to keep her property, regardless of value, provided that the debtor uses her income for the next three to five years to pay off creditors.[87] Thus, the

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[84] GAO Report, *supra* note 25, at 26.

[85] Peter S. Goodman, *Panel Says Obama Plan Won't Slow Foreclosures*, N.Y. Times, Oct. 9, 2009, at B1.

[86] Stellwagen v. Clum, 245 U.S. 605, 617 (1918).

[87] Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors 281 (5th ed. 2006).

creditors are provided with payment of their debt and the debtor is given a fresh start by being able to keep her property and discharging debts under the repayment plan.

In order to facilitate the debtor's ability to propose a repayment plan that will be effective in providing the debtor with a fresh start, the Bankruptcy Code allows the debtor to modify the rights of creditors. Under the Bankruptcy Code, 11 U.S.C § 1325(a)(5), a debtor is required to pay the entire amount of an allowed *secured* claim. Section 506(a), a secured claim is defined as a lien equal to the value of the property, whereas if the lien exceeds the value of the property, the claim is unsecured.[88] Reading these two provisions in conjunction, the result is what is known as "lien stripping"[89] or a "cramdown."[90] This means the debtor can bifurcate a claim where the value of the secured property is worth less than what is owed on the property.[91] The claim is split into a secured portion, equal to the value of the collateral, and an unsecured portion, equal to the remainder of the loan.[92] The secured portion of the claim is required to be paid in full in order for the debtor to receive a discharge on her debts.[93] However, the unsecured portion is merely treated as any unsecured claim, but is required to be paid as much as would have been paid in a Chapter 7 proceeding.[94]

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[88] 11 U.S.C. § 506(a) (2006).

[89] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 579 (2009).

[90] WARREN & WESTBROOK, *supra* note 87, at 290.

[91] 11 U.S.C. §506(a); WARREN & WESTBROOK, *supra* note 87, at 281.

[92] WARREN & WESTBROOK, *supra* note 87, at 281.

[93] 11 U.S.C. § 1325(a)(5).

[94] WARREN & WESTBROOK, *supra* note 87, at 281; Levitin, *supra* note 89, at 579-80.

Furthermore, section 1322(b)(2) provides that the debtor may "modify the rights of holders of secured claims . . . ."[95] As a result, the debtor has the ability to change the contract terms of a loan including the interest rates and the payment schedule.[96] However, the lien stripping and modifying of loan contract terms are not available for a debtor's primary residence. Section 1322(b)(2) states in full 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 the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims."[97] The result is that the terms of a loan secured by the primary residence of a debtor may not be altered. Therefore, in order to stay in possession of her primary residence, the debtor must cure any defaults on mortgage payments and continue to make monthly payments subject to the original terms of the loan.[98]

Primary residence mortgages were excluded from the § 506(a) cramdown provision in *Nobelman v. American Savings Bank*.[99] In *Nobelman*, Supreme Court held that § 1322(b)(2)'s exception to modification for claims secured by the debtor's principal residence "proscribed modification of the rights of a homestead mortgagee,"[100] which includes a § 506(a) cramdown.[101] In so holding, the Court also recognized that § 1322(b)(2) prohibits alteration to the lender's

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[95] 11 U.S.C. § 1322(b)(2).

[96] John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 Utah L. Rev. 1123, 1128-30; Levitin, *supra* note 89, at 579.

[97] 11 U.S.C. § 1322(b)(2).

[98] Eggum et al., *supra* note 96, at 1125-26.

[99] 508 U.S. 324 (1993).

[100] *Id.* at 327.

[101] *Id.* at 332.

right to repayment of the principal, the rate of interest, the term of the loan, the existence of the lien until the debt is paid off, the right of foreclosure, and the right to a deficiency action.[102]

In his concurring opinion, Justice Stevens shed light on the reasoning behind the majority's holding stating that:

> 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 mortgagees was intended to encourage the flow of capital into the home lending market.[103]

Justice Stevens short, but often quoted, concurrence has been interpreted to support two important bankruptcy policies. First, his concurrence and the majority opinion show a shift in bankruptcy law from favoring debtor protection to favoring creditor protection,[104] which has been furthered bolstered by the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[105] Second, it displayed a policy of protecting the home mortgage market by ensuring that borrowers and lenders received the benefit of their bargain.[106] By ensuring that the benefit of the bargain could not be modified in a Chapter 13 case, home ownership is promoted because lenders are not worried that they will extend credit to borrowers only to lose their rights when a borrower files for bankruptcy.[107]

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[102] *Id.* at 329.

[103] *Id.* at 332 (Stevens, J., concurring).

[104] Paul J. Bento, Note, *Bankruptcy—Chapter 13 'Strip Down'- Section 1322(b)(2) Prohibits a Debtor From Bifurcating a Homestead Mortgagee's Claim Into Secured and Unsecured Portions So as to Reduce the Amount of An Underseucred Mortgage to the Fair Market Value of the Collateral-Nobleman v. American Savings Bank*, 24 SETON HALL L. REV. 1033, 1054 (1993).

[105] Pub. L. No. 109-8, 119 Stat. 23.

[106] Bento, *supra* note 104, at 1055.

[107] Jane Kaufman Winn, *Lien Stripping After* Nobelman, 27 LOY. L.A. L. REV. 541, 577 (1994).

B. *The Case for Amending Chapter 13 of the Bankruptcy Code*

Despite the policy reasons for proscribing lien stripping for primary residences, section 1322(b)(2) should be amended to eliminate the modification exception for claims secured by a debtor's primary residence in cases where the debtor's monthly payments are in the unaffordable range.[108] The amendment would address two major shortcomings in the current regime: 1) HAMP is not effective in forestalling a majority of the foreclosures in America as a result of the subprime mortgage crisis; and 2) the policy reasons supporting credit flows to home buyers is still valid, but the exception for holders of secured interests in real property need to be amended for contemporary credit markets. By amending the Bankruptcy Code, homeowners will be able to use the bankruptcy system to not only forestall foreclosure, but to make a repayment plan that is viable and will allow these owners to stay in their homes. Furthermore, an amendment to allow for modification on a primary residence in some circumstances will address the way credit is extended for home mortgages.

1. Amending Section 1322(b) of the Bankruptcy Code Will Address the Shortcomings of the Making Homes Affordable Plan

By amending § 1322(b) of the Bankruptcy Code, homeowners can use the bankruptcy system as a method for keeping their homes when they are in financial distress or default. The most recent proposal to allow for limited amendments to Chapter 13 of the Bankruptcy Code was passed by the House of Representatives and referred to the Senate on March 5, 2009.[109] The bill entitled, Helping Families Save Their Homes Act of 2009, allows the debtor to modify the rights of holders of claims secured by the debtor's principal residence that is subject to a notice of

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[108] Defined as 30% or more of the debtors income. *See supra* note 1.

[109] Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. (as passed by House of Representatives, March 5, 2009).

foreclosure and originated prior to the passage of the bill.[110] Although this bill was passed by the House, the bill that was ultimately enacted by the Senate excluded the bankruptcy provisions.[111] Most likely, the exclusion was due to criticism the Chapter 13 amendments faced, including the argument that it would raise costs in the housing market, lenders and servicers would not receive the benefit of the bargain (i.e. the bargained for exchange of a mortgage in return for repayment of interest and principal in full) and bankruptcy courts would suffer from a large influx of filings.[112] However, by limiting the availability of bankruptcy modifications to debtors spending 30% or more of their income on mortgage payments at the time of origination, borrowers in this category will be protected by allowing them to modify, while capital will continue to flow to affordable mortgages. Therefore, despite the fact that the Senate failed to enact the proposed changes to Chapter 13, amending the Bankruptcy Code is still a viable option for addressing the shortcomings of HAMP and should be reconsidered by the Senate in the amended form suggested in this paper.

Helping Families Save Their Homes provides three methods of modification to a homeowners principle residence: 1) "by providing for payment of the amount of a secured claim as determined under section 506(a)(1);"[113] 2) by "prohibiting, reducing, or delaying adjustments" to an adjustable rate of interest;[114] 3) by modifying the terms of the loan to extend the loan

[110] H.R. 1106, 111th Cong. §103(1)(C).

[111] Helping Families Save Their Homes Act of 2009, S. 896, 111th Cong. (2009) (enacted). *See also* Helping Families Save Their Homes Act of 2009, S. 895, 111th Cong.. The bill, S. 895, included the bankruptcy provisions but appears to have been abandoned by the Senate because the remainder of the text was included in S. 896. GovTrack.us, S.895: Helping Families Save Their Homes Act of 2009, http://www.govtrack.us/congress/bill.xpd?bill=s111-895 (last visited Nov. 27, 2009).

[112] Center for American Progress, Saving American Homes 101, http://www.americanprogress.org/issues/2009/03/pdf/housing_101.pdf (last visited, Nov. 27, 2009).

[113] H.R. 1106, 111th Cong. §103(1)(C)(A).

[114] H.R. 1106, 111th Cong. §103(1)(C)(B).

repayment period up to forty years[115] and adjusting interest rates equal to the current average prime rate.[116] The effect of these modifications is that by filing for bankruptcy, the debtor is given the opportunity to develop a repayment plan that will allow the debtor to continue making payments on her mortgage, thus allowing her to keep her home.[117] However, borrowers who are in financial distress and cannot afford to cure a default, while continuing to make monthly mortgage payments, will have the opportunity under the amended Code to modify the terms of their mortgage, alleviating this burden.[118] Thus, amending Chapter 13 of the Bankruptcy Code would achieve modification, similar to HAMP, but it would also address many of the HAMP's shortcomings.[119]

One of the key problems with HAMP is that it does not address underwater borrowers who are forced to make payments on a loan worth more than the property.[120] The first provision proposed under the Helping Families Save Their Homes Act (H.R. 1106) is to allow homeowners to use § 506(a) to pay the secured portion of the mortgage claim (the cram-down provision). Under this provision, borrowers who have negative equity in their homes will be able to bifurcate

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[115] Extending the repayment period is a necessary amendment to the Bankruptcy Code because currently, a Chapter 13 repayment plan must be completed within five years. 11 U.S.C. § 1322(d). Therefore, allowing an extension on the mortgage payment period would override this requirement but only to the extent that it affects the debtor's principal residence.

[116] H.R. 1106, 111th Cong. §103(1)(C)(C)(i), (ii).

[117] WARREN & WESTBROOK, *supra* note 87, at 281.

[118] *See supra* Part II.A.

[119] It is important to note that Helping Families Save Their Homes Act of 2009, H.R. 1106, is *not* a permanent amendment to the Bankruptcy Code because, along with some other restrictions, it applies only to those mortgages originated prior to the proposed enactment of the bill. Thus, this retrospective clause would mean that mortgages originated after the passage of the bill would abide by the currently enacted Chapter 13 Code. By contrast, I argue that a permanent amendment is necessary to address the changing landscape of lending in the housing industry.

[120] *See supra* notes 84-85.

the secured claim based on the market value of the property.[121] As a result, borrowers filing for bankruptcy will have not only the option of modifying their mortgage, but also they will be able to strip the lien down to the fair market value of the property. This is important because underwater borrowers pose a threat to housing recovery in that they have a more difficult time selling their home and they are more likely to go into foreclosure.[122]

Even where a borrower is not underwater, the terms of the Helping Families Save Their Homes Act (H.R. 1106) allowing for extension of the repayment period or reduction of interest rates are still necessary provisions to avoid foreclosure. Although ostensibly borrowers could both reduce the rate of interest or extend the repayment period under HAMP, there are several advantages to allowing the borrower to make these changes in a bankruptcy filing. Even if the advantages for a particular borrower of modifying in bankruptcy are only marginal to modifying outside of bankruptcy, the mere fact that the borrower has the ability to modify within bankruptcy will provide more incentives for lenders to voluntarily modify mortgage loans in lieu of bankruptcy.[123] Although a modification in bankruptcy is still subject to confirmation by the court,[124] the debtor unequivocally will be able to modify and create a repayment plan provided that the debtor adheres to the statutory provisions governing the repayment plan and submits the plan in good faith.[125] Therefore, although not all mortgage lenders or servicers are required to

[121] *See supra* notes 88-94 and accompanying text.

[122] Ruth Simon & James R. Hagerty, *1 in 4 Borrowers Under Water*, WALL ST. J., Nov. 24, 2009, at A1.

[123] Press Release, House Committee on Financial Services, Judiciary and Financial Services Committee- Housing Bill Introduced in the House (Feb. 23, 2009), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/press022409.shtml. *See also Progress of the MHA*, *supra* note 60, at 21 (written testimony of Alys Cohen, National Consumer Law Center).

[124] 11 U.S.C. § 1325.

[125] § 1325(a)(3) (good faith requirement).

participate in HAMP, the presence of a bankruptcy modification could spur more lenders and servicers to voluntarily participate. Furthermore, the presence of a bankruptcy modification alternative will have the dual effect of not only providing an incentive for lenders to pursue voluntary modifications but also to regulate the out-of-bankruptcy modification practices. Modifications by servicers and lenders under HAMP have been not necessarily followed the guidelines set forth by the Treasury with many servicers charging fees to homeowners for modification or requiring waivers of legal rights, although this is strictly prohibited by HAMP.[126] Providing homeowners with the alternative option of filing for bankruptcy could have the effect of ensuring that servicers abide by Treasury guidelines and offer out-of-bankruptcy modifications on fair and equitable terms. If servicers are faced with a modification controlled by the court, they may have more of an inducement to deal fairly with the homeowner.

One of the most important problems with HAMP is that it is not modifying mortgages at a rate fast enough to outpace foreclosures.[127] By contrast, in a Chapter 13 bankruptcy, borrowers will have the protection of the automatic stay immediately upon filing for bankruptcy.[128] Once the automatic stay is in place, the foreclosure proceeding is suspended and the borrower would then have the chance to make modifications.[129] Therefore, if borrowers that may have been eligible for HAMP use Chapter 13 instead, more homeowners will be able to avoid foreclosure by simply filing for bankruptcy to buy time to make modifications. Although there are still procedures that must be adhered to in order to file for bankruptcy, the debtor would have control

[126] *Progress of the MHA*, *supra* note 60, at 3, 9, 21 (written testimony of Alys Cohen, National Consumer Law Center) (citing reports that servicers are offering loan modifications that do not comport with the guidelines set forth in the Making Homes Affordable Program).

[127] *See supra* notes 55-62 and accompanying text.

[128] 11 U.S.C. § 362(a) (2006).

[129] *Id.*

over the process. By contrast, borrowers in HAMP are subject to the servicer's procedures for determining if the borrower is eligible and for commencing the modification process.[130] By filing for bankruptcy instead of entering a modification program, borrowers will be able to avoid the cumbersome process of proving that they are eligible for the modification plan and entering a trial period that might not even lead to a loan modification.[131] The result here is that modification in bankruptcy is more likely and therefore could substantially reduce foreclosures. However, this would create a dichotomy for the borrower of either being forced to file for bankruptcy to achieve modification or being subjected to a cumbersome out-of-bankruptcy modification process, during which time they could still face foreclosure. Although the solution may be the leverage created by the bankruptcy option to induce the servicer to more aggressively pursue out-of-bankruptcy modification, as discussed earlier.[132]

Amending the Bankruptcy Code would also address the coordination and conflict of interest issue between servicers and investors. First, the restrictions placed on servicers' ability to modify mortgages by the PSAs would be moot. The contractual nature of the PSAs prevents servicers from agreeing to modifications with borrowers if they are prohibited in the PSA;[133] however, in bankruptcy, the debtor has the ability to modify contractual claims and thus, the debtor would be able to modify a PSA that restricts out-of-bankruptcy modification. Servicers could not avoid modification on the grounds that it would be a breach of the PSA and subject

[130] *See supra* notes 61-78 and accompanying text.

[131] *Id.*

[132] *See supra* notes 123-126 and accompanying text.

[133] *Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before S. Judiciary Comm.*, 110th Cong. (2008) (testimony of Adam J. Levitin, Professor, Georgetown University Law Center).

them to liability.[134] Second, the perverse incentives for servicers to pursue default and foreclosure over modification would be avoided.[135] A modification in bankruptcy would take the discretion to pursue modification away from the servicer and give the debtor and the court control over the repayment plan.[136] Consequently, modification within a Chapter 13 bankruptcy eliminates both the coordination problem of whether the servicer has the ability to modify the mortgage and the conflict of interest problem which incentivizes servicers to pursue foreclosure over modification, thereby increasing the chances that the borrower will be able to achieve successful modification.

Further, unlike HAMP, the Bankruptcy Code has the advantage of clear standards, judicial oversight and precedent. A major problem with HAMP is that lenders are not equipped to make these modifications and they are given the power to determine which borrowers are eligible for a modification plan without any clear standard to be applied for all homeowners.[137] By contrast, the bankruptcy system is governed by a comprehensive statute that governs both the substance and procedure in a consistent manner.[138] Bankruptcy also has the advantage of case law interpreting this statute and experienced judges and professionals to guide through the process.[139] The result is that homeowners entering bankruptcy will be subject to clear and consistent guidelines for eligibility, repayment and discharge, as opposed to the confusion

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[134] Eggum et al., *supra* note 96, at 1165.

[135] *See supra* notes 67-72 and accompanying text.

[136] *See generally Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before S. Judiciary Comm.*, 110th Cong. (2008) (testimony of Adam J. Levitin, Professor, Georgetown University Law Center).

[137] *See supra* notes 79-81 and accompanying text.

[138] 11 U.S.C. § 101 *et seq.*; *see also* Eggum et al., *supra* note 96, at 1165.

[139] Eggum et al., *supra* note 96, at 1165.

surrounding the process of applying for and receiving modification through the loan servicers.[140] This should result in greater efficiency and an increase in the number of homeowners able to achieve modification and avoid foreclosure. Servicers will also not be able to engage in abusive practices such as requiring borrowers to waive legal rights to obtain modification or forcing borrowers to pursue a modification that has unfavorable terms or results in excessive fees for the borrower. Stringent judicial oversight and the necessity of plan confirmation will assist in curbing servicers from participating in these practices. Finally, the bankruptcy option is more efficient because it does not require the creation or new government agencies or additional government expenditures because it is funded by debtor fees.[141]

Finally, HAMP does advocate for allowing judicial modification of home mortgages during bankruptcy.[142] Thus, the Treasury concedes in its plan that judicial modification should be an option. However, under the Treasury's plan, modification will occur at the discretion of the judge and only after the borrowers have unsuccessfully tried to modify their loans through their lenders or servicers.[143] While this provision is a step in the right direction, it does not go far enough and is too restrictive to really help homeowners avoid foreclosure. Therefore, the most sensible option is to allow borrowers to be able to modify the mortgage on their principal residence in bankruptcy, not in place of or in addition to, but *as an alternative to* HAMP. Rather than requiring the borrower to first comply with the HAMP process, the borrower should have the option of choosing bankruptcy or the modification process outside of bankruptcy. The

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[140] Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. TIMES, June 29, 2009, at A1 (discussing the difficulty borrowers are facing dealing with paperwork and mortgage companies).

[141] Eggum et al., *supra* note 96, at 1165.

[142] MHA Program Description, *supra* note 26, at 7.

[143] *Id.* at 8.

advantage of this would be to give the borrower control of the decision to pursue the process of modification in or outside of bankruptcy since there are many factors that may contribute to a borrower's decision to file for bankruptcy. Additionally, if the borrower decides to attempt the out-of-bankruptcy option and is deemed not eligible, the borrower can still attempt modification in bankruptcy.[144]

Overall, by amending the Bankruptcy Code, many of the problems facing the Making Homes Affordable Plan will either be moot or satisfied by the provisions of the Code and judicial process. As such, in order to overcome the foreclosure crisis and sustain credit markets in the long-term, section 1322(b)(2) should be amended to allow debtors to modify the mortgage on their primary residence when the debtor is spending more than 30% of their income on mortgage payments at the time of origination.

2. Changing Policy in the Credit Markets Supports Amending Section 1322(b) in the Long-Term

Amending Chapter 13 of the Bankruptcy Code is an effective approach for addressing the current foreclosure crisis brought on by the collapse of the housing market. However, beyond just the immediate effects of impeding foreclosures, amending the Bankruptcy Code is also supported by the changing policies in the credit market. Thus, the Code should be amended retrospectively to apply to mortgages facing foreclosure as a result of the current crisis and also prospectively to address the changing policies and procedures in the housing industry.

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[144] The debtor will still be required to meet certain eligibility requirements in Chapter 13 and the debtor must be able to prove that she has sufficient income to make the proposed repayments in order to have her plan confirmed. However, if the debtor is truly able to propose a viable repayment plan, there is no ability to prevent the debtor from utilizing Chapter 13. 11 U.S.C. § 1322(a)(1).

The main reason for excluding primary residences from loan modifications in Chapter 13 is to protect the credit markets on the theory that if modification was possible, lenders would not be willing to lend to borrowers because of the possibility of losing the value of the loan when housing prices dropped and borrowers filed for bankruptcy.[145] While this reasoning may have been persuasive at the time *Nobelman* was decided, it is no longer compelling in today's credit market. Lenders should not be afforded extra protection against borrower default because they are increasingly engaging in risky or abusive lending practices.[146] Lenders are extending loans to subprime borrowers, by offering these borrowers ARMs and interest only periods, which can be initially attractive, but can create an inability to pay the loans when the interest rate resets or principal payments become due.[147] Therefore, while the policy promoting homeownership is being served by lenders extending loans to parts of the population typically deemed undesirable candidates for loans, lenders should not be able to offer subprime lenders exotic loan terms and still have the protection of the anti-modification provision in bankruptcy. Further exacerbating the issue is the growth of the mortgage backed securities market, which breaks from the traditional mortgagor-mortgagee relationship by packing, pooling and selling off the loans as investment products. By engaging in this behavior, the risk profile of the underlying mortgages became distorted for the investors of mortgaged backed securities.[148]

A second policy supporting the anti-modification provision on primary residences is that in order to promote home ownership, pricing in the credit market must remain low. The concern

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[145] *See supra* notes 103-107; *see also* Eggum et al., *supra* note 96, at 1156-58.

[146] *Id.*

[147] *Id.*; Whitney Travis, *Stripping Down the Subprime Crisis*, 10 TRANSACTIONS: TENN. J. BUS. L. 51, 65 (2008).

[148] Travis, *supra* note 147, at 65.

with a bankruptcy modification is that if borrowers are allowed to modify their loans, then lenders will only extend credit when a premium is paid to compensate for the lender's risk of nonpayment of the entire debt.[149] While this is a valid concern, there are a number of different factors that suggest this concern does not have enough impact to prevent modification in bankruptcy. First, foreclosures are costly to creditors and they do not usually result in receipt of the full value of the property.[150] Although creditors can pursue a deficiency judgment against the debtor, this is also costly and many states have antideficiency statutes, which prevent the creditor for receiving the full value of the property.[151] Therefore, the possibility of a bankruptcy modification should not have anymore of an affect on pricing and credit availability than the possibility of foreclosure.

Second, a study conducted by Adam Levitin used three measures of mortgage pricing to compare single family primary residences with vacation homes and multifamily residences, which are not subject to the anti-modification provision in bankruptcy.[152] The study revealed that all three measures indicated that pricing in the mortgage markets is not affected by modification.[153] Levitin's findings suggest that permitting modification in a Chapter 13 bankruptcy would not have the negative impact on pricing in the mortgage market as originally thought. Any impact, if at all, would be small and most likely affect the highest-risk borrowers,

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[149] Levitin, *supra* note 89, at 586.

[150] Nina Liao, *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, 2253 (2009).

[151] Liao, *supra* note 150.

[152] Levitin, *supra* note 89, at 579.

[153] Levitin used three measures: effective mortgage interest rates, PMI rates, and secondary-mortgage-market pricing from Fannie Mae and Freddie Mac. For further discussion of these measures and the study, see Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 579 (2009).

which would be beneficial because it would hopefully discourage aggressive lending by either not lending to borrowers who could not afford the loan.[154] Finally, Levitin found that lenders receiving a modified return on a mortgage loan would collect as much, if not more than a foreclosure.[155] The result of his study demonstrates that modification is not only a viable option to avoid foreclosure, its effects on pricing in the credit markets are insubstantial and therefore, the broader policy of affording protection to creditors at the expense of debtors is not legitimate. However, Levitin's study has received critiques from opponents to bankruptcy modification, most notably Mark Scarberry. Scarberry asserts that Levitin relies on empirical evidence that does not take into account the substantial changes that would need to be made to the cram down provision in order to make it feasible for homeowners.[156] Therefore, Levitin's study cannot accurately depict the real risk that would impact mortgage pricing.[157] Scarberry's argument reflects the necessity for the final condition on the proposed modification amendment, which is that modifications should be allowed only for primary residences where borrowers spend 30% or more of their monthly income at the time the loan is made on housing.

By qualifying the amendment of § 1322(b)(2) to allow modification on primary residences only to borrowers that spend 30% or more of their monthly income at the time the loan is made on housing, pricing on affordable loans will be unaffected and lenders will be forced to price risk in the unaffordable category appropriately. Those that have the greatest likelihood of facing foreclosure will be helped, while the long-term goal of maintaining stability

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[154] *Id.* at 599, 602.

[155] *Id.* at 602.

[156] Mark S. Scarberry, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13*, PEPP. L. REV. (forthcoming 2010), *available at* http://ssrn.com/abstract=1520794.

[157] *Id.*

in the credit markets once the economy has recovered will be preserved. Lenders who avoid subprime lending and exotic mortgage products will still receive the full benefit of the bargain. This being the case, more lenders should avoid aggressive lending strategies in order to be able to avoid the modification provision in bankruptcy. By qualifying the modification amendment to borrowers in the unaffordable range, debtors who need foreclosure prevention assistance the most will benefit but the long-term goal of maintaining the credit market will also be supported.

IV. Conclusion

The Obama Administration's Making Homes Affordable Plan promoting loan modifications through a partnership with the government and lenders is in theory a viable method of avoiding foreclosures and stabilizing the housing market. However, in practice, the Plan is riddled with problems, most notably the fact that housing foreclosures are outpacing the modifications. As a result, the Government should not utilize more of taxpayer's funds to fix the problem, in what is akin to trying to stop a hemorrhaging wound with a Band-Aid. Instead, the focus should be on amending Chapter 13 of Bankruptcy Code to allow for homeowners to modify the lender's claim on their primary residence when the debtor's housing costs are in the unaffordable range. An amendment to the Bankruptcy Code will not only address the current mortgage foreclosure crisis, but it will also reflect the policy shift in the credit markets regarding the need to preserve the original terms of a primary residence mortgage.