THE HOME MORTGAGE AND CHAPTER 13: AN ESSAY ON UNINTENDED CONSEQUENCES

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INTRODUCTION

Assume a bank holds a $400,000 loan secured by a mortgage[1] on Bertha Borrower's home (her principal residence). The value of Bertha's home has fallen to $200,000. Bertha is in default under the mortgage and the mortgagee notifies her that it intends to foreclose. In response, Bertha files a voluntary petition for chapter 13 relief which stays any potential foreclosure. If the amendments now before Congress[2] are enacted, the following, *inter alia*, can happen to that mortgage loan in chapter 13. The mortgage may be reduced to the $200,000 value of the property, leaving a mortgage with a 100% loan-to-value ratio.[3] The term of the loan may be

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[1] Throughout this essay we refer to a security interest in real estate as a "mortgage." Where the word mortgage is employed, it is meant to apply as well to a deed of trust, trust deed or other designation of a security interest in real property. *See* First Am. Title Ins. Co. v. First Trust Nat'l Ass'n (*In re* Biloxi Casino Belle Inc.), 368 F.3d 491, 499 (5th Cir. 2004) (stating "[m]ortgages, deeds of trust, and trust deeds are all generally understood to refer primarily . . . to documents that create security interests in land").

[2] Two major bills before Congress at this writing provide for modifications of principal residence mortgages in chapter 13: H.R. 1106, introduced by Congressman Conyers, was passed by the House of Representatives on March 5, 2009 (hereinafter the "House Bill"), and S.61, introduced by Senator Durbin (hereinafter the "Senate Bill"). Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 1106, 111th Cong. (1st Sess. 2009) (stating purpose is "[t]o prevent mortgage foreclosures and enhance mortgage credit availability"); Helping Families Save Their Homes in Bankruptcy Act of 2009, S. 61, 111th Cong. (1st Sess. 2009) (stating purpose is "[t]o amend title 11 of the United States Code with respect to modification of certain mortgages on principal residences, and for other purposes"). The proposed changes to chapter 13 collectively will be referred to herein as the "Amendments."

[3] The loan-to-value ratio is the percentage determined by comparing the amount of the loan to the value of the property securing the loan. *See* Alex M. Johnson, Jr., *Adding Another Piece to the Financing Puzzle: The Role of Real Property Secured Debt*, 24 LOY. L.A. L. REV. 335, 342 n.47 (1991) ("Loan-to-value is the percentage which expresses the amount of the loan when compared to the appraised or accepted value of the property."). In normal times, this is usually about 75–80%. *See* MICHAEL T. MADISON, JEFFRY R. DWYER & STEVEN W. BENDER, THE LAW OF REAL ESTATE FINANCING §7.3 (2d ed. 2008) ("The most common maximum loan-to-value ratio . . . is 75 percent."); *see also* Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 541 (2001) (describing loan-to-value ratio of less than 70% as "relatively conservative"); Michael H. Schill, *Uniformity*

extended by many years. The interest rate may be reduced based on a formula that differs in the bills before Congress, plus a "reasonable" premium for risk, and any prepayment fee or interest rate adjustments associated with the mortgage loan may be eliminated. This represents a radical change from current law, which has a "safe harbor"[4] in chapter 13, under which a plan may not modify the rights of a holder of a mortgage on the debtor's principal residence.[5] This Safe Harbor will be eliminated for most loans on a debtor's principal residence under the Amendments.

The Amendments are obviously the result of the subprime crisis and the current economic meltdown, which has left vast numbers of homeowners in danger of losing their homes.[6] It is expected that the Amendments will be beneficial to those homeowners who file in chapter 13 without enormous initial injury to those affected lenders that may be recipients of governmental largesse to clean their portfolios of "toxic" loans.[7] Unfortunately, the Amendments may produce unintended consequences, which may result in serious harm to both borrowers and lenders, and may have the potential of casting at least a shadow over the ability to meet statutory and constitutional requirements for confirmation of plans in chapter 13.

The Safe Harbor itself helped to produce the problematic consequences that today's Amendments are designed to cure. However, the Amendments go well beyond simply undoing the Safe Harbor. They make dramatic changes in the mortgagee's bargain that may be a source of "buyers' remorse" for its proponents if the Amendments are adopted in their present form. This essay will discuss the

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or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets, 64 S. CAL. L. REV. 1261, 1268 (1991) (noting, in practice of mortgage loan origination, "a loan-to-value ratio of 80 percent or less" is typically required).

[4] This safe harbor will hereinafter be referred to as "Safe Harbor."

[5] Section 1332(b)(2) provides that a chapter 13 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, ..." 11 U.S.C. § 1322(b)(2) (2006).

[6] According to Credit Suisse estimates, some five million homes have entered foreclosure in the past three years, and over nine million more will be in the foreclosure process in the next four years. *Can't Pay or Won't Pay?*, ECONOMIST, Feb. 21, 2009, *available at* http://www.economist.com/world/unitedstates/displaystory.cfm?story_id=13145396 ("In normal times, new foreclosures run at fewer than [one million] a year."). *See* Dan Levy, *Foreclosure Filings in U.S. Jumped 30% in February*, BLOOMBERG.COM, Mar. 12, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFS4Zbll06TU (depicting worsening conditions in housing market where "[a] total of 290,631 homes received a default or auction notice or were seized by the lender" in February 2009); *Overdue Mortgage Payments on Rise*, WALL ST. J., Mar. 6, 2009, at A5 (stating overdue mortgages and foreclosure rates are currently highest in forty years with "11% of mortgages on one- to four-family homes . . . at least a month overdue or in the foreclosure process at the end of 2008"); Sheryl Gay Stolberg and Edmund L. Andrews, *$275 Billion Plan Seeks to Address Crisis in Housing*, N.Y. TIMES, Feb. 19, 2009, at A1 (describing "tidal wave of foreclosures" and estimating that "[a]lmost one in 10 home mortgages is either delinquent or in foreclosure").

[7] For example, analogous to the Herculean effort to clean the stall, the Federal "government has invested $52 billion in Citi[bank], while agreeing to eat up to $249 billion in losses on the bank's toxic real estate portfolio." Editorial, *Bank of the United States*, WALL ST. J., Jan. 12, 2009, at A12. The editorial suggests that Citibank's endorsement of the Amendments is "a case of Citi colluding with its new political owners in order to force competing banks to break contracts and take more losses." *Id. See* Patrice Hill, *Citi Receives Third Rescue as U.S. Ratchets Up Stake*, WASH. TIMES, Feb. 28, 2009 at A01 (discussing government's exchange of debt for equity shares of Citibank and the granting of certain governmental guarantees).

unintended consequences resulting from the 1978 enactment of the Safe Harbor as well as the unintended consequences that could result from the enactment of the Amendments. At this writing, while the House Bill has been passed, developing opposition from some Democrats, as well as many Republicans, may prevent Senate action at least in this session.[8] However, the final content of the Amendments is still being negotiated. This essay, albeit with the compulsion of a hard deadline, deals with what we perceive to be the provisions that will probably be included if legislation is enacted. Part I will review the circumstances giving rise to the enactment of the Safe Harbor in 1978, and the unintended consequences it promoted. Part II will briefly review the Amendments and their affect on the rights of mortgagees. Part III will discuss a systemic problem the Amendments may force us to consider that may shed doubt on the ability, both statutorily and constitutionally, to confirm chapter 13 plans. We conclude that while the proposed elimination of the Safe Harbor is beneficial, the modifications of mortgages permitted under the Amendments are fraught with potential problems and possible adverse consequences. Finally, we will suggest alternative amendments as an approach to the sometimes necessary Bankruptcy Code interference with individual lawful transactions, which may serve to mitigate the potential adverse consequences caused by such interference.

I. THE ENACTMENT OF THE SAFE HARBOR

Unintended consequences are not new to chapter 13 and its provisions dealing with home loans. It started in 1978 when the Bankruptcy Code was enacted[9] containing the well-intentioned but ill-conceived Safe Harbor in chapter 13 protecting the rights of holders of mortgages on a debtor's principal residence, a provision that became one of the initial motivating factors leading to the current crisis.

Under the former chapter XIII of the Bankruptcy Act[10] confirmation of a plan required the unanimous approval of all secured creditors whose claims were dealt with by the plan.[11] Thus confirmation of a plan modifying the rights of any secured creditor would not have been possible without the secured creditor's approval. The

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[8] *See* CONGRESSDAILY (Apr. 9, 2009), http://www.nationaljournal.com/congressdaily (reporting legislation may be placed on back burner in Senate in light of opposition from Republicans and moderate Democrats).

[9] The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (enacting title 11 of United States Code governing bankruptcy proceedings).

[10] Act of July 2, 1898, ch. 541, § 2, 30 Stat. 544 (1898) (repealed 1978). The Act was substantially amended by the Chandler Act of 1938 which added chapter XIII for "Wage Earner Plans." Chandler Act of 1938, ch. 575, 52 Stat. 840 (1938) (repealed 1978).

[11] 11 U.S.C. § 1052(1) (1976) (originally enacted as 13 U.S.C. § 652(1)) (requiring approval by majority in number of unsecured creditors "and by the secured creditors whose claims are dealt with by the plan"); There was no provision for cramdown over the objections of any secured creditors. *See* Terry v. Colonial Stores Employee's Credit Union of Atlanta, 411 F.2d 553, 554 (5th Cir. 1969) (barring confirmation of wage earner's plan for failure to get acceptance of "secured creditor[] whose claim [was] dealt with by the plan").

original version of the Bankruptcy Code's section 1322(b)(2) in the House of Representatives[12] was designed to change this by providing that a chapter 13 plan would be able to modify the rights of any holders of secured or unsecured claims. The Senate Bill, on the other hand, contained an exception that would have prohibited modification of any claim "wholly secured by mortgages on real property."[13] In the end, a compromise was reached[14] under which section 1322(b)(2) would permit modification of unsecured claims and of secured claims "other than a claim secured only by a security interest in real property that is the debtor's principal residence." The Safe Harbor was born.

It might seem curious that this Safe Harbor, protecting mortgage lenders making loans to residential borrowers, was enacted at all, and especially in 1978.[15] At that time our President was Jimmy Carter, a Democrat. The Democrats ruled both the House and the Senate—292-143 in the House, and 61-39 in the Senate (the last time to this day that the Democrats had a filibuster proof majority in the Senate).[16] These are not people who would normally be pictured as being involved in a cabal with lenders against homeowners. Perhaps there was another motive.

That other motive may have come, surprisingly, by way of the lenders. In hearings before the Subcommittee on Improvements in the Judicial Machinery of the Senate Committee on the Judiciary in 1977,[17] Edward J. Kulik, Senior Vice President of the Real Estate Division at Massachusetts Mutual Life Insurance Company, speaking on behalf of the Independent Bankers Association, The Mortgage Bankers Association, The National Association of Mutual Savings Banks,

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[12] 123 CONG REC. H8200, at 35,670 (1st Sess. 1977) (proposing, in H.R. 8200, in subchapter II, section 1322, to allow modification of rights of secured and unsecured creditors). *See* Lomas Mortgage, Inc. v. Louis, 82 F.3d 1, 4–5 (1st Cir. 1996) (observing original House version allowing modification of secured and unsecured claims was different from final version due to compromise with Senate).

[13] S. 2266, 95th Cong., subch. II (2d Sess. 1978). *See* Patricia Lindauer, Note and Comment, *Optimizing the "Fresh Start": Mortgage Cramdown Under Chapter 13 of the Bankruptcy Code*, 11 J.L. & COM. 257, 269 (1992) (discussing Senate Bill's version of section1322(b) which excepted residential mortgage lenders "from the debtor's power to modify secured claims"); Brian K. Van Engen, Nobelman v. American Savings Bank: *The Supreme Court's Answer Raises More Questions*, 20 J. CORP. L. 363, 366 (1995) (describing legislative history of Senate Bill and its limitation on modifying mortgages).

[14] The final version of section 1322(b)(2) was characterized as a "compromise agreement" by the legislative leaders in both houses. 124 CONG. REC. H11089, at 32,392 (2d Sess. 1978) (statement by the Hon. Don Edwards, Chairman, Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary) (describing final version as "good compromise"); 124 CONG. REC. S17406, at 33,990 (2d Sess. 1978) (statement by the Hon. Dennis DeConcini, Chairman, Subcomm. on Improvements in the Judicial Machinery of the Senate Comm. on the Judiciary) ("Both Houses should take pride in the final compromise product.").

[15] *See* Nobelman v. Am. Sav. Bank, 508 U.S. 324, 332 (1993) (Stevens, J., concurring) ("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.")

[16] *See* United States Senate, Party Division in the Senate, 1789–Present, http://senate.gov/pagelayout/history/one_item_and_teasers/partydiv.htm (last visited Apr. 4, 2009) (providing party divisions within Senate from 1789 to present).

[17] *Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Comm. on the Judiciary*, 95th Cong. 702–21 (1977), *microformed on* CIS No. 78-S521–31 (Cong. Info. Serv.) [hereinafter *Hearings on S. 2266 and H.R. 8200*].

The National Association of Real Estate Investment Trusts, and the United States League of Savings Associations, argued that the House version of the legislation would "cause residential mortgage lenders to be extraordinarily conservative in making loans in cases where the general financial resources of the individual borrower are not particularly strong."[18] His counsel, Robert O'Malley, added that if mortgages could be modified in bankruptcy, the savings and loans would be "more conservative than they are now in the flow of credit."[19]

It is possible that Mr. Kulik may have been most concerned about protecting the residential mortgage loan portfolios of Massachusetts Mutual or the other institutions he represented as well as encouraging investment in Real Estate Investment Trusts, but his argument that the lack of a Safe Harbor would encourage conservative underwriting of residential loans obviously struck a chord with those who decried "red lining"[20] and believed that the nation would be benefited by easier

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[18] *Id.* at 714 (statement of Edward J. Kulik, Senior Vice President of Real Estate Div., Mass. Mutual Life Ins. Co.). *See* Lomas Mortgage, Inc. v. Louis, 82 F.3d 1, 5 (1st Cir. 1996) (observing section 1322(b)(2) "appears to have been the product of [Kulik's] testimony"); *In re* Strober, 136 B.R. 614, 621 (Bankr. E.D.N.Y. 1992) (highlighting Kulik's testimony as to negative effects of forced cramdown on real estate).

[19] *Hearings on S. 2266 and H.R. 8200*, *supra* note 17, at 715 (statement of Robert O'Malley, Attorney, Covington & Burling). *See id.* at 652–53 (statement of Alvin O. Wiese, Jr., Chairman, National Consumer Finance Association, Subcomm. on Bankruptcy) (arguing for limits on proposed section 1322(b)(2) to better protect value of secured creditors' collateral). Various courts and commentators have commented on this legislative process. *See Lomas Mortgage*, 82 F.3d at 5 (discussing Senate and House of Representatives' versions of section 1322(b)(2) being "shaped into a compromise bill through a series of agreed-upon floor amendments" during which "the Senate backed off its position that no modifications would be permitted"); Grubbs v. Houston First Am. Sav. Ass'n, 730 F.2d 236, 246 (5th Cir. 1984) (explaining Senate preferred to amend section 1322(b)(2) so *all* claims secured by real estate were barred from modification, but compromised with House to limit anti-modification to claims "'secured only by a security interest in real property *that is the debtor's principal residence*'"); Jane Kaufman Winn, *Lien Stripping After* Nobelman, 27 LOY. L.A. L. REV. 541, 567–68 (1994) (discussing compromise between Senate and House of Representatives' opinions of section 1322(b)(2), remarking that since subcommittee never reported its findings, actual impact of Kulik's testimony on "final Senate determination" is "impossible to determine").

[20] "Red lining" is a perceived practice of financial institutions in refusing to make loans in low income and predominantly minority areas because of credit risks associated with those neighborhoods. *See* NAACP v. Am. Family Mut. Ins. Co., 978 F.2d 287, 290 (7th Cir. 1992) ("'Redlining' is charging higher rates or declining to write insurance for people who live in particular areas . . . ."); United Cos. Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 203 n.5 (D. Mass. 1998) ("Redlining is the practice of denying the extension of credit to specific geographic areas due to the income, race, or ethnicity of its residents."). The name stems from the concept that the institutions seemingly draw a red line around those areas within which no loans will be made. *See NAACP*, 978 F.2d at 290 (remarking redlining is done "figuratively, sometimes literally, enclosed with red lines on a map"). This practice gave rise to several pieces of federal legislation designed to cause regulated financial institutions to demonstrate that they serve the convenience and needs of the communities in which they are charted to do business, including the Community Reinvestment Act ("CRA") and the Home Mortgage Disclosure Act ("HMDA"). Community Reinvestment Act of 1977, 12 U.S.C. § 2901–08 (2000); Home Mortgage Disclosure Act of 1975, 12 U.S.C. § 2801–10 (2000). *See* Michael S. Barr, *Credit Where it Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 523 (2005) (examining history and purpose of CRA and HMDA "to address racial discrimination as well as lack of access to credit in low- and moderate-income communities"); Marcia Johnson et al., *The Community Reinvestment Act: Expanding Access*, 12 KAN. J.L. & PUB. POL'Y 89, 90 (2002) (discussing policy rationale of CRA as being a "response to discrimination by financial institutions against racially and ethnically disenfranchised people and their communities"). *But see* Hicks v. Resolution Trust Corp., 970 F.2d 378, 382 (7th Cir. 1992) (construing CRA as "financial in its nature" and not "intended to prevent racially

credit for home buyers because it would enable more people to achieve the American Dream of home ownership. In *Nobelman*, Justice Stevens concluded that legislative history indicated "favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market."[21] So the Safe Harbor was not just protection for lenders; it was in large measure an experiment in social engineering through the Bankruptcy Code, an experiment that had unintended consequences for the lenders, borrowers and the national economy.

Certainly, the Safe Harbor for principal residence mortgages in chapter 13 did not alone cause the subprime crisis. However it was a motivating factor that, together with such events as the relaxation of qualitative restrictions on institutional lending;[22] the development of structured finance for the securitization of residential mortgages (invented in 1970, but a "success story" by the mid 1980s,[23] moving the heart of real estate lending from Main Street to Wall Street[24]); and, the misuse of

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discriminatory lending policies or minority 'redlining'"). Various studies have analyzed the causes, effects, and problems associated with red lining. *See* Henry M. Jay, Note and Comment, *Full Disclosure: How Should Lenders Respond to the Heightened Reporting Requirements of the Home Mortgage Disclosure Act?*, 10 N.C. BANKING INST. 247, 247–48 (2006) (noting HMDA's strict disclosure standard may expose financial institutions to much "fallout, scrutiny, and [] litigation"); Craig E. Marcus, Note, *Beyond the Boundaries of the Community Reinvestment Act and the Fair Lending Laws: Developing a Market-Based Framework for Generating Low- and Moderate-Income Lending*, 96 COLUM. L. REV. 710, 710 n.2 (1996) (reporting low numbers of banks in less affluent neighborhoods); David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1700–01, 1712, 1721 (2004) (highlighting ramifications of past redlining lingering in today's society); Lawrence J. White, *Financial Modernization: What's in It for Communities?*, 17 N.Y.L. SCH. J. HUM. RTS. 115, 123–25 (2000) (positing CRA hurts financial institutions by decreasing their profits and ability to cross-subsidize).

[21] Nobelman v. Am. Sav. Bank, 508 U.S. 324, 332 (1992) (Stevens, J., concurring). *See* First Nat'l Fid. Corp. v. Perry, 945 F.2d 61, 64 (3d Cir. 1991) (finding Safe Harbor "was intended to make home mortgage money on affordable terms more accessible to homeowners by assuring lenders that their expectations would not be frustrated").

[22] An example of this can be found in the 1983 revision of the investment limitations for life insurance companies in New York. N.Y. INS. LAW § 81 (1977), *amended by* L. 1984, ch. 367 (1984) (current version at N.Y. INS. LAW § 1404(4)(A)(v) (2009) (permitting loan-to-value ratio up to ninety percent)). The amendments modified the "complex qualitative limitations" on life insurance company investments to relinquish the "minutely detailed specifications of permitted investments . . . [then] found in sections 81 and 80(3) of the Insurance Law and substitute[d] increased reliance on prudent management under the supervision of the board of directions." NEW YORK STATE, LEGISLATIVE ANNUAL 1983, at 245–46 (New York Legislative Service, Inc. 1983). As a result, no longer did real estate mortgage loans have to meet a certain loan-to-value ratio (normally 75%), allowing life insurance companies to make loans with greater risk factors. *See supra* note 3.

[23] *See* David Alan Richards, *"Gradable and Tradable": The Securitization of Commercial Real Estate Mortgages*, 16 REAL EST. L.J. 99, 102 (1987) (referring to residential mortgage securitization, "invented in 1970," as "success story"); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380–83 (1991) (describing historical background of securitization which was "not recognized as a significant financial innovation until the 1970s and 1980s").

[24] *See* Joseph Philip Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J. 489, 490 (1996) (discussing evolution of Wall Street's increased involvement in real estate market); Georgette Chapman Poindexter, *Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing*, 2 BERKELEY BUS. L.J. 233, 237 (2005) (documenting shift in real estate financing from Main Street to Wall Street in 1980s); Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 562 (2001) (highlighting Wall Street's increased involvement in real estate financing).

the securitization process, including so-called reverse red lining[25] and developing conflicts of interest for rating agencies;[26] led inextricably to the excess in home mortgage lending of the recent past.[27]

So now Congress is considering how to undo the social engineering of 1978. Interestingly, had chapter 13 been enacted in 1978 without the Safe Harbor, lenders probably would not have suffered as much, nor would underwriting have become as restrictive as the testimony before the Senate predicted it would. True, it would have been possible in chapter 13 for borrowers to strip down their principal residence mortgages to the depressed value of the collateral, but it is doubtful that most borrowers in chapter 13 would have availed themselves of that opportunity.

The structure of chapter 13, as enacted, would have required the debtor's plan to provide for complete payment of the stripped-down mortgage balance over the three to five year period of the plan, a formidable task for many homeowners in bankruptcy.[28] Borrowers were alternatively permitted to treat the mortgage "outside the plan" (as this process was described in jargon) under section 1322(b)(5); that is, the plan could provide for the curing of the default over a reasonable period of time[29] and making payments as required under any mortgage "on which the last

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[25] When it became clear that lenders, by packaging the loans and selling them in tranches to others, no longer had to worry about the long-term viability of the loans they made, the self-protective lid on imprudent lending no longer functioned. This led to the development of something called "reverse red-lining" where vulnerable populations were targeted with high pressure marketing techniques into high cost loans they had little prospect of repaying. *See* Jean Braucher, *Theories of Overindebtedness: Interaction of Structure and Culture*, 7 THEORETICAL INQ. L. 323, 334 (2006) ("Subprime lending focuses on those who are already overindebted and even in default. 'Reverse red-lining' involves targeting vulnerable populations such as racial minorities, women and the elderly . . . ."); *see also* Monica Pinciak-Madden & Katya Jestin, *Subprime Crisis: The Unraveling Promises To Increase the Number of Civil Suits and Criminal Investigations*, N.Y. L.J., Jan. 5, 2009, at S4 (noting "[h]igh-risk, high-interest subprime loans to borrowers with low credit scores . . . had moved from being a niche product in the industry to accounting for almost 14 percent of all mortgages outstanding during" first half of decade); *cf.* Nomi Prins, *The Risk Fallacy*, FORTUNE, Nov. 10, 2008, at 112 (noting "systems the banks created to protect themselves are at the heart of the financial meltdown").

[26] *See generally* Kara Scannell, *SEC Puts Ratings Firms on Notice*, WALL ST. J., Apr. 16, 2009, at C6.

[27] The consequences of these excesses are clearly seen in minority communities. *See* John P. Relman, *Foreclosures, Integration, and the Future of the Fair Housing Act*, 41 IND. L. REV. 629, 636 (2008) ("Nationwide, the impact of the foreclosure crisis is felt most acutely in minority communities."); Susan Schmidt & Maurice Tamman, *Housing Push for Hispanics Spawns Wave of Foreclosures*, WALL ST. J., Jan. 5, 2009, at A1 (noting consequences of legislation designed to "'open the doors to the American Dream'" and stating "[i]n 2005 alone . . . expensive nonprime mortgages [to Hispanics] . . . [were] soaring 169%").

[28] *See* 11 U.S.C. § 1322(d) (2006) (delineating statutory time limits for plan length and proscribing periods longer than five years). Section 1322(d) does not permit a plan to provide for payments beyond the three or five year period of the plan, based on certain income qualifications. *Id.* This is one of the reasons a new chapter, chapter 12, was needed in 1986 when protection was being written for the family farmer. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, 11 U.S.C. §§ 1201–31 (1986) (adding chapter 12 to title 11 for family farmer debtors). That chapter, which otherwise closely follows chapter 13, added subsection (9) to section 1222, a corollary of section 1322, which allows the plan to provide for payment of an allowed secured claim over a period exceeding the three or five year period permitted under section 1222(c). 11 U.S.C. § 1222(b)(9), (c) (2006).

[29] 11 U.S.C § 1322(b)(5) (2006) (permitting cure "of any default within a reasonable time"). *See* Grubbs v. Houston First Am. Sav. Ass'n, 730 F.2d 236, 247 (5th Cir. 1984) (holding curing of default on principal residence after pre-petition acceleration was not prohibited modification of home mortgage and permitting

payment is due after the date on which the final payment under the plan is due."[30] In other words, the plan would not modify the mortgage and the borrower would continue to make payments as required under the mortgage.[31] Except for the inconvenience of a rather long period permitted for curing defaults, the mortgage lender would not have been severely hurt if the mortgage were treated outside the plan under this alternative.

Thus, while a realistic look at the chapter without the Safe Harbor should have caused the lenders to say, "we don't like it but we can live with it," the lenders objected, were successful, got the Safe Harbor that helped precipitate the current crisis, and, if the Amendments are passed, will not only lose the Safe Harbor, but will end up with a law that will allow the courts to make what some see as draconian mortgage modifications. Unintended consequences—and how!

II. THE AMENDMENTS

There are two major bills, one in the House of Representatives and one in the Senate, that attempt to do away with the Safe Harbor.[32] Each goes further to expand the entry requirements for filing in chapter 13 and to permit changes in the terms of existing mortgages that may have the effect of depriving the mortgagee of the benefit of a bargain that was sanctioned under law, including the Bankruptcy Code, at the time the mortgages were made. We will make reference to the more significant differences between the House and the Senate versions. Unfortunately, the bills present a moving target as negotiations are being held to try to achieve consensus. Although it appears that enactment is within sight, it is possible that the Act may vary from the language discussed herein. We will first review the Amendments, pointing out some of the ambiguities and problems that may flow therefrom, and then discuss some potential statutory and constitutional issues in areas where the Courts previously have seemingly feared to tread but upon which the Amendments may shed a spotlight that may be hard to ignore.

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cure over thirty-six month life of plan); Di Pierro v. Taddeo (*In re* Taddeo), 685 F.2d 24, 28 (2d Cir. 1982) (allowing deceleration and cure).

[30] 11 U.S.C. § 1322(b)(5).

[31] Before the growth of subprime mortgages, this provision allowing for curing and reinstatement "was all that was needed to avoid the foreclosure, reinstate the mortgage and minimize the loss. Many debtors successfully employ chapter 13 to cure mortgage defaults while still maintaining the regular payments and no modification of the underlying terms was necessary." Henry E. Hildebrand III, *Let's Remove Special Bankruptcy Protection for Subprime Mortgages*, 26 AM. BANKR. INST. J. 14, 14 (Sept. 2007).

[32] *See supra* note 2.

A. Eliminating the Safe Harbor

The Amendments are intended to eliminate the Safe Harbor when the property is threatened with foreclosure. Even this simple attempt to repeal the Safe Harbor is not without some problems.

1. Notice of Foreclosure

The right to modify mortgages is conditioned on the receipt of "a notice that foreclosure may be commenced." Thus, without a notice of foreclosure, the Safe Harbor remains valid. This raises the question of what is a "notice that foreclosure may be commenced?" Would a notice that the borrower is in default suffice as a notice that foreclosure *may* be commenced? If so, would a telephone call: "We didn't receive this month's payment yet" do it? Or is there some kind of formality and words that would be necessary?[33] The House and Senate Bills do not answer these questions. The House Bill provides some specifics. It requires that the debtor submit a "certification that the debtor has received notice that . . . [the mortgagee] may commence a foreclosure."[34] While this specifies a procedure, it does not define for the debtor what a notice of foreclosure is. Given our observation of the bankruptcy courts over the years, our guess is that the language will be treated rather broadly.

One of the authors of this essay, who sometimes demonstrates a peculiarly Machiavellian bent, has suggested that what the mortgagee might do is stop all communication with Bertha Borrower once she is in arrears (in other words, do nothing that could be construed as a notice of potential foreclosure—although he caveats that failure to communicate could serve as an implied notice that foreclosure is probable) and when the amount of the default reaches the section 303(b) limit (currently $13,475), file an involuntary chapter 7 petition against the borrower.[35] Under chapter 7, the mortgage would normally "pass through

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[33] Some state foreclosure statutes have specific requirements for notice prior to foreclosure. *See*, *e.g.*, N.Y. REAL PROP. ACTS. LAW § 1303 (McKinney 2008) (requiring specified notice with specific language and requirements).

[34] H.R. 1106, 111th Cong. § 101 (2009).

[35] This is assuming that there are fewer than twelve entities holding claims against the prospective debtor. Otherwise, the mortgagee would need two other claimants to join in the petition under section 303(b)(1)–(2). 11 U.S.C. § 303(b)(1)–(2) (2006) (providing differing guidelines for involuntary filing depending on how many creditors debtor has). Since it might be difficult for the mortgagee to determine at this stage the number of claims against the prospective debtor, the three claimant approach might be safer, but certainly more difficult. *See* FED. R. BANKR. P. 1003(b) ("If it appears that there are 12 or more creditors as provided in § 303(b) of the Code, the court shall afford a reasonable opportunity for other creditors to join in the petition before a hearing is held thereon."); *see also* Liberty Tool, & Mfg. v. Vortex Fishing Sys., Inc. (*In re* Vortex Fishing Sys., Inc.), 277 F.3d 1057, 1061 (9th Cir. 2001) ("[The court] must assure that other creditors have a 'reasonable opportunity' to exercise their § 303(c) statutory power to join as petitioners when the alleged debtor's answer to the petition filed by fewer than three petitioners asserts that the petition fails the § 303(b)(1) three-petitioner requirement for debtors with twelve or more creditors.") (citation omitted).

bankruptcy unaffected",[36] leaving the mortgagee with the full amount of the debt or the property.[37] Of course Bertha may be able to convert the case to a chapter 13,[38] but she would enter chapter 13 without having received a foreclosure notice, and her plan would have to be subject to the restriction of the Safe Harbor.

This suggestion raises questions that careful drafting might have avoided. If the issue is raised, the courts may react by dismissing the chapter 7 involuntary petition on the ground that it was not filed in good faith[39] or even perhaps massaging the language of the statute to construe the filing of the involuntary petition as the equivalent of a foreclosure notice.

2. To What Mortgages do the Amendments Apply?

The House Bill contains an important restriction on the ability to avoid the Safe Harbor that the Senate Bill does not. It provides that the mortgage on the principal residence may be modified only if the mortgage was originated *before* the effective date of the Amendments. This indicates an intention to deal just with existing mortgages in the present crisis and allow the Safe Harbor to continue to apply to all new loans, perhaps avoiding the argument that the Amendments will make it difficult for solid people of modest means to obtain mortgage financing or result in higher interest rates for borrowers in the future. While it may be true that lenders have short institutional memories, it is difficult to believe that they would soon feel safe enough to again make loans to anyone who does not have a really good credit rating. As a result, red lining concerns may be bolstered by statistical validity.

The Senate Bill is not restricted to existing mortgages, but will apply to all mortgages entered into before or after the effective date. This difference between

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[36] Dewsnup v. Timm, 502 U.S. 410, 417 (1992).

[37] In the usual chapter 7 case where the mortgage is in default, if the debtor had equity in the property, the trustee would order a sale of the property at which the mortgagee could credit bid to protect itself. 11 U.S.C. § 363(k) (2006) (allowing holder of a claim secured by property being sold to "bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property"); *see In re* Antaeus Technical Servs., Inc., 345 B.R. 556, 562 (Bankr. W.D. Va. 2005) ("[A] secured creditor generally has a right to 'credit bid' in a bankruptcy sale pursuant to section 363(k) of the Bankruptcy Code."); Mark S. Scarberry & Scott M. Reddie, *Home Mortgage Strip Down in Chapter 13 Bankruptcy: A Contextual Approach to Sections 1322(b)(2) and (b)(5)*, 20 PEPP. L. REV. 425, 477 n.358 (1993) (explaining, even under section 363(k), mortgagee has right to "bid its entire debt at the foreclosure sale"). If there were no equity in the property, then the trustee might lift the stay and abandon the property so the mortgagee could foreclose. 11 U.S.C. § 554(a) (2006) ("[T]he trustee may abandon any property of the estate that is . . . of inconsequential value and benefit to the estate."); *see In re* Paolella, 79 B.R. 607, 609–10 (Bankr. E.D. Pa. 1987) (observing frequent recognition by courts "that where the estate has no equity in a property, and the estate is to be liquidated, abandonment will virtually always be appropriate, because no unsecured creditor could benefit from its administration").

[38] 11 U.S.C. § 706(a) (2006) (providing debtor may convert chapter 7 case to chapter 13 case "at any time").

[39] *See* United States Optical, Inc. v. Corning Inc. (*In re* United States Optical, Inc.), No. 92-1496, 1993 U.S. App. LEXIS 6960, at *9–10 (4th Cir. Apr. 1, 1993) (stating "[c]ourts are duty bound to conduct an inquiry, if requested, to determine whether an involuntary petition has been filed in good faith"); *In re* Sky Group Int'l, Inc., 108 B.R. 86, 90 (Bankr. W.D. Pa. 1989) (applying good faith standard to an involuntary chapter 7 case).

the House and Senate versions of the Amendments is one of the important issues that must be resolved before a bill can be enacted.

3. Negotiation Prerequisite

The House Bill (but not the Senate Bill as it is currently written) adds a new subsection (h) to section 1322 under which modification of the mortgage would be permitted only if the debtor certifies either: (i) that the debtor has contacted the lender within the time periods specified regarding modification of the loan, and furnished the lender with a statement of income, expenses and debt; or (ii) that a foreclosure sale is scheduled within thirty days of the commencement of the case.[40] This new subsection was recently added and appears to be an attempt to blunt the argument that the legislation should be delayed "to give homeowners and lenders more time to modify the terms of existing mortgages."[41]

B. Changes Permitting Substantive Modification of Mortgages

All Congress would have to do to permit strip-down of mortgages on the debtor's principal residence would be to eliminate the Safe Harbor and allow the plan to provide for payment of the stripped down mortgage balance over the term of the loan even if it extended beyond the period of the plan. This would mean that, in the hypothetical at the beginning of this essay, Bertha Borrower's debt service would be decreased substantially since the interest under the mortgage would be applied to a balance that was half the size of the mortgage prior to chapter 13 filing. This is what chapter 12 did to save the Family Farmer in 1986.[42] The drafters of the Amendments, however, have proposed more thorough changes to modify the lender's rights under the mortgage.

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[40] This is a highly simplified version of the proposed subsection (h). The subsection, *inter alia*, contains specific requirements for the time the negotiations must be commenced and specifies different requirements for cases commenced after the thirty days following the effective date of the Amendments and cases filed before that date. Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103 (2009) (outlining proposed amendments to section 1322 of title 11).

[41] John Conyers Jr., Op-Ed., *Loan Modification Can Stop the Foreclosure Crisis*, WALL ST. J., Jan. 30, 2009, at A11. Interestingly, Mr. Conyers asserts in this piece that "[f]or more than three decades, the bankruptcy code has permitted the very kind of court modification we are considering today, for every other form of secured debt . . . ." *Id.* This would seem to be inaccurate. While it is true that the elimination of the Safe Harbor alone would bring chapter 13 in line with the rest of chapter 13 and other chapters that permit secured debt to be modified, those chapters do not permit the modifications of the scope permitted under the Amendments. *See* 11 U.S.C. § 1322(b)(2) (2006) (allowing plan to "modify the rights of holders of secured claims"); Till v. SCS Credit Corp., 541 U.S. 465, 475 (2004) (positing "in cases . . . involving secured interests in personal property, the court's authority to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract is perfectly clear"); Scarborough v. Chase Manhattan Mortgage Corp. (*In re* Scarborough), 461 F.3d 406, 411 (3d Cir. 2006) (observing "a creditor who takes *any* interest in personal property forfeits the benefit" of "anti-modification protection of § 1322(b)(2)").

[42] *See* 11 U.S.C. § 1222(b)(9) (2006) (providing for payment of allowed secured claims over longer period of time than three- to five-year plan period).

1. Strip-Down

Strip-down of secured claims is not new to chapter 13, or for that matter, chapter 11. Under section 506(a), an undersecured claim is a secured claim to the extent of the value of the collateral and an unsecured claim for the deficiency between the value of the collateral and the amount of the loan. As discussed below, the problem for the chapter 13 mortgagee is that, unlike chapter 11, there is no "fair and equitable" absolute priority for the unsecured claim.

In our hypothetical, the lender's $400,000 loan on Bertha Borrower's house would be bifurcated under section 506(a) into a secured claim for $200,000 and an unsecured claim for $200,000.[43] While section 1325(a)(5)(B)(ii) purports to insure that the value of the payments under the stripped-down lien as of the effective date of the plan will equal the $200,000 value of the collateral, chapter 13 guarantees very little with respect to the $200,000 unsecured claim, except that unsecured creditors must receive at least what they would have received under chapter 7, which may not be much.[44] Mechanically, the strip-down is accomplished by making a new subsection (11) containing the mortgage modifications under the Amendments applicable "notwithstanding paragraph (2)" of section 1322(b). If we apply this to our hypothetical, as a result of the strip-down under chapter 13, Bertha Borrower's lender will, realistically, have its debt cut in half.

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[43] 11 U.S.C. § 506(a) (2006) (bifurcating undersecured creditor's claim into secured and unsecured claims based on value of underlying collateral). This is assuming that the loan is recourse, which is probably the case in chapter 13. Otherwise, there is no provision in chapter 13 for conversion of a nonrecourse claim into a recourse claim, such as section 1111(b). 11 U.S.C. § 1111(b) (2006) (treating allowed secured claim in chapter 11 as recourse "whether or not such [claim] has such recourse").

[44] *See* 11 U.S.C. § 1325(a)(4) (2006) (allowing plan to be confirmed if unsecured creditors are to receive amount "not less than the amount that would [have been] paid" under chapter 7 proceeding). In addition to this, on objection by an unsecured creditor, section 1325(b)(1) requires that all "disposable income" as therein defined, will be applied to make payments under the plan. 11 U.S.C § 1325(b)(1)(B) (2006). *See* Maney v. Kagenveama (*In re* Kagenveama), 541 F.3d 868, 872 (9th Cir. 2007) (discussing how section 1325(b)(1) allows confirmation of plan over objection of "a trustee or holder of an allowed unsecured claim . . . only if the plan provides that all of the debtor's 'projected disposable income' received during the 'applicable commitment period' is applied to make payments under the plan"). It is not clear how much good this does for the objecting unsecured creditor since it is the payments under the plan to which the creditor is objecting to in the first place. *See In re* McGovern, 282 B.R. 506, 509 (Bankr. S.D. Fla. 2002) (holding requirement that disposable income be used to make payments under plan does not require an increase in payments under plan despite objection by unsecured creditor). A creditor may, however, move for modification of the plan under section 1329 after confirmation to increase payments. 11 U.S.C. § 1329(a) (2006) (permitting plan to be modified post-confirmation "upon request of the debtor, the trustee, or the holder of an allowed unsecured claim"); *see* Waldron v. Brown (*In re* Waldron), 536 F.3d 1239, 1245 (11th Cir. 2008) ("When a debtor discloses assets acquired after confirmation, creditors may move the bankruptcy court to modify the plan to increase payments made by the debtor to satisfy a larger percentage of the creditors' claims."). Furthermore, courts may of course consider on confirmation whether the payments under the plan represent an appropriate portion of disposable income. *See In re* Gleason, 267 B.R. 630, 635 (Bankr. N.D. Iowa 2001) (denying confirmation of debtors' plan after trustee's objection as "Debtors' disposable income allows monthly plan payments substantially larger than proposed"); *cf. In re* Belt, 106 B.R. 553, 562 (Bankr. N.D. Ind. 1989) ("The Code requires a meaningful and realistic budget accompanied by devotion of most of the debtor's surplus income to repay creditors.").

On the other hand, in chapter 11, if the unsecured class votes not to accept the plan, the plan cannot be confirmed unless the plan is fair and equitable as to that class,[45] which means that no one junior (such as the debtor) may receive any property on account of a junior interest unless the unsecured creditors are paid in full.[46] Thus, strip-down of the secured claim, which in itself should not have a dramatic effect on the lender in chapter 11,[47] is a very serious thing to the lender in chapter 13.

2. Extension of the Term

Strip-down of debt is just the beginning, however. The term of the loan may be extended for many years. The provision is not a model of clarity. Both bills provide that the loan may be modified "to extend the repayment period for a period that is no longer than the longer of 40 years (reduced by the period for which such loan has been outstanding) or the remaining term of such loan, beginning on the date of the order for relief under this chapter."[48] Note that the amendment does not say the loan may be extended *to* a maximum of forty years less the period for which such loan has been outstanding. It says the loan may be extended *for* that period. However, the phrase "beginning on the date of the order for relief" would seem to indicate that, whatever the length of the extension is determined to be, it will start at the date of the order for relief and substitute for the existing repayment period.

What we think the extension means is that if Bertha Borrower's loan has been outstanding for five years and it has ten years to run, the court can extend the term for thirty-five years (forty years less the five years the loan has been outstanding). However the modified repayment period would start on the date of the order for relief. Thus, the remaining term on Bertha's loan would be approximately thirty-five years instead of the present ten years, or an actual extension of twenty-five years.

3. Reduction of the Interest Rate

As of this writing, there is a conflict between the House Bill and the Senate Bill as to the formula for the adjustment of the interest rate. The Senate Bill would

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[45] 11 U.S.C. § 1129(b)(1) (2006) (allowing for plan confirmation over objection of dissenting class, as long as plan is, *inter alia*, "fair and equitable" as to such class).

[46] 11 U.S.C. § 1129(b)(2)(B)(ii) (2006) (defining "fair and equitable" to require that unless claim of dissenting class of unsecured creditors is fully paid, the holder of any claim or interest that is junior may not receive or retain under the plan on account of such junior claim or interest any property).

[47] At least in single asset real estate cases, the lender can generally cause the unsecured class to reject the plan, and there may be no other class to accept the plan under section 1129(a)(10) unless creative classification of claims is permitted. 11 U.S.C. § 1129(a)(10) (2006) (requiring "at least one class of claims that is impaired under the plan [to have] accepted the plan" for confirmation); *see* Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture, 995 F.2d 1274, 1279 (5th Cir. 1991) (stating that "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan")

[48] H.R. 1106, 111th Cong. § 103 (2009); S. 61, 111th Cong. § 4 (1st Sess. 2009).

permit adjustment of the interest to the rate to the Federal Reserve's published rate on conventional mortgages, plus a reasonable premium for risk. The published rate would not be expected to be a rate given for mortgages with a 100% loan-to-value ratio (which Bertha's stripped-down mortgage would become)[49] so its relevance to mortgages modified in chapter 13 is not that clear.

The House Bill, as it passed that Chamber, employed a less confusing formula, but one certainly less advantageous to the lenders. It would set a rate equal to the average prime offer rate[50] plus a "reasonable premium for risk." This use of prime plus risk may have been influenced by the 2004 decision of the U.S. Supreme Court in *Till v. SCS Credit Corp*.[51] *Till* dealt with a chapter 13 subprime security interest in a used truck with an "eye popping"[52] interest rate, to which the Safe Harbor did not apply. The plurality saw the question in the case as what rate of interest would be needed to meet the section 1325(a)(5)(B)(ii) requirement that the stripped-down mortgage have a present value equal to the value of the collateral. The opinion selected the prime rate plus a risk adjustment. We will review *Till* in more detail in connection with our discussion, *infra*, of the value of the lender's stripped-down mortgage.

Of course, the prime rate is so foreign to Bertha Borrower's stripped-down 100% of value mortgage that it would seem the premium for risk would have to be a highly *eye-explosive un*-reasonable percentage, a percentage that undoubtedly would make it doubtful that Bertha Borrower could pay it. More on this when we discuss the value of the property distributed to the mortgagee below.

4. Other Unpleasantries for the Lender

The above changes alone were not deemed sufficient to protect borrowers such as Bertha. In addition, the bills permit the plan to prohibit, reduce or delay any

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[49] *See* Bd. of Governors of the Fed. Reserve Sys., *Mortgage Markets*, 5 STATISTICAL SUPPLEMENT TO THE FEDERAL RESERVE BULLETIN 32 (Sept. 2008) (providing data on mortgage markets, including rates); *cf. supra* note 3.

[50] The "average prime offer rate" is "derived from average interest rates, points, and other pricing terms offered by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics." Regulation C (Home Mortgage Disclosure), 73 Fed. Reg. 63,329, 63,331 (Oct. 24, 2008) (to be codified at 12 C.F.R. pt. 203); *see* 73 Fed. Reg. 44,522, 44603 (July 30, 2008) (to be codified at 12 C.F.R. 226.35(a)(2)); *see also* Jack Rogers, *High-Priced Mortgages—What Now?*, KY. BANKER MAG., Aug. 1, 2008, at 16 (defining average prime offer rate as "an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics").

[51] 541 U.S. 465, 478–79 (2004) (adopting formula approach, which "begins by looking to the national prime rate" and then adjusting based on particular debtor's risk of default, for determining appropriate interest rate on cramdown loan).

[52] *In re* Till, 301 F.3d 583, 593 (7th Cir. 2002) (Rovner, J., dissenting) (observing debtors' interest rate "was an eye-popping 21 percent" and arguing "[c]ompelling a debtor to pay such a burdensome rate of interest diminishes the feasibility of the Chapter 13 plan"). *But see Till*, 541 U.S. at 492 (Scalia, J., dissenting) (asserting formula approach "will systematically undercompensate secured creditors for the true risks of default" and arguing for adoption of presumptive contract rate).

adjustments of interest under the terms of the loan;[53] "waive[ ] any prepayment penalty;"[54] and, free the debtor of liability for certain fees, costs or charges incurred while the case is pending.[55] The House Bill would amend section 502(b) to disallow the lender's principal residence mortgage claim altogether if the mortgage is "subject to a remedy for rescission under the Truth in Lending Act notwithstanding the prior entry of a foreclosure judgment."[56] Meanwhile the Senate Bill, which also deals with remedies for rescission under the Truth in Lending Act, would preserve the remedy rather than disallow the claim, but would expand the scope of the provision to cover "any other provision of applicable State or Federal consumer protection law that was in force when the noncompliance took place, notwithstanding the prior entry of a foreclosure judgment."[57]

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[53] H.R. 1106, 111th Cong. § 103 (1st Sess. 2009) (amending section 1322 to allow modification of mortgage such that "'if any applicable rate of interest is adjustable under the terms of such loan[,] by prohibiting, reducing, or delaying adjustments to such rate of interest applicable on and after the date of filing of the plan'"); S. 61, 111th Cong. § 4 (1st Sess. 2009) (using same language as House Bill to permit fixing of formerly adjustable interest rate). The provision in both bills is the same. The effect is that the court may convert any adjustable rate to a fixed rate at the lower interest set by the court.

[54] H.R. 1106, § 104 ("'[A] plan may provide for the waiver of any prepayment penalty on a claim secured by the debtor's principal residence.'"); S. 61, § 5 (adopting same language as House Bill). This is identical in both bills. It is assumed the provision is meant to "void" a prepayment fee since it would seem that the only entity that can "waive" the fee would be the mortgagee. The use of the street jargon "penalty" is interesting not only because it may be pejorative, but also because it makes one wonder if a brazen lender might argue that the fee or charge for prepayment in Bertha's note is a fair charge and not a "penalty" (which the law abhors), and thus cannot be "waived" under the Amendments. *See, e.g.*, Bear Stearns Gov't Sec., Inc. v. Dow Corning Corp. (*In re* Dow Corning Corp.), 419 F.3d 543, 549 (6th Cir. 2005) (observing penalties are "unenforceable for reasons of public policy" under Texas law); United States *ex rel.* Long v. SCS Bus. & Tech. Inst., Inc., 173 F.3d 870, 877 (D.C. Cir. 1999) (referring to particular penalty as "inconsistent with public policy"); Interface Group-Nevada v. TWA (*In re* TWA), 145 F.3d 124, 134 (3d Cir. 1998) ("[P]ublic policies of New York are 'firmly set against the imposition of penalties or forfeitures for which there is no statutory authority.'" (quoting Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc., 361 N.E.2d 1015, 1081 (N.Y. 1977))).

[55] This is contained in both bills and found in section 5 of the Senate Bill and section 104 of the House Bill. S. 61, § 5 (adding "'the debtor, the debtor's property, and property of the estate are not liable for a fee, cost, or charge that is incurred while the case is pending and arises from a debt that is secured by the debtor's principal residence'" to section 1322(c)); H.R. 1106, § 104 (amending section 1322(c) with same language used in Senate Bill).

[56] H.R. 1106, § 102 (amending section 502(b)). *See* Rowland v. Novus Fin. Corp. 949 F. Supp.1447 (D. Haw. 1996) *and* Fairbanks Capital Corp. v. Jenkins, 225 F. Supp. 2d 910 (N.D. Ill. 2002) (stating that under the Truth in Lending Act (section 125(f), 15 U.S.C. § 1635(f); 12 C.F.R. section 226.23(a)(3)), debtor has three days to rescind but if lender fails to deliver required notice of rescission rights or fails to make material disclosures the rescission period is three years after consummation of transaction). Upon receipt of the mortgagor's notice of rescission, the mortgage is void and the mortgagee's claim becomes an unsecured claim. *See In re* Whitley, 177 B.R. 142, 152–53 (Bankr. D. Mass. 1995). Under the Amendments, the mortgagee's claim would seem to be disallowed in its entirely. It could be argued that if the required notice or disclosures have not been received, the mortgagee is subject to a right of rescission even though notice of rescission has not been received by the mortgagee.

[57] S. 61, § 3 (adding to section 502(b)). What does the section in both bills mean by "prior entry of a foreclosure judgment" in the context of a mortgage being foreclosed not by judicial proceedings but under a power of sale, contained in the mortgage, pursuant to a state power of sale statute?

5. Expanding the Chapter 13 Entry Requirements

While the expansion of entry requirements does not deal directly with modifications of the mortgage, it expands the significance of the Amendments by increasing the number of people who may take advantage of the permitted modifications.

Presently section 109(e) states that only a person (or an individual and the individual's spouse) "with regular income[58] [who] owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than $336,900 and noncontingent, liquidated, secured debts of less than $1,010,650"[59] may file in chapter 13. The Amendments would exclude both the secured and unsecured portions of any mortgage on the debtor's principal residence from these computations if the value of the residence is less than the secured debt limit. This has the effect of allowing more people to file in chapter 13. Thus, since the value of Bertha Borrower's mortgage is less than $1,010,650, her debts for purposes of filing a chapter 13 plan will not include the $200,000 secured claim or the $200,000 unsecured claim of her mortgagee.

III. SYSTEMIC PROBLEM

There is a systemic problem with plan confirmation under chapter 13 that has been with us for some time. It deals with the question of whether the chapter 13 plan substantially impairs the secured creditors' rights in violation of the Fifth Amendment to the Constitution. Section 1325(a)(5)(B)(ii) was designed to insure that every plan provide a secured creditor with the value of its collateral. It is the value of the collateral that seems to be the bottom line for constitutional validity of the plan under a series of Supreme Court cases discussed below.[60]

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[58] 11 U.S.C. § 109(e) (2006). This is not changed by the Amendments. The general rule is that unemployed debtors, as a practical matter, do *not* have "regular income" and therefore are ineligible for chapter 13 relief. *See In re* Palacios, No. 08-11172-SSM, 2008 WL 700968, at *2 n.1 (Bankr. E.D. Va. Mar. 13, 2008) (stating debtor's unemployment status raises issue of eligibility since only individuals "'with regular income' may be a debtor under chapter 13" (quoting 11 U.S.C. § 109(e))); *In re* Greene, No. 99-31804DWS, 1999 WL 1271763, at *3 (Bankr. E.D. Pa. Dec. 30, 1999) (holding debtor's unemployment and therefore lack of "regular income disqualifies him from relief under Chapter 13"). *But see In re* Antoine, 208 B.R. 17, 20–21 (Bankr. E.D.N.Y. 1997) (allowing unemployed debtor to remain in chapter 13 based on spouse's promise to contribute her earnings to fund plan). Since many of those who will want the benefit of the Amendments may have been without employment for many months, the regular income requirement could prove troublesome. *See* Julia Preston, *A Slippery Place in the U.S. Work Force*, N.Y. TIMES, Mar. 22, 2009, at A1 (revealing that unemployment has led to missed mortgage payments and eventual foreclosure).

[59] 11 U.S.C. § 109(e) (2006). These amounts are adjusted based on the Consumer Price Index every three years. *See* 11 U.S.C. § 104(a)(1) (2006) (providing method of adjusting dollar amounts).

[60] The cases discussed are *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278–79 (1940); *Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke*, 300 U.S. 440, 459 (1937); and *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 584 (1935). These cases protect the lien of the secured creditor up to the value of the collateral. Professor Kenneth N. Klee, one of the principal draftspersons of the Bankruptcy Code, noted that "[i]t is no coincidence . . . that the Bankruptcy Code preserves the essence" of the rights protected under these cases. KENNETH N. KLEE, BANKRUPTCY AND THE SUPREME COURT 139 (American

Saying that the secured creditor will receive the value of its collateral does not necessarily mean that the secured creditor is actually receiving the value of its collateral. In 2004, the Supreme Court, without dealing with the constitutional requirements, considered what had to be distributed to a secured creditor under section 1325(a)(5)(B)(ii) in the context of a sub-prime lien on a used truck. The Court concluded that an interest rate of prime plus a risk factor would comply with the section since it would "fairly compensate a creditor for its exposure."[61]

For various reasons discussed below, it might be possible to justify that result under the chapter 13 as it existed at the time. The Amendments, however, so modify the rights of the secured creditor that, if they should be enacted, it may become extremely difficult, if not impossible, to meet the requirement of section 1325(a)(5)(B)(ii), and by extension, the requirements of the Fifth Amendment. Remarkably, the House Bill (but not the current version of the Senate Bill) appears to admit that the modified mortgage will not furnish the secured creditor with the present value of the collateral by providing explicitly that section 1325(a)(5)(B)(ii) does not apply to mortgages modified by the Amendments.[62] Whether this exception was inserted out of ignorance of the constitutional issue involved, or just Congressional hubris, is not clear.

In the discussion below, we will first review the constitutional issue, how it developed, and where it now stands. Then we will look to section 1325(a)(5)(B)(ii) in an attempt to determine whether (assuming it remains applicable) its requirements as well as the requirements of the Fifth Amendment can realistically be met.

A. The Constitutional Issue

While rights of unsecured creditors may be and are regularly modified in bankruptcy,[63] a mortgage is an interest in or lien on real estate and, as such, is a right to property, a right that is protected by the Fifth Amendment to the Constitution, to which even the bankruptcy power is subject.[64]

The issue of the extent of protection afforded to a secured creditor's property interest came before the courts during the Great Depression. In 1934, Congress, in

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College of Bankruptcy 2008) (citing, *inter alia*, to section 1129(b)(2)(A)(i), the chapter 11 equivalent of section 1325(a)(5)(B)(ii), as one of the provisions that preserves those rights).

[61] Till v. SCS Credit Corp., 541 U.S. 465, 476–77 n.14 (2004).

[62] H.R. 1106, 111th Cong. § 105 (1st Sess. 2009) (modifying section 1325(a)(5) by inserting "'except as otherwise provided in section 1322(b)(11)'" which, in turn, provides for modification of rights of principal residence mortgagee).

[63] In *Louisville Joint Stock Land Bank v. Radford*, Justice Brandeis pointed out that under the bankruptcy power, Congress may discharge personal obligations and impair rights under contract, but it could not take substantive rights in specific property. 295 U.S. 555, 601–02 (1935).

[64] *See id.* at 589 ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment."); *see also* United States v. Sec. Indus. Bank, 459 U.S. 70, 75 (1982) ("The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation.") (citation omitted).

the First Frazier-Lemke Act[65] amended then section 75 of the Bankruptcy Act in an attempt to provide relief for the severely distressed agricultural community. The amendment would have allowed many troubled farmers to remain on the farm by permitting the scaling down of mortgage debts and allowing the farm debtor, after an appraisal, to acquire full title to the farm upon payment of the appraised value. However, it was quickly urged that this Frazier-Lemke Act effected an unconstitutional change in the relative rights of the mortgagor and the mortgagee, which the Supreme Court considered in *Louisville Joint Stock Land Bank v. Radford*.[66]

In a unanimous decision delivered by Justice Brandeis, the Court held the Act unconstitutional because the Act took from the mortgagee, without compensation, five substantive rights in specific property acquired by the mortgagee prior to the passage of the Act[67] and, as such, violated the Takings Clause of the Fifth Amendment. The rights taken were: (1) the right to retain the lien until the indebtedness is paid; (2) the right to realize on the security in a public sale; (3) the right to determine when the sale will be held (subject to the discretion of the court); (4) the right to credit bid at the sale; and, (5) the right to control the property during the period of default. The right to a distribution with present value equal to the allowed claim was already protected under the Act, which provided for the payment in cash to the secured creditor of the appraised value of the collateral.

Immediately after the decision came down, the proponents of the original Frazier-Lemke Act began to prepare a new bill that would satisfy the requirements of the *Radford* decision. Within three months, the Second Frazier-Lemke Act was passed,[68] intended to protect the rights of secured creditors by avoiding, according to Senator Borah, "the objectionable features of the former act as they were denounced by the Supreme Court."[69]

The new act was held to satisfy the requirements of the Fifth Amendment in *Wright v. Vinton Branch of Mountain Trust Bank*, a unanimous Supreme Court decision again written by Justice Brandeis.[70] In reality, the changes made by

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[65] Frazier-Lemke Act of 1934, ch. 869, 48 Stat. 1289 (1934) (codified as 11 U.S.C. § 203(s) (1934)) (repealed 1949). *See* Smith v. White, 166 F.2d 269, 271 (9th Cir. 1948) (saying Frazier-Lemke Act "'was designed to relieve distressed farmers who were in default on their farm mortgages and to relieve agriculture from the effects of the deflation in land values resulting from the depression'" (quoting H.R. REP. NO. 1127, at 974 (1944))); Paradise Land & Livestock Co. v. Fed. Land Bank of Berkeley, Cal., 108 F.2d 832, 834 (10th Cir. 1939) (describing Frazier-Lemke Act as law "passed during a national crisis to afford relief to distressed agriculture").

[66] 295 U.S. 555 (1935).

[67] Note that the House Bill is applicable, by its terms, only to mortgagees' rights acquired *prior* to the passage of the Act. H.R. 1106, 111th Cong. § 103 (1st Sess. 2009) (limiting scope to loans "originated before the effective date" of Act).

[68] Act of Aug. 28, 1935, ch. 792, 49 Stat. 942, 943–45 (1935) (codified as 11 U.S.C. § 203(s) (1935)). *See* John C. Anderson & Rex D. Rainach, *Farmer Reorganizations Under the New Bankruptcy Code*, 28 LOY. L. REV. 439, 455 (1982) ("[P]romptly after the Supreme Court's decision in *Radford*, Congress passed the second Frazier-Lemke Act in 1935 to correct the faults in the first Act.").

[69] 79 CONG. REC. 13,632 (Aug. 19,1935) (statement of Senator Borah).

[70] Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, 300 U.S. 440 (1937).

Congress were not that extensive.[71] However, it did preserve three of the five rights denied in the first Act: the right to retain the lien until the indebtedness is paid; the right to realize on the security by public sale (indeed, the mortgagee was afforded the right to request a judicial sale as an alternative to payment by the debtor of the appraised value of the property); and, the court found that the right to bid at the sale, while not explicit, was implied in the legislation. But, all the rights *Radford* said were taken, were not restored. Justice Brandeis pointed out, however, that *Radford* did not hold that the deprivation of any one of the rights enumerated would have rendered the Act invalid. Rather, it had held that the "effect of the statute in its entirety was to deprive the mortgagee of his property without due process of law."[72] The Court concluded that with the changes made, the Second Frazier-Lemke Act made "no unreasonable modification of the mortgagee's rights[,] and hence [was] valid."[73]

The Second Frazier-Lemke Act, however, like most insolvency legislation, had an ambiguity problem. That problem came before the Supreme Court in *Wright v.*

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[71] This has caused some commentators and courts to question "whether *Radford* retains any vitality after *Vinton Branch*," at least with respect to the Takings rather than the Due Process clause. KLEE, *supra* note 60, at 140. Prof. Klee pointed out, however, that the courts and commentators have not reached consensus as to the viability of *Radford*. *Id. See* James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 981 (1983) ("The most plausible explanation of the irreconcilability of *Radford* and the subsequent Frazier-Lemke Act cases is that the later cases overrule or substantially undercut the vitality of *Radford*."). On the other hand, another commentator, Patrick A. Murphy, stated that:

> No later opinion has substantially contradicted the basic holding of *Radford* that a significant infringement of a substantive property right held by a secured creditor constitutes an uncompensated "taking" within the meaning of the final clause of the fifth amendment and may also, as suggested in *Wright* v. *Vinton Branch*, be a deprivation of property without "due process of law." These two clauses of the fifth amendment . . . seem to be treated as one by the Supreme Court in the Frazier-Lemke decisions, although the problem of the secured creditor, at least after the second *Wright* v. *Union Central* opinion, could be said to fall under the just compensation clause.

Patrick A. Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15, 26 (1974). This conclusion derives support from the citation of *Radford* by the Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410 (1992), as a seemingly appropriate application of the Takings Clause. *Id.* at 419 (discussing *Radford* and noting "[t]he Court invalidated [Frazier-Lemke Act] under the Takings Clause"). *See In re* Carroll, 11 B.R. 45, 47 (Bankr. E.D.N.Y. 1981) ("Congress may not use the bankruptcy power to deprive a creditor of substantive rights in specific property acquired prior [to] the enactment of the Bankruptcy Reform Act of 1978 without providing that creditor with 'just compensation.'" (citing *Radford*, 295 U.S. at 602 (1935))).

[72] *Vinton Branch*, 300 U.S. at 457. *Radford* seemed based on the Takings Clause of the Fifth Amendment. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 601–02 (1935) (concluding Frazier-Lemke Act "has taken from the [creditor] without compensation" and is thus void as "Fifth Amendment commands that, however great the Nation's need, private property shall not be thus taken even for a wholly public use without just compensation"). In *Vinton Branch*, Justice Brandeis implicates the Due Process Clause as well. *Vinton Branch*, 300 U.S. at 470 ("The question . . . is whether the legislation modifies the secured creditor's rights, remedial or substantive, to such an extent as to deny the due process of law guaranteed by the Fifth Amendment.").

[71] *Vinton Branch*, 300 U.S. at 470.

Union Central Life Insurance Co.[74] The Act stated that, on request of the debtor or a creditor, "the court shall cause a reappraisal of the debtor's property, . . . fix the value of the property, . . . and the debtor shall then pay the value so arrived at into court"[75] as a prelude to redemption. The Act also stated that on request of any creditor "the court *shall order* the property upon which such secured creditors have a lien to be sold at public auction."[76] In *Union Central*, the debtor wanted the value fixed for redemption, but the creditor wanted the property sold at a public sale. Since both provisions appeared to be mandatory, Justice Douglas stated the issue as: "whether . . . the debtor must be accorded an opportunity, on his request, to redeem the property . . . before the court may order a public sale."[77]

Justice Douglas answered the question in the affirmative, holding that while the right to a judicial sale was constitutionally protected, "the debtor's request for redemption . . . cannot be defeated by a request of a secured creditor for a public sale"[78] because the rights of secured creditors were already adequately protected by the statute. Justice Douglas then explained what constitutional rights secured creditors had in words that have become well known:

> Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, *to the extent of the value of the property*. There is no constitutional claim of the creditor to more than that. And so long as that right is protected the creditor certainly is in no position to insist that doubts or ambiguities in the Act be resolved in its favor . . . . Under our construction . . . the creditor will not be deprived of the assurance that the value of the property will be devoted to the payment of its claim.[79]

Thus, the Supreme Court told us that the right of the secured creditor to the value of the security is protected by the Constitution. While, under *Vinton Branch*, certain of the mortgagee's rights in the collateral could be changed without violating the Constitution, the bottom line of protection afforded by the Constitution was the value of the collateral. In *Union Central*, a payment by the debtor of the full value as determined by an appraisal or reappraisal of the property securing the debt was held to protect the mortgagee's rights.

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[72] 311 U.S. 273 (1940).
[73] Act of Aug. 28, 1935, ch. 792, 49 Stat. 942, 944 (1935) (codified as 11 U.S.C. § 203(s) (1935)).
[76] *Id.* (emphasis added).
[77] Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 275–76 (1940).
[78] *Id.* at 279.
[79] *Id.* at 278–79 (citations omitted) (emphasis added) (positing "seemingly inconsistent" positions of creditor and debtor can be balanced yet, when necessary, balance should tip in favor of debtor provided secured creditor is assured of value of collateral). *See* Lend Lease v. Briggs Transp. Co. (*In re* Briggs Transp. Co.), 780 F.2d 1339, 1342 (8th Cir. 1985) (indicating adequate protection protects secured creditors' constitutional rights to "the extent of the value of their property" and no more (citing *Union Cent.*, 311 U.S. at 278)); *In re* Lanier, 372 B.R. 727, 732 (Bankr. M.D. Pa. 2007) (noting Justice Douglas in *Union Central* provided, in dicta, best articulation of constitutional rights of secured creditors).

It is important to recognize that, in *Union Central*, the constitutionally protected value that the creditor was to receive was payment by the debtor in cash, and not the receipt of a stripped-down mortgage lien purportedly reflecting that value, as provided for in chapter 13's proposed Amendments. Thus, it becomes especially important that the mortgagee actually receive that present value. Unfortunately, the Amendments tend to make it very difficult to claim that the mortgagee will in fact receive the mandated value on plan confirmation. As a result, it exposes the truth of Justice Scalia's statement that, in fact, the mortgagee is being "systematically undercompensated[d]"[80] and highlights the issue that may spark another Supreme Court review. Thus, the Amendments, if enacted, could become the unintended catalyst that will result in a new sober look at whether chapter 13 can function as constitutionally mandated.

B. Compliance with Section 1325(a)(5)(B)(ii)

As previously discussed, section 1325(a)(5)(B)(ii) appears designed to meet the constitutional requirements by mandating that the plan must distribute to the secured creditor property that has a present value equal the allowed amount of the secured claim, which is the value of the collateral as determined by section 506(a).[81] While the House Bill has conveniently provided that this section mandating constitutional compliance will not apply to the Amendments, the Senate Bill, at least in its current version,[82] has not. How this will play out, either through

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[80] Till v. SCS Credit Corp., 541 U.S. 465, 491–92 (2004) (Scalia, J., dissenting) (arguing in chapter 13 cases setting of interest rate on deferred payments to secured creditors based on prime rate as opposed to contract rate unfairly shifts risk of default to creditors and likely will not adequately protect interests of secured creditors). *Cf. The Looming Foreclosure Crisis: How to Help Families Save Their Homes: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. (2007) (statement of Mark S. Scarberry, Professor, Pepperdine Univ. Sch. of Law), *available at Pepperdine School of Law Professor Scarberry Testifies on Looming Foreclosure Crisis Before Senate Panel*, U.S. FED. NEWS, Dec. 5, 2007, 2007 WLNR 24059979 (discussing home mortgage strip-down in bankruptcy and advocating against amendments to allow home mortgage strip-down in chapter 13 because of unfavorable treatment of mortgage holders); Matthew Henschen O'Brien, Note, Till*ing the Cram Down Landscape: Using Securitization Data to Expose the Fundamental Fallacies of* Till, 59 VAND. L. REV. 257, 276–78 (2006) (explaining concerns regarding undercompensation of creditors linked to importance of maintaining broad access to credit).

[81] 11 U.S.C. § 506(a) (2006) (limiting allowed secured claim to value of collateral to "be determined in light of the purpose of the valuation and of the proposed disposition or use of such property"). Section 1325(a)(5)(B)(ii) reads in part as follows:

> (a) . . . [T]he court shall confirm a plan if— . . . (5) with respect to each allowed secured claim provided for by the plan— . . . (B) . . . (ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim . . . .

11 U.S.C. § 1325(a)(5)(B)(ii) (2006).

[82] A version of the Senate Bill introduced in the last session of Congress in November 2008 contained a similar provision to what is now in the House Bill. S. 3690, 110th Cong. § 103 (a)(2) (2d Sess. 2008). *See supra* note 62 and accompanying text. In what it identified only as a "[c]onforming amendment," it would have made section 1325(a)(5)(B)(ii) inapplicable to mortgage modifications under the Amendments. *Id.* In

Conference or negotiation, if a final bill is enacted is not known. Therefore, it is appropriate to look at how the courts have dealt with determining the present value of distributions under the plan to the secured creditor in the past, and how the scope of the Amendments may affect those determinations.

One of the sublime statements of the meaning of present value was spoken by Learned Hand, parts of which have been incorporated in the Bankruptcy Code:

> [P]ayment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.[83]

If we apply section 1325(a)(5)(B)(ii)'s requirement that what the secured creditor receives must have a value equal to the value of the collateral to our hypothetical, it means that Bertha Borrowers plan must distribute to her mortgagee property with a present value equal to $200,000, the stripped-down amount of the $400,000 mortgage. Since the stripped-down mortgage of $200,000 is what is being distributed on the secured claim, that mortgage is supposed to be worth its face amount at the time the plan is confirmed. This may be "mission impossible." If the requirement were met, the mortgagee should be able to take that stripped-down mortgage and sell it in the secondary mortgage market[84] for its face amount. The loan now has a 100% loan-to-value ratio. Its term may have been extended, say, to thirty-five years. The interest rate may be reduced to perhaps as low as prime plus a risk factor. How can the mortgagee convince someone to purchase that mortgage for $200,000? The "unpleasant truth" is that there would be no market for that

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the current Session, perhaps based on a realization that the "conforming amendment" constituted an admission against interest, the "conforming amendment" was deleted from the Senate Bill—but the provisions authorizing modification of mortgages that caused the "conforming amendment" to be written in the first place, were not. S. 61, 111th Cong. (1st Sess. 2009).

[83] Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Holding Corp.), 75 F.2d 941, 942 (2d Cir. 1935). *See, e.g.*, 11 U.S.C. § 361(3) (2006) (using indubitable equivalent in context of adequate protection); 11 U.S.C. § 1129(b)(2)(A)(iii) (2006) (presenting indubitable equivalent in framework of fair and equitable plan).

[84] The "secondary mortgage market" refers to the purchase and sale of mortgages after they have been originated. *See* Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2191–98 (2007) (explaining history and development of secondary market and Fannie Mae and Freddie Mac as purchasers of conventional home mortgages from private lenders); *see also* Hurt v. Fed. Nat'l Mortgage Ass'n & Home Securitization Trust 1 (*In re* Homeowners Mortgage & Equity, Inc.), 354 F.3d 372, 374 (5th Cir. 2003) (defining Fannie Mae as "a congressionally chartered private corporation [that] purchases mortgage loans from original lenders in a secondary mortgage market"); Fred Wright, *The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression*, 57 ALA. L. REV. 231, 259 (2005) (describing driving purpose of secondary mortgage market as "help[ing] to ensure that real estate capital [is] readily available so that mortgage lenders [can] remain relatively liquid and continuously make new mortgages").

mortgage at that price. If the mortgage were to be sold, it could be sold only at a severe discount. Thus the mortgagee will not have received the value of the collateral as the statute (and the Fifth Amendment) demands.

Without the Amendments, the issue of compliance with section 1325(a)(5)(B)(ii) has been finessed by providing an interest rate to cover the time value of money plus a premium to compensate the creditor for the risk of non-payment of the principal. This approach has resulted in a seeming consensus that has brought equilibrium to the interpretation of this section. However, that equilibrium was achieved under a statute without the Amendments. The concern is that the Amendments so modify the mortgage that it would become difficult, should the Amendments become law, to continue to finesse the issue in this way. Thus the Amendments may jolt our present equilibrium with serious potential implications.

C. The Till *Decision and the "Prime-Plus" Equilibrium*

Before the current economic crisis, the issue of compliance with section 1325(a)(5)(B)(ii) came before the U.S. Supreme Court in *Till v. SCS Credit Corp.*[85] The case involved a subprime mortgage on a used truck and the question the Court decided to resolve was how the installment payments under the mortgage "must be calibrated to ensure that, over time, the creditor receives disbursements whose total present value equals or exceeds that of the allowed claim."[86]

Each lower court functioning on the case and the dissent at the Court of Appeals, had come up with a different formula for determining the appropriate interest rate to meet the requirements of section 1325(a)(5)(B)(ii). The one commonality among all of them had been an assumption that the value of what was distributed could be determined simply by picking the right interest rate. The Supreme Court followed suit, seemingly content with the idea that interest rate alone would determine compliance with section 1325(a)(5)(B)(ii). Justice Stevens, writing for the plurality (with Justices Souter, Ginsburg and Breyer), selected the bankruptcy court's determination that the appropriate formula should be the prime rate plus a premium for risk, which, as pointed out earlier, may be the reason this formula was chosen for the Amendments in the House Bill.

Justice Scalia (joined by Chief Justice Roberts and Justices O'Connor and Kennedy), in his dissent, opted for the contract rate as the *presumptive* rate for meeting the section 1325(a)(5)(B)(ii) requirement, maintaining that the approach of selecting the prime rate "we *know* is too low" and letting the judge determine the amount of the risk premium will, in practice, "systematically undercompensate secured creditors for the true risks of default."[87] Justice Thomas found nothing in the language of the statute that would require such a payment for risk and concluded that all that must be done to give the secured creditor the value of the collateral in

[85] 541 U.S. 465 (2004) (plurality opinion).
[86] *Id.* at 469 (footnote omitted).
[87] *Id.* at 491–92 (Scalia, J., dissenting).

situations where the payments are made over time, would be to provide for interest to cover the time value of the late disbursements.[88] Both the Stevens opinion and the Scalia dissent concluded that a premium for risk was necessary to give the secured creditor the present value of the collateral but, as pointed out above, disagreed over the appropriate method for accomplishing that.

Learned Hand's "indubitable equivalence" was not referred to. Yet, as Justice Scalia pointed out, prime-plus is inherently problematic in determining whether the current value of the distribution to the secured creditor is equal to the allowed secured claim. Justice Stevens defended prime-plus based on the absence of a cramdown market rate of interest in chapter 13.[89]

D. Exposure to the Market

An alternative means of determining the value of the distribution under the plan would be to attempt to ascertain what someone would be expected to pay for that distribution if it were to be exposed to the market. This was apparently not

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[88] *Id.* at 487 (Thomas, J., concurring) (concluding statute is satisfied if "plan . . . propose[s] an interest rate that will compensate a creditor" for delayed use of property). *See* Rake v. Wade, 508 U.S. 464, 472 n.8 (1993) ("[A] creditor receives the 'present value' of its claim only if the total amount of the deferred payments includes the amount of the underlying claim plus an appropriate amount of [interest] to compensate the creditor for the decreased value of the claim caused by the delayed payments."). The opinion of Justice Thomas should not be easily dismissed. If the mortgagee were paid the value of the collateral in cash, the requirement of section 1325(a)(5)(B)(ii) would have been met. If that amount is paid not on confirmation but over time, the mortgagee should get compensated for the time value of the late payments. *See Till*, 541 U.S. at 487 (Thomas, J., concurring) (asserting "risk-free rate should suffice" to satisfy section 1325(a)(5)(B)(ii)). Justice Scalia criticized this because he said that Justice Thomas was simply assuming that the payments would be made, which might not occur. *Id.* at 505 (Scalia, J., dissenting) (positing risk of nonpayment must be considered "[b]ecause there is no guarantee that the promised payments will in fact be made"). As a result, Justice Scalia supported requiring a premium for risk of non-payment. *Id.* at 498–99, 508 (Scalia, J., dissenting) (arguing for risk premium that requires "full risk compensation"). But perhaps Justice Thomas had in mind that a default is self-correcting, in that if there is a default the mortgagee should be able to foreclose (requiring court approval while the plan is in effect) and obtain the property or its full value at the foreclosure sale. This, however, does not take into account that the security for the payments does not have a consistent and inflexible value, so that when foreclosure takes place, what the secured creditor receives may not reflect the value at the time of plan confirmation.

[89] *Till*, 541 U.S. at 476 n.14 (stating there is "no readily apparent Chapter 13 'cramdown market rate of interest'"). Looking at footnote 14 as a whole, including the citations to articles to support the fact that there may be a cramdown market rate of interest in chapter 11, it may seem that the cramdown rate of interest Justice Stevens is referring to is the rate of interest on something like debtor-in-possession financing. *Id.* (suggesting debtor-in-possession financing market indicates existence of "free market of willing cramdown lenders" in chapter 11). However, perhaps the rate we should be looking for is not that. Rather, what we should be looking for is whether there is a market rate of interest for liens similar to that distributed to the secured creditor under the plan. *See In re* Cantwell, 336 B.R. 688, 693 (Bankr. D.N.J. 2006) (adopting *Till* formula approach as appropriate interest rate in chapter 11 case where "there [was] no evidence produced to establish that an 'efficient market' exists to refinance"). *But see* Bank of Montreal v. Official Comm. of Unsecured Creditors (*In re* Am. HomePatient, Inc.), 420 F.3d 559, 567–68 (6th Cir. 2005) (positing formula approach is not required in context of chapter 11 proceedings).

considered an option by the Court.[90] However, the language of the chapter 13 instructs that the secured creditor must receive the present *value* of the property being distributed. And, the Supreme Court, only ten years ago, made clear that "the best way to determine value is exposure to a market."[91]

In both formulae (prime-plus or market exposure) the determinative tools are the same: both will employ interest and risk to find value. The difference is that with market exposure, the appropriate interest and risk percentage would not be determined in isolation by a court. Rather, the interest and risk factor would be based on what return one would expect prospective purchasers, assessing the risk of default and comparing that risk with the risk and return on alternative investments, would require before they would be willing to purchase the rights to that stream of income.[92] If, in lieu of this, the present value of amounts distributed is to be determined by a court starting with the close to riskless prime rate and adding what the court concludes is a "reasonable premium for risk,"[93] there is real concern that

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[90] *Till*, 541 U.S. at 476 n.14. Justice Stevens alluded to market exposure in the context of determining an appropriate interest rate in a chapter 11 cramdown when in reference to section 1129(b)(2)(A)(i)(II), a similar provision to section 1325(a)(5)(B)(ii), he said:

> [W]hen picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

Id. See Bank of Montreal v. Official Comm. of Unsecured Creditors (*In re* Am. HomePatient, Inc.), 420 F.3d 559, 568 (6th Cir. 2005) (applying footnote 14 of *Till* to hold "that the market rate should be applied in Chapter 11 cases where there exists an efficient market" while formula approach should be applied "where no efficient market exists"). *See In re* 3dfx Interactive, Inc., 389 B.R. 842, 864–865 (Bankr. N.D. Cal. 2008) (explaining attributes of "appropriate market exposure" including estimation of what a "hypothetical willing and able buyer . . . acting at arms length in an open and unrestricted market" would pay); *cf.* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 456 (1999) (urging "market's scrutiny of the purchase price by means of competing bids" in realm of new value exception to absolute priority rule). *But see* Elizabeth B. Rose, Comment, *Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 EMORY BANKR. DEV. J. 249, 282–283 (2006) (highlighting concerns about "overreliance on solutions . . . 'generated by the marketplace'" which "cannot correct deal protection fees, credit bidding, and disparity in bidders' information" in realm of 363 sales).

[91] *Bank of Am. Nat'l Trust & Sav. Ass'n*, 526 U.S. at 457.

[92] This is not different from the traditional methods used by appraisers to determine present value of the stream of income by determining what discount prospective purchases would demand. The formula used when the income stream is known (as it would be if a court determines the interest rate) is simply to divide that stream by a percentage representing the return a prospective purchaser would demand, called in real estate appraisal a capitalization rate, and in valuing a stream of income, a discount rate. The quotient would be the present value of the income stream or property being appraised. *See* Patrice Leigh Ferguson & John E. Camp, *Valuation Basics and Beyond: Tackling Areas of Controversy*, 35 FAM. L.Q. 305, 316 (2001) (distinguishing discount and capitalization rates by explaining "discount rate represents the total expected rate of return that an investor requires to justify investing in an asset because of the amount of risk associated with the investment," while "capitalization rate is derived by subtracting the expected sustainable growth from the discount rate").

[93] *See* Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004) Justice Stevens stated that courts making risk adjustments generally approved from 1%–3%. *Id.* at 480. *See* Gen. Motors Acceptance Corp. v. Valenti (*In re* Valenti), 105 F.3d 55, 64 (2d Cir. 1997) ("A review of the caselaw in those jurisdictions that use this approach to determine a fair rate of interest suggests that the risk premium has been set by bankruptcy courts

prime plus will not reflect the actual *present value* of the income stream as required by section 1325(a)(5)(B)(ii).

Applying this to our hypothetical involving Bertha Borrower's house, assume her mortgage were offered for sale in a hypothetical market at the stripped-down amount of $200,000 with a prime-plus interest rate set by the Court of, say, 5% or $10,000 a year. If, because of perceived risk, including the lack of an equity cushion after strip-down and the extended length of the term, the interest rate required to attract money to purchase this mortgage were, say 10%, any prospective purchaser wanting 10% for this type of investment would be willing to pay only $100,000 for the mortgage, which would afford the purchaser the 10% return it demands. Thus, if value is determined by the price the mortgage would bring in a hypothetical market, the *value* of the mortgage on Bertha's house would be $100,000, not the $200,000 required by section 1325(a)(5)(B)(ii) and Bertha's plan could not be confirmed.

Of course, *Till* did not deal with a mortgage on a principal residence (if the mortgage had been on a principal residence the Safe Harbor would have prevented a strip-down). The example, however, illustrates the problem for the Supreme Court—if exposure to the market method is employed to determine the value of the distribution to the secured creditor, it might be impossible for *any* plan to be confirmed, either because there is no efficient market to determine the value of what is being distributed, or because an efficient market would produce less than what is required under section 1325(a)(5)(B)(ii). In *Till*, the Supreme Court avoided considering this and found equilibrium by looking to "first principles" and asking "only what rate will fairly compensate a creditor for its exposure"[94] even though we may know that this will result in the lender being "systematically undercompensated."[95]

Perhaps, when dealing with a subprime security interest in a used truck under an *unamended* chapter 13, it may be possible to acquiesce in the determination of the Supreme Court in *Till* that an appropriate interest rate is all that is needed. After all, under chapter 13 as presently written, the $4,000 value of the truck would have to be paid off within three or five years.[96] Section 1325(a)(6) does not permit the

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at from one to three percent."). Justice Scalia, on the other hand, objected to this seemingly objective and ascertainable nature of the risk premium, stating in part:

> If the risk premium is typically small relative to the prime rate—as the 1.5% premium added to the 8% prime rate by the court below would lead one to believe—then this subjective element . . . might be forgiven. But in fact risk premiums, if properly computed, would typically be substantial. For example, if the 21% contract rate is an accurate reflection of risk in this case, the risk premium would be 13%—nearly two-thirds of the total interest rate.

Id. at 499 (Scalia, J., dissenting).

[94] *Till*, 541 U.S. at 476 n.14. *See supra* note 89 (explaining *Till* footnote 14 in greater detail).

[95] *Till*, 541 U.S. at 508 (Scalia, J., dissenting).

[96] *See* 11 U.S.C. § 1322(d)(2) (2006) (limiting a pay-out under a plan to three or five years); *see also In re* Johnson, 384 B.R. 763, 777 (Bankr. E.D. Mich. 2008) ("Bankruptcy Code § 1322(d)(2)(C) does not permit

bankruptcy court to confirm a plan unless the court is convinced that the debtor will be able to make the payments under the plan, and with only a maximum look forward of five years, a conclusion that the payments will be made and that there is little risk of default, is not outside the realm of possibility.[97] Thus, a court may be able to determine, with relative confidence, the appropriate risk premium to cover any inaccuracy in the court's feasibility conclusion under section 1325(a)(6). Under these circumstances, as Justice Scalia pointed out, the decision is "unlikely to burnish the Court's reputation for reasoned decisionmaking."[98] It is possible, then, that the use of prime-plus may be defended (albeit skiddishly) even though it may be clear that the property distributed on the secured claim could not, at plan confirmation, be disposed of by the mortgagee for its face amount.

E. The Effect of the Amendments

Will the Supreme Court come to the same conclusion, however, if the Amendments should be enacted? Under the Amendments, we would not be dealing with the same circumstances on which the *Till* decision was based. The payments to Bertha Borrower's lender would not have to be made within a three to five year period, but could be made over a period of, say, thirty-five years.[99] Add to this the reduction of the interest rate, and the Amendments may make it clear that the prime-plus formula cannot meet the statutory requirement. It would seem next to impossible to look forward over thirty-five years and conclude that under the modified mortgage the "debtor will be able to make all payments under the plan and to comply with the plan" as required under section 1325(a)(6), or that in truth, the value of what is distributed equals the face amount of the stripped-down mortgage as required by section 1325(a)(5)(B)(ii).

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confirmation of a plan that provides for payments over a period that is longer than 5 years."); *In re* Musselman, 341 B.R. 652, 654–55 (Bankr. N.D. Ind. 2005) (construing chapter 13 plan payment period as capable of continuing beyond three years but not beyond five years).

[97] 11 U.S.C. § 1325(a)(6) (2006) (requiring finding "debtor will be able to make all payments under the plan and to comply with the plan" in order to have plan confirmed). Nevertheless, many three to five year plans fail. In *Till*, respondent claimed that more than 60% of chapter 13 plans fail. *Till*, 541 U.S. at 480. Petitioners claimed that the rate of failure was 37% for confirmed plans, still a "substantial" risk. *Id.* at 493 (Scalia, J., dissenting). *See* Jean Braucher, *An Empirical Study of Debtor Education in Bankruptcy: Impact on Chapter 13 Completion Not Shown*, 9 AM. BANKR. INST. L. REV. 557, 564 (2001) (noting "[c]ompletion of a chapter 13 plan is an exacting standard of personal financial management" and "nationally, less than a third of chapter 13 cases are closed as completed"); William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 411 (1994) (finding "[f]or the whole country the average reported rate for closing [chapter 13] cases as completed [to be] only 31%" in 1993, and that "a majority of chapter 13 plans are not completed in all regions of the country"); *see, e.g.*, *In re* Davis, 64 B.R. 358, 359 (Bankr. S.D.N.Y. 1968) ("[D]ebtors' failure to make post-confirmation payments would constitute a material default by the debtors with respect to the terms of the confirmed plan . . . and is a specific ground for . . . dismissing a Chapter 13 case.").

[98] *Till*, 541 U.S. at 508 (Scalia, J., dissenting).

[99] *See* discussion *supra* Part II.B.2.

Would a court, then, have to choose an astronomical interest rate to compensate for risk? Both the plurality and dissent in *Till* agreed that where the risk of default is "so high as to necessitate an 'eye-popping' interest rate, . . . , the plan probably should not be confirmed"[100] and "if the rate is too high for the plan to succeed, the appropriate course is not to reduce it to a more palatable level, but to refuse to confirm the plan."[101] Thus, the Amendments may make it possible for the Supreme Court to find that the prime-plus approach taken in *Till* is not satisfactory for resolving the present value of long term mortgages. Even if the Court were to select exposure to a hypothetical market as a test of compliance with section 1325(a)(5)(B)(ii), it may be doubtful that this test would afford a basis for compliance with the statutory requirement. If neither the prime-plus nor the market exposure test can work in light of the Amendments, the unintended consequences to the viability of chapter 13 would be serious.

F. A Spill-Over to Chapter 11?

Unfortunately, depending on what the Supreme Court rules if it again looks at the rights of holders of secured claims in chapter 13, there may be growing concern relating to a provision similar to section 1325(a)(5)(B)(ii) in chapter 11, section 1129(b)(2)(A)(i)(II). This section provides that on cramdown under chapter 11, the plan must provide the holder of a secured claim whose lien is retained, deferred cash payments totaling at least the allowed amount of the claim, having a value on the effective date of the plan equal to the value of the collateral. Thus, the issue of whether the secured claim is receiving the mandated value can be raised in that chapter as well, another disturbing result that could be achieved by the Amendments.

While this essay is not directed at chapter 11, we would like to note that there are many differences in the treatment of secured claims between the two chapters that may result in the issues discussed herein being treated differently, at least in single asset real estate cases. Among the many differences may be: (i) the secured claim holder's ability to elect a full claim under section 1111(b)(2),[102] and (ii) the

[100] Till v. SCS Credit Corp., 541 U.S. 465, 480–81 (2004) (citation omitted). *See In re* Bivens, 317 B.R. 755, 769 (Bankr. N.D. Ill. 2004) (rejecting creditor's requested "'eye-popping[]'" interest rate as it would render plan unfeasible); *In re* Pokrzywinski, 311 B.R. 846, 850 (Bankr. E.D. Wis. 2004) (citing *Till* and cautioning "rate should not be so high as to doom the chapter 13 plan").

[101] *Till*, 541 U.S. at 491 (Scalia, J., dissenting). *See* Bank of Montreal v. Official Comm. of Unsecured Creditors (*In re* Am. HomePatient, Inc.), 420 F.3d 559, 569 (6th Cir. 2005) (referring to plurality opinion in *Till* that if interest rates are eye-poppingly high, plan should not be confirmed (citing *Till*, 541 U.S. at 480–81)); *In re Bivens*, 317 B.R. at 769 (finding "eye-popping" interest rate suggested by creditor "not truly related to the risk of post-petition default" and likely to "'doom the plan'").

[102] 11 U.S.C. § 1111(b)(2) (2006). This election allows the holder of the secured claim to elect a full claim notwithstanding the section 506(a) bifurcation. 11 U.S.C. § 506(a)(1) (2006). It would, however, receive deferred cash payments that may have a present value as low as the value of the collateral. *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2006) (stipulating "deferred cash payments totaling . . . a value, as of the effective date of the plan, of at least the value of" the collateral).

fact that absolute priority may be accorded to the mortgagee's unsecured deficiency claim, which may effectively prevent the borrower from keeping the property without paying debts[103] unless the "new value exception" eventually triumphs.[104] In *Till*, Justice Stevens' somewhat confusing footnote 14 indicated that the plurality was not certain its decision in *Till* would apply in chapter 11.[105] If the Amendments are adopted, we may have an authoritative answer to Justice Stevens' unresolved question.

IV. HELPING HOMEOWNERS WHILE PUTTING A GOOD FACE ON CHAPTER 13

While at this writing we are unsure what, if anything, will eventually be forthcoming from Congress, we submit two suggestions for alternative amendments

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[103] 11 U.S.C. § 1129(b)(2)(B)(ii) (2006) (codifying absolute priority rule). Under section 1111(b) the holder of the secured claim is entitled to an unsecured claim for the unsecured portion of the debt as determined under section 506(a) notwithstanding that the debt is nonrecourse. 11 U.S.C. § 506(a) (2006) (bifurcating undersecured claim into secured claim to extent of value of underlying collateral and unsecured claim for deficiency); 11 U.S.C. § 1111(b) (2006) (treating holder of nonrecourse secured claim as having "recourse against the debtor" thus permitting such holder to have unsecured deficiency claim). In a single asset real estate case, the mortgagee's unsecured claim will generally dominate the unsecured class sufficiently to cause the unsecured class to reject the plan in those situations where the plan calls for the debtor to keep the property without paying the unsecured debt. 11 U.S.C. § 1126(c) (2006) (providing class accepts plan if "accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class"). The unsecured class would then be entitled to absolute priority under section 1129(b)(2)(B)(ii). 11 U.S.C. § 1129(b)(2)(B)(ii) (requiring plan be "fair and equitable" toward objecting impaired unsecured class which in turn requires application of absolute priority rule). Because of this power to prevent confirmation of the plan, the mortgagee is normally not sufficiently concerned about the interest rate on the secured claim to make a fuss. *See* David Gray Carlson, *Artificial Impairment and the Single Asset Chapter 11 Case*, 23 CAP. U. L. REV. 339, 345 (1994) (stating "[b]ecause the bank's nonrecourse mortgage is turned into a recourse claim" it can always block plan as dominant unsecured creditor).

[104] Under the so-called "new value exception" the borrower may infuse capital and override the protection discussed in the previous footnote. *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 120–21 (1939) (noting where necessary for the success of the enterprise "old stockholders [may] make a fresh contribution and receive in return a participation reasonably equivalent to their contribution"); In *Bank of America National Trust & Savings. Ass'n v. 203 N. LaSalle St. Partnership*, the Supreme Court did not decide whether the concept of new value survived the adoption of the Bankruptcy Code, but concluded that if the debtor's plan were not given market exposure, the retention of the property by the debtor was "'on account of'" its junior interest and thus barred by section 1129(b)(2)(B)(ii) even if a new value exception had been incorporated in the Code. 526 U.S. 434, 456–58 (1999). *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (2006) (prohibiting holders of junior claims from receiving or retaining "on account of" such interest where objecting senior class does not receive in full). One of our author's vituperative feelings toward the new value exception, may be found in Robert M. Zinman, *New Value and the Commission:* How Bizarre!, 5 AM. BANKR. INST. L. REV. 477, 478 (1997).

[105] *Till*, 541 U.S. at 476 n.14 (distinguishing chapter 11 from 13 with regard to "free market of willing cramdown lenders"). The reason given for that uncertainty suggested that the market exposure test might be preferred in chapter 11 because "numerous lenders advertise financing for Chapter 11 debtors in possession. . . . Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Id.* (listing several advertising sites for debtor in possession financing) (citations omitted). However, one must question whether looking to debtor in possession financing is the proper method of determining what the public would pay for a specific 100% of value mortgage.

that maybe help ease the burden on homeowners while mitigating some of the potential consequences that could result from the enactment of the Amendments.

A. Two Simple Changes

As mentioned earlier in this essay, there were simple changes in chapter 13 that might help make the present chapter more friendly to homeowners facing foreclosure in this crisis while helping to avoid some of the possible unintended consequences this essay discusses. They were: (i) simply delete the Safe Harbor in section 1322(b)(2) so that the plan may modify the rights of holders of secured claims on the debtor's principal residence; and, (ii) add a new subsection to section 1322(d) providing that, in connection with holders of secured claims on the debtor's principal residence, the plan may provide for payment of allowed secured claims over a period that is longer than five years, but not in excess of the remaining term of such mortgage.

If these two changes were applied to Bertha Borrower, her mortgage could be reduced to $200,000 (the value of the collateral) and this reduced mortgage would be paid off in the, say, ten years remaining on its term. While the interest rate would be the contract rate under the existing mortgage, the effect of the changes would be to reduce substantially Bertha's monthly payments, because the interest will be applied to half of the present base, and likewise, amortization will be substantially reduced. Also, because the most Draconian provisions of the Amendments would have been eliminated, it would also seem less likely that an attack, however justified, will be mounted on such a revised chapter 13 based on violation of section 1325(a)(5)(B)(ii) or the constitutional requirements discussed above.

B. Insuring Fairness and Good Bankruptcy Policy

In addition, we suggest adding a bit of sugar to make both the medicine go down and the statute fairer from both an equity and policy standpoint. There is no question that the mortgagee is being asked to make the sacrifice necessary to help Bertha Borrower stay in her home. This sacrifice includes, even under the modified simple changes suggested above, having its mortgage cut in half, with little prospect of recovery on the unsecured portion of the debt. We know, however, that real estate values fluctuate in cycles and that when this crisis is over, it is likely that realty values will rise sharply, perhaps to former levels or much higher. Yet, under the present statute there is no provision that would enable the lender to recoup any portion of what it was asked to sacrifice for the benefit of the borrower. This is unfair and bad bankruptcy policy.

Assume that next door to Bertha lives Harry Homeowner who has a similar mortgage of $400,000 on his house now worth only $200,000. Bertha files in chapter 13 and gets the mortgage reduced to $200,000 while Harry scrapes and sacrifices to continue to pay his debt service. In five years, Bertha, operating under her confirmed plan, has amortized her loan to say, $170,000 and Harry, not operating under chapter 13 but under the terms of his $400,000 mortgage, has amortized his loan down to $380,000. At this time the crisis has eased and both houses are now worth $300,000. But, Harry still has a $380,000 mortgage on his house while Bertha has a mortgage of only $170,000. Chapter 13 has given Bertha more than protection against foreclosure, it has given her a windfall with a permanent transfer of her lender's rights to cover a temporary crisis. At the same time, it has punished Harry for struggling to pay his debts. What this does is to encourage filing in bankruptcy for personal gain, which is obviously not the reason Congress passed the Bankruptcy Code in the first place.

This has been partially recognized in the House Bill which provides that the strip-down of the mortgage is permitted only on the condition that if the debtor sells the property during the period of the plan and the proceeds of the sale are greater than the stripped-down claim, the borrower must pay the lender 80% of the difference in the first year of the plan, 60% in the second year, 40% in the third year, and 20% in the fourth year. While this may recognize the inequity, it would seem to be more window dressing than substance. For example: (i) there is no payment if the property is not sold in the first four years of the plan so the debtor can avoid any payment by not selling until at least the fifth year of the plan; (ii) it would be inequitable as between the debtor forced to sell for economic reasons and the debtor not selling; and, (iii) it would still encourage bankruptcy filing because the debtor would in any case be able to keep large portions of the windfall, especially in the later years of the plan when increases in value are more likely.

But the idea is there, and it constitutes an acknowledgement of the potential inequity created by the Amendments. Our proposal is different. It is offered for discussion. It would not be conditioned on a sale of the property and would not provide for payment in cash by the borrower. It would provide that when the last payment is made under the plan, the court will revalue the property before granting a discharge. To avoid the time and expense of appraisals, the revaluation should be done based on a designated index of home sale prices in the area. If the revaluation shows the property is worth more than the initial section 506(a) valuation, then the mortgage will be adjusted back to reflect such increase.[106] Thus, in Bertha Borrower's case, if the value of property in her area had increased by 50% since the effective date of the plan, the principal balance of the mortgage would be raised by $70,000 ($100,000 increase in value less $30,000 she paid in amortization) to $270,000. It would still give her an advantage over Harry Homeowner whose mortgage is now at $380,000, but at least it would bring some equity to the outcome.

An adjustment along these lines would create an atmosphere of fairness in connection with bankruptcy administration and perhaps serve as a model that can be

[106] The adjustment should be limited to the amount of the mortgage that had been stripped-down, less any amortization after the case has been commenced.

used in other situations where bankruptcy must interfere with rights under contract because of a crisis in the economy.

CONCLUSION

The message this essay is attempting to communicate is that, however meritorious proposed legislation may be, if the potential consequences of the legislation are not thoroughly explored, the legislation, beneficial on its face, may be regretted. We have explored the unintended consequences that resulted from the inclusion of the Safe Harbor in chapter 13. And, at risk of being likened to Chicken Little,[107] have explored potential risks associated with the Amendments.

Whether and in what form the Amendments may be enacted, and whether a successful attack will be made after any such enactment, remains to be seen. We are concerned, however, that, if enacted, the Amendments may become the unintended catalyst that may result in a new sober look at whether chapter 13 can function as constitutionally and statutorily mandated.

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[107] A nervous person who continually warns of potential calamity. From a child's story about an individual who, when hit by an object falling from above, believed that the sky was falling.