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**Saving Homes in Bankruptcy:  
Housing Affordability and Loan Modification**

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SAVING HOMES IN BANKRUPTCY:  
HOUSING AFFORDABILITY AND LOAN MODIFICATION

John Eggum, Katherine Porter & Tara Twomey\*

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I. INTRODUCTION

Nationwide, millions of families are expected to lose their homes to foreclosure over the next several years.<sup>1</sup> Falling home prices and tighter credit markets have made it difficult or

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<sup>1</sup> See ELLEN SCHLOMER ET AL., LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 3 (2006) (estimating that 2.2 million families with subprime loans have lost or will lose their homes to foreclosure over the next few years); *Foreclosures to Affect 6.5 mln Loans by 2012-Report*, REUTERS, Apr. 22, 2008, <http://www.reuters.com/article/bondsNews/idUSN2233380820080422> (citing the Credit Suisse Report dated April 22, 2008, that estimated as many as 6.5 million foreclosures by the end of 2012, equating to 12.7% of all residential borrowers). In May 2008, Federal Reserve Chairman Ben Bernanke observed that 1.5 million homes were in some stage of foreclosure in 2007, an increase of 53% over the previous year. Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Columbia Business School's 32nd Annual Dinner (May 5, 2008), *available at*

impossible for families to refinance their way out of unaffordable home loans. The safety net provided by appreciating real property values has crumbled, leaving homeowners at risk of serious financial distress. For many families, homeownership has become a financial liability, rather than a financial asset.

To date, responses to the foreclosure crisis have left homeowners who are in default on their mortgage loans with few options. Foreclosures continue to outpace loan modifications,<sup>2</sup> despite being identified as a preferred strategy for reducing the number of foreclosures.<sup>3</sup> The federal government and the credit industry largely have confined their efforts to voluntary programs that offer, at best, temporary or limited aid, such as forbearance agreements or short-term modifications.<sup>4</sup> When other alternatives are unavailable or insufficient, families may turn to bankruptcy to prevent the loss of their home.<sup>5</sup> Bankruptcy permits homeowners to halt foreclosures and cure defaults on their mortgage loans by repaying missed payments over a period of years. However, families face serious challenges in saving their homes using bankruptcy law. In today's market, a large fraction of struggling homeowners may have mortgage obligations that are not affordable.<sup>6</sup> Bankruptcy law does not permit debtors to modify the terms of mortgages secured by a principal residence.<sup>7</sup> This limitation on restructuring home mortgage loans may pose an insurmountable barrier to families who are trapped in unaffordable loans. Such families may be unable to avoid foreclosure using the bankruptcy process because they cannot

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<http://www.federalreserve.gov/newsevents/speech/Bernanke20080505a.htm>). Foreclosures continue to surge in 2008. *See* Press Release, RealtyTrac Staff, U.S. Foreclosure Activity Increases 23 Percent in First Quarter (Apr. 29, 2008), *available at*

<http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4566&acct=64847> (stating that foreclosure filings for first quarter 2008 were up 23% from the previous quarter).

<sup>2</sup> In September 2007, Moody's Investor Services surveyed sixteen mortgage servicers that accounted for 80% of the market for subprime loans and found that most of those companies had modified only about 1% of loans with interest rates that reset in January, April, and July 2007. MICHAEL P. DRUCKER & WILLIAM FRICKE, MOODY'S SUBPRIME MORTGAGE SERVICER SURVEY ON LOAN MODIFICATIONS 1 (Sept. 21, 2007), *available at* [http://americansecuritization.com/uploadedFiles/Moodys\\_subprime\\_loanmod.pdf](http://americansecuritization.com/uploadedFiles/Moodys_subprime_loanmod.pdf). In a December 17, 2007 update, Moody's reported that the number had only slightly increased to 3.5%. AASHISH MARFATIA, U.S. SUBPRIME MARKET UPDATE: NOVEMBER 2007, STRUCTURED FINANCE 2 (2007). Recent data from the HOPE NOW Alliance indicates that foreclosure starts in the third quarter of 2008 (575,000) are nearly double the number of loan modifications for the same period (264,000). HOPE NOW Loss Mitigation National Data July 07 to October 2008, *available at*

[http://www.hopenow.com/site\\_tools/data.php](http://www.hopenow.com/site_tools/data.php). Similarly, recent information from the Federal Housing Finance Agency shows that in August 2008 servicers modified a mere 4,402 loans out of the 31 million loans guaranteed by Freddie Mac and Fannie Mae while delinquencies climbed to 2.03% of the total loans. *See* Emily Flitter, *Loan Mods at 4k in August for GSEs*, *American Banker* (Nov. 26, 2008).

<sup>3</sup> *See, e.g.*, Shelia C. Bair, Chairwoman, Fed. Deposit Ins. Corp., Remarks at American Securitization Forum Annual Meeting (June 6, 2007) ("The immediate task is to sustain homeownership by ensuring that servicers have the flexibility they need to make prudent loan modifications.").

<sup>4</sup> *See, e.g.*, Anna Marie Kukec, *Trend Won't End Soon, So What's Being Done?*, *DAILY HERALD*, Nov. 28, 2007, at 1, (highlighting the temporary and limited extent of programs intended to help with the foreclosure crisis).

<sup>5</sup> *See* Posting of Bob Lawless to Credit Slips: A Discussion on Credit and Bankruptcy, <http://www.creditslips.org/creditslips/2008/05/foreclosures-an.html#more> (May 21, 2008, 19:39) (suggesting higher bankruptcy filing rates may be tied to the foreclosure crisis).

<sup>6</sup> Some of these families may have unaffordable loans because of easy underwriting standards used at the time of loan origination. Another large subset of families may have adjustable-rate loans with mortgage payments that have sharply escalated after loan origination.

<sup>7</sup> 11 U.S.C. § 1322(b)(2) (2006). By contrast, bankruptcy debtors may modify mortgage debt on investment property and second homes. *See id.*

keep up with their ongoing mortgage payments or cannot do so while curing the defaults on their mortgage loans.

This Article explores the intersection between home affordability and the potential of bankruptcy to help families save their homes from foreclosure. Using an original data set of homeowners who filed chapter 13 bankruptcy, this Article analyzes the relationship between housing costs and income for bankrupt families. This Article finds that more than two-thirds of bankrupt families live in unaffordable or severely unaffordable housing according to standards used by the Department of Housing and Urban Development.<sup>8</sup> These families must devote a large proportion of their incomes to housing costs, which could jeopardize their chance to save their homes and lower the odds that they complete their bankruptcy cases successfully. Amending bankruptcy law to permit the modification of the terms of home mortgages could reduce unaffordable housing costs and enhance the usefulness of bankruptcy as a tool to address the current foreclosure crisis.

Part II of this Article explains the benefits and limitations of using chapter 13 bankruptcy as a home-saving device. Part III describes the methodology of a mortgage study that contains over 1700 chapter 13 bankruptcy cases filed by homeowners (“Mortgage Study”), and explains the metrics used to assess the affordability of these debtors’ housing costs. Part IV presents the Mortgage Study data on the housing affordability for bankrupt families. Part V considers the implications of these findings for improving the bankruptcy system and for crafting effective policy responses to the rising number of foreclosures.

## II. BANKRUPTCY AS A HOME-SAVING DEVICE

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to bankruptcy as a last resort to try to save their homes.<sup>9</sup> A bankruptcy filing halts a pending foreclosure.<sup>10</sup> Debtors who file a chapter 13 bankruptcy case can cure any defaults on mortgage loans over a period of years.<sup>11</sup> This right to cure is applicable even if the creditor has accelerated the loan and even if state law or the loan contract does not provide such a right.<sup>12</sup> This right to repay mortgage arrearages over time offers families the opportunity under federal law to save their homes from foreclosure.

To retain a home in chapter 13 bankruptcy, the law generally requires bankruptcy debtors to make their ongoing monthly mortgage payments as well as to make additional periodic payments to repay any arrearages on the mortgage loan.<sup>13</sup> As a result, chapter 13 bankruptcy is well-suited to aid families who have defaulted on their mortgage loans due to a temporary loss of income (e.g., unemployment, illness, divorce). If debtors have recovered from this temporary setback at the time of bankruptcy, they may have sufficient income to make ongoing mortgage payments as well as make payments under their bankruptcy plans to repay any past due amounts. Homeowners

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<sup>8</sup> See *infra* Part IIIB.

<sup>9</sup> Raisa Bahchieva et al., *Mortgage Debt, Bankruptcy, and the Sustainability of Homeownership*, in CREDIT MARKETS FOR THE POOR 73 (Patrick Bolton & Howard Rosenthal eds., 2005) (stating that chapter 13 bankruptcy is frequently used by families who face foreclosure and explaining its benefits over chapter 7 bankruptcy for homeowners).

<sup>10</sup> See 11 U.S.C. § 362. A limited exception to this general rule for repeat filers was enacted in 2005. See Pub. L. No. 109-8, § 302, 119 Stat. 23 (codified at 11 U.S.C. § 362(c)(4)).

<sup>11</sup> See 11 U.S.C. § 1325(b).

<sup>12</sup> See, e.g., *In re Robinson*, 285 B.R. 732, 738 (Bankr. W.D. Okla. 2002) (stating that federal bankruptcy law right to cure could not be frustrated by state law).

<sup>13</sup> See, e.g., *General Motors Acceptance Corp. v. Chapman (In re Chapman)*, 135 B.R. 11, 14 (Bankr. M.D. Pa. 1990) (noting practice of allowing debtors to extend their plans to repay arrearages on mortgages).

facing foreclosure because they are overwhelmed with unsecured debts, such as credit card or medical bills, may also benefit from a chapter 13 bankruptcy. For these debtors, bankruptcy can reduce the amounts owed to unsecured creditors to a fraction of the total debt, thereby freeing up income to permit debtors to meet their mortgage payments. Debtors who have rebounded from temporary income loss or who need to address large unsecured debts stand the greatest chance of saving their homes in bankruptcy.

Embedded in this description of the benefits of chapter 13 bankruptcy for homeowners in financial distress is a crucial assumption—that these families have incomes at the time of their bankruptcy filings that are sufficient to permit them to meet their future mortgage payments and other living expenses. To receive a bankruptcy discharge and to cure defaults on their mortgage loans, families need to stay current on their ongoing mortgage obligations. A family's success in saving its home in bankruptcy may turn in large part on the relationship between its current income and its housing costs.

An example from a bankruptcy case in the Mortgage Study sample is illustrative.<sup>14</sup> This bankrupt family had a thirty-year fixed-rate mortgage loan with an interest rate of 7.35%. The monthly mortgage payment for principal and interest at the time of the debtor's bankruptcy filing was \$503. Other housing costs such as taxes, insurance, water, sewer, electricity and heating fuel added another \$286 per month to the housing expenses, which totaled \$789. The family's monthly gross income at the time of the bankruptcy filing was \$1908. This family's housing costs subsumed 41% of its income. When it filed bankruptcy, the family owed a past due debt to its mortgage creditor of \$5234 in principal and interest and \$1228 in fees and costs. To cure the default and save its home from foreclosure, this family needed to repay this total arrearage of \$6462. Currently the most common loss mitigation option offered by mortgage companies to struggling homeowners is a repayment plan. Yet, this non-bankruptcy option is not likely to be workable for this family. Under a typical twelve-month repayment plan, this family would have to pay an additional \$538 per month for one year. This would increase the family's total housing costs to \$1327 per month and push the debtor's housing costs-to-income ratio to 69%. That is, a repayment plan outside of bankruptcy would require the family to commit a little more than two of every three dollars that it earned as income to its mortgage obligations. Additionally, this nonbankruptcy repayment option would leave the debtor with only \$581 in residual income after meeting its housing costs to pay for food, transportation, telephone, medical costs, credit card debt payments and other miscellaneous expenses.

By contrast, in bankruptcy, this family could cure the arrearage on the mortgage loan over a period of up to five years as part of a chapter 13 repayment plan.<sup>15</sup> The arrearage of \$6462 could be repaid over sixty months, which translates to \$108 per month to the mortgage creditor to cure the default. This additional payment boosts the family's housing costs-to-income ratio up to 44%. While this increase may still be a challenge for the family to manage, it is likely to pose a significantly smaller obstacle than the most common repayment plan available outside of bankruptcy. In this case, the debtors' actual bankruptcy plan proposed a monthly payment of

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<sup>14</sup> This example is based upon the petition, schedules, chapter 13 plan and mortgagee's proof of claim in Mortgage Study case ED VA 38 (on file with Katherine Porter). Each case in the Mortgage Study sample was given a unique identifier assigned by the researchers (ED VA 38, in this instance). The letters signify the judicial district where the case was filed. The numbers represent the sequence of the case in the sample. We do not refer to the cases by their court-supplied case numbers because we do not wish to violate the privacy concerns of the debtors whose cases were randomly selected for inclusion in the Mortgage Study sample. Bankruptcy court records, however, are public documents and all cases are on file with author Katherine Porter, as noted.

<sup>15</sup> See 11 U.S.C. §§ 1322, 1325. The length of the plan is affected by the debtor's income and family size, as well as whether or not unsecured claims will be paid in full. See 11 U.S.C. §§ 1322(d), 1325(b)(1), (b)(4).

\$328, which covered not only the mortgage arrears, but also tax arrears, the trustee payment,<sup>16</sup> attorney fees and a 100% repayment of all debts owed to unsecured creditors.<sup>17</sup> Two years later this family is faring well in bankruptcy. They appear to be current on their ongoing payments to their mortgage creditor and their bankruptcy repayment plan remains pending.

As the above example demonstrates, bankruptcy can be a powerful tool for fighting foreclosure because it can improve a family's chances for catching up on past, missed mortgage payments. However, the ability of homeowners to cure mortgage defaults in bankruptcy is significantly undermined when their monthly mortgage payments before bankruptcy are severely unaffordable. Debtors who have suffered a permanent decline in income before bankruptcy are less likely to be able to take advantage of their right under bankruptcy law to repay their debts through a chapter 13 repayment plan. Similarly, debtors suffering from payment shock as a result of teaser rates on adjustable-rate mortgages,<sup>18</sup> or those who have been saddled with unaffordable loans from the moment of loan origination<sup>19</sup> will find it more difficult to save their homes under the current bankruptcy laws.

Homeowners with mortgage payments that overwhelm their incomes face much greater challenges in saving their homes in bankruptcy. The right to cure a mortgage default under § 1322(b)(5) of the Bankruptcy Code does not itself permit a homeowner to modify terms of a mortgage loan. Section 1322(b)(2) sets forth the general rules regarding modification of claims in bankruptcy, permitting debtors to modify the rights of secured and unsecured creditors. Some of the ways that secured claims may be modified include altering the payment schedule, reducing

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<sup>16</sup> The chapter 13 trustee collects payments made by chapter 13 debtors and disburses those payments to creditors in accordance with the debtor's confirmed chapter 13 plan. *See* *First Bank and Trust v. Gross (In re Reid)*, 179 B.R. 504, 507 (E.D. Tex. 1995). The chapter 13 trustee is generally paid a commission or fee for administering these payments. *See* 9 AM. JUR. 2D BANKRUPTCY § 588 (2006). The fee is typically 4–10% of the amount being paid through the plan. *Id.*

<sup>17</sup> The trustee will pay a dividend to unsecured creditors in accordance with the debtor's chapter 13 plan. *See In re Phelps*, 149 B.R. 534, 535 (Bankr. N.D. Ill. 1993) (noting trustee payment of dividends to unsecured creditors). In chapter 13, debtors may modify claims of unsecured creditors by paying them less than the full value of their claim. *See* 11 U.S.C. § 1322(b)(2). Unsecured creditors may receive a dividend of 0 to 100% on their claims. *See Branigan v. Bateman (In re Bateman)*, 515 F.3d 272, 280 (4th Cir. 2008) (stating varying range of dividend percentages). A dividend of 100% means the unsecured creditors will be paid in full, a dividend of 50% means the unsecured creditors will be paid fifty cents on the dollar and a 0% dividend will produce no return to the unsecured creditors. After unsecured creditors are paid the dividend specified in the debtor's chapter 13 plan, any remaining debt is discharged upon completion of the plan. *See* 11 U.S.C. § 1328.

<sup>18</sup> *See generally* MAJORITY STAFF OF THE JOINT ECON. COMM., THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX REVENUES, AND HOW WE GOT HERE 6, 20 (2007), available at <http://jec.senate.gov/archive/Documents/Reports/10.25.07OctoberSubprimeReport.pdf> (identifying the root of the subprime mortgage crisis as the prevalence of 2/28 and 3/27 teaser loans).

<sup>19</sup> *See generally* STATE FORECLOSURE PREVENTION WORKING GROUP, DATA REP. NO. 1, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE 10 (2008) (stating that more than 30% of subprime and Alt-A ARMs are already at least thirty days past due before any rate reset). Over the past several years, many borrowers were unwittingly pushed into unaffordable loans by unscrupulous mortgage brokers or lenders. *See, e.g., Mortgage Market Turmoil, Causes and Consequences: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement of Alan M. White, Community Legal Services, Inc., on behalf of Jennie Haliburton), available at [http://banking.senate.gov/public/\\_files/haliburton.pdf](http://banking.senate.gov/public/_files/haliburton.pdf) (describing elderly homeowner whose monthly payment for principal, interest, taxes and insurance consumed 62% of her social security payment and left her with only \$664 a month for all other expenses such as food, medicine, and utilities).

the contract interest rate,<sup>20</sup> or “stripping down” the amount of the claim to the value of the collateral.<sup>21</sup> However, the rule permitting the modification of secured claims is limited by additional language in the same section that creates an exception for certain mortgage loans. The exception prohibits the modification of “a claim secured only by a security interest in real property that is the debtor’s principal residence.”<sup>22</sup> This exception is commonly known as the “anti-modification” rule. This language means that bankruptcy debtors cannot change or adjust the terms of their home mortgages. This restriction on loan modification can make it nearly impossible for debtors with unaffordable mortgage payments to save their homes from foreclosure through the bankruptcy process.

Because families remain obligated to make their future mortgage payments according to the original loan terms, those who have severely unaffordable mortgage loans may be more likely to fail in chapter 13 bankruptcy. Sometimes, the high housing costs began at the time of loan origination. For example, a debtor from the Mortgage Study was saddled with a monthly mortgage payment of \$2465, which was nearly equal to her monthly gross income of \$2699.<sup>23</sup> The debtor’s mortgage loan was a six-year fixed-rate loan with an interest rate of 11%. The loan was an “interest only” obligation with a \$271,465 balloon payment due at the end of the six-year term. The debtor’s bankruptcy court records listed an additional monthly contribution from a family member of \$1322. However, even with these additional funds the monthly mortgage payment consumed 62% of household income without taking into consideration real estate taxes, insurance and utilities. Unable to make the monthly mortgage payments going forward, the automatic stay preventing foreclosure on the home was lifted by the court within just a few months of the bankruptcy filing. Despite seeking relief in bankruptcy, this debtor lost her home to foreclosure.<sup>24</sup>

Similarly, debtors suffering from payment shock on adjustable-rate mortgages may also be unable to use bankruptcy to save their homes. The so-called exploding adjustable-rate mortgage is

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<sup>20</sup> See, e.g., *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004) (holding that in modifying the interest rate on a car claim being paid under a chapter 13 plan, the bankruptcy court should use the prime rate, adjusted to reflect potential risk, taking into account “such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan”).

<sup>21</sup> “Stripping down” or bifurcating a secured creditor’s claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion represented by any amount owed over the value of the collateral. 11 U.S.C. § 506(a)(1); see *American Gen. Fin. v. Paschen* (*In re Paschen*), 296 F.3d 1203, 1206 (11th Cir. 2002) (defining “secured” and “unsecured” portions of a bifurcated claim). Section 506(a), which authorizes such bifurcation, provides that a creditor’s claim “is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property.” 11 U.S.C. § 506(a). The section serves two purposes: (1) it limits the estate’s liability on a secured claim to payment up to the actual value of the collateral, and (2) it permits the under-secured creditor to have an allowed unsecured claim and share on par with the other allowed unsecured claims. Through this process, the secured creditor’s rights in the collateral are preserved, but its rights to the debtor’s property other than the collateral are limited and no greater than those of other creditors. Thus, the Code prevents the secured creditor from obtaining an unfair advantage in the bankruptcy case over the unsecured creditors out of proportion to the true value of its security interest.

<sup>22</sup> 11 U.S.C. § 1322(b)(2); see *Nobleman v. Am. Sav. Bank*, 508 U.S. 324, 331–32 (1993).

<sup>23</sup> This example is drawn from the bankruptcy court records of Mortgage Study case ND CA 5 (on file with Katherine Porter). Notably, the debtor’s Statement of Financial Affairs reveals that the debtor’s income between 2002 and 2005 never exceeded \$28,000 per year (\$2333 per month), yet the loan, which was originated in September 2005, from the outset had a monthly mortgage payment of \$2465.

<sup>24</sup> The bankruptcy court records do not reveal the house’s ultimate disposition but the county records show a trustee’s deed was filed after a notice of default and notice of trustee sale, consistent with a completed non-judicial foreclosure. (land record on file with Katherine Porter).

the mortgage product that dominated the subprime market from 2004 to 2006.<sup>25</sup> It is usually characterized by a fixed interest rate for the first two years of the loan, followed by an adjustment of the interest rate every six months thereafter.<sup>26</sup> Often, these loans were structured with an initial “teaser” or discounted interest rate for a period of two or three years. After the initial period of the fixed interest rate expires, the loan’s interest rate, and accordingly the borrower’s payments, usually increase significantly. In one case from the Mortgage Study, a Minnesota family had an adjustable-rate mortgage with an initial teaser interest rate of 7.99% and a monthly principal and interest payment of \$1781.<sup>27</sup> While the debtors’ income remained stable from prior years, in the seven months before bankruptcy the interest rate on their loan adjusted twice. These changes caused the interest rate on their loan to escalate to 10.99%, giving the family a monthly payment of \$2780. The payment shock from the interest adjustment added \$1000 per month to the family’s mortgage obligation. After the interest rate adjusted on the loan, the debtors did not make any payments on it. At the time of bankruptcy, the debtors’ housing costs, including mortgage payment (principal, interest, taxes, and insurance) and utilities for the home (water, sewer, and garbage) were equal to 67% of the debtors’ income. Within one year of filing chapter 13 bankruptcy, this family faced a motion from its mortgage creditor to lift the bankruptcy stay of foreclosure. The court granted the motion, giving the creditor permission to foreclose under state law. Although the bankruptcy court records do not detail the final outcome, this family probably lost its home. Bankruptcy did not permit this family to address the real obstacle to keeping its home—unaffordable ongoing mortgage payments.

Bankruptcy law’s current prohibition on modifying home mortgage loans is a serious limitation on bankruptcy’s usefulness as a home-saving device. Families who have recovered from temporary income declines or whose primary financial problem is large unsecured debts may succeed in saving their homes in bankruptcy. However, the families who are in financial distress because they are trapped in unaffordable home loans may find little relief under existing bankruptcy law. The remainder of this Article constructs an empirical measure of the affordability of bankrupt families’ housing costs in relation to their current incomes and analyzes the implications of these findings for bankruptcy’s potential as a foreclosure prevention system.

### III. METHODOLOGY

The data presented in this Article comes from the Mortgage Study, an original database of homeowners in bankruptcy. This section briefly describes the methodology of that study<sup>28</sup> and details the affordability standard that we use to measure the housing costs of bankrupt households.

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<sup>25</sup> See CTR. FOR RESPONSIBLE LENDING, A SNAPSHOT OF THE SUBPRIME MARKET 1 (2007), *available at* <http://www.responsiblelending.org/pdfs/snapshot-of-the-subprime-market.pdf> (reporting 89–93% of subprime mortgages made from 2004 to 2006 had exploding interest rates).

<sup>26</sup> The interest rate on an adjustable-rate mortgage is usually based on the value of an index, such as LIBOR (London Inter-Bank Offered Rate) or comparable U.S. treasuries, plus a fixed amount called the margin. The margin in Mortgage Study case D MN 22 (on file with Katherine Porter) was 7.74%, and the LIBOR index on the date of consummation was 1.186%. See BBA, 2003 – HISTORIC LIBOR RATES, <http://www.bba.org.uk/content/1/c4/24/38/Aug03.xls>. The fully indexed rate on the date of consummation was 8.93%.

<sup>27</sup> This example is based on the bankruptcy court records in Mortgage Study case D MN 22 (on file with Katherine Porter).

<sup>28</sup> For a more extensive recitation of the Mortgage Study’s methodology, see Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. (forthcoming 2008) (manuscript at 13–16, *available at* <http://ssrn.com/abstract=1027961>).

### A. Mortgage Study

The Mortgage Study is a large, multi-state study of chapter 13 bankruptcy debtors who are homeowners. The study's main objective was to develop comprehensive data on the intersection of mortgage lending, homeownership, and bankruptcy.<sup>29</sup> The National Conference of Bankruptcy Judges' Endowment for Education, a non-profit and non-partisan organization that funds basic research and education about bankruptcy, provided financial support for the study.<sup>30</sup> Katherine Porter and Tara Twomey are co-principal investigators of the study.

The Mortgage Study built a sample of 1733 chapter 13 bankruptcy cases.<sup>31</sup> To be included in the study, the bankruptcy debtor had to own a home.<sup>32</sup> The cases were filed during the month of April 2006.<sup>33</sup> Because of rapid changes in the mortgage market in the last few years, the data may not reflect the effects, if any, of the current "foreclosure crisis" on the bankruptcy system. For example, the sample may underrepresent the affordability problems created by adjustable-rate mortgages, which continued to grow in popularity until late in 2006. On the other hand, the data may be more representative of the usual situations of households that file bankruptcy to save homes during the thirty-year period since the Bankruptcy Code's adoption in 1978 of the law restricting the modification of home mortgages.

The sampling procedure was to select every fifth case in each judicial district included in the sample. In this way, the sample reflects the number of chapter 13 filings per district, so that districts with higher numbers of chapter 13 filings are represented accordingly.<sup>34</sup> The sample includes bankruptcy cases filed in forty-four judicial districts, which represent twenty-four different states.<sup>35</sup> These states all permit non-judicial foreclosure of residential mortgages. We limited the sample in this regard because we believe that homeowners may be more likely to file bankruptcy as an anti-foreclosure measure in non-judicial foreclosure states where foreclosure is usually easier and faster.<sup>36</sup>

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<sup>29</sup> *Id.* at 15.

<sup>30</sup> The National Conference of Bankruptcy Judges and its Endowment for Education ("Endowment") are not responsible for the data or findings presented in this Article, which are solely the responsibility of the authors. In funding the grant, the Endowment does not endorse or express any opinion about the methodology utilized, or any conclusions, opinions, or results contained in any report, article, book, or other writing based on the research funded by the Endowment.

<sup>31</sup> We excluded chapter 7 cases from the sample because homeowners are less likely to file chapter 7 bankruptcy than chapter 13 bankruptcy. *See* Bahchieva et al., *supra* note 9, at 104 (reporting that homeowners are "nearly 50 percent more likely to file for Chapter 13 than Chapter 7"). Homeowners prefer chapter 13 because it contains special provisions to permit homeowners to cure defaults on their mortgages by repaying arrearages over time through their repayment plan. *See* 11 U.S.C. §§ 1322, 1325 (2006).

<sup>32</sup> While all cases in the sample were filed by homeowners, four percent of these homeowners did not report owing any mortgage debt at the time of bankruptcy.

<sup>33</sup> The initial coding of the data occurred in October or November 2006. We intentionally allowed for this lapse of time to try to ensure that the court records were substantially complete when we coded the data. We rechecked the court records approximately eighteen months after the initial filing to check for any additional objections to mortgagees' proofs of claim.

<sup>34</sup> For example, in a district with few chapter 13 filings, such as Wyoming, only two cases are in the sample. At the other extreme, the sample contains 164 cases from the Northern District of Georgia because that district has a large number of chapter 13 cases filed.

<sup>35</sup> In 2006, the chapter 13 bankruptcy filings in these states accounted for 61% of all chapter 13 filings in the nation.

<sup>36</sup> *See* Porter, *supra* note 28, at n.83 (citing BARLOW BURKE, REAL ESTATE TRANSACTIONS 336 (2006) ("[Power of sale foreclosure] is cheaper than judicial foreclosure and takes less time.")); *see also* 1 GRANT NELSON & DALE WHITMAN, REAL ESTATE FINANCE LAW 635 (2002) (discussing the extensive procedures involved in judicial foreclosures).

The data come from the public court records in each debtor's case. The electronic filing system for federal court pleadings, PACER,<sup>37</sup> was used to access most of the records.<sup>38</sup> In each case, data was coded from the debtor's bankruptcy petition and schedules of assets and liabilities. Data was also drawn from the case docket and from any proofs of claim and attachments thereto filed by mortgage creditors or their agents. Approximately 150 pieces of data were coded for each case.

This Article analyzes the housing affordability of bankruptcy debtors in 1713 cases. Twenty cases were eliminated from the complete Mortgage Study sample because of irregularities in these few debtors' schedules.<sup>39</sup> To calculate home affordability, we adopted the standard of the Department of Housing and Urban Development ("HUD") as detailed *infra* in the next section. That metric requires two main pieces of data: income and housing costs.

Data on income were coded from Schedule I of each debtor's bankruptcy schedules.<sup>40</sup> This income figure represents the debtor's actual monthly income at the time of the bankruptcy filing. Comparing these income data with debtors' housing costs provides a robust measure of debtors' abilities to pay their housing expenses at the time they filed chapter 13 bankruptcy.<sup>41</sup>

A debtor's "housing cost" as referred to in this Article is a combination of four expenses. Each of these expenses is reported on debtors' bankruptcy records on Schedule J: (1) mortgage payment;<sup>42</sup> (2) property tax payment; (3) insurance payment; and (4) utility payments.<sup>43</sup> The

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<sup>37</sup> PACER is an acronym for Public Access to Court Electronic Records, the online system for accessing federal court records.

<sup>38</sup> We thank the chief judges of each district (with one exception) in the Mortgage Study for granting us a research waiver of PACER fees. The Southern District of Texas, a consolidated court in which the District Court determines whether to grant a fee waiver, denied our application for a fee waiver. When PACER did not appear to contain complete court files, we obtained paper records.

<sup>39</sup> Some cases were eliminated because of missing information, such as no income given on the appropriate schedule despite an indication that the debtor was employed. Others were eliminated because the debtor reported a mortgage payment of zero despite listing a mortgage debt on the schedule of secured debt. Before elimination, each of these cases was individually reviewed for coding error.

<sup>40</sup> The Mortgage Study also coded data on income from each debtor's Form B22, which is the form that collects the data for the "means test" used to determine a bankruptcy debtor's eligibility for bankruptcy relief and their repayment obligations in chapter 13. The Form B22 income figure, although labeled "current monthly income," is in fact an average of the debtor's historical income for the six months before the bankruptcy filing. *See* 11 U.S.C. § 101(10A) (2006); *see also* B22C (Official Form 22C) (Chapter 13) (01/08) (2008), available at [http://www.uscourts.gov/rules/BK\\_Forms\\_08\\_Official/B\\_022C\\_0108f.pdf](http://www.uscourts.gov/rules/BK_Forms_08_Official/B_022C_0108f.pdf). Thus, the Schedule I income data are more representative of a debtor's income when a debtor decided to file chapter 13 and attempted to retain their homes. To satisfy our curiosity, we did analyze debtors' B22 income in relation to housing costs. The results were largely similar, but because Schedule I income (time of bankruptcy filing) was often somewhat lower than Form B22 income (average income in months before bankruptcy), the findings on housing affordability were somewhat less grim than those that are the focus of this Article. We note that we have no reason to know the direction of change of debtors' incomes after bankruptcy filing. While some households may improve their financial prospects, others may find that their incomes continue to decline.

<sup>41</sup> Knowing debtors' income at the time they took out their mortgage loans would provide an additional perspective on debtors' decision-making in borrowing and the lenders' original terms for underwriting the loan with regard to income. These data are difficult, if not impossible, to derive from the bankruptcy court records. A major barrier in this regard is the failure of many mortgagees to attach a note to their claim from which a loan date could be obtained. *See* Porter, *supra* note 28 (manuscript at 17) (showing that 41.1% of mortgage creditors did not file a note with their proofs of claim). The other difficulty is that the Statement of Financial Affairs that is part of debtors' schedules provides income data for, at most, the three years that preceded the bankruptcy, and loan origination often preceded that period.

<sup>42</sup> If a debtor had more than one mortgage loan, we combined the payment on each obligation to calculate their total housing obligations.

coding procedure accounted to the greatest extent possible for whether tax or insurance were included in a debtor's mortgage payment.<sup>44</sup> Payments that were included in the utility expense were electricity, gas or oil, water, and sewer.<sup>45</sup>

### B. Calculating Affordable Housing

"Affordable housing" is a flexible and nebulous concept. The term has been invoked in several ways, depending on context and objective.<sup>46</sup> HUD has made the concept of affordability more concrete by creating a measure that reflects the percentage of income that a household spends on housing costs.<sup>47</sup> HUD then categorizes housing as affordable, unaffordable, or severely unaffordable based on whether housing cost divided by household income exceeds certain thresholds.<sup>48</sup> A household is deemed to be living in affordable housing if its housing costs subsume no more than 30% of its income.<sup>49</sup> A household is termed to have unaffordable housing if it commits between 30% and 50% of its income to paying housing costs.<sup>50</sup> Severely unaffordable housing is defined as requiring a household to expend more than half (50%) of its income.<sup>51</sup>

HUD's housing affordability standards have shaped federal housing policy for decades.<sup>52</sup> For example, HUD has issued an internal directive to mortgage companies stating that loans insured

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<sup>43</sup> See B6J (Official Form 6J) (12/07) (2007), available at [http://www.uscourts.gov/rules/BK\\_Forms\\_1207/B\\_006J\\_1207f.pdf](http://www.uscourts.gov/rules/BK_Forms_1207/B_006J_1207f.pdf).

<sup>44</sup> Some debtors included taxes and/or property insurance in their reported mortgage payment. To prevent double-counting, the Mortgage Study coding noted whether each debtor had indicated in the pre-printed box on the schedule that the mortgage payment included tax or insurance. The utilities coded were electricity, water/sewer, and gas.

<sup>45</sup> Schedule J contains an "other" utility field. See *id.* A small fraction (45 of 1713) of debtors in the Mortgage Study sample entered all utilities in this field as a combined number, sometimes including cable television or another expense that is not part of the utility expense in the housing affordability standard. Because we had no way to know what portion of these combined figures was attributable to specific utilities, we used the entire amount of the combined utility. It is unlikely that this had any effect on the analysis because of the small number of schedules completed in this manner and because of the low amounts of combined utilities in relation to the overall housing expense figure. Specifically, the average and median "other" utility expenses were \$162 and \$113, respectively, for Mortgage Study cases.

<sup>46</sup> See J. David Hulchanski, *The Concept of Housing Affordability: Six Contemporary Uses of the Housing Expenditure-to-Income Ratio*, 10 HOUS. STUD. 471, 475–86 (1995) (discussing the historical development and modern use of expenditure-to-income ratios as an affordability metric).

<sup>47</sup> See DAVID A. VANDENBROUCKE, HOUSING AFFORDABILITY DATA SYSTEM 11, 14 (2007), available at [http://www.huduser.org/Datasets/hads/HADS\\_doc.pdf](http://www.huduser.org/Datasets/hads/HADS_doc.pdf) (explaining the Housing Affordability Data System dataset and detailing the metrics used by HUD to evaluate housing costs and burdens).

<sup>48</sup> See *id.* at 11; OFFICE OF POLICY DEV. AND RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING, 1978–1999, at 1 (2003) [hereinafter TRENDS IN WORST CASE NEEDS FOR HOUSING], available at <http://www.huduser.org/publications/PDF/trends.pdf>.

<sup>49</sup> The 30% figure is the baseline HUD standard. See VANDENBROUCKE, *supra* note 47, at 11. The actual criteria used by HUD incorporates a statistical analysis of regions, area median incomes, housing fair market value, and area poverty levels to analyze what is affordable for a given area. *Id.* at 7–13; see also TRENDS IN WORST CASE NEEDS FOR HOUSING, *supra* note 48, at 1.

<sup>50</sup> TRENDS IN WORST CASE NEEDS FOR HOUSING, *supra* note 48, at 1.

<sup>51</sup> *Id.*

<sup>52</sup> The 30% figure is the end result of an evolving policy begun in the 1920s that suggested that all housing, owned and rented, should cost one week's worth of wages (a 25% of income standard). See DANILO PELLETIERE, GETTING TO THE HEART OF HOUSING'S FUNDAMENTAL QUESTION: HOW MUCH CAN A FAMILY AFFORD? 1–2 (2008), available at [http://www.nlihc.org/doc/AffordabilityResearchNote\\_2-19-08.pdf](http://www.nlihc.org/doc/AffordabilityResearchNote_2-19-08.pdf). Thirty percent has been the most used standard since the 1970s. *Id.* at 1–5.

by the Federal Home Administration (FHA) may be issued only when housing payment-to-income ratios do not exceed 31%.<sup>53</sup> When Congress has legislated, it has demonstrated a special concern for those spending more than 30% of their income on housing.<sup>54</sup> For those with severely unaffordable housing costs (households spending more than 50% of their incomes on housing), Congress has enacted laws that attempt to give even greater aid.<sup>55</sup> The widespread adoption of the HUD affordability standard makes it the best available metric for assessing the challenges that bankrupt households may face in retaining their homes in chapter 13 bankruptcy.

While a concrete, objective benchmark for determining affordability is a useful tool, it is not a perfect measure of whether a family can meet its housing expenses without undue hardship for the following reasons. First, the HUD standard has a fixed-time approach. For example, the HUD affordability benchmark assumes that income is stable and does not consider income volatility. A further assumption is that housing costs are fixed. However, property tax rates, insurance premiums, and utility costs are apt to change over time, usually increasing at least annually. For debtors with adjustable-rate mortgages, even their mortgage payment may change as time elapses. While these are real limitations, such assumptions are an inherent part of the HUD affordability standard. Further, the general analytical model that is used in chapter 13 bankruptcy is also a snapshot, moment-in-time approach that considers what the debtor can afford to pay at the time of the bankruptcy filing or at plan confirmation, which typically occurs a few weeks thereafter. Both the Bankruptcy Code and HUD use static measures to capture what is in reality a dynamic relationship between income and expenses. While the analytical approaches are parallel, the attempt is nonetheless to forecast a household's financial future using limited data from a particular moment in time.

Second, merely because the HUD standard labels housing as unaffordable does not mean that some Americans do not actually succeed in paying for such housing. Studies show that many homeowners exceed HUD's affordability guidelines. The Joint Center for Housing Studies of Harvard University reports that, as of 2006, about 29.5% of all U.S. homeowners, corresponding to over 22 million households, have housing costs that exceed HUD's 30% affordability benchmark.<sup>56</sup> The same study also found that about 40% (8.8 million) of these 22 million

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<sup>53</sup> Letter from John C. Weicher, Assistant Sec'y for Hous.-Fed. Hous. Commissioner, U.S. Dep't of Hous. & Urban Dev., to All Approved Mortgagees (Apr. 13, 2005), *available at* <http://www.fhasecure.gov/offices/adm/hudclips/letters/mortgagee/files/05-16ml.doc>. However, that same directive indicates that "compensating factors" may allow this limit to be exceeded, indicating that even HUD views its own concept of affordability as somewhat flexible and dependent on an individual debtor's situation. *Id.*

<sup>54</sup> See Housing and Urban-Rural Recovery Act of 1983, Pub. L. No. 98-181, 97 Stat. 1153 (amending, in section 122, the Housing and Community Development Act of 1974, 12 U.S.C. § 1706e (repealed 1990)), to give a special priority to loan applicants currently paying in excess of 30% of income for housing); see also 42 U.S.C. § 1490a(a)(2)(A) (2006) (requiring that rental rates not exceed 30% of adjusted income for certain low income persons, in section entitled "[I]oans to provide occupant owned, rental, and cooperative housing for low and moderate income, elderly or handicapped persons or families").

<sup>55</sup> See, e.g., 7 U.S.C. § 2014(e)(6)(A) (giving an "excess shelter expense deduction" for eligible low-income food stamp recipient households spending more than 50% of income on housing).

<sup>56</sup> JOINT CTR. FOR HOUS. STUD. OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2008, at 40 [hereinafter JCHS REPORT], *available at* <http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf> (analyzing housing affordability using the same affordability metrics as this paper). The JCHS Report found that about 34.9% of all U.S. households (including both homeowners and renters) live in housing that exceeds HUD's affordability guidelines. *Id.*

households have homes that are severely unaffordable.<sup>57</sup> That translates into 11.7% of all U.S. homeowners spending more than 50% of their incomes on housing.<sup>58</sup>

While some of these homeowners in unaffordable housing will face foreclosure because they cannot sustain their housing costs, it is not inevitable that high-cost homeownership efforts will fail. Some households, by virtue of rising income or housing appreciation, will succeed at homeownership, even if those households met the unaffordable benchmark at one time. Other households will succeed in purchasing their homes by sacrificing goods and services, such as internet and cable television, or by diverting income from other productive uses, such as saving for retirement or their children's college educations.<sup>59</sup> Thus, it is inaccurate to equate all homeownership that is unaffordable under the HUD standards as "unsustainable" because such a label may not mirror the reality of homeownership outcomes. Of course, the converse is equally true. That is, some families will lose their homes after a financial collapse despite having affordable housing costs. Housing affordability is a useful measure for comparing groups of Americans and studying homeownership expense at a moment in time, it is not an absolute predictor of outcome in any given situation.

The characteristics of bankruptcy debtors will affect the likelihood that these families can withstand unaffordable housing costs. Most families who file bankruptcy face high debts and earn low incomes.<sup>60</sup> These circumstances ratchet up the risks that such families cannot succeed in saving homes that are unaffordable. The HUD affordability standard is a way to evaluate the risk of home loss for these families in bankruptcy.

People who file bankruptcy earn low incomes.<sup>61</sup> Figure 1 shows that homeowners who file chapter 13 bankruptcies have fewer dollars to spend on expenses than most Americans. The average debtor in the Mortgage Study's sample had an annual income of \$43,263. The median debtor earned \$36,348.<sup>62</sup> In 2006, when the debtors in the study filed bankruptcy, the average American household earned \$65,527.<sup>63</sup> The median household had an annual income of \$48,451.<sup>64</sup> The data from the Mortgage Study show that chapter 13 homeowners (a subset of all bankruptcy debtors) earn incomes that are substantially lower than the general population of Americans.

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<sup>57</sup> *Id.* 15.8% of all households (homeowners and renters combined) live in housing that is severely unaffordable. *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> See ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO-INCOME TRAP* 133 (2003) (discussing the increasing cost burden that homeowners acquiesce to, and explaining that, over the last generation, "the proportion of *middle-class families* that would be classified as house poor or near-poor has doubled").

<sup>60</sup> David Himmelstein et al., *Did BAPCPA Fail? The Impact of the 2005 Amendments on Families in Trouble*, 82 AM. BANKR. L.J. (forthcoming 2008) (reporting financial characteristics of bankruptcy debtors from Consumer Bankruptcy Project studies in 1981, 1991, 2001, and 2007).

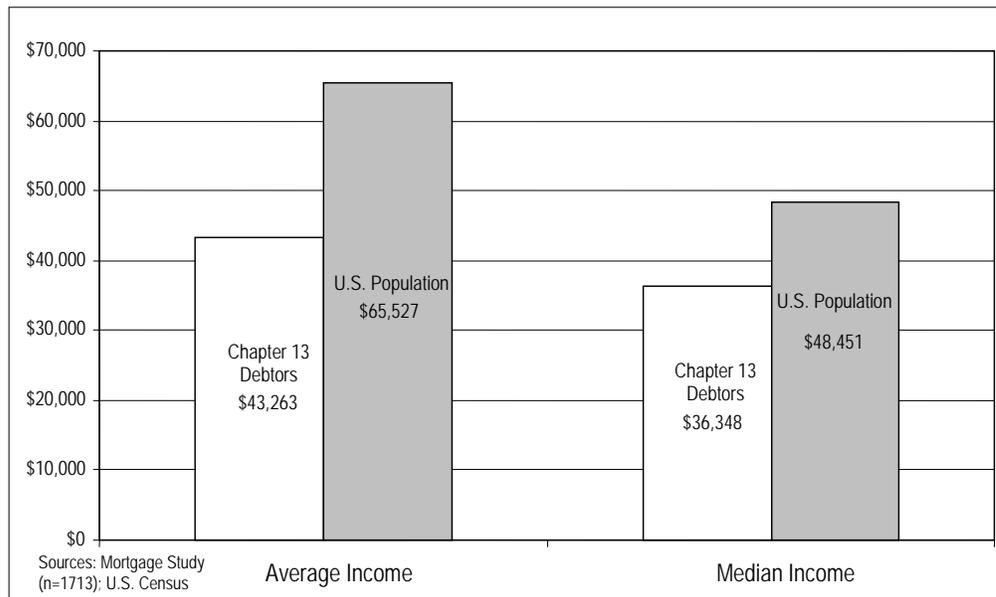
<sup>61</sup> *Id.* at figs. 1 & 2 (reporting incomes of bankruptcy debtors from Consumer Bankruptcy Project studies).

<sup>62</sup> These annual income figures were constructed by multiplying each debtor's monthly income at the time of their bankruptcy filing by twelve months.

<sup>63</sup> U.S. Census Bureau, United States—Selected Economic Characteristics 2006, [http://factfinder.census.gov/servlet/ADPTable?geo\\_id=01000US&qr\\_name=ACS\\_2006\\_EST\\_G00\\_DP3&ds\\_name=ACS\\_2006\\_EST\\_G00\\_](http://factfinder.census.gov/servlet/ADPTable?geo_id=01000US&qr_name=ACS_2006_EST_G00_DP3&ds_name=ACS_2006_EST_G00_) (last visited Nov. 3, 2008).

<sup>64</sup> *Id.*

Figure 1: Income of Bankruptcy Debtors and U.S. Population, 2006<sup>65</sup>



This income disparity quite probably decreases the likelihood that families filing bankruptcy are able to comfortably exceed the 30% benchmark of affordability. The reality is that as income levels rise, people can afford to spend a greater percentage of their income on housing. This effect is the result of higher-earning households having enough absolute dollars left over for expenses such as food that are relatively consistent among families of all income levels. While the HUD standards apply to all people, regardless of whether they earn near the poverty line or in the top percentile of all Americans, those with relatively lower incomes will find it harder to maintain housing beyond the affordability benchmark.

As an alternate measure of whether bankruptcy debtors can afford their homes, this Article also analyzes the amount of income debtors have left after they have paid their housing costs. This amount, known as residual income, has consistently been identified as an additional, critical element in determining housing affordability.<sup>66</sup> Unlike the general HUD affordability metric, which is measured as a percentage of income, residual income is measured as an absolute dollar value. Thus, the residual income standard reflects the reality that some amount of certain baseline expenses (e.g., clothing, medicine or food) are necessarily incurred by all people, regardless of income level.

The Department of Health and Human Services (“HHS”) publishes official federal poverty guidelines each year.<sup>67</sup> These guidelines set out, based on family size, the threshold income below which a family is deemed to live in poverty.<sup>68</sup> These guidelines can be used to determine whether

<sup>65</sup> Sources: Mortgage Study (n=1713); U.S. Census Bureau, 2006 American Community Survey, Selected Economic Characteristics: 2006 (2006), [http://factfinder.census.gov/servlet/ADPTable?\\_geo\\_id=01000US&-qr\\_name=ACS\\_2006\\_EST\\_G00\\_DP3&-ds\\_name=ACS\\_2006\\_EST\\_G00](http://factfinder.census.gov/servlet/ADPTable?_geo_id=01000US&-qr_name=ACS_2006_EST_G00_DP3&-ds_name=ACS_2006_EST_G00).

<sup>66</sup> See, e.g., Steven C. Bourassa, *Measuring the Affordability of Home-Ownership*, 33 URB. STUD. 1867, 1868–69, 1876 n.4 (1996) (explaining one study’s approach toward residual income and citing to others).

<sup>67</sup> 42 U.S.C. § 9902(2) (2006).

<sup>68</sup> U.S. Dep’t of Health and Human Servs., 2006 Federal Poverty Guidelines,

families have a minimal level of residual income. Subtracting 30% for housing costs from these poverty guidelines gives the amount of money a poverty-level family would have available to spend on non-housing expenses. These non-housing poverty amounts can be tested against the incomes that bankrupt families have remaining and available after paying their housing costs. If a family that has an above-poverty income in fact has insufficient residual income to spend at the poverty level on non-housing goods, they are deemed to be living in “housing induced poverty.”<sup>69</sup> Most families in bankruptcy are middle class and do not earn below the poverty line.<sup>70</sup> Thus, applying the HHS poverty guidelines to bankrupt families is a valuable measure of whether housing costs leave bankrupt families with insufficient residual income. At the heart of the concept of housing affordability is the idea that housing costs should not force families to live in poverty-level conditions.

#### IV. FINDINGS

In this section, we present four analyses of Mortgage Study data to measure the housing affordability of bankruptcy debtors. First, we determine the proportions of bankruptcy debtors that fit the three categories of HUD housing affordability: those living in affordable housing (less than 30% of income spent on housing), those living in unaffordable housing (30% to 50% of income spent on housing), and those living in severely unaffordable housing (more than 50% of income spent on housing). We then compare the sample of bankruptcy debtors to all U.S. households, breaking down each group’s housing costs using the same standards.<sup>71</sup> Second, we parse the housing affordability of bankruptcy debtors in more detail by presenting the distribution of housing affordability by income decile. Third, we offer a regional comparison of housing affordability among bankruptcy debtors. Fourth, we construct a residual income analysis to assess the amount of income, in dollars, that bankrupt households have left for other expenses after paying for housing. Collectively, these analyses are the first detailed examination of the housing costs of bankruptcy debtors who are trying to save their homes. These data offer insights on the challenges that face families that file chapter 13 bankruptcy to prevent foreclosure.

##### *A. Housing Affordability of Bankrupt Homeowners Compared to All U.S. Homeowners*

The key finding of this Article is grim. As measured by the HUD standard of housing cost as a percentage of income, fewer than three in ten homeowners in chapter 13 bankruptcy have affordable housing costs. The remaining seven in ten homeowners in bankruptcy face unaffordable housing costs. Compared to the general population of homeowners, families trying to save their homes in bankruptcy are much more likely to be living in unaffordable housing.

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<http://aspe.hhs.gov/poverty/06poverty.shtml> (last visited Nov. 3, 2008); *see, e.g.*, Annual Update on the HHS Poverty Guidelines, 70 Fed. Reg. 3848, 3848–49 (Jan. 24, 2006) (establishing 2006 poverty guidelines).

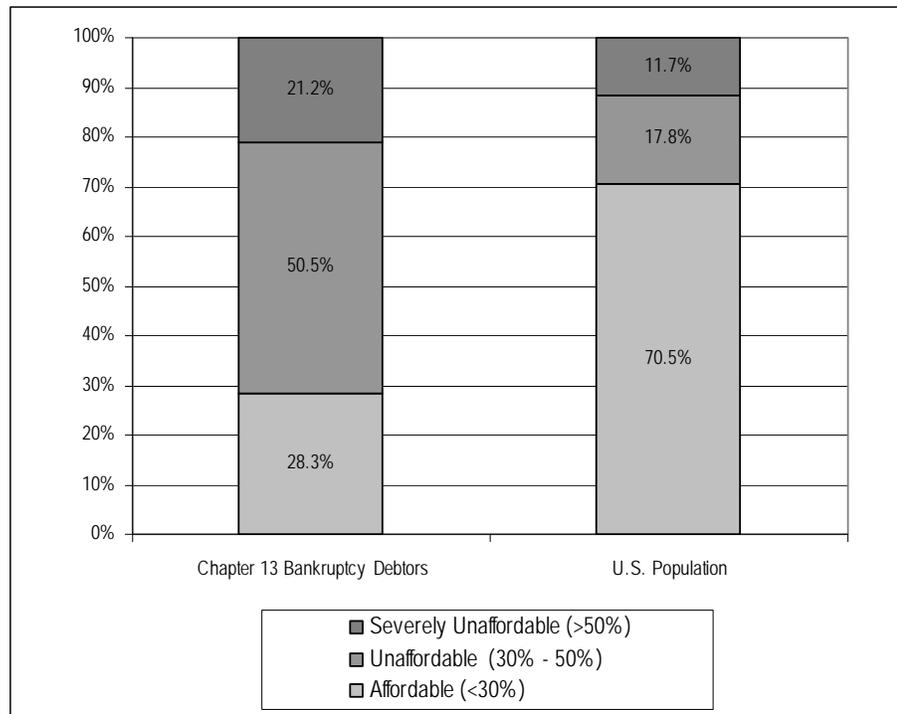
<sup>69</sup> *See* Nandinee K. Kutty, *A New Measure of Housing Affordability: Estimates and Analytical Results*, 16 HOUS. POL’Y DEBATE 113, 123 (2005) (defining “housing-induced poverty” and reporting that in 1999, 4.3% of American households not in poverty were living in housing-induced poverty, meaning that after paying housing costs they could not afford the “poverty basket of nonhousing goods”); *see also* PELLETIERE, *supra* note 52, at 13–14 (discussing the approach used by Kutty and other housing policy commentators).

<sup>70</sup> Elizabeth Warren, *Financial Collapse and Class Status: Who Goes Bankrupt?*, 41 OSGOODE HALL L.J. 115, 117, 144 (2003) (concluding that families in bankruptcy are “overwhelmingly middle class” after analyzing education, occupation, homeownership and income levels of debtors).

<sup>71</sup> Data on all U.S. households is from the JCHS Report. *See* JCHS REPORT, *supra* note 56 and accompanying text.

Figure 2 reports the data on the housing affordability of chapter 13 bankruptcy debtors and compares these results with all American households.

Figure 2: Housing Costs as a Percentage of Income of Bankruptcy Debtors and U.S. Population<sup>72</sup>



Only about 28% of homeowners that file chapter 13 bankruptcy live in affordable housing. Even though homeowners very frequently seek bankruptcy relief to save their homes, only a minority of these households have mortgage and other housing costs that subsume 30% or less of their income. The majority of chapter 13 homeowners (over 71%) enter bankruptcy with current housing expenses that are unaffordable or severely unaffordable on their current incomes. These households may find it difficult to keep up with the combination of ongoing housing payments, other expenses allowed under their chapter 13 plans, and their plan payments to repay creditors or cure mortgage arrearages.<sup>73</sup>

For over one-fifth of families (21.25%) trying to save their homes in bankruptcy, more than half of every dollar they earn as income goes to pay for housing costs. These families meet or exceed the HUD criteria for severely unaffordable housing. As a group, those in severely unaffordable housing spend an average of \$1775 a month on housing costs and have an average

<sup>72</sup> Source: Mortgage Study (n=1713); Joint Center for Housing Studies

<sup>73</sup> Not all chapter 13 debtors are concerned with being current on plan payments until plan completion. Some debtors file chapter 13 intending to cure arrearages and then exit bankruptcy without receiving a discharge. Gordon Bermant & Jean Braucher, *Making Post-Petition Mortgage Payments Inside Chapter 13 Plans: Facts, Law, Policy*, 80 AM. BANKR. L.J. 261, 269 (2006). Also, some debtors are able to confirm plans that pay nothing to their unsecured creditors because after subtracting payments to secured creditors and allocating for expenses, there is no remaining disposable income to pay to unsecured creditors.

income of just over \$2800.<sup>74</sup> This translates into spending nearly two of every three dollars of income on housing, an inversion of HUD's affordability standard that suggests that families need two-thirds of their incomes to meet non-housing costs.

Chapter 13's requirement of living on a strict budget for three to five years will pose a formidable challenge to families in unaffordable or severely unaffordable housing. Assuming these families do not have large increases in income in the next few years, these families will have fixed or escalating housing expenses that limit their flexibility in coping with unexpected expenses. For these families, chapter 13 repayment may represent a lengthy sentence of continued financial hardship. Ultimately, many of these families may just be prolonging their financial distress before eventually losing their homes to foreclosure.<sup>75</sup>

Bankrupt families face steeper housing costs relative to their incomes than the general population of American homeowners. Figure 2 illustrates the disparity between the housing affordability of chapter 13 bankruptcy homeowners and that of all U.S. homeowners. The best available data indicate that about one in three (29.5%) of all Americans own homes that are either unaffordable or severely unaffordable.<sup>76</sup> This level of unaffordable housing is itself troubling for those concerned with the economics of American families.<sup>77</sup> However, bankruptcy debtors fare markedly worse by comparison. Families in bankruptcy live in housing that is either unaffordable or severely unaffordable at more than two and a half times the rate of the general population of homeowners. Unaffordable housing is a common problem for American families, but for bankruptcy debtors, it is the norm, rather than an exception.

The high homeownership costs of bankruptcy debtors have not been thoroughly documented until now.<sup>78</sup> Bankruptcy scholarship on the subject is sparse, and real estate finance scholars have largely ignored the frequency with which families facing foreclosure seek bankruptcy relief.<sup>79</sup> Yet, the large fraction of families who enter bankruptcy with unaffordable housing costs has serious implications for the bankruptcy system. The widespread problem of housing unaffordability may jeopardize the efficiency of the chapter 13 bankruptcy system. Prior research has shown that only about one in three chapter 13 bankruptcy cases ends in successful plan

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<sup>74</sup> The median debtor in severely unaffordable housing spent \$1448 on housing costs, with a median income of \$2449.

<sup>75</sup> See Sarah W. Carroll & Wenli Li, *The Homeownership Experience of Households in Bankruptcy* 3, 8, and tbl. 2 at 23 (Fed. Res. Bank of Philadelphia, Working Paper No. 08-14, 2008) (reporting that 27.9% of Chapter 13 debtors who owned homes and filed bankruptcy between August 1, 2001 and August 1, 2002 lost their homes to foreclosure by August 2007).

<sup>76</sup> See JCHS REPORT, *supra* note 56, at 40, tbl. A-7.

<sup>77</sup> As a matter of general housing policy there has long been recognition of the widespread unaffordability of housing, but these discussions focus only on the general population and not households in bankruptcy. See, e.g., K.E. Hancock, "Can Pay? Won't Pay?" or *Economic Principles of "Affordability"*, 30 URB. STUD. 127, 128-29 (1993) (discussing problems with affordability generally without intimating that there may be special problems for households in insolvency proceedings).

<sup>78</sup> While we measure home affordability as a ratio of income to housing costs, one obvious possibility is that bankrupt families purchased houses that were markedly more expensive than most Americans. Analyzing the relative home prices of bankrupt families is beyond the scope of this paper. Such an analysis would be complex, taking into account the year of home purchase and most importantly the variation in home values, preferably at a zip code level of comparison. As a very tentative baseline, we report that the average home value of debtors in the Mortgage Study sample was \$ \$147,929. The median debtor reported a home value of \$111,200. These figures are derived from the debtors' bankruptcy schedules filed under penalty of perjury (on file with Katherine Porter).

<sup>79</sup> See Melissa B. Jacoby, *Bankruptcy Reform and Homeownership Risk*, 2007 U. ILL. L. REV. 323, 325-26 (noting paucity of real estate finance scholarship that mentions bankruptcy).

completion and a discharge.<sup>80</sup> A family in unaffordable housing may fail to make their ongoing mortgage payment, which typically results in the mortgage creditor filing a motion for relief from the bankruptcy stay to foreclose on the family's home. Alternatively, families may divert money earmarked for a chapter 13 plan payment to meet their ongoing housing obligations. Defaulting on a chapter 13 repayment plan usually will lead to the bankruptcy case being dismissed. When this occurs, the debtor does not receive a discharge of any of their pre-bankruptcy debts. The bankruptcy stay is terminated when the case is dismissed, leaving the mortgage creditor free to proceed with foreclosure if there are any unpaid arrearages on the mortgage.<sup>81</sup> Unaffordable housing costs may be an important, yet heretofore unrecognized, factor in determining a family's success in completing a chapter 13 bankruptcy plan.

Families may file another bankruptcy if their initial filing did not result in a confirmed or completed plan. Repeat filings of bankruptcy among chapter 13 cases are fairly common. In the Mortgage Study sample, 30.88% of debtors reported a prior bankruptcy on their current bankruptcy petitions.<sup>82</sup> As measured by the proportion of filers in each group of affordability, the housing cost burdens of repeat bankruptcy debtors and first-time bankruptcy debtors appear to be similar.<sup>83</sup> In both groups, a majority of debtors have housing costs that require them to expend a high percentage of their incomes.<sup>84</sup>

These first data on housing affordability offer a new insight into the challenges that families face in trying to save their homes in chapter 13 bankruptcy. Further empirical work could usefully explore whether a relationship exists between housing affordability and plan confirmation or plan completion leading to discharge. Additionally, housing affordability may correlate with whether a family is ultimately able to retain their house, whether they remain in chapter 13 or exit the bankruptcy system. The first study of homeownership outcomes of a sample of chapter 13 debtors in Delaware reports that a "higher monthly mortgage payment relative to income increases the probability of foreclosure."<sup>85</sup> If confirmed in a larger study, such findings would have important implications for measuring the effectiveness of chapter 13 bankruptcy and also for assessing how to structure nonbankruptcy relief that seeks to help families address unaffordable housing costs.

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<sup>80</sup> See Scott F. Norberg & Andrew J. Velkey, *Debtor Discharge and Creditor Repayment in Chapter 13*, 39 CREIGHTON L. REV. 473, 476 (2006) (finding an overall plan completion rate of 33%); Jean Braucher, *An Empirical Study of Debtor Education in Bankruptcy: Impact on Chapter 13 Completion Not Shown*, 9 AM. BANKR. INST. L. REV. 557, 571 (2001) (stating the national chapter 13 plan completion rate is approximately 31%); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *AS WE FORGIVE OUR DEBTORS* 216–17 (1989) (reporting that only one-third of chapter 13 cases ended in discharge).

<sup>81</sup> Debtors must complete all payments under the plan before a court will enter a discharge of their pre-bankruptcy debts. 11 U.S.C. § 1328 (2006). If a debtor materially defaults with respect to a term of a confirmed plan, such as by failing to make plan payments, a court may dismiss the chapter 13 case. 11 U.S.C. § 1307(c)(6).

<sup>82</sup> Neither the date nor the chapter of the prior bankruptcy was coded as part of the Mortgage Study. Another study of chapter 13 cases found that over 50% of bankruptcy debtors had filed at least one prior bankruptcy. Norberg & Velkey, *supra* note 80, at 479 (studying 795 chapter 13 cases in seven judicial districts).

<sup>83</sup> A cross-tabulation did not reveal a statistically significant difference between the representation of repeat bankruptcy filers and first-time filers in the three categories of affordability. Pearson chi-square=2.654. p=.265 (on file with Katherine Porter).

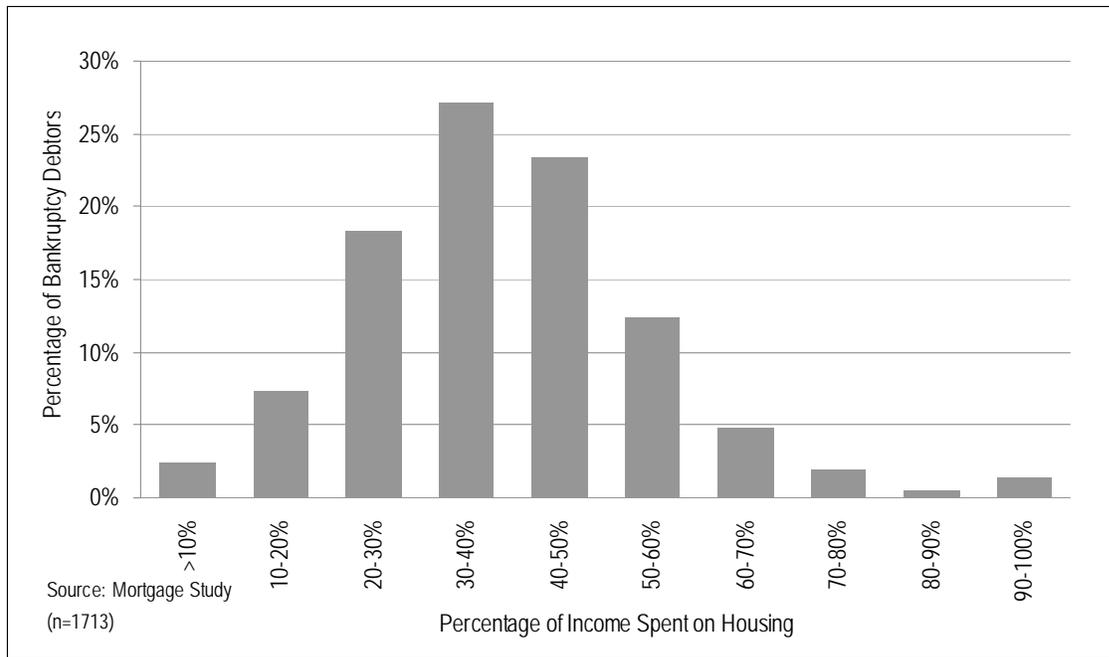
<sup>84</sup> See Mortgage Study (on file with Katherine Porter).

<sup>85</sup> Carroll & Li, *supra* note 75, at 15, tbl. 3 (finding that the ratio of monthly mortgage payment to income had a statistically significant effect in a regression model that attempted to measure whether bankruptcy cases ended in home loss from foreclosure).

### B. Decile Breakdown of Chapter 13 Debtors' Housing Affordability

The percentage of debtors in the three categories of housing costs—affordable, unaffordable, and severely unaffordable—provides a basic picture of housing affordability. A decile analysis of debtor housing costs in relation to income provides a more detailed picture that reveals more about the distribution of bankrupt families across the affordability spectrum. Figure 3 illustrates the percentage of chapter 13 debtors at each decile of income required to pay their housing costs.

Figure 3: Percentage of Bankruptcy Debtors by Decile of Housing Affordability



Three observations can be made based on this analysis of affordability. First, for the debtors at the lowest end of the affordability spectrum—those spending less than 10% of income on housing—it is unlikely the primary purpose of seeking bankruptcy protection was preventing foreclosure. Of these debtors, 83% had no mortgage, and the remainder had incomes far in excess of their housing costs.<sup>86</sup> These families may have chosen chapter 13 repayment bankruptcy instead of chapter 7 liquidation bankruptcy in part because they wanted to retain their homes, but imminent foreclosure or mortgage arrearage was unlikely the driving factor for their bankruptcy filings. For the one in ten debtors who spends less than 20% of household income on housing costs, factors other than housing affordability seem likely to be the principal determinants of success in addressing financial problems in bankruptcy.

Second, at the other end of the affordability spectrum, some bankrupt families are spending 90 to 100% of their incomes on housing.<sup>87</sup> In this top decile, 72% of families had housing costs that exceeded their total incomes. At the time of their bankruptcy filings, these families did not have enough dollars to pay their mortgages and other housing costs, much less purchase

<sup>86</sup> Mortgage Study data (on file with Katherine Porter.)

<sup>87</sup> Additional error checking was performed for all records reporting a housing cost to income ratio above 75% to ensure accuracy.

subsistence goods such as food, medicine, and clothing. Homeowners filing these bankruptcy cases seem doomed to fail at retaining their homes through a bankruptcy repayment plan.

Despite circumstances that appear to make a repayment plan patently impossible, there are several possible explanations for these debtors' decisions to file chapter 13 bankruptcy.<sup>88</sup> Some debtors may be expecting a significant increase in current income immediately after their bankruptcy filings. As discussed in Part II, the affordability metrics are static, measuring housing costs only as of the date of bankruptcy filing and using the debtor's current actual income at the moment of the bankruptcy. Filing chapter 13 while spending 90% or more of one's income on housing costs may be rational for a debtor whose income on the day of bankruptcy filing is an unemployment check but who is starting a higher paying job in a few weeks.

The second plausible explanation for filing bankruptcy with unfeasible housing costs is that some families may be using bankruptcy to forestall pending foreclosures and gain time to cope with the eventual loss of their homes. Although there is a great deal of state-to-state variety in foreclosure processes, a common feature of nonjudicial foreclosure is its speed. For example, in Texas, as few as forty-one days can elapse between mortgage default and home sale.<sup>89</sup> The rapidity of the foreclosure process may not give families enough time to make a frank assessment of whether they can keep their homes. Alternatively, debtors may know the loss of their homes is imminent, but file bankruptcy to delay that eventual outcome. In such situations, the mortgage company is likely to obtain relief from the bankruptcy stay and be able to proceed with foreclosure. However, this process can take a month or more, during which time the debtor can find new housing or may be able to sell the property themselves, which reduces the loss of equity that typically comes with a foreclosure sale.<sup>90</sup>

Another reason that families with extremely high housing costs in relation to income may file chapter 13 bankruptcy is that they are unable to accept that they cannot save their homes. Buying a home is the largest financial investment and greatest financial risk that most people ever make.<sup>91</sup> Losing a home can feel like a major personal failure and often will publicly expose the depth of a families' financial problems.<sup>92</sup> These factors, and others such as a desire to protect their children from changing homes and schools,<sup>93</sup> could cause people to try to save their homes even when a rational analysis would show that such efforts are doomed to failure.<sup>94</sup> The court

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<sup>88</sup> An additional reason could be a debtor's bankruptcy attorney steering the debtor into chapter 13 rather than chapter 7, even though the family has no plausible chance of being able to use chapter 13's specialized home-saving provisions or of being able to confirm a repayment plan. Attorneys may prefer chapter 13 because such cases usually garner higher attorney's fees than chapter 7 and such fees may be paid over time, permitting some families to enter bankruptcy that could not afford to pay the lump-sum filing fee required to enter chapter 7 bankruptcy.

<sup>89</sup> See, e.g., TEX. PROP. CODE ANN. § 51.002 (Vernon 2007) (allowing real property purchased under a deed of trust with a power of sale clause to be sold after debtor is given twenty days to cure the default on the obligation and the property is advertised for twenty one days).

<sup>90</sup> See generally NELSON & WHITMAN, *supra* note 36, at 796–98, 823–25 (discussing the effect of filing a chapter 13 bankruptcy on foreclosure proceedings).

<sup>91</sup> See Jacoby, *supra* note 79, at 324 & n.5 (citing a variety of studies to support this contention). A home is also most families' largest non-financial asset. WARREN & TYAGI, *supra* note 59, at 136.

<sup>92</sup> See, e.g., Stephanie Armour, *Foreclosures Take Toll on Mental Health: Crisis Hotlines, Therapists See a Surge in Anxiety Over Housing*, USA TODAY, May 15, 2008, at A1 (telling the story of Raymond and Deanna Donaca, who are believed to have committed suicide after unsuccessfully attempting to prevent the foreclosure of their home).

<sup>93</sup> Eric S. Nguyen, *Parents in Financial Crisis: Fighting to Keep the Family Home*, 82 AM. BANKR. L.J. 229, 237–39 (2008) (presenting findings from empirical analysis showing that parents of school-age children are more likely to retain their homes during a period of financial distress than non-parents).

<sup>94</sup> Jacoby, *supra* note 79, at 334 (citing research on the psychological effects of home loss).

record data do not reveal the extent to which these three explanations (anticipated increase in income, delay of foreclosure, or unwillingness to accept loss of a home) motivate bankruptcy filings by families whose housing costs are in the top deciles of the unaffordability distribution. While such families make up less than 5% of all debtors in the Mortgage Study sample, their presence in the chapter 13 bankruptcy system is curious given the apparent hopelessness of these debtors' prospects for saving their homes.

A third notable feature of the distribution is the number of chapter 13 debtors who collectively spend more than 50% of their incomes on housing costs. More than one in three of the families in this severely unaffordable category are spending 60% or more of their incomes on housing. That is, a sizeable component of the one in five debtors whose housing costs exceed 50% is not near the demarcation between unaffordable and severely unaffordable. As the distribution in the upper deciles in Figure 2 shows, nearly one in ten families spend 60% or more of its income on housing costs.

The hardship facing such families can be seen in an examination of the actual dollar amounts at issue. Among the top three deciles (families paying 70% or more of their incomes on housing), the average household had a monthly paycheck of \$2181. The same average household in these top three tiers then reportedly spends \$1997 of those dollars on housing costs. The funds available for all other expenses after paying housing costs is less than \$184 per month, an insufficient amount to even feed a single adult in America. The situation of the typical (median) household in the top three deciles of housing affordability is similarly bleak. This household has a monthly paycheck of \$1887 and spends \$1723 on housing costs. The depth of the plight of families in severely unaffordable housing and the small but steady distribution of families along the top half of the affordability spectrum suggest that many families may stand little chance of saving their homes under the current bankruptcy system that does not permit the adjustment of ongoing mortgage obligations.

### *C. Regional Breakdown of Chapter 13 Debtors' Housing Affordability*

Across the United States, there is considerable variation in both the number of chapter 13 cases each year and the characteristics of the chapter 13 debtors.<sup>95</sup> The housing affordability of homeowners that file bankruptcy also varies. A regional analysis of the differences in affordability shows that some pockets of the bankruptcy system have particularly large numbers of debtors with unaffordable housing costs.

The Mortgage Study gathered data from bankruptcy cases filed in twenty-four states.<sup>96</sup> To analyze the geographic differences in housing affordability, the regional divisions of the U.S.

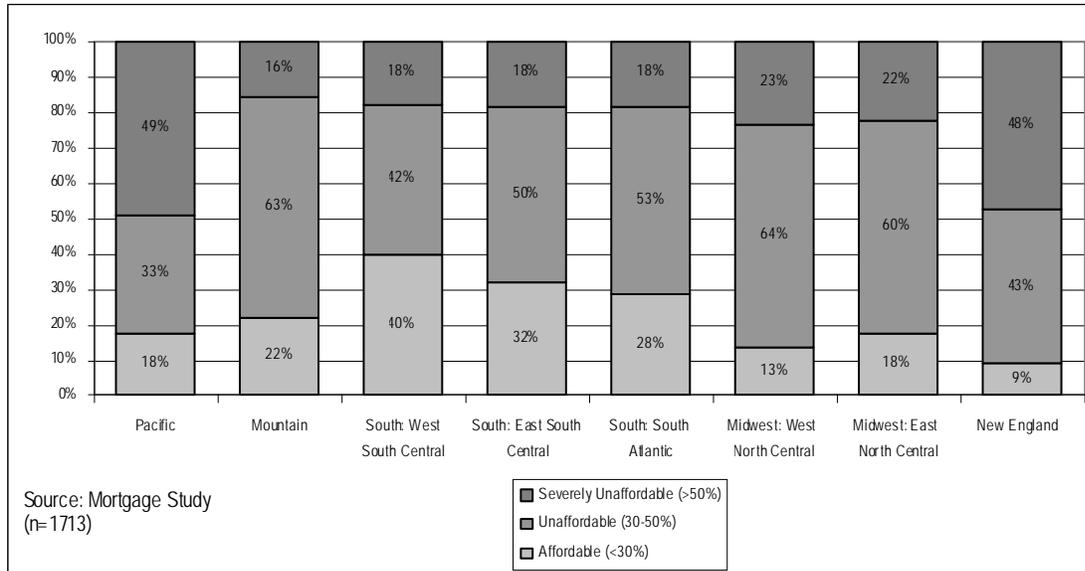
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<sup>95</sup> See Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 580–82 (1993) (documenting variation in chapter 13 bankruptcy practice).

<sup>96</sup> Table 1 reports the percentage of cases in each region. Two factors explain the disparity in the number of cases per region. One, only non-judicial foreclosure states were selected, as explained in Part III, *supra*. Historical legal developments have resulted in many southern states having non-judicial foreclosure schemes, in part explaining the large percentage of southern states represented in the Study. See generally NELSON & WHITMAN, *supra* note 36, at 665 n.1 (listing the states that have adopted non-judicial foreclosure schemes). The other reason there is variation in the number of cases per region is the sample was weighted so districts with more chapter 13 cases had more cases in the sample. As noted in Part II, *supra*, there are large district-to-district variations in the number of chapter 13 cases filed and in the fraction of all bankruptcy filings that are made in chapter 13 rather than chapter 7.

Census Bureau were used to categorize each state in the sample.<sup>97</sup> Figure 4 shows the percentage of chapter 13 debtors with affordable, unaffordable, and severely affordable housing costs in each census region.

Figure 4: Housing Affordability of Bankruptcy Debtors by Geographic Region



Bankrupt families who live on either coast are much more likely to live in severely unaffordable housing than their counterparts in the middle of the country. Nearly half of the debtors in the study who reside in the New England or Pacific region (consisting of families in California)<sup>98</sup> enter bankruptcy with housing costs that exceed 50% of their incomes. The large number of families in severely unaffordable housing in these areas illustrates the affordability

Table 1: Percentage of Cases in Mortgage Study Sample by U.S. Census Region

<i>Region</i>	<i>Cases per Region</i>
New England	2.57%
Midwest: East North Central	8.76%
Midwest: West North Central	5.78%
South Atlantic	30.71%
East South Central	24.75%
West South Central	17.86%
Mountain	3.74%
Pacific	5.84%

No cases were sampled from the Middle Atlantic Division, consisting of New York, New Jersey, and Pennsylvania because these states require judicial foreclosure of residential mortgages, and the Mortgage Study drew its sample only from states that require judicial foreclosure of mortgages of a borrower's principal residence.

<sup>97</sup> See generally U.S. Census Bureau, *Census Regions and Divisions of the United States*, available at [http://www.census.gov/geo/www/us\\_regdiv.pdf](http://www.census.gov/geo/www/us_regdiv.pdf) (last visited Nov. 3, 2008).

<sup>98</sup> The other states in the Pacific region (Alaska, Hawaii, Oregon, and Washington) were excluded from the Mortgage Study sample because these states all require judicial foreclosure of residential mortgages.

problem facing thousands of bankrupt families. These two regions have large populations and constitute a significant portion of all chapter 13 cases each year. Adding to the unaffordability problems in the New England and Pacific regions is the extremely low percentage of debtors in affordable housing. Fewer than one in ten families in New England files bankruptcy with housing costs that consume below 30% of their incomes. In the Pacific region, the ratio is less than two in ten families. In these jurisdictions, the vast majority of debtors will devote more than 30% of their incomes to pay ongoing housing costs, leaving very few dollars to use for current expenses, to repay unsecured creditors or to cure mortgage arrearages.

In contrast, families in the South appear to have much better prospects for saving their homes. Severely unaffordable housing is less common, and affordable housing is more common. The part of the country with the best affordability characteristics is the South: West South Central region,<sup>99</sup> where fully 40% of chapter 13 families spend 30% or less of their incomes on housing. These debtors may be better off than their coastal counterparts in trying to save their homes. However, even this group of bankruptcy debtors still faces much sharper housing costs relative to their incomes than the American population in general.<sup>100</sup>

While scholars have noted variation in chapter 13 plan completion rates among judicial districts and states,<sup>101</sup> none has considered how differences in housing affordability may explain such disparities. Additional empirical research could attempt to gauge the presence of such effects and determine if differences that were previously attributed to “local legal culture”<sup>102</sup> are at least to some degree driven by variation in housing affordability. Moderate housing costs give families more flexibility in their budgets to meet unexpected expenses or cope with drops in income. With less of their earnings committed to a mortgage and other nondiscretionary costs of homeownership such as utilities, these families may appear to have a reasonable chance at completing a chapter 13 plan and earning a discharge in bankruptcy.

Attorneys, trustees, and judges may share the sense, even if unarticulated hereto, that housing costs are an important factor in the viability of chapter 13 bankruptcy cases and may be more likely to promote chapter 13 bankruptcy as a viable option to halt foreclosure and save homes in parts of the country, such as the South, where housing affordability is less of a problem. Even if plan completion rates do not relate to housing affordability, more families may be attracted to chapter 13 and may file bankruptcy in an attempt to save their homes (even if ultimately such an attempt is unsuccessful) if their housing costs subsume less of their incomes. That is, debtors outside the New England and Pacific regions may believe that they stand a better chance of saving their homes in bankruptcy even if no such effect exists.

#### *D. Residual Income Analysis*

As the findings in the prior sections illustrate, unaffordable housing is a widespread problem in bankruptcy. Both across the country and across the distribution of bankruptcy debtors, many families are trying to save homes despite being saddled with housing costs that are unaffordable or severely unaffordable under the HUD standards. In this section of the Article, we use an

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<sup>99</sup> In the Mortgage Study sample, the states in this region are Arkansas and Texas.

<sup>100</sup> See *supra* fig.2.

<sup>101</sup> See *supra* note 77 and accompanying text.

<sup>102</sup> See Braucher, *supra* note 95, at 580–82 (studying local legal culture and examining district-by-district variations in the attitudes and expectations of the repeat players in the bankruptcy system—judges, trustees, lawyers, and creditors); Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence From the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL’Y 801, 804–05 (1994) (documenting persistence of inter-district variations within states).

alternate standard of housing affordability, residual income, to examine the hardships imposed by high housing costs. As explained in Part II, *supra*,<sup>103</sup> residual income measures the absolute dollars that a family has remaining to spend on all other expenses after paying its housing costs. The residual income figures used in this Article are the HHS federal poverty guidelines less a 30% allowance for housing.<sup>104</sup> For example, under the HHS guidelines, a family of four was deemed to be living in poverty if its monthly income was less than \$1667.<sup>105</sup> If a family spent 30% of that income on housing, it would have approximately \$1166 remaining as residual income for other expenses. The federal government considers an income that exceeds that level to be necessary to avoid living in poverty.<sup>106</sup>

To analyze how many families had housing costs that left them with poverty-level incomes, we compared each family's income at the time of its bankruptcy filing, less its actual housing costs, with the HHS poverty benchmarks adjusted to permit a 30% housing expenditure. This measure reveals how many bankrupt families have residual incomes after housing costs that leave them with a poverty-level income to spend on non-housing expenses.

Because the HHS poverty threshold is very low, most bankrupt families had enough residual income to prevent them from being classified as living in housing-induced poverty. While much lower than the average for the American population, the incomes of most bankrupt families still exceed the poverty level. Only a small fraction (3.68%) of the families in chapter 13 bankruptcy could not afford the poverty-line level of goods and services because their incomes at the time of their bankruptcy filings were already below the poverty line.<sup>107</sup> A larger percentage of bankrupt homeowners failed to earn enough to meet the residual income standard. Approximately 8% (7.94%) of families in bankruptcy had incomes above the poverty line, but after paying housing costs, did not have sufficient remaining income to purchase the poverty-level basket of non-housing goods and services. These families' housing costs left them with a poverty or below-poverty subsistence lifestyle. In total, nearly one in eight (11.62%) bankrupt families did not have enough income or residual income at the time of their bankruptcies to avoid poverty.

While only a minority of bankrupt families suffer housing-induced poverty, its presence among chapter 13 debtors is testament to the strength of families' motivation to save their homes.

<sup>103</sup> See *supra* notes 63–68 and accompanying text.

<sup>104</sup> Table 2 shows the annual and monthly income guidelines for the HHS poverty standards and the adjustments made to those standards to allow for housing costs that subsume 30% of income.

Table 2: Residual Income Criteria Using HHS Poverty Guidelines

<i>Family Size</i>	<i>Annual Income HHS 2006 Poverty Guidelines</i>	<i>Monthly Income HHS 2006 Poverty Guidelines</i>	<i>Monthly Poverty Threshold Residual Income (HHS minus 30%)</i>
1	\$9,800.00	\$816.67	\$571.67
2	\$13,200.00	\$1,100.00	\$770.00
3	\$16,600.00	\$1,383.33	\$968.33
4	\$20,000.00	\$1,666.67	\$1,166.67
5	\$23,400.00	\$1,950.00	\$1,365.00
6	\$26,800.00	\$2,233.33	\$1,563.33
7	\$30,200.00	\$2,516.67	\$1,761.67
8	\$33,600.00	\$2,800.00	\$1,960.00

<sup>105</sup> See *supra* note 104/104.

<sup>106</sup> *Id.*

<sup>107</sup> Only 0.41% of families whose income put them below the poverty line had enough left after housing costs to afford more than the poverty-line level of goods and services.

These families are willing to suffer poverty to make a last effort to hang on to their homes. These families' bankruptcies reflect their hope that bankruptcy can help them succeed at homeownership despite housing costs that overwhelm their incomes.

## V. IMPLICATIONS

The Mortgage Study data highlight the heavy burdens that families face in trying to save their homes in bankruptcy. More than 70% of bankrupt homeowners have housing costs that are unaffordable or severely unaffordable on their incomes. However, current bankruptcy law does not permit families to modify the terms of their home mortgages. To succeed in bankruptcy and save their homes from foreclosure, these families must achieve the difficult task of trying to stretch their incomes both to cure their mortgage arrearages and to make regular mortgage payments. Because the law does not permit courts to address ongoing problems with housing affordability, the anti-modification rule for home mortgages undermines bankruptcy's potential as a home-saving tool. Particularly for today's families, many of whom have adjustable-rate mortgages or other nontraditional loan products, bankruptcy may be an incomplete or inadequate solution to their home affordability problems. To help families sustain their attempt at homeownership and to reduce the harms of the foreclosure crisis, bankruptcy law should be amended to permit courts to modify the terms of the home mortgages of chapter 13 debtors to adjust housing costs to affordable levels. This section examines the antimodification rule in the context of the modern mortgage market and outlines the recent legislation introduced in Congress to empower bankruptcy courts to modify the terms of home mortgages. The section concludes by summarizing the procedural and administrative benefits of using the bankruptcy system to address the housing affordability problem that is a central feature of the foreclosure crisis.

### A. *The Antimodification Rule in Historical and Current Contexts*

The Bankruptcy Code's anti-modification rule prohibits the modification of claims secured by real property that is the debtor's principal residence.<sup>108</sup> The rule has its origins in the Bankruptcy Reform Act of 1978,<sup>109</sup> which created the current Bankruptcy Code.<sup>110</sup> Under bankruptcy law prior to the 1978 Code, chapter XIII of the Bankruptcy Act of 1898, a repayment plan could not be approved unless every secured creditor that would receive payments in the plan consented to it.<sup>111</sup> Additionally, debtors under chapter XIII had no ability to address debts secured by their home residences because the term "claim" expressly excluded "claims secured by estates in real property or chattel real."<sup>112</sup> These limitations made bankruptcy relief of limited or no use for debtors who needed to deal with defaults on loans to mortgage creditors.

In enacting the Bankruptcy Code, Congress sought to improve the ability of bankruptcy debtors to repay their mortgage creditors and save their homes from foreclosures.<sup>113</sup> The new chapter 13 bankruptcy system was designed to provide individuals with the opportunity to repay

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<sup>108</sup> See 11 U.S.C. § 1322(b)(2) (2006).

<sup>109</sup> Pub. L. No. 95-598, 92 Stat. 2549 (1978).

<sup>110</sup> The Bankruptcy Code has been amended several times since its enactment in 1978, most recently by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.). Nevertheless, the Code's overall structure remains very similar to the statute as enacted in 1978.

<sup>111</sup> See Bankruptcy Act §§ 651–52, 11 U.S.C. §§ 1051–52 (1976).

<sup>112</sup> See Bankruptcy Act § 606, 11 U.S.C. § 1006(1) (repealed in 1979).

<sup>113</sup> See e.g., 11 U.S.C. § 1322(b) (2006).

debts, in full or in part, while retaining assets.<sup>114</sup> An innovation of chapter 13 was enabling the debtor to cure defaults on secured claims through the repayment of loan arrearages over time, even if the terms of the loan or nonbankruptcy law did not give the borrower this right.<sup>115</sup> The new chapter 13 also permitted debtors to modify the rights of holders of secured or unsecured claims.<sup>116</sup> This provision allowed bankruptcy courts to approve repayment plans that changed the prebankruptcy terms of a debt. However, the law contained an important exception to this modification rule for claims “secured only by a security interest in real property that is the debtor’s principal residence . . . .”<sup>117</sup> This antimodification rule has endured as a feature of chapter 13 for three decades.

During the current foreclosure crisis, Congress has considered several proposals to eliminate the antimodification rule.<sup>118</sup> Proponents of such change assert that the existing law is a barrier to effective bankruptcy relief for homeowners that face foreclosure.<sup>119</sup> To evaluate the merits of such a change, the antimodification rule should be examined in its historical context. This background highlights the significant changes in the modern mortgage market and the circumstances of the current foreclosure crisis that may undermine the traditional justification for the rule.

The legislative history with respect to the antimodification rule is sparse. Section 1322(b)(2) as enacted in 1978 appears to have been a compromise between competing versions of legislation. The Senate bill provided that debtors’ plans could “modify the rights of holders of secured claims and holders of unsecured claims, except claims wholly secured by real estate mortgages . . . .”<sup>120</sup> The House version of § 1322(b)(2) took a broader approach and simply stated that the debtors’ plan of reorganization could “modify the rights of holders of secured claims or of holders of unsecured claims.”<sup>121</sup> Secured creditors objected strenuously to these changes. In particular, advocates for secured creditors argued that debtors should not be able to modify secured claims by reducing the monthly payment or by reducing the amount of the claim to the value of the collateral.<sup>122</sup> Creditors also suggested that a right to modification would discourage

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<sup>114</sup> See S. REP. NO. 95-989 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5927 (“Chapter 13 is designed to serve as a flexible vehicle for the repayment of part or all of the allowed claims of the debtor.”); H.R. REP. NO. 95-595 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6079 (“The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets.”).

<sup>115</sup> See 11 U.S.C. § 1322(b)(5).

<sup>116</sup> 11 U.S.C. § 1322(b)(2).

<sup>117</sup> *Id.*

<sup>118</sup> See, e.g., Homeowner Assistance and Taxpayer Protection Act, S. 3690, 110th Cong. § 103 (2008); Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101 (2007); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007); Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 101 (2008); HOMES Act, S. 2133, 110th Cong. § 2 (2007); HOMES Act, H.R. 3778, 110th Cong. § 202 (2007).

<sup>119</sup> CTR. FOR RESPONSIBLE LENDING, HR 3609—COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES 1 (2008), available at <http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf>.

<sup>120</sup> S. REP. NO. 95-989, at 141 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5927.

<sup>121</sup> H.R. REP. NO. 95-595, at 429 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6384.

<sup>122</sup> See *Grubbs v. Houston First Am. Sav.*, 730 F.2d 236, 245 (5th Cir. 1984) (citing *Bankruptcy Reform Act, Pt.1: Hearings Before the Subcomm. on Improvements of the Judicial Machinery of the S. Comm. on Judiciary*, 94th Cong. 124, 127–28, 130, 132–34, 137–38, 139, 141–42, 167–68, 176–80 (1975) (statements of Walter Vaughan on behalf of the American Bankers Association, and of Alvin Wiese, National Consumer Finance Association)).

savings and loan associations from making home loans.<sup>123</sup> While it is impossible to pinpoint the exact reason why Congress excluded debtors' principal residences from the new rule that permitted the modification of claims, the solvency of the savings and loan industry probably was a pressing concern for Congress at the time that it was considering the adoption of the new Bankruptcy Code.

During the 1970s, savings and loan institutions dominated the residential mortgage market in the United States.<sup>124</sup> The secondary mortgage market, in which loans were originated and then sold, was in its nascence. The typical late 1970s home mortgage loan was a thirty-year mortgage with a fixed interest rate and equal monthly payments.<sup>125</sup> While bankruptcy reform was being debated in Congress, the savings and loan industry was being squeezed by a mismatch of high short-term interest rates paid on deposits and lower fixed interest rates and level payments being paid on residential mortgage loans.<sup>126</sup> Because the savings and loan institutions funded mortgage loans from federally-insured deposits, trouble for the industry created large potential liability for the federal government.<sup>127</sup> Congress may have created an exception for home mortgage loans from modification in chapter 13 bankruptcy as a concession to the financial challenges facing savings and loan institutions. The special treatment of home mortgages certainly reflects a political compromise, as well as the broader financial context, of the time in which chapter 13 was created.

However, the days in which the savings and loan industry dominated the residential mortgage market in the United States have long past.<sup>128</sup> Efforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by concerns about the growth of abusive lending practices in the late 1980s and early 1990s.<sup>129</sup> During this period, home mortgage lending was profoundly transformed. The secondary mortgage market expanded

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<sup>123</sup> See *id.* at 245 n.13 (citing *Bankruptcy Reform Act of 1978: Hearings Before the Subcomm. on Improvements of the Judicial Machinery of the S. Comm. on the Judiciary*, 95th Cong. 652–53, 703, 707, 714–15, 719–21 (1977) (statements of Alvin Wiese and John V. Kulik, National Association of Real Estate Investment Trusts) (discouraging savings and loan associations from making home loans).

<sup>124</sup> See Douglas B. Diamond, Jr. & Michael J. Lea, *Housing Finance in Developed Countries: An International Comparison of Efficiency: United States*, 3 J. OF HOUSING RES. 145, 145 (1990).

<sup>125</sup> See *id.* (explaining that deregulation of lending practices in the late 1970s and early 1980s gave rise to adjustable rate mortgages).

<sup>126</sup> See *id.*; see also Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. OF ECON. PERSP. 93, 98 (2005). Fixed-rate mortgages paid between five and six percent while yield on short term Treasury bills generally did not exceed four percent. See *id.* at 97. The year before the Bankruptcy Code was enacted, the yield rate on three-month Treasury bills had begun a steady climb from a 4–6% range in 1977 to 6–9% in 1978 and into double digit figures to reach an annualized high of over 14% in 1981. See Fed. Reserve, Statistical Release H15, 3-Month Auction High Bill Rate by Issue Date (June 30, 2000), [http://www.federalreserve.gov/releases/H15/data/Annual/discontinued\\_AH\\_M3.txt](http://www.federalreserve.gov/releases/H15/data/Annual/discontinued_AH_M3.txt).

<sup>127</sup> Barbara Randolph, *Special Report: The Savings and Loan Crisis*, TIME, Feb. 20, 1989, at 68 (estimating cost of bailing out struggling savings and loan institutions at \$10 billion in 1983).

<sup>128</sup> See CYNTHIA ANGELL & CLARE D. ROWLEY, FED. DEPOSIT INS. CORP., FDIC, BREAKING NEW GROUND IN U.S. MORTGAGE LENDING, (2006), [http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006\\_summer04.html](http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html) (describing decline in savings and loan mortgage originations after regulatory reform).

<sup>129</sup> For example, in 1994 Congress passed the Home Ownership and Equity Protection Act (HOEPA), which created a special class of high cost home mortgages. Pub. L. No. 103-325, §§ 152(a)–(c), 154(a), 108 Stat. 2190, 2191, 2196 (1994). For this class of home loans, HOEPA banned certain practices such as balloon payments, negative amortization, and default interest rates. See *id.* § 152(d).

exponentially, and the securitization of residential mortgage loans became common.<sup>130</sup> Non-depository mortgage lenders, such as finance companies, became the primary originators of residential mortgage loans, and the subprime market that made mortgage loans on less robust underwriting standards began to flourish.<sup>131</sup>

Early subprime loans, often fixed-rate, were characterized by high interest rates and high points and fees at origination.<sup>132</sup> For example, in 1999 subprime mortgage loans had interest rates as high as 19.99%, with a median interest rate between 11% and 11.99%. By contrast, for the same year the interest rate for conventional prime thirty-year mortgages was 7.43%.<sup>133</sup> The higher interest rates on subprime loans translated into higher monthly mortgage payments for loans of identical amounts. These higher monthly payments increased the incidence of unaffordable housing costs while concomitantly expanding the homeownership markets to lower income families, many of whom had fewer assets and weaker credit histories than traditional homeowners.

Loan-to-value ratios for mortgages also increased during the 1990s as lenders aggressively marketed home equity loans and debt consolidation programs in which the debt on the home exceeded the value of the property.<sup>134</sup> Lenders knowingly allowed borrowers to leverage their homes beyond the current market value of those homes.<sup>135</sup> Rather than relying on equity in the collateral, lenders counted on borrowers' abilities to refinance as home prices appreciated and borrowers' fear of foreclosure to protect their interests.<sup>136</sup> These high loan-to-value lenders also "turned away from traditional mortgage lending standards in favor of underwriting standards similar to those used for unsecured (primarily, credit card) loan products."<sup>137</sup> Despite looser underwriting standards and subprime loan products that put families in home loans that greatly exceeded affordability criteria, lenders nevertheless had some modicum of protection from loss because bankruptcy's antimodification rule limited the attractiveness and scope of chapter 13

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<sup>130</sup> In 1994, approximately \$10 billion worth of home equity loans were securitized. DANIEL IMMERGLUCK & MARTI WILES, *TWO STEPS BACK: THE DUAL MORTGAGE MARKET PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT*, WOODSTOCK INSTITUTE 12 (1999). In 2003, securitization in the subprime market had mushroomed to \$203 billion. Derrick M. Land, *Residential Mortgage Securitization and Consumer Welfare*, 61 CONSUMER FIN. L.Q. REP. 208, 217 (2007); see also Lei Ding, Janneke Ratcliffe, Michael A. Stegman & Roberto G. Quercia, *Neighborhood Patterns of High-Cost Lending: The Case of Atlanta*, 17 J. AFFORDABLE HOUS. & CMTY. DEV. L. 193, 194 (2008) (reporting that growth in subprime securitization increased over forty-four-fold between 1994 and 2006, from \$11 billion to more than \$483 billion).

<sup>131</sup> See Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 527–28 (2000).

<sup>132</sup> See *id.* at 536–37 (providing data on interest rate range for subprime loans).

<sup>133</sup> See *id.*

<sup>134</sup> In 1998 the Office of Thrift Supervision issued a warning to lenders about the risks of high-loan to value ratios. OFFICE OF THRIFT SUPERVISION, DEPT. OF THE TREASURY, THRIFT BULLETIN TB 72 at 1-3 (1998) ("An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property. . . . Until recently, the high LTV [loan to value] home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders.").

<sup>135</sup> See *id.*

<sup>136</sup> See CHARLES CALOMIRIS & JOSEPH MASON, *HIGH LOAN-TO-VALUE MORTGAGE LENDING: PROBLEM OR CURE?* 11 (1999), available at [http://www.aei.org/doclib/20021130\\_71252.pdf](http://www.aei.org/doclib/20021130_71252.pdf); Posting of Elizabeth Warren to Credit Slips: A Discussion on Credit and Bankruptcy, <http://www.creditslips.org/creditslips/2007/11/hostage-value.html> (Nov. 21, 2007, 16:54).

<sup>137</sup> CALOMIRIS & MASON, *supra* note 136, at 11.

relief for homeowners in financial distress. During the late 1990s and early 2000s, however, lenders primarily escaped foreclosure because of borrowers' ability to refinance as home prices appreciated and because of strong demand for mortgage-backed securities that expanded underwriting standards. While Chapter 13 bankruptcy could do little to help homeowners during the early 2000s, the market largely provided a safety valve for families in unaffordable loans.

The more recent advent of "exotic" or "non-traditional" subprime loan products has exacerbated the extent to which the antimodification rule hampers bankruptcy's effectiveness as a home-saving tool. Many of these new mortgage products become severely unaffordable within a few years of origination by virtue of changing terms. The most dominant non-traditional mortgage product is the adjustable-rate mortgage (ARM). The most common product, the 2/28 ARM, is characterized by a fixed rate for the first two years, followed by an adjustment every six months thereafter. Often these loans are structured with an initial "teaser" or discounted rate. After the two-year fixed period for these loans expires, the interest rate, and accordingly the borrower's payments, can increase significantly.<sup>138</sup> To determine whether the borrower had the ability to make payments on the 2/28 ARM loan, lenders typically considered only whether the monthly payment based on the teaser rate would be affordable.<sup>139</sup> The expiration of the fixed-rate period brings with it a sharp increase in monthly payment, often referred to as "payment shock."<sup>140</sup> By mid-2006, hybrid ARMs such as 2/28s or 3/27s, made up 81% of the securitized subprime market.<sup>141</sup>

Similarly, borrowers with option ARM loans are also subject to payment shock. With an option ARM, borrowers have the "option" of making a minimum payment, an interest-only payment, or a fully amortized payment. For most borrowers who took out such loans, the minimum payment is the only affordable payment on their incomes. However, this payment is insufficient to cover accrued interest on the loan, which results in any unpaid interest being added to the principal balance. As a result, the loan balance increases with time (i.e., negatively amortizes). Despite making payments over a period of months or years, the homeowner will find herself owing an increasing amount of mortgage debt, rather than building equity. Almost all option ARMs have trigger points that cause the loans to recast so that they will fully amortize over the remaining duration of the loan terms. Most option ARMs will recast five years from origination (a time trigger) or if the loan balance exceeds 110% of the original loan amount (a loan balance trigger).<sup>142</sup> Like the expiration of the teaser rate on a 2/28 ARM, the recasting of an option ARM leads to a very large increase in the monthly payment amount for most borrowers.

Additionally, weaker underwriting standards have led to the rapid growth of no documentation or low documentation loans that require no or limited verification of ability to

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<sup>138</sup> Typically, there is a cap on the increase in the first adjustment of 2% and caps on subsequent adjustments of 1%.

<sup>139</sup> Beverlea (Suzy) Gardner & Dennis C. Ankenbrand, *Hybrid ARMs: Assessing the Risks, Managing the Fallout*, SUPERVISORY INSIGHTS, Summer 2008, at 14, 17, available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf> (listing underwriting weakness with hybrid ARM originations from 2004 until 2007, including qualifying buyers based on introductory payment); Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007) ("The Agencies are concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment.").

<sup>140</sup> Gardner & Ankenbrand, *supra* note 139, at 17.

<sup>141</sup> DERIVATIVE FITCH, STRUCTURED FINANCE: U.S. SUBPRIME RMBS IN STRUCTURED FINANCE CDOs 2 (2006).

<sup>142</sup> If the borrower makes only minimum payments every month, the loan balance trigger will usually be reached before the time trigger.

repay the loan.<sup>143</sup> As a result of these changes in the modern mortgage market, traditional tools for preventing foreclosures such as nonbankruptcy forbearance agreements or chapter 13 bankruptcy repayment plans are much less effective than in the past. The bankruptcy right to repay mortgage arrearages over time does not address the ongoing increase in mortgage payments that millions of homeowners face with the nontraditional loan products originated in the last decade.

The antimodification rule enacted in 1978, at least in part to protect the savings and loan industry, has not been amended in thirty years, despite these vast changes in the residential mortgage market. The dramatic growth of high interest rate loans and nontraditional loan products has translated into far more unaffordable home loans. Particularly as the new products age, the changes in these loan terms have created sharp upticks in mortgage payments that cannot be met by families whose incomes rarely have experienced similar, dramatic increases. Unaffordable housing costs are a widespread feature of today's American homeownership experience and are the driving factor of the foreclosure crisis. Absent the ability to address exploding interest rates, negatively amortizing loans, and over-leveraged homes, bankruptcy will be an incomplete or inadequate solution to the current problem of homeownership affordability.

### *B. Proposals to Permit Modifying Home Mortgages in Bankruptcy*

In the wake of rapidly rising foreclosure rates in late 2007, policymakers struggled to formulate solutions. A popular proposal was to repeal the antimodification provision of the Bankruptcy Code to improve bankruptcy relief as a means to help families struggling with unaffordable home loans. Current law was criticized as a major roadblock to keeping families in their homes. Several bills were introduced in Congress to allow bankruptcy courts to modify the terms of chapter 13 debtors' residential mortgage loans.<sup>144</sup> Consumer advocates backed the legislation, citing a continued escalation in the number of foreclosures and describing the harms that families and communities suffer from foreclosure.<sup>145</sup> The lending industry mounted a strong and continuous opposition to the bills, relying mainly on their predictions that the modification of home mortgages in bankruptcy would cause mortgage rates to rise 1.5% to 2% on future loans.<sup>146</sup> The industry's figures were heavily criticized for being unsupported by empirical analysis,<sup>147</sup> but the industry generated enough concern over mortgage market liquidity that, as of November 2008, none of the bills has garnered sufficient support to succeed in the Senate or the House of

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<sup>143</sup> By 2006 no or low documentation loans made up 49% of mortgage loans originated in the United States. See CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 38 (2007), available at <http://billcara.com/CS%20Mar%2012%202007%20Mortgage%20and%20Housing.pdf>.

<sup>144</sup> See *supra* note 118.

<sup>145</sup> CTR. FOR RESPONSIBLE LENDING, H.R. 3609: COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES (2008), available at <http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf>.

<sup>146</sup> *Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?—Part II: Hearing Before Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. at 3. (2007) [hereinafter Kittle Testimony] (statement of David Kittle, Mortgage Bankers Association), available at <http://www.mortgagebankers.org/files/StoptheBankruptcyCramDown/StatementofDavidKittle.pdf>; see Mortgage Bankers Association, Press Release, "Stop the Cram Down Resource Center" Puts a Price Tag on Bankruptcy Reform, Jan. 15, 2007, available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/59343.htm>.

<sup>147</sup> Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Georgetown Public Law and Legal Theory Working Paper Series, Research Paper No. 1087816, 2008), available at <http://ssrn.com/abstract=1087816>.

Representatives. Notwithstanding concerns about political feasibility, an examination of the proposals to eliminate the antimodification rule illustrates how changing bankruptcy law could help families in unaffordable home loans save their homes and could reduce the incidence of foreclosure.

### 1. Interest Rate Freezes or Reductions

Each of the proposed bills to permit the modification of mortgage loans in bankruptcy would provide, to some extent, for freezes or reductions of interest rates on mortgage loans. For example, S. 2136 would allow for payment of the mortgage at a “fixed annual percentage rate,” even if the actual terms of the promissory note obligate the borrower to pay under an adjustable rate.<sup>148</sup> A bankruptcy court would have the authority to recalibrate the interest rate to be “equal to the most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System . . . plus a reasonable premium for risk.”<sup>149</sup> If enacted into law, this provision would permit a homeowner to file a Chapter 13 bankruptcy case as a tool to stop adjustments on an exploding ARM, convert an ARM into a fixed-rate loan, or reduce the interest rate on a high-cost subprime loan.

The beneficial effect of the ability to modify interest rates is illustrated by reexamining the situation of the Minnesota family in the Mortgage Study that filed bankruptcy.<sup>150</sup> Recall that the family had an adjustable-rate mortgage with an initial teaser interest rate of 7.99% and a monthly payment of \$1781.<sup>151</sup> However, after the first two years of the loan the interest rate began to quickly adjust upward so that within seven months the interest rate had reached 10.99% and the payment had climbed to \$2780.<sup>152</sup> If the interest rate freeze or reduction provision had been available when this family filed bankruptcy in April 2006, the debtors’ chapter 13 plan could have fixed the interest on their mortgage at 6.51%<sup>153</sup> plus a premium for risk of an additional 1 to 2%.<sup>154</sup> The resulting postmodification interest rate range of 7.51% to 8.51% would be very close to the initial rate on the loan of 7.99%, allowing this family to continue with the affordable payment that it had managed to pay before the initial rate adjusted. Given the prevalence of ARM loans and high-rate subprime fixed loans among the loans currently in foreclosure,<sup>155</sup> the ability to adjust or freeze an interest rate likely would give hundreds of thousands of families a fighting chance to prevent foreclosure and save their homes.

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<sup>148</sup> S. 2136, 110th Cong. § 101 (2007).

<sup>149</sup> S. 2136, 110th Cong. § 101(a)(3) (2007); *see also* S. 2636, 110th Cong. § 412 (2008); H.R. 3609, 110th Cong. § 4 (2007); *cf. Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) (establishing interest rate for secured claims subject to modification, i.e., those not secured by a debtor’s principal residence, at prime rate plus premium for risk).

<sup>150</sup> *See supra* note 27 and accompanying text.

<sup>151</sup> *See id.*

<sup>152</sup> *See id.*

<sup>153</sup> *See* Fed. Reserve Bd., Federal Reserve Statistical Release H.15—Historical Data, <http://www.federalreserve.gov/releases/h15/data.htm> (last visited Nov. 3, 2008).

<sup>154</sup> Although the starting point for an interest rate that uses conventional mortgage rates as a base would be different than for other secured claims, which use the prime rate as a base, a bankruptcy court could be expected to apply the same set of factors delineated in the Supreme Court’s decision in *Till v. SCS Credit Corp.*, 541 U.S. 465, 478–79 (2004), for modifying non-mortgage claims in determining the appropriate risk premium for mortgage loans. According to the Supreme Court, the risk factors include “the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan.” *Id.* at 479.

<sup>155</sup> *See* CTR. FOR RESPONSIBLE LENDING, *supra* note 25, at 1–3.

## 2. Reduction of Principal Amount (Strip Down)

“Stripping down” or bifurcating a secured creditor’s claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion, which is any amount of the debt that exceeds the value of the collateral.<sup>156</sup> This process has the effect of writing down the principal balance on a loan that is secured by the mortgage to the value of the property as of the time of the bankruptcy. Section 506(a), which authorizes such bifurcation, provides that a creditor’s claim “is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property.” The interaction between § 506(a) and the antimodification rule of § 1322(b)(2) was once the subject of much debate. The Circuit Courts of Appeals were divided on whether mortgage claims could be stripped down.<sup>157</sup> In *Nobleman v. American Savings Bank*, the Supreme Court held that the antimodification rule prohibited the strip down of claims secured by mortgages on the debtor’s principal residence.<sup>158</sup>

Each of the proposed bills would have changed the strip down rules in certain circumstances. A chapter 13 debtor could reduce the amount of outstanding principal on the mortgage to the value of the collateral at the time of the bankruptcy. The secured claim would be based on this new lower amount, reducing the payments that a family would have to make to retain its home. A Mortgage Study case from Texas illustrates how strip down would improve home affordability.<sup>159</sup> In this case, the mortgage creditor filed a claim asserting that it was owed \$162,270 in total debt. Its proof of claim accepted the debtor’s valuation of the market value of the property as \$120,200. Assuming this is an accurate valuation, if the claim were subject to strip down, the secured portion of the claim would be limited to \$120,200, the value of the home. The remaining debt of approximately \$42,000 would become additional unsecured debt owed by the bankruptcy debtor. For the unsecured portion of its claim, the mortgage company would receive a pro rata distribution of the debtor’s payments of his disposable income. The mortgage payment necessary to retain the property would be recalculated based on a principal amount of \$120,200, which would be less than the amount of the note’s principal at origination, which was \$125,115. The effect of the strip down would be to reduce the ongoing monthly mortgage payment and improve the debtor’s chances of keeping the house by making the mortgage payments more affordable.

## 3. Reamortization of Loan Term

Under current law, a secured claim that is subject to strip down must be paid in full within the three- to five-year duration of a chapter 13 plan.<sup>160</sup> While this feat often can be accomplished for claims secured by personal property, few debtors are able to pay the entire amount of their mortgages in that short time period. The proposed bills to repeal the antimodification rule all would permit a bankruptcy court to authorize payments on a home mortgage to be reamortized over a period extending beyond the three- to five-year term of the chapter 13 plan.<sup>161</sup> By combining an extension of the loan term with an interest rate adjustment or a reduction in

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<sup>156</sup> 11 U.S.C. § 506(a) (2006).

<sup>157</sup> See *Bellamy v. Fed. Home Loan Mortgage Corp. (In re Bellamy)*, 962 F.2d 176 (2d Cir. 1992); *Eastland Mortgage Co. v. Hart (In re Hart)*, 923 F.2d 1410 (10th Cir. 1991); *Wilson v. Commonwealth Mortgage Corp.*, 895 F.2d 123 (3d Cir. 1990); *Hougland v. Lomas & Nettleton Co. (In re Hougland)*, 886 F.2d 1182 (9th Cir. 1989).

<sup>158</sup> 508 U.S. 324 (1993).

<sup>159</sup> This example is from Mortgage Study case ND TX 43 (on file with Katherine Porter).

<sup>160</sup> See 11 U.S.C. § 1322(d).

<sup>161</sup> See *supra* note 118.

principal, many families would be able to cure their arrearages in chapter 13 bankruptcy and avoid foreclosure.

For example, the previously-discussed debtor<sup>162</sup> from the Mortgage Study with a monthly payment nearly equal to her gross monthly income could have used the reamortization and interest rate reduction provisions to create a more affordable, fully amortizing loan. This debtor faced a severely unaffordable monthly mortgage payment even after contributions from a family member. The debtor's original loan had an interest rate of 11% and was a six-year balloon note. Under most bills that would permit the modification of mortgage loans in bankruptcy, the debtor could have reduced the interest rate to 6.51% plus a risk premium and reamortized the loan over a thirty-year period, reduced by the period the loan had been outstanding. Because the loan was originated in September 2005, just seven months before the bankruptcy filing, the new loan term could have been up to twenty-nine years. With a principal balance on the loan of \$269,000 at the time of the bankruptcy, the adjusted monthly payment amount for that twenty-nine-year term would have been approximately \$1,900 after reamortization.<sup>163</sup> While this payment would still be severely unaffordable by HUD standards because it would require the debtor and her household to spend 51% of their combined gross income on the mortgage payment, the reduction is dramatic from the prior situation, in which the family spent more than 60% of its income. Importantly, the modification would also put the debtor on the path to true homeownership because it would make the loan fully amortize. Rather than relying on precarious housing markets to build any equity while the debtor made only interest payments, the debtor could commit fewer dollars and improve her chances of achieving sustainable homeownership.

### *C. Benefits of Bankruptcy as a Foreclosure Prevention System*

The affordability data offer support for the substantive benefits of permitting bankruptcy courts to modify the terms of mortgage loans of chapter 13 debtors. Amending bankruptcy law to improve its efficacy to help families save their homes is also a superior policy response because it would be an administratively and procedurally efficient solution to the foreclosure crisis. Compared to the existing and proposed schemes of foreclosure aid, a bankruptcy-based solution to the problem of housing unaffordability offers the greatest potential of immediate and lasting relief to homeowners that are committed to saving their homes. This section articulates four procedural benefits of allowing bankruptcy courts to modify home mortgages that complement the substantive benefit of addressing the unaffordability problem that threatens families' homeownership.

The first benefit of permitting bankruptcy-based mortgage loan modifications is that the bankruptcy system already contains screening mechanisms to ensure that only needy families are helped. Any proposal for relief will help only some subset of Americans with mortgages. Requiring a bankruptcy filing to receive a loan modification would subject families to the built-in checks in existing bankruptcy law to gauge their need for relief. In 2005, Congress amended the Bankruptcy Code to require that consumers pass a "means test," a stringent mechanical standard to ensure that consumers pay their debts if they can afford to do so.<sup>164</sup> "Good faith" on the part of a debtor is also an explicit statutory requirement for chapter 13 bankruptcy relief,<sup>165</sup> and an experienced cadre of bankruptcy judges is already familiar with this standard. Because all

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<sup>162</sup> See *supra* note 23 and accompanying text.

<sup>163</sup> This calculation assumes that the court fixed the interest rate at 7.5%, reflecting a risk premium of 1% over the 6.51% rate on conventional prime mortgages in April 2006.

<sup>164</sup> 11 U.S.C. §§ 707(b)(2), 1325(b)(3); see HENRY J. SOMMER, COLLIER CONSUMER BANKRUPTCY PRACTICE GUIDE ¶ 23.02(3)(b) (2006).

<sup>165</sup> 11 U.S.C. § 1325(a)(3) (stating that plan must be proposed in good faith).

individuals with consumer debt are subject to these screening criteria, there is no need to develop separate standards to determine which homeowners should be eligible for a loan modification. Unlike a program of voluntary modifications, bankruptcy offers uniform federal standards to ensure that only needy families get help. Bankruptcy also requires a debtor to suffer real burdens that prospectively would deter consumers who are looking for a better deal but who could pay according to the existing terms of their mortgage loans. Families that wanted to modify a loan in bankruptcy would incur expenses such as attorney's fees and filing fees and would have to contend with the harm to their credit scores and the stigma of a public bankruptcy filing.<sup>166</sup>

The second benefit of modifying loans in bankruptcy administrative efficiency. As a foreclosure rescue system, a bankruptcy solution would not require any new bureaucracy or the expansion of any government agencies. The costs of such relief to the general public would be nonexistent or negligible. The bankruptcy system is self-financed from fees paid by debtors.<sup>167</sup> Expanding bankruptcy relief to allow the modification of mortgages does not require taxpayer dollars to be spent on creating and implementing a relief system from scratch. Instead, such a solution uses the existing bankruptcy architecture and administration, including judges, the U.S. Trustee, and panel trustees. These personnel are experienced in adjudicating disputes between consumers and creditors, reducing time that would be needed to hire, train, and supervise staff. Compared to a nebulous system of aid such as a foreclosure rescue fund, a bankruptcy modification solution would not waste time in trying to set eligibility criteria or implement a program of relief.

A third advantage of expanding bankruptcy relief to help homeowners is the way in which a bankruptcy-based system would override mortgage servicers' disincentives to modify loans. Despite contentious opposition to proposals to modify mortgages in bankruptcy, the mortgage industry seems to agree with consumer advocates that homeowners and servicers are not communicating successfully (or at all) about the possibility of voluntary loan modifications. The Mortgage Bankers Association admits that neither lenders nor servicers have any communication with 50% of homeowners in foreclosure.<sup>168</sup> Consumers complain about difficulty in contacting their mortgage servicers, in identifying agents with authority to offer modifications, and in persuading servicers that modification (rather than a repayment or forbearance plan) is the relief that they need to avoid foreclosure.<sup>169</sup> Additionally, mortgage servicers have struggled to provide the kind of high-quality and labor-intensive customer service necessary to do loan modifications. Indeed, servicers have financial incentives to impose fees and charges on struggling homeowners to overcome the costs of servicing loans in default,<sup>170</sup> even if such servicing practices create roadblocks to homeowners trying to cure their defaults and save their homes. If mortgages could be modified in bankruptcy, consumers could affirmatively initiate the modification process by filing a chapter 13 bankruptcy. From this signal, the mortgage company would know that a family

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<sup>166</sup> See Jacoby, *supra* note 79, at 330–31 (detailing costs of chapter 13).

<sup>167</sup> U.S. DEP'T OF JUSTICE, U.S. TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS: FISCAL YEAR 2005 10, *available at* [http://www.usdoj.gov/ust/eo/public\\_affairs/annualreport/docs/ar2005.pdf](http://www.usdoj.gov/ust/eo/public_affairs/annualreport/docs/ar2005.pdf) (*last visited* Nov. 3, 2008).

<sup>168</sup> Kittle Testimony, *supra* note 146, at 10 (admitting that servicer had no contact with 50% of homeowners whose mortgages were foreclosed).

<sup>169</sup> See *Possible Responses to Rising Mortgage Foreclosures: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 9–14 (2007) (statement of Sheila Bair, Chairman, FDIC), *available at* [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/htbair041707.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbair041707.pdf); STATE FORECLOSURE PREVENTION WORKING GROUP, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE: DATA REPORT NO. 1, at 6 (2008); Kurt Eggert, Comment: *What Prevents Loan Modifications?*, 18 Hous. Pol'y Debate 279 (2007).

<sup>170</sup> See Porter, *supra* note 28, at 5–6 (describing how mortgage servicers earn revenue from default charges).

is committed to trying to save its home. Instead of missed opportunities to communicate, consumers and servicers would negotiate over possible modification within the structured framework of a bankruptcy case. Mortgage servicers' incentives to pile on default fees and their ability to unreasonably refuse to do loan modifications would be checked by the bankruptcy courts, acting pursuant to a statutory scheme of permissible modifications.

A final benefit of bankruptcy modification is its relative invulnerability to legal attacks. This benefit would protect mortgage creditors or servicers that grant modifications and would give the government a strong argument that its system of aid to homeowners was constitutionally permissible. Today, many residential mortgages are securitized. Mortgage servicers and trustees who are responsible for such securitized mortgages are obliged to follow the terms of pooling and servicing agreements and other contracts with investors who own the mortgage-backed securities. While regulators have tried to ease concerns about liability to servicers or trustees that could arise from modifying mortgages, the potential for liability (or at least lawsuits that must be defended) may lead to reluctance to engage in widespread loan modifications. An additional concern is that investors may file lawsuits against trustees or against other groups of investors if loan modifications are made that do not benefit them. Because different tranches of investors face different losses depending on the nature of their investments, the investors' interests are not uniformly aligned to modify mortgages.<sup>171</sup> Loan modifications pursuant to bankruptcy law would not be voluntary and would protect servicers and trustees from allegations that they acted unfairly or unreasonably in modifying mortgages. Congress would also have the protection of its constitutional authority to enact uniform bankruptcy laws to defend a bankruptcy-based solution to the foreclosure crisis.<sup>172</sup> Without this basis, the government may be vulnerable to constitutional challenges if it engages in efforts to force mortgage holders to modify their private contracts with homeowners. A bankruptcy modification solution would greatly reduce the potential of legal liability for modifying loans.

Any effective policy response to the foreclosure crisis will have to grapple with the problem of unaffordable loan terms. Modifying the mortgage loans of bankruptcy debtors would not only provide the needed affordability relief to help families succeed at homeownership, such a solution would also offer administrative advantages that other proposed responses to the foreclosure crisis cannot match. This combination of substantive and procedural benefits may make bankruptcy-based loan modification the most conservative approach that would also provide a viable means to help reduce the number of foreclosures.

## VI. CONCLUSION

The record number of foreclosures in 2007 and 2008 is threatening homeownership as a fundamental institution of American middle-class life. The inability of millions of families to afford the strain housing costs place on their incomes is a driving factor in the foreclosure crisis. While chapter 13 bankruptcy offers families the opportunity to repay arrearages on their mortgage loans in a repayment plan, this relief does not address the ongoing struggle with loan affordability that resulted from the loose underwriting standards and non-traditional loan products that characterized the mortgage market in the last several years. The Mortgage Study data show that even in 2006, before the height of the current foreclosure crisis, more than seven in ten homeowners in bankruptcy had mortgage payments and related housing costs that exceeded income affordability standards. Repealing the prohibition on modifying home mortgage loans in bankruptcy would improve the effectiveness of chapter 13 bankruptcy as a home-saving device

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<sup>171</sup> Eggert, *supra* note 169, at 290.

<sup>172</sup> U.S. CONST. art. I, § 8, cl. 4.

and reduce the economic and policy consequences of the foreclosure crisis by giving millions of families a chance to save their homes.