

2014

House Swaps: A Strategic Bankruptcy Solution to the Foreclosure Crisis

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Recommended Citation

Lynn M. LoPucki, *House Swaps: A Strategic Bankruptcy Solution to the Foreclosure Crisis*, 112 Mich. L. Rev. 689 (2014)

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HOUSE SWAPS: A STRATEGIC BANKRUPTCY SOLUTION TO THE FORECLOSURE CRISIS

Lynn M. LoPucki*

Since the price peak in 2006, home values have fallen more than 30 percent, leaving millions of Americans with negative equity in their homes. Until the Supreme Court's 1993 decision in Nobelman v. American Savings Bank, the bankruptcy system would have provided many such homeowners with a remedy. They could have filed bankruptcy, discharged the negative equity, committed to pay the mortgage holders the full values of their homes, and retained those homes. In Nobelman, however, the Court misinterpreted reasonably clear statutory language and invented legislative history to resolve a three-to-one split of circuits in favor of the minority view that debtors could not modify even the unsecured portions of the mortgages on their principal residences. Courts and commentators have since assumed that modifying home mortgages in bankruptcy is impossible.

This Article presents a legal strategy for modifying home mortgages despite Nobelman. The strategy requires that debtors move out of their houses, lease the houses for one year, file bankruptcy, and propose mortgage modification plans that pay mortgage holders the full current values of the houses. This Article argues that despite the artificiality of a move-out with the intention to return, bankruptcy judges will approve the modification plans. The judges will do so because existing precedent requires approval and because the modification plans will be in the best interests of not only the debtors but also the mortgage holders and the American economy. The strategy will enable hundreds of thousands of homeowners to retain homes they would otherwise have lost to foreclosure.

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INTRODUCTION

The nonmodifiability of home mortgages in bankruptcy is one of the many ways in which the American legal system is rigged against the middle class.¹ The bankruptcy system allows debtors to strip mortgages and security interest debts down to the collateral value on virtually every kind of debt, except the two kinds that middle-class Americans are most likely to owe: (1) mortgages against individual debtors' principal residences and (2) security interests in individual debtors' automobiles if the debtors financed those automobiles within the 910-day period preceding bankruptcy. By contrast, corporations, large or small, can strip down and modify mortgages or security interests against *any* kind of asset—including homes acquired through foreclosure and automobiles financed in the 910-day period preceding bankruptcy. Wealthy individuals can likewise strip down and modify mortgages against second and third homes.

Contrary to popular belief, the inability to strip down home mortgages does not result from congressional action. It is the product of the Supreme Court's 1993 decision in *Nobelman v. American Savings Bank*.² In that case, the Court ignored the plain meaning of Bankruptcy Code subsection

1. Bankruptcy expert and now U.S. senator Elizabeth Warren (D-Mass.) has advanced the theme that the nation's economic system is "rigged against [the middle class]":

I'm here tonight to talk about hard-working people: people who get up early, stay up late, cook dinner and help out with homework; people who can be counted on to help their kids, their parents, their neighbors, and the lady down the street whose car broke down; people who work their hearts out but are up against a hard truth—the game is rigged against them.

Elizabeth Warren, Democratic Convention Speech (Sept. 5, 2012), *available at* <http://abcnews.go.com/Politics/OTUS/transcript-elizabeth-warrens-democratic-convention-speech/story?id=17164726>.

2. 508 U.S. 324 (1993).

1322(b)(2) and invented legislative history to resolve a conflict of circuits against the majority view.³

This Article presents a legal strategy by which individuals can modify their home mortgages and retain their homes despite *Nobelman*.⁴ The strategy requires that debtors move out of their homes for periods of one year. In most parts of the United States, judges need only follow well-established legal precedent for the strategy to succeed.

The implementation of this strategy has important implications not only for individuals struggling to save their homes but also for the American economy. Five years after the onset of the financial crisis, the United States remains mired in the ensuing mortgage foreclosure crisis.⁵ Negative equity—debtors owing more than their homes are worth—drives the crisis.⁶ At the end of the first quarter of 2013, about one in five of the approximately 49 million home mortgages outstanding in the United States—about 9.7 million—still exceeded the value of the home.⁷

Homeowners with negative equity are more likely to default. For example, a recent study found that an additional 16% of homeowners who owed more than 140% of the values of their homes transitioned into default each year, as compared with only 2.5% of homeowners with equity.⁸ Once homeowners transitioned into default, the odds were “well over 90%” that the homeowners would never resume payments unless their loans were modified.⁹

The process that follows mortgage default is highly inefficient. Foreclosure takes months and sometimes years.¹⁰ In the interim, the debtor is often

3. See *infra* Section III.B.

4. The idea of moving out of the house to render the mortgage modifiable dates back to at least 2000. See LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT 284 (3d ed. 2000). The idea of a swap, as opposed to a mere move-out, originated with Cornell University Law School professor Robert C. Hockett. Robert Hockett, *How About Home Lease Swapping as a Mortgage Market Cure?*, BENZINGA (Oct. 14, 2011, 3:01 PM), <http://www.benzinga.com/news/11/10/1987688/how-about-home-lease-swapping-as-a-mortgage-market-cure>.

5. See, e.g., Elizabeth M. Lynch, Op-Ed., *The Second-Mortgage Shell Game*, N.Y. TIMES, Feb. 18, 2013, at A17, available at http://www.nytimes.com/2013/02/18/opinion/the-second-mortgage-shell-game.html?pagewanted=all&_r=0 (arguing that through a foreclosure settlement ostensibly intended to keep people in their homes, “banks have been given a backdoor mechanism to continue foreclosures at the same pace as before”).

6. Laurie S. Goodman et al., *The Case for Principal Reductions*, J. STRUCTURED FIN., Fall 2011, at 29, 29 (“Even controlling for [competing factors] the undeniable conclusion continues to hold: *Equity is the key driver of defaults!*”).

7. *CoreLogic Reports 850,000 More Residential Properties Return to Positive Equity in First Quarter of 2013*, CORELOGIC (June 12, 2013), <http://www.corelogic.com/about-us/news/core-logic-reports-850,000-more-residential-properties-return-to-positive-equity-in-first-quarter-of-2013.aspx> (“9.7 million, or 19.8 percent of all residential properties with a mortgage, were still in negative equity at the end of the first quarter of 2013.”).

8. Goodman et al., *supra* note 6, at 29.

9. *Id.* at 31 (“[O]nce a loan is 60+ days delinquent and under water, the likelihood of eventual default (without modification) is generally well over 90%.”).

10. E.g., LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT 32–36 (7th ed. 2012) (describing foreclosure procedures and duration).

without the means or the incentive to maintain the property. Some sever and sell appliances, fixtures, trees, plants, and even basic building materials.¹¹ Mortgage holders must pay attorneys' fees and court costs. They may be able to obtain deficiency judgments against their borrowers, but the judgments are usually uncollectible. They must nearly always purchase the property at the foreclosure sale.¹² The mortgage holder may then incur additional legal expenses in evicting the former owner. After obtaining possession, the mortgage holder must maintain the vacant property and pay the costs of reselling it. The most widely quoted estimates state that, on average, a mortgage foreclosure costs the lender \$50,000¹³ or 27% to 60% of the outstanding loan balance,¹⁴ but in actuality, little hard public data exists.

Foreclosures are often personal tragedies for homeowners.¹⁵ Homeowners may struggle for years, lose their homes in the end, and sacrifice their mobility in the interim. The process also destroys their credit ratings.¹⁶

Collectively, foreclosures are problematic for the American economy. A flood of foreclosed homes puts downward pressure on housing prices. Mortgage holders' capital is tied up in illiquid, nonproducing mortgages. The result is that new loans are often not available for qualified buyers who

11. See, e.g., John Collins Rudolf, *Nice Home. Where's the Rest of It?*, N.Y. TIMES, Dec. 23, 2009, at B1, available at <http://www.nytimes.com/2009/12/23/business/economy/23stripped.html?pagewanted=all>. The article reports,

In Nevada and other states hit hard by the housing crisis, stripping fixtures and appliances from homes in foreclosure has become commonplace. Craigslist, the Web site for classified ads, functions as a bazaar where stripped items are sold openly. Often, the stripping is . . . done by the owner, just before the bank forecloses on the mortgage and takes the property back.

Id. The debtors who experience this lack of incentive are those who remain in possession of the home after they realize that they will not be able to keep it and who do not expect to be held liable for or to pay deficiency judgments.

12. See Jonathon Townsend, *Foreclosure Sale Prices: An Empirical Analysis* 30–33 (2013) (unpublished manuscript) (on file with author) (study of Minneapolis mortgage foreclosure finding that the mortgage holders purchased 98 of 100 homes); see also Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 875 (1985) (“In the sample of 118 foreclosure sales, the mortgagee bid successfully in 91 cases, or seventy-seven percent of the total . . .”).

13. THE 2007 JOINT ECONOMIC REPORT, S. REP. NO. 110-251, at 41 (2007), available at <http://www.jec.senate.gov/archive/Documents/Reports/12.19.07%20Annual%20Report.pdf>.

14. MORTGAGE BANKERS ASSOC., *LENDERS' COST OF FORECLOSURE 2* (2008), available at <http://dcwintonlaw.com/wp-content/uploads/2010/06/Lenders-Cost-of-Foreclosure.pdf>; John Y. Campbell et al., *Forced Sales and House Prices*, 101 AM. ECON. REV. 2108, 2110 (2011).

15. Arlo Chase, *Rethinking the Homeownership Society: Rental Stability Alternative*, 18 J.L. & POL'Y 61, 80–84 (2009) (discussing foreclosure effects on individuals, neighborhoods, and local governments).

16. Kenneth P. Brevoort & Cheryl R. Cooper, *Foreclosure's Wake: The Credit Experiences of Individuals Following Foreclosure 2* (Fed. Reserve Bd., Fin. & Econ. Discussion Series No. 2010-59, 2010), available at <http://federalreserve.gov/pubs/feds/2010/201059/201059pap.pdf> (“[T]he credit scores of mortgage borrowers entering foreclosure decline to subprime levels, regardless of their score level before their delinquency, and remain depressed for several years after foreclosure.”).

would otherwise have taken advantage of the reduced prices. The workforce is less mobile because homeowners with negative equity are not entitled to sell their homes without paying negative equity in cash at closing.

A broad consensus exists that eliminating negative equity through mortgage modification is the best solution to the mortgage crisis.¹⁷ Bankruptcy academics overwhelmingly endorse mortgage modification in bankruptcy as a means to that end.¹⁸ Bankruptcy mortgage modification would entitle qualified debtors to file bankruptcy, strip their mortgages down to the values of the homes, and agree to pay the remaining balances in full, with interest. Debtors would benefit by retaining their homes, mortgage holders would benefit by recovering more than they could get through foreclosure, and the economy would benefit through the stabilization of the housing market and the elimination of some of the consumer debt overhang.

Such reform would effectively reverse the Supreme Court's 1993 decision in *Nobelman v. American Savings Bank*.¹⁹ In *Nobelman*, the Court held that bankrupt homeowners could not strip down mortgages secured only by the debtors' principal residences.²⁰ Even after *Nobelman*, some home mortgages remain modifiable because they are secured by nonreal property, such

17. E.g., CONG. OVERSIGHT PANEL, NO. 64-832, MARCH OVERSIGHT REPORT: THE FINAL REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL 82 (2011) [hereinafter CONGRESSIONAL OVERSIGHT PANEL FINAL REPORT], available at <http://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf> (noting that "[i]n December 2009, the Panel encouraged Treasury to consider incentivizing servicers to use principal reduction to deal with these 'underwater' borrowers"); Paul Krugman, Op-Ed., *Against Learned Helplessness*, N.Y. TIMES, May 30, 2011, at A19, available at <http://www.nytimes.com/2011/05/30/opinion/30krugman.html> (noting that "[t]he core of our economic problem is, instead, the debt—mainly mortgage debt—that households ran up during the bubble years of the last decade" and advocating a serious program of mortgage modification); Ben S. Bernanke, Chairman, Fed. Reserve Sys., Speech at the Independent Community Bankers of America Annual Convention (Mar. 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm> ("In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure.").

18. E.g., Adam J. Levitin, *Resolving the Foreclosure Crisis: Modifications of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 647 ("[P]ermitting modification of all home mortgages in bankruptcy stands out as the best of all possible solutions proposed to the mortgage crisis."); Alexandra P. Everhart Sickler, *Mitigating the Foreclosure Crisis with Bankruptcy Mortgage Modifications*, 9 U.C. DAVIS BUS. L.J. 85, 92 (2008) ("Because the private sector's progress has been too slow to keep pace with record foreclosure rates, bankruptcy mortgage modification is a necessary complement to the range of solutions that have been proposed or recently initiated by the government and the private sector."); Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications*, 41 CONN. L. REV. 1107, 1130 (2009) ("Allowing bankruptcy courts to impose mortgage modifications, including principal reductions to align debt with home values, would be a useful step."). But see Todd J. Zywicki, Op-Ed., *Don't Let Judges Tear up Mortgage Contracts*, WALL ST. J., Feb. 13, 2009, at A13, available at <http://online.wsj.com/article/SB123449016984380499.html> (arguing that mortgage modification will result in a windfall to borrowers and an increase in bankruptcy filings).

19. 508 U.S. 324 (1993).

20. *Nobelman*, 508 U.S. at 327–32.

as a mortgage escrow account.²¹ Because the vast majority of home mortgages are secured only by the debtors' principal residences,²² however, mortgage modification is currently not generally available.

Unless someone takes action, the negative equity problem will persist. One research firm projects that "[a]t the current rate of decline, negative equity will persist and remain a market factor for years to come, with average underwater borrowers taking more than 10 years in some markets to regain positive equity."²³

The strip-down prohibition in subsection 1322(b)(2) of the Bankruptcy Code applies only to "a claim secured only by a security interest in real property that is the debtor's principal residence."²⁴ Read literally, that language does not prohibit modification of a home mortgage once the debtor ceases use of the home as a principal residence. Most courts that have considered the issue since *Nobelman* have read the language literally. They have held that, if a debtor has, in good faith, moved out of the mortgaged home prior to filing the bankruptcy case, the house is no longer the debtor's principal residence and the prohibition does not apply.²⁵ As a result, the debtor can strip the mortgage down.

This reading provides the foundation for a strategy in which debtors who seek to retain their homes rather than lose them to foreclosure can move out of their homes in good faith, file under Chapter 13 of the Bankruptcy Code, confirm plans that strip down their mortgages, and then move back into those homes and retain them. This Article explores the real-world viability of this strategy.

Robert Hockett initially proposed the swap aspect of this strategy.²⁶ This aspect involves matching two neighbors, each seeking to retain their homes through bankruptcy. Simultaneously, each leases the home of the other for a period of one year, moves into it, and files bankruptcy. Both strip down their mortgages, and, at the end of the leases, both move back into their own homes.

This strategy will work because it both conforms to the letter of the law and serves rather than thwarts public policy. A large majority of the courts

21. *E.g.*, *In re Bradsher*, 427 B.R. 386, 391–92 (Bankr. M.D.N.C. 2010) (holding that an escrow account is not real property under North Carolina law and allowing modification).

22. Lenders avoid taking mortgages against principal residences and other collateral because such mortgages can be modified under Chapter 13. *See, e.g.*, Mary Jo Newborn Wiggins & Maj-Le Tate, *Bankers to Battle Stations!: Lenders Pounce on Lien Stripping, but Options Persist for Debtors*, BUS. L. TODAY, Sept.–Oct. 1995, at 24, 28 ("[L]enders should be especially cautious when considering taking security interests in other property in addition to a debtor's principal residence.").

23. *The Private Mortgage Market Investment Act, Part 2: Hearing Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 54 (2011) (statement of Mark Fleming, Chief Economist, CoreLogic), available at <http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg72632/pdf/CHRG-112hhrg72632.pdf>.

24. 11 U.S.C. § 1322(b)(2) (2012).

25. *See* cases cited *infra* Section II.B.

26. *See* Hockett, *supra* note 4.

that have considered the issue have held that a house is no longer a debtor's principal residence once the debtor moves out of it—even if the debtor plans a later return.²⁷ That the debtor's purpose in moving is to render the mortgage eligible for strip-down is not alone sufficient to demonstrate bad faith. It is merely a type of bankruptcy planning that the courts have held unobjectionable in analogous contexts. The principal impediment to this strategy is the myth that Congress intended to prohibit the strip-down modification of all principal residence mortgages.²⁸

Using the facts of *Nobelman*, Part I of this Article explains why strip-down is beneficial not only to homeowners but also to their mortgage holders and to the economy as a whole.

Part II shows that the majority view favors strip-down on each of the three legal issues on which the house-swap strategy depends. First, once a debtor moves out of a home and rents it to someone else, the home is no longer the debtor's "principal residence"—even if the debtor plans to return in the future. Second, whether the home is a debtor's principal residence for purposes of bankruptcy strip-down is determined as of the time of bankruptcy, not as of the time of the mortgage contract. Third, debtors who move out of their homes prior to bankruptcy so that they will be entitled to strip-down are not, for that reason alone, acting in bad faith and so rendered ineligible for Chapter 13 relief.

Part III addresses the common misconception that Congress sought to attract capital to the housing market by prohibiting strip-down of all home mortgages. Although such an intent would be legally irrelevant in light of the clear statutory language to the contrary, the legislative history contains no evidence that Congress intended to prohibit all home mortgage strip-downs.

Part IV describes three kinds of plans through which debtors can propose to pay their stripped-down mortgages: (1) modification and reinstatement, (2) balloon payment, and (3) house distribution. Under existing case law, all, some, or none of these options might be available in a particular district. Part V explains the practical advantages of swapping houses rather than simply moving out and renting. The Article concludes that a move-out, strip-down strategy is viable in most districts and can be implemented without legislation.

I. THE SUPERIORITY OF THE BANKRUPTCY SOLUTION

The facts of *Nobelman* illustrate the benefits of strip-down.²⁹ Leonard and Harriet Nobelman filed a case under Chapter 13 of the Bankruptcy Code owing \$71,335 in principal, interest, and fees against a condominium

27. See cases cited *infra* note 76.

28. See *infra* notes 147–150 and accompanying text.

29. See *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 326–27 (1993).

with an uncontroverted value of only \$23,500.³⁰ The condominium was the Nobelmans' principal residence.³¹

The Nobelmans proposed a Chapter 13 plan that would have stripped the mortgage down to \$23,500. The plan provided that they would retain the house and pay the mortgage holder, American Savings Bank ("American"), principal and interest on the \$23,500 remaining balance.³² Resolving a circuit split of three to one³³ in favor of the minority view, the Supreme Court held that debtors could not strip down mortgages against their principal residences.³⁴

A. *The Debtors' Perspective*

Under the Court's decision, the Nobelmans would have had to pay \$71,335—three times the property's value—to retain their home. Their bankruptcy alternative was to discharge their debts in the bankruptcy case, including the deficiency owing to American on the mortgage, and thereby gain a "fresh start" without the home. After bankruptcy, they could have purchased a condominium just like the one they had lost through foreclosure for \$23,500—if they could have financed it. They might also have rented such a condominium at a rental rate that would have reflected its \$23,500 value. Surrendering the home and discharging the mortgage debt was obviously the better solution.

Had it been available, the option of stripping down the mortgage debt and retaining the home would have been better yet. Instead of the hassle and expense of finding a new home just like it, the Nobelmans could have stayed in the home they already had. They could have continued to be homeowners despite their probable inability to qualify for a mortgage on the hypothetical home-just-like-it.

30. *Id.* at 326 (stating these amounts and noting that \$23,500 was "an uncontroverted valuation").

31. *Id.* at 332 ("Section 1322(b)(2) prohibits such a modification where, as here, the lender's claim is secured only by a lien on the debtor's principal residence.").

32. *Id.* at 328 ("[T]he plan proposes to make \$23,500 worth of payments pursuant to the monthly payment terms of the mortgage contract . . .").

33. Compare *Eastland Mortg. Co. v. Hart* (*In re Hart*), 923 F.2d 1410, 1415 (10th Cir. 1991) (finding that the position taken by the Third and Ninth Circuits "reflects the plain meaning of section 1322(b)(2)"), and *Wilson v. Commonwealth Mortg. Corp.*, 895 F.2d 123, 127–28 (3d Cir. 1990) ("[S]ection 1322(b)(2) does not preclude modification of the unsecured portion of an undersecured mortgage debt."), and *Hougland v. Lomas & Nettleton Co.* (*In re Hoagland*), 886 F.2d 1182, 1184 (9th Cir. 1989) (holding that strip-down is allowed because the term "secured claim" in section 1322 is defined by section 506), with *Nobelman v. Am. Sav. Bank* (*In re Nobelman*), 968 F.2d 483, 487 (5th Cir. 1992) (citing *Dewsnup v. Timm*, 502 U.S. 410 (1992)) (prohibiting cramdown while stating that the *Dewsnup* opinion "lends support to this view that bifurcation is impermissible"), *aff'd*, 508 U.S. 324.

34. *Nobelman*, 508 U.S. at 322 ("Section 1322(b)(2) prohibits such a modification where, as here, the lender's claim is secured only by a lien on the debtor's principal residence.").

B. *The Mortgage Lenders' Perspective*

After the decision in *Nobelman*, American had the right to lift the automatic stay, foreclose on the condominium, buy it at the foreclosure sale for the amount of the mortgage, evict the Nobelmans, and resell it.

Foreclosed property generally nets creditors about 27 percent less on average than equivalent properties not involved in foreclosures.³⁵

These discounts are not highly sensitive to the type of housing, but they are larger for houses with low-priced characteristics in low-priced neighborhoods. This suggests that the foreclosure discount may be related to vandalism, through two possible channels. First, foreclosed houses may have been damaged before they are sold. Second, mortgage lenders must protect foreclosed houses while they are vacant; the threat of vandalism may be greater in bad neighborhoods, and costs of protection likely account for a larger fraction of the value of a low-priced house. The costs of protection induce mortgage lenders to sell foreclosed houses urgently, leading to discounts in illiquid housing markets.³⁶

If the Nobelmans' condominium netted American 27 percent less than its \$23,500 market value, American's total recovery from foreclosure would have been \$17,155. Because the Nobelmans had discharged their debt in bankruptcy, American could not have recovered a judgment for the portion of the mortgage debt not paid from the sale proceeds (hereinafter a "deficiency judgment").

Thus, American probably would have benefitted from strip-down as well.³⁷ Stay lifting, foreclosure, and resale would have been unnecessary, saving American the expenses of all three. After strip-down, American would have been entitled to \$23,500 plus interest on that amount.³⁸ The Nobelmans would have been required to commence payments to American within thirty days after the bankruptcy case's filing.³⁹

35. Campbell et al., *supra* note 14, at 2110 ("We find large foreclosure discounts, about 27 percent on average.").

36. *Id.*

37. See Robert J. Shiller, *Reviving Real Estate Requires Collective Action*, N.Y. TIMES, June 24, 2012, at B6, available at <http://www.nytimes.com/2012/06/24/business/economy/real-estates-collective-action-problem.html> ("[I]t is well known that in foreclosures, lenders lose so much on the legal costs and depressed market values of the homes that it would be in their interest to lower mortgage balances so the homeowners stay in place and don't default.").

38. The Bankruptcy Code provides,

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

11 U.S.C. § 1325(a)(5)(B)(ii) (2012).

39. See *id.* § 1326(a)(1) ("Unless the court orders otherwise, the debtor shall commence making payments not later than 30 days after the date of the filing of the plan or the order for relief, whichever is earlier . . .").

The benefit to American is less clear than the benefit to the Nobelmans because the Nobelmans might not have made the payments under their plan.⁴⁰ Had they not done so, American would have been permitted to foreclose. But American would also have incurred additional expenses and in the end possibly recovered less than \$17,155.

On the other hand, the Nobelmans must have been people of some economic substance. They had qualified to pay a \$68,000 mortgage when they bought the condominium just a few years before. Through discharge, the Nobelmans' bankruptcy would free them from nonmortgage obligations that had been competing for their income. To strip the mortgage down, the Nobelmans would have had to prove, to the satisfaction of the bankruptcy judge, that they would have been able to make payments on the \$23,500 obligation.⁴¹ Thus, it seems likely that American would have recovered more from bankruptcy strip-down than from foreclosure.

Why, then, do lenders frequently object to strip-down plans? Lenders may choose a low foreclosure recovery over the probability of a higher strip-down recovery because foreclosure may deter the lenders' other borrowers from filing bankruptcy. Most debtors who cannot make the payments on their homes neither file bankruptcy nor walk away. They continue their efforts to pay, often well beyond the point at which they have any reasonable hope of success.⁴²

This continuation benefits lenders in several ways. First, lenders continue to receive some payments—on a \$68,000 mortgage rather than a \$23,500 mortgage. Second, fees, penalties, and default interest accrue on a mortgage, increasing the potential profits in cases where debtors ultimately succeed in paying. Third, the value of a home may rise while a debtor struggles to make payments. If it does, the value of a lender's foreclosure right rises along with it. But these benefits are better viewed as flowing from debtors' erroneous beliefs that they can succeed in retaining their home than from the creditors' legal rights. If debtors were better informed, these benefits would not exist.

Factors other than self-interest may account for much of the lender resistance to strip-down. First, asset-securitization contracts sometime prohibit lenders from consenting to modifications that reduce the balance

40. The Supreme Court recently noted that "[t]here is some dispute about the true scale of [the risk that the plan will fail]—respondent claims that more than 60% of Chapter 13 plans fail, but petitioners argue that the failure rate for *approved* Chapter 13 plans is much lower." *Till v. SCS Credit Corp.*, 541 U.S. 465, 480 (2004) (plurality opinion) (citation omitted). But the Court required that Chapter 13 debtors compensate creditors for that risk. *Id.* ("Together with the cramdown provision, this requirement obligates the court to select a rate high enough to compensate the creditor for its risk . . .").

41. See 11 U.S.C. § 1325(a)(6) ("[T]he court shall confirm a plan if . . . the debtor will be able to make all payments under the plan and to comply with the plan . . .").

42. Peter S. Goodman, *U.S. Loan Effort Is Seen as Adding to Housing Woes*, N.Y. TIMES, Jan. 2, 2010, at A1, available at <http://www.nytimes.com/2010/01/02/business/economy/02modify.html?pagewanted=all> ("[D]esperate homeowners have sent payments to banks in often-futile efforts to keep their homes, which some see as wasting dollars they could have saved in preparation for moving to cheaper rental residences.").

owing on the mortgage loan.⁴³ In those cases, lenders cannot consent, even if the proposed reductions would benefit them. Second, servicing agents who act on behalf of lenders may have conflicts of interest. That is, their servicing contracts may provide for higher servicing fees when debtors remain in default than when their loans have been reinstated through strip-down.⁴⁴ Third, lenders and their representatives may simply have an emotional preference for controlling the repayment process. If strip-down is permitted, a bankruptcy judge decides which debtors get repayment plans and how much those debtors must pay for them. If strip-down is not permitted, the lender makes that decision alone. Even if the lenders did not believe that they would make better decisions than judges, they might simply prefer to retain control.

Mortgage holders are likely to recover more under Chapter 13 plans than they would through foreclosures. To confirm plans, bankruptcy judges must find that the debtors proposing them will be able to pay the mortgage holders the full values of their homes.⁴⁵ Mortgage holders should not be able to veto plans that are in their own interests. The risks are that the mortgage holders might use their veto powers to gain illegitimate advantages over their debtors and that the agency problems discussed previously might result in veto abuse.

C. *The Social Perspective*

Economists agree that the “debt overhang” constituting the mortgage crisis is bad for the economy.⁴⁶ Debtors who owe more on their houses than

43. Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1089–91 (2009) (presenting evidence of the nature of these prohibitions and reviewing the literature regarding their prevalence).

44. E.g., Christopher Mayer et al., *Essay, A New Proposal for Loan Modifications*, 26 YALE J. ON REG. 417, 417 (2009); see also CONGRESSIONAL OVERSIGHT PANEL FINAL REPORT, *supra* note 17, at 68 (“[I]ncentives built into the mortgage servicing system often make foreclosures more attractive than modification.”). But see Manuel Adelino et al., *Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization 1* (Fed. Reserve Bank of Bos., Pub. Pol’y Discussion Paper No. 09-4, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf> (claiming that their proprietary data show that “servicers renegotiate similarly small fractions of loans that they hold in their [unsecuritized] portfolios”).

45. That is, the debtor must offer to pay the full value of the collateral, see 11 U.S.C. §§ 506(a), 1325(a)(5), and the court must find that “the debtor will be able to make all payments under the plan,” *id.* § 1325(a)(6).

46. For example, the Federal Reserve Board recently stated,

Looking forward, continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery. . . . [T]here is scope for policymakers to take action along three dimensions that could ease some of the pressures afflicting the housing market. In particular, policies could be considered that would help moderate the inflow of properties into the large inventory of unsold homes

FED. RESERVE BD., *THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS 1* (2012), available at <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>.

the houses are worth cannot sell or refinance the houses to take advantage of record-low mortgage interest rates. The mortgage foreclosure process consumes the resources of those on both sides in a zero-sum game. The conflict over evicting debtors from their homes frequently results in the wasteful removal and sale of fixtures, landscaping, and building materials, and sometimes even in the destruction of the property.⁴⁷ Foreclosure floods the market with houses, which drives house prices down, reducing the wealth of all homeowners.⁴⁸ Repossessing banks sell the houses to investors who must then spend additional resources finding people to occupy the houses.⁴⁹

House values and interest rates have declined sharply since many borrowers bought their homes. As a result, many borrowers ("Can-Pay-Value Borrowers") cannot afford to pay the balances owing on their mortgages but can nonetheless afford to pay the full values of their houses. The best solution to the mortgage foreclosure crisis is for Can-Pay-Value Borrowers to remain in their houses and pay their values, plus interest at the current market rates, to their mortgage holders. Keeping borrowers in their homes with payment that they can afford prevents physical decline in the conditions of the houses,⁵⁰ increases values in the neighborhoods by keeping houses off the market,⁵¹ saves the high costs of mortgage foreclosure and occupant turnover, and minimizes conflict between homeowners and their mortgagors.⁵² Allowing Can-Pay-Value Borrowers to remain in their homes imposes little or no cost on mortgagees.

Other similarly situated borrowers ("Can-Pay-Loan-Balance Borrowers") have the financial ability to pay the full amounts of their mortgages

47. E.g., Rudolf, *supra* note 11.

48. Stephan Whitaker & Thomas J. Fitzpatrick IV, *The Impact of Vacant, Tax-Delinquent, and Foreclosed Property on Sales Prices of Neighboring Homes* 7–11 (Fed. Reserve Bank of Cleveland, Working Paper No. 11-23R, 2012), available at <http://www.clevelandfed.org/research/workpaper/2011/wp1123r.pdf> (reviewing the literature measuring the adverse effect of foreclosures on the values of neighboring homes); see also CONGRESSIONAL OVERSIGHT PANEL FINAL REPORT, *supra* note 17, at 89 ("As foreclosure starts and completions have remained at a persistently high level, home prices have continued to fall.").

49. See David Dayen, *Your New Landlord Works on Wall Street: Hedge Funds Are Snatching up Rental Homes at an Alarming Rate*, NEW REPUBLIC (Feb. 12, 2013), <http://www.newrepublic.com/article/112395/wall-street-hedge-funds-buy-rental-properties> ("Over the past couple years, hedge funds, private equity firms and the biggest banks have raised massive amounts of capital to buy distressed or foreclosed single-family homes, often in bulk, at bargain prices. Their strategy is to convert them to rental units for a while before reselling them when prices appreciate.").

50. See Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851, 863 (2006) (finding empirically that higher neighborhood foreclosure rates lead to higher levels of violent crime at appreciable levels).

51. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 58 (2006) (finding that foreclosures of conventional single-family loans have a significant impact on nearby property values).

52. *Supra* notes 10–12 and accompanying text.

with interest at the contract rates. One could argue that Can-Pay-Loan-Balance Borrowers should be relieved of their obligations to pay negative equity to provide equitable treatment in comparison with Can-Pay-Value Borrowers. But that relief might reduce mortgage holders' recoveries while producing few of the social benefits discussed above.

The tension that results from granting debt relief to those who have managed their finances badly, while denying debt relief to others who have managed their finances well, is inherent in bankruptcy.⁵³ "Equity," in the bankruptcy sense, is achieved by providing a "fresh start" to any honest debtor who reaches a certain level of distress. Bankruptcy policy is keyed not so much to fairness as to necessity. Excessive debt generates antisocial incentives. The resulting behavior, often referred to as "informal bankruptcy," is both a social and an economic problem.⁵⁴ If relief is not provided, debtors tend toward deception, fraud, and irresponsibility in their economic behavior. Bankruptcy prevents these adverse consequences. The price of bankruptcy is that it is public and many observers will consider the filing an acknowledgement of failure that imposes considerable stigma.⁵⁵ The fresh start policy is not entirely unfair because Can-Pay-Loan-Balance Borrowers do not incur that stigma.

The Bush and Obama Administrations have each created several new programs for the purpose of enabling various categories of home mortgage borrowers to remain in their homes.⁵⁶ In defining eligibility, each program grappled with the problem of equity, and in implementing its standards of

53. See, e.g., Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 463–67 (1997) (discussing this tension in a subsection entitled "Offending Basic Concepts of Economic Justice").

54. Amanda E. Dawsey et al., *Non-Judicial Debt Collection and the Consumer's Choice Among Repayment, Bankruptcy and Informal Bankruptcy*, 87 AM. BANKR. L.J. 1, 6 (2013) ("[C]onsumers who choose informal bankruptcy may be more apt to participate in the underground economy, which can also generate significant transactions and societal costs." (footnote omitted)); Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 492 (1997) ("[Debtors] need the chance to remain productive members of society, not [to be] driven underground or into joblessness by unpayable debt.").

55. Teresa A. Sullivan et al., *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 239 (2006) ("[T]he rise in bankruptcy filings cannot be attributed in any significant part to a decline in the stigma associated with bankruptcy."); see also Sickler, *supra* note 18, at 104–05 ("There is also little danger that bankruptcy mortgage modification will supplant industry efforts and flood bankruptcy courts with Chapter 13 debtors. Bankruptcy is a costly and painful process for debtors and therefore 'remains the refuge of last resort' for those who cannot pay their debts. It is a common sense proposition that most borrowers will avoid bankruptcy and its negative credit consequences until they have exhausted all other options." (footnote omitted)).

56. CONGRESSIONAL OVERSIGHT PANEL FINAL REPORT, *supra* note 17, at 69–71 (listing sixteen such programs).

eligibility, each program created a new and inexperienced bureaucracy.⁵⁷ One after another, these programs failed.⁵⁸

Many policymakers realize that the bankruptcy system already provides a superior program for enabling distressed borrowers to remain in their homes. The bankruptcy system provides standards of eligibility for mortgage relief and judges experienced in administering them.⁵⁹ In the spring of 2009, the Obama Administration advanced a bill to overturn *Nobelman*. That bill passed the House but failed in the Senate by a vote of forty-five to fifty-one.⁶⁰ No effort is underway for additional congressional action. Fortunately, in 1978, Congress left enough flexibility in subsection 1322(d)(2) of the Bankruptcy Code for debtors, debtors' attorneys, and bankruptcy judges to achieve the same result without additional congressional action. As should be apparent from this Article, the strategies for achieving strip-down are complex and difficult to implement. But once implemented, they will provide substantial benefits for debtors, mortgage holders, and the American economy.

In many, if not most, instances, the move-out, strip-down strategy will provide the most efficient solution to the problem of debtor inability to pay. The debtor will remain the owner of the house. The bankruptcy court will require that the debtor devote all the debtor's disposable income over the period of the plan to payments under the plan,⁶¹ thus eliminating the problem of moral hazard. The creditor will receive more than it would have if its debtors were well advised and the option of strip-down did not exist.

II. LEGAL ISSUES PRESENTED

This Article's recommended strategies will be useful to debtors who meet the following requirements:

57. See, e.g., Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons from the Lackluster First Year of the Home Affordable Modification Program (HAMP)*, 52 ARIZ. L. REV. 727, 771 (2010) ("HAMP involved rapidly putting a bureaucracy in place to manage a reluctant corps of servicers. It also quickly became apparent that the low quality of modifications HAMP produced raised questions about their sustainability.").

58. See, e.g., CONGRESSIONAL OVERSIGHT PANEL FINAL REPORT, *supra* note 17, at 86–87 (showing high levels of HAMP redefaults); Braucher, *supra* note 57, at 788 ("[HAMP] quickly bogged down under servicer reluctance and bureaucratic implementation challenges.").

59. Susan E. Hauser, *Cutting the Gordian Knot: The Case for Allowing Modification of Home Mortgages in Bankruptcy*, 5 J. BUS. & TECH. L. 207, 227 (2010) ("[T]he bankruptcy system brings with it an experienced corps of valuation experts. Bankruptcy judges already value property on a daily basis and are eminently qualified to determine accurate property values in the local areas they serve.").

60. Editorial, *As Foreclosures Surge . . .*, N.Y. TIMES, May 4, 2009, at A22, available at <http://www.nytimes.com/2009/05/04/opinion/04mon2.html> ("The Obama administration sat by last week as 12 Senate Democrats joined 39 Senate Republicans to block a vote on an amendment that would have allowed bankruptcy judges to modify troubled mortgages.").

61. 11 U.S.C. § 1325(b)(1) (2012) ("[T]he court may not approve the plan unless . . . the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period . . . will be applied to make payments to unsecured creditors under the plan . . .").

(1) Each of the debtors owns and occupies a house and owes a mortgage against it that substantially exceeds its current market value. Each wants to retain ownership.

(2) Each is eligible to be a debtor under Chapter 13 of the Bankruptcy Code. In general, debtors are eligible to file under Chapter 13 if they are either an individual or an individual and the individual's spouse who, on the date of the petition, have regular income and owe noncontingent, liquidated, unsecured debts of less than \$383,175 and noncontingent, liquidated, secured debts of less than \$1,149,525.⁶²

(3) Each of the debtors has not engaged in wrongful conduct that would disqualify the debtor from bankruptcy under the "good faith" provisions of Chapter 13. Those provisions disqualify individuals otherwise eligible, if the individuals have engaged in various kinds of wrongful conduct.⁶³

(4) Each is capable of making the payments on a stripped-down mortgage, including interest at the current market rate.

(5) Each has not covenanted to continue using the house as a principal residence. (The large majority of mortgages in the United States do not contain such a covenant.)

Even if a debtor meets all these requirements, three potential legal issues remain. The first is whether a house remains the owner's principal residence if the debtor moves out with the intent to later move back in. The second is whether the Bankruptcy Code prohibits strip-down if the house was the debtor's principal residence at the time of the mortgage contract, or if it only prohibits strip-down if the house was the debtor's principal residence at the time of bankruptcy. The third is whether a debtor who moves out of a principal residence for the purpose of qualifying for strip-down is proceeding in bad faith. As the following Sections explain, courts have already resolved each of these issues in favor of the move-out, strip-down strategy.

A. *The Definition of "Principal Residence"*

The Bankruptcy Code defines "debtor's principal residence" as "a residential structure if used as the principal residence by the debtor."⁶⁴ By definition, a debtor can only have one principal residence at a time.⁶⁵ Whatever structure the debtor principally "uses" as a residence at a particular time is the debtor's principal residence at that time.⁶⁶

62. See *id.* § 109(e) note (Adjustment of Dollar Amounts).

63. *Id.* § 1325(a)(3), (7) (requiring that the debtor file the petition and propose the plan in good faith).

64. *Id.* § 101(13A)(A).

65. *In re Stanley*, 461 B.R. 161, 165 n.3 (Bankr. E.D.N.Y. 2011) ("A homeowner may have only one principal residence.").

66. N.J. STAT. ANN. § 54:4-8.58 (West 2002 & Supp. 2013) ("'Principal residence' means a homestead actually and continually occupied by a claimant as the claimant's permanent residence, as distinguished from a vacation home, property owned and rented or offered for rent by the claimant, and other secondary real property holdings."); *In re Boward*, 334 B.R. 350, 352 (Bankr. D. Mass. 2005) (holding that "uses as a residence" in 11 U.S.C. § 522(d)(1)

To say that a debtor who has moved out and rented the house to a tenant, but who intends to move back in one year, is presently “using” the structure as the debtor’s principal residence strains the Code’s language. It is more accurate to say that the debtor is using the structure as rental property.

Some authorities treat future intent as the basis for distinguishing “residence” from “domicile.”⁶⁷ By that definition, “residence” means present occupancy without the intent to remain permanently; domicile requires intent to remain permanently. For example, *Black’s Law Dictionary* defines “residence” as follows:

The place where one actually lives, as distinguished from a domicile
Residence usu[ally] just means bodily presence as an inhabitant in a given place; *domicile* usu[ally] requires bodily presence plus an intention to make the place one’s home. A person thus may have more than one residence at a time but only one domicile.⁶⁸

Numerous other authorities make the same distinction between residence and domicile.⁶⁹ Some state exemption statutes also define residence in a manner that ignores future intention.⁷⁰

“is free of ambiguity and plain in its meaning: the debtor must be residing in the property at the time of the commencement of the bankruptcy case”); *In re Shell*, 295 B.R. 129, 131 (Bankr. D. Alaska 2003) (“A ‘principal residence’ is defined as ‘the actual dwelling place of an individual’”).

67. For example, Norton states,

“Domicile” and “residence” are distinct terms and should not be used interchangeably. A person is “domiciled” in only a single place where that person has established a physical presence with an intent to remain there and with the intention to return there when the debtor may be at other locations. “Residence,” on the other hand, generally refers to presence as an inhabitant in a given place.

1 WILLIAM L. NORTON, JR., *NORTON BANKRUPTCY LAW AND PRACTICE* 3D § 17:4 (William L. Norton, Jr. & William L. Norton, III eds., 2008) (footnotes omitted). Similarly, for exemption purposes, several courts have made the same distinction between domicile and residence. As one court put it,

Domicile has been defined as a place where a person has a permanent home and an intention of returning. The term “residence” on the other hand does not include the intention required for domicile. “Residence means living in a particular locality, but domicile means living in that locality with intent to make it a fixed and permanent home.”

In re Marsico, 278 B.R. 1, 14 (Bankr. D.N.H. 2002) (citations omitted) (quoting *BLACK’S LAW DICTIONARY* 1176 (5th ed. 1979)).

68. *BLACK’S LAW DICTIONARY* 1423 (9th ed. 2009).

69. See *supra* note 67.

70. E.g., ALASKA STAT. § 09.38.500(12) (2012) (“‘[P]rincipal residence’ means the actual dwelling place of an individual or dependents of the individual and includes real and personal property.”); *Gottstein v. Kraft*, 274 P.3d 469, 476 (Alaska 2012). But see *Roberts v. Twp. of W. Bloomfield*, No. 303098, 2012 Mich. App. LEXIS 921, at *2 (Mich. Ct. App. May 10, 2012) (“A ‘principal residence’ is defined as ‘the 1 place where an owner of the property has his or her true, fixed, and permanent home to which, whenever absent, he or she intends to return and that shall continue as a principal residence until another principal residence is established.’”).

Of course, absence from the residence structure on a temporary or transient basis does not interrupt residency.⁷¹ When a debtor temporarily moves to a second home, most authorities determine which is the debtor's principal residence by considering actual occupancy during the current year. Thus, for example, the U.S. Department of Housing and Urban Development states that "[a] *principal residence* is a property that will be occupied by the borrower for the majority of the calendar year."⁷² Other authorities define principal residence as the house the person occupies for more than half the current year, without regard for the person's intentions.⁷³

Under these authorities, if a debtor were to move out of a mortgaged house and rent it for one year, the house would no longer be the debtor's principal residence. That would remain true even if the debtor intended to move back into the house at the end of the year.

At least one authority, however, treats residence as the equivalent of domicile.⁷⁴ That gives rise to the possibility that if a debtor has moved out of a house but intends to return, a court would regard the house as the debtor's principal residence. In this scenario, to ensure that a court would not consider the house to be the debtor's principal residence, the debtor would not only have to move out and rent the house; the debtor would also have to abandon the intention to return.

In the context of strip-down, the effect of requiring abandonment would be to create an odd circularity. If a court rules that a house is a debtor's principal residence because the debtor intends to return to it, the debtor would not be able to strip the mortgage down, would lose the home, and would therefore not be able to return to it. Any debtor who realized that this would be the effect of having an intention to return to the home could not hold such an intention. Having thus abandoned the intention to return, the debtor would be entitled to retain the home. This problem will rarely

71. *E.g.*, N.J. STAT. ANN. § 54:4-8.58.

72. U.S. DEP'T OF HOUS. & URBAN DEV., HUD 4155.1, MORTGAGE CREDIT ANALYSIS FOR MORTGAGE INSURANCE, at 4-B-5 (2011), available at <http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4155.1/41551HSGH.pdf>.

73. IDAHO CODE ANN. § 55-1006 (2012) ("A homestead is presumed abandoned if the owner vacates the property for a continuous period of at least six (6) months."); MD. CODE ANN., EDUC. § 24-513(4) (LexisNexis 2008) ("Principal residence" means a dwelling actually occupied or expected to be actually occupied by the homeowner or the homeowners for more than 6 consecutive months of the present calendar year."); WIS. STAT. ANN. § 145.245(1)(a)(3)(c) (West 2006 & Supp. 2012) ("Principal residence" means a residence which is occupied at least 51% of the year by the owner.).

74. *Boyer v. Sylvester*, No. CPU4-10-003496, 2011 Del. C.P. LEXIS 14, at *17 (Del. Ct. Com. Pl. July 1, 2011) ("[I]n Delaware, the term 'resident' is often equated with the legal term of 'domicile.'" (quoting *Williamson v. Standard Fire Ins. Co.*, No. 04C-07-033 RFS, 2005 Del. Super. LEXIS 281, at *5 (Del. Super. Ct. Aug. 19, 2005)) (internal quotation marks omitted)). *But see* *Miss. Band of Choctaw Indians v. Holyfield*, 490 U.S. 30, 48 (1989) ("[O]ne can reside in one place but be domiciled in another."); *In re Lozada Rivera*, 470 B.R. 109, 115 (Bankr. D.P.R. 2012) ("The term 'residence' is not defined in the Bankruptcy Code. It is not synonymous of 'domicile' because 'the specified enumeration of each in the Code indicates an intention to maintain a legal distinction between them.'" (quoting *In re Marsico*, 278 B.R. 1, 4 (Bankr. D.N.H. 2002))).

arise, however, because future intent is considered irrelevant to residency in nearly all jurisdictions. In a jurisdiction where it is relevant, the circularity just described may be evidence of a debtor's lack of intention to return.

B. *The Timing Issue*

The strip-down strategy raises a timing issue: whether modification is prohibited if a home was a debtor's principal residence at the mortgage's creation or only if it was the debtor's principal residence at the bankruptcy case's filing. The identically worded antimodification provisions that appear in subsections 1322(b)(2) and 1123(b)(5) of the Bankruptcy Code shield from modification "a claim secured only by a security interest in real property that *is* the debtor's principal residence."⁷⁵ Because these provisions are part of the Bankruptcy Code, they can only apply if and when the debtor files bankruptcy. The provisions' use of the present tense makes clear that, for the provisions to apply, the real property must be the debtor's principal residence when the debtor files bankruptcy. As this Section will demonstrate, the courts have overwhelmingly interpreted this language to mean that if real property is not a debtor's principal residence at the time of bankruptcy, the debtor is entitled to modify the mortgages against it. No differences between the two antimodification provisions exist that are relevant to the issues discussed in this Section, so I have not distinguished the cases discussed below by whether they arose under Chapter 11 or Chapter 13.

Two sets of cases are relevant to the timing issue. "Move-out cases" are factually similar to the strategies recommended in this Article and are thus more directly relevant to the timing issue than are "different-collateral cases." In move-out cases, debtors have granted mortgages against houses that were their principal residences, moved out prior to bankruptcy, and then sought to modify the mortgages. Different-collateral cases are less directly relevant but still raise the timing issue. In different-collateral cases, debtors remain in their houses at bankruptcy, but the mortgage collateral is different at the time of bankruptcy than it was at the time of the mortgage transaction. In both kinds of cases, the issue is whether the antimodification provisions should be applied to circumstances as they existed at the time of the mortgage contract or as they existed at the time of bankruptcy. I discuss the two kinds of cases separately.

1. *The Move-Out Cases*

To determine how the courts have resolved the timing issue, I reviewed all cases reported on Westlaw or Lexis in which a court decided or addressed that issue. In ten such cases, debtors granted mortgages against their principal residences, moved out prior to bankruptcy, and then sought to modify their mortgages in Chapter 11 or Chapter 13 plans.⁷⁶ In each of the ten cases,

75. 11 U.S.C. §§ 1322(b)(2), 1123(b)(5) (2012) (emphasis added).

76. *Mariner's Inv. Fund, LLC ex rel. Second Mariners Inv. Fund REO, LLC v. Delfierro* (*In re Delfierro*), No. WW-11-1249-KiJuH, 2012 WL 1933316 (B.A.P. 9th Cir. May 29, 2012);

the mortgage lender objected, citing the antimodification provision. In nine of the ten cases, the courts denied the mortgage holder's objection, holding that principal residence status must be determined as of the filing of the bankruptcy case.⁷⁷

In the lone exception, *In re Smart*, the court denied the debtor's motion for modification.⁷⁸ Although the house in *Smart* was not the debtor's principal residence at the time of bankruptcy, the court held that the debtor could not modify the mortgage because the house had been the debtor's principal residence at the time of the mortgage transaction.⁷⁹

Smart is weak authority, however, because the logic of the court's argument fails in two ways. The first failure occurred when the court held that the antimodification provision was ambiguous regarding the time as of which it should determine principal residence status (the "timing issue").⁸⁰ Recall that the antimodification provision states that "the plan may . . . modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence."⁸¹ This is the entirety of the *Smart* court's erroneous reasoning regarding that language:

Rather than focusing on the *remotely* antecedent term, "*claim*", this Court believes that the critical phrase, "*real property that is the debtor's principal residence*", is intended to modify its more immediate antecedent term, "*security interest*". With that focus, this Court believes that the subject clause is susceptible of at least two credible interpretations. First, it can be read, as the Debtors suggest, to refer to a home's status as a principal residence at the *present time* (or the petition date). Second, it can be read, as urged by [the Connecticut Housing Finance Authority ("CHFA")], to refer to the home's status *at the time that the security interest was created*. To avoid this ambiguity, congressional drafters needed to employ more modifying

Benafel v. One W. Bank, FSB (*In re Benafel*), 461 B.R. 581 (B.A.P. 9th Cir. 2011); BAC Home Loans Servicing, LP v. Abdelgadir (*In re Abdelgadir*), 455 B.R. 896 (B.A.P. 9th Cir. 2011); *In re Putnam*, No. 10-14079, 2011 WL 5839692 (Bankr. N.D. Cal. Nov. 21, 2011); *In re Christopherson*, 446 B.R. 831 (Bankr. N.D. Ohio 2011); *In re Roemer*, 421 B.R. 23 (Bankr. D.D.C. 2009); Wells Fargo Bank, N.A. v. Jordan (*In re Jordan*), 330 B.R. 857 (Bankr. M.D. Ga. 2005); Jackson v. U.S. Dep't of Agric. (*In re Jackson*), 318 B.R. 229, 232 (Bankr. M.D. Ga. 2004); *In re Smart*, 214 B.R. 63, 68 (Bankr. D. Conn. 1997); *In re Lebrun*, 185 B.R. 665 (Bankr. D. Mass. 1995).

77. *In re Delfierro*, 2012 WL 1933316, at *1; *In re Benafel*, 461 B.R. at 588; *In re Abdelgadir*, 455 B.R. at 903; *In re Putnam*, 2011 WL 5839692, at *1; *In re Christopherson*, 446 B.R. at 835; *In re Roemer*, 421 B.R. at 23; *In re Jordan*, 330 B.R. at 860; *In re Jackson*, 318 B.R. at 232; *In re Lebrun*, 185 B.R. at 666.

78. *In re Smart*, 214 B.R. at 68.

79. *Id.* ("[T]his Court allies itself philosophically with those Courts which approach post-*Nobelman* modification issues from the perspective of the circumstances existing at the time of the subject credit transaction, not the serendipitous or manipulated facts existing on the date of the filing of the petition.").

80. *Id.* ("By failing to be more explicit, Congress left an ambiguity in the statute which compels recourse to its legislative history.").

81. 11 U.S.C. § 1322(b)(2) (2012).

words. For instance, if Congress had intended the Debtors' suggested construction, it might have drafted the clause as follows: "... a claim secured only by a security interest in real property that is *at the time of the filing of the petition* the debtor's principal residence. . . ."; or alternatively, if the congressional purpose was consistent with CHFA's contention, the drafters might have drawn the clause as follows: "... a claim secured only by a security interest in real property that is *at that time* the debtor's principal residence" By failing to be more explicit, Congress left an ambiguity in the statute which compels recourse to its legislative history.⁸²

The court's error lies in its claim that the words "real property that is the debtor's principal residence" can be read to refer to "the home's status at the time the security interest was created."⁸³ The error becomes apparent if we imagine that Congress added the language proposed in *Smart*: "at the time that the security interest was created."⁸⁴ The antimodification provision would then have read, "a claim secured only by a security interest in real property that *is* the debtor's principal residence at the time the security interest *was* created." The effect is a clash in the two verbs' tenses. To correctly express the meaning that *Smart* ascribes to the provision, the "is" would have to become "was": "real property that *was* the debtor's principal residence at the time the security interest *was* created." Seventeen courts have addressed the timing issue since *Smart*. None have repeated or endorsed the *Smart* court's argument for ambiguity. That argument is simply wrong.

Having reached the legislative history through error, the *Smart* court then misinterpreted it to reach the conclusion that the court should determine the debtor's principal residence as of the time of the mortgage transaction.⁸⁵ This misinterpretation is described in Section III.C, below.

Considering the clarity of the statutory language and the holdings of ten of the move-out cases decided to date, it should be apparent that the antimodification provision is unambiguous with respect to debtors who moved out of their principal residences in good faith prior to bankruptcy. These debtors are entitled to modify their mortgages.

2. The Different-Collateral Cases

Courts have considered a similar timing issue in applying the antimodification provisions to different-collateral cases. In these cases, the collateral changed between the time of the mortgage contract and the time of bankruptcy. To decide whether the mortgage claim was "a claim secured

82. *In re Smart*, 214 B.R. at 67–68.

83. *Id.* at 67 (emphasis omitted).

84. *Id.* (emphasis omitted).

85. The facts of *Smart* were extreme in one respect that might have justified the result that the court reached. The Smarts' mortgage was held by the Connecticut Housing Finance Authority, and the Authority had the right to declare mortgage debt immediately due and payable if the Smarts ceased to occupy the property as their principal residence. *Id.* at 64–65. The court did not, however, present a legal theory under which these facts would justify the result.

only by a security interest in real property that is the debtor's principal residence,"⁸⁶ a court first had to decide whether principal residence status was necessary at the time of the mortgage transaction or the bankruptcy filing.

The issue in a different-collateral case is not whether a house was a debtor's principal residence at whatever time the court considered appropriate for testing. The house was the debtor's principal residence. The issue is instead whether the claim was secured *only* by the debtor's principal residence at that time. Nonetheless, courts in different-collateral cases interpret the same antimodification provisions to determine whether the statutory language speaks of principal residence as of the bankruptcy or as of some earlier time. In nine of ten different-collateral cases, the courts have held that it speaks as of the time of bankruptcy.⁸⁷

The lone exception, *In re Hildebran*,⁸⁸ was one of the first cases to construe the antimodification provisions. The court ruled in favor of the debtor on highly sympathetic facts. The collateral was business property at the time of the mortgage transaction, and the debtors were mere guarantors.⁸⁹ By coincidence, the property later became their principal residence.⁹⁰ In deciding the case, the court went straight to the legislative history without first finding the necessary ambiguity in the language of the statute⁹¹ and, like numerous other courts, misinterpreted that history.

86. 11 U.S.C. § 1322(b)(2).

87. *In re Austin*, No. 11-412191, 2012 WL 1372212, at *2 (Bankr. S.D. Ill. Apr. 19, 2012); *In re Baker*, 398 B.R. 198, 203 (Bankr. N.D. Ohio 2008); *In re Leigh*, 307 B.R. 324, 331 (Bankr. D. Mass. 2004); *In re Donahue*, 221 B.R. 105, 111 (Bankr. D. Vt. 1998), *amended by* 231 B.R. 865 (Bankr. D. Vt. 1998), *rev'd sub nom.* Tatko v. Donahue (*In re Donahue*), 232 B.R. 610 (D. Vt. 1999); *In re Howard*, 220 B.R. 716, 718 (Bankr. S.D. Ga. 1998); *In re French*, 174 B.R. 1, 7 (Bankr. D. Mass. 1994); *In re Boisvert*, 156 B.R. 357, 359 (Bankr. D. Mass. 1993); *In re Amerson*, 143 B.R. 413, 416 (Bankr. S.D. Miss. 1992); S. Discount Co. of N.C. v. Ivey (*In re Ivey*), 13 B.R. 27, 29 (Bankr. W.D.N.C. 1981).

88. 54 B.R. 585 (Bankr. D. Ore. 1985).

89. *Id.* at 585.

90. *Id.* at 586.

91. *Id.*

FIGURE 1.
Date of Principal Residence Determination
Under Subsection 1322(b)(2) OF THE BANKRUPTCY CODE

| | Petition Date | | Mortgage Transaction Date | |
|----------------------------|--|---|---------------------------|--|
| | <i>Holding</i> | <i>Dicta</i> | <i>Holding</i> | <i>Dicta</i> |
| Move-Out Cases | 2012 <i>Delfierro</i> 2011 <i>Cristopherson</i> 2011 <i>Putnam</i> 2011 <i>Benafel</i> 2011 <i>Abdelgadir</i> 2009 <i>Roemer</i> 2005 <i>Jordan</i> 2004 <i>Jackson</i> 1995 <i>Lebrun</i> | None | 1997 <i>Smart</i> | None |
| Different-Collateral Cases | 2012 <i>Austin</i> 2008 <i>Baker</i> 2004 <i>Leigh</i> 1998 <i>Donahue</i> 1998 <i>Howard</i> 1994 <i>French</i> 1993 <i>Boisvert</i> 1992 <i>Amerson</i> 1981 <i>Ivey</i> | 2012 <i>Wages</i> 1995 <i>Parker</i> 1992 <i>Dinsmore</i> 1992 <i>Graham</i> 1991 <i>Dent</i> 1991 <i>Groff</i> 1980 <i>Green</i> | 1985 <i>Hildebran</i> | 2010 <i>Moore</i> 2005 <i>Bulson</i> 2004 <i>Scarborough</i> 1995 <i>Guilbert</i> |
| All Cases | 18 | 7 | 2 | 4 |

Eleven other courts have weighed in on the timing issue in different-collateral cases even though the cases did not present the issue. (In each, the collateral was the same at the time of the mortgage transaction and at bankruptcy.) Seven of these courts said that the collateral's nature should be tested as of the time of bankruptcy.⁹² Four said that it should be tested as of the time of the mortgage transaction.⁹³

In re Scarborough is the most important of the cases in the latter group because the dicta are from a federal court of appeals. The facts of *Scarborough* presented no timing issue. At all relevant times, the mortgage in *Scarborough* encumbered "a multi-unit dwelling . . . with one apartment on the first floor and one apartment on the second floor."⁹⁴ The *Scarborough* court concluded that the antimodification provision did not bar modification of the mortgage because the mortgage secured not only the principal residence but also a rental unit that was not the debtor's principal residence.⁹⁵ The

92. *In re Wages*, 479 B.R. 575 (Bankr. D. Idaho 2012); *Parker v. Fed. Home Loan Mortg. Corp.*, 179 B.R. 492 (E.D. La. 1995), *vacated on other grounds sub nom. Parker v. Fed. Home Loan Mortg. Corp. (In re Parker)*, 70 F.3d 1269 (5th Cir. 1995); *In re Graham*, 144 B.R. 80 (Bankr. N.D. Ind. 1992); *In re Dinsmore*, 141 B.R. 499 (Bankr. W.D. Mich. 1992); *In re Groff*, 131 B.R. 703 (Bankr. E.D. Wis. 1991); *Dent v. Assocs. Equity Servs. Co. (In re Dent)*, 130 B.R. 623 (Bankr. S.D. Ga. 1991); *In re Green*, 7 B.R. 8 (Bankr. S.D. Ohio 1980).

93. *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406, 412 (3d Cir. 2004); *In re Moore*, 441 B.R. 732, 741 (Bankr. N.D.N.Y. 2010); *In re Bulson*, 327 B.R. 830, 845 (Bankr. W.D. Mich. 2005); *In re Guilbert*, 176 B.R. 302, 304 (D.R.I. 1995).

94. *In re Scarborough*, 461 F.3d at 409.

95. *Id.* at 414.

court addressed the timing issue only to deflect a potential objection that its holding would be subject to debtor manipulation:

One objection to this reading of § 1322(b)(2) is that “a debtor could easily sidestep the . . . home mortgage exception by adding a second living unit to the property on the eve of the commencement of his Chapter 13 proceeding.” However, for purposes of § 1322(b)(2), the critical moment is when the creditor takes a security interest in the collateral. “It is at that point in time that the underwriting decision is made and it is therefore at that point in time that the lender must know whether the loan it is making may be subject to modification in a Chapter 13 proceeding at some later date.”⁹⁶

The above passage constitutes the entire discussion of timing in *Scarborough*. The passage asserts that the lender must know whether the loan it is making is subject to modification at the time of underwriting, but it does not even attempt to explain why that need should, or how it could, trump the plain meaning of the statute.

To support this reasoning, *Scarborough* cites two lower court opinions in which the courts had employed the same gambit.⁹⁷ As in *Scarborough* itself, neither of the lower court cases cited in the *Scarborough* excerpt presented the timing issue. In both, the courts mentioned timing only to assert that the rule they adopted would not be subject to debtor manipulation.⁹⁸ Neither court said more than the above passage from *Scarborough*, and neither cited any authority for its assertions.

*In re Moore*⁹⁹ was the fourth case in which a court said the status of the collateral should be determined as of the time of the mortgage. *Moore* arose after *Scarborough*. Although the facts of *Moore* presented no timing issue, the court quoted the single sentence in which *Scarborough* presented its timing test.¹⁰⁰ Thus, in none of the four cases saying that the status of collateral should be determined as of the time of the mortgage did the court have a timing issue before it or give significant attention to timing. In all four cases, the courts’ statements regarding timing were pure dicta.

Thus, the overwhelming weight of authority is that, to determine whether the antimodification provision applies, a court should examine the

96. *Id.* at 412 (citations omitted) (quoting *In re Bulson*, 327 B.R. at 846).

97. *Id.*

98. *In re Bulson*, 327 B.R. at 846 (“Countrywide argues that a debtor could easily sidestep the Section 1322(b)(2) home mortgage exception by adding a second living unit to the property on the eve of the commencement of his Chapter 13 proceeding. However, the definition I adopt refers to the status of the debtor’s property when the mortgage loan is made.”); *In re Guilbert*, 176 B.R. at 305 (“[I]f [a principal residence that is also used to house other tenants is modifiable], homeowners poised to file for protection under Chapter 13 would, as a matter of course, seek temporary tenants prior to their filing, in order to modify the rights that their secured creditors have in their home.”).

99. 441 B.R. 732 (Bankr. N.D.N.Y. 2010).

100. *In re Moore*, 441 B.R. at 741 (“[T]he relevant time period is necessarily when the creditor takes a security interest in the real property in question, and the Court must, therefore, ‘look to the character of the collateral at the time of the mortgage transaction.’” (quoting *In re Scarborough*, 461 F.3d at 412)).

debtor's use of the collateral at the time of the bankruptcy case. If the debtor is not using the house as a principal residence at that time, the debtor is entitled to modify the mortgage.

C. Good Faith

The good-faith requirement of Chapter 13 is found in two provisions of 11 U.S.C. § 1325(a). Paragraph (3) requires that "the plan has been proposed in good faith," and paragraph (7) requires that "the action of the debtor in filing the petition was in good faith."¹⁰¹

Courts use a "totality of circumstances" test to determine good faith.¹⁰² The test requires that a court weigh several factors.¹⁰³ The circuits employ different lists of factors, and the factor descriptions are vague. Even within circuits, there is little consistency across cases. Judges' moral judgments often appear to be the determinative factor.

In two cases, courts have commented in dicta on the possibility of a debtor moving out of a house to render the mortgage subject to strip-down. In both cases, the judges mentioned good faith in reacting negatively to the idea of move-out as a deliberate debtor strategy. The Bankruptcy Appellate Panel ("BAP")'s opinion in *Abdelgadir* quoted the bankruptcy judge as stating during a hearing that "[g]ood faith is always an issue . . . if, for example, somebody, you know, had a piece of property, and they moved out, and then it was obvious they're going to move back the next month, that raises an issue of good faith."¹⁰⁴ The BAP expressed no opinion about the quotation.¹⁰⁵ In *In re Putnam*, the bankruptcy court commented that "[t]his does not mean, of course, that a debtor can move out of his home the day before bankruptcy and then modify his home loan; such manipulation and trickery would be evidence of bad faith which might render a plan unconfirmable pursuant to § 1129(a)(3) of the Code."¹⁰⁶ Although neither of these reactions has any precedential value, together they suggest that some judges' initial reactions to the move-out strategy will be negative.

Those negative reactions, however, conflict with two good-faith principles. First, residential borrowers should not be "mulcted for lack of 'good faith'" simply for exercising their contract rights.¹⁰⁷ Second, so long as a

101. 11 U.S.C. § 1325(a) (2012).

102. See, e.g., *Drummond v. Welsh* (*In re Welsh*), 465 B.R. 843, 851 (B.A.P. 9th Cir. 2012), *aff'd*, 711 F.3d 1120 (9th Cir. 2013) (Chapter 13 case); *Condon v. Brady* (*In re Condon*), 358 B.R. 317 (B.A.P. 6th Cir. 2007) (Chapter 13 case).

103. E.g., *Berliner v. Pappalardo* (*In re Puffer*), 674 F.3d 78, 82 (1st Cir. 2012) ("We believe that the totality of the circumstances approach to adjudicating good faith should apply equally to inquiries under section 1325.").

104. BAC Home Loans Servicing, LP v. *Abdelgadir* (*In re Abdelgadir*), 455 B.R. 896, 900 (B.A.P. 9th Cir. 2011) (internal quotation marks omitted).

105. See *id.*

106. No. 10-14079, 2011 WL 5839692, at *1 (Bankr. N.D. Cal. Nov. 21, 2011).

107. *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990).

debtor acts within the debtor's legal rights, there is "nothing sinister"¹⁰⁸ in a debtor's arranging the debtor's affairs to maximize the property the debtor may retain in bankruptcy.

1. The Contractual Right to Move

Many, if not most, residential first mortgages prohibit the borrower from moving out of the mortgaged house for a period of one year. For example, the relevant provision of the Fannie Mae–Freddie Mac Uniform Instrument Form for California deeds of trust provides as follows:

6. OCCUPANCY. Borrower shall occupy, establish, and use the Property as Borrower's principal residence within 60 days after the execution of this Security Instrument and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender otherwise agrees in writing, which consent shall not be unreasonably withheld, or unless extenuating circumstances exist which are beyond Borrower's control.¹⁰⁹

Implicit in such a prohibition is a borrower's right to move out after one year. The debtor who moves out after fulfilling the contractual obligation to remain for at least one year is not acting in bad faith but merely exercising a right provided under the contract. As Circuit Judge Easterbrook famously stated in *Kham & Nate's Shoes*, "[P]rinciples of good faith . . . do not block use of terms that actually appear in the contract."¹¹⁰ The court elaborated,

Debtor submits that conduct may be "unfair" and "inequitable" . . . even though the creditor complies with all contractual requirements, but we are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do "more"—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later. Contracts specify the duties of the parties to each other, and each may exercise the privileges it obtained.¹¹¹

108. Judge Learned Hand famously stated the following with respect to tax planning: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands." *Comm'r v. Newman*, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting). Hand also proclaimed, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury, there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

109. FANNIE MAE & FREDDIE MAC, UNIFORM INSTRUMENT FORM 3005: CALIFORNIA DEED OF TRUST 7–8 (2001) [hereinafter DEED OF TRUST], available at https://www.fanniemae.com/content/legal_form/3005w.doc. Substantially the same provision appears in the *American Jurisprudence* uniform covenants for national use in residential mortgages. 13 AM. JUR. LEGAL FORMS 2d *Mortgages and Trust Deeds* § 179:37, sec. 6 ("Borrower shall occupy, establish, and use the property as borrower's principal residence within [number of days] days after the execution of this security instrument and shall continue to occupy the property as borrower's principal residence for at least one year after the date of occupancy . . .").

110. *Kham & Nate's Shoes*, 908 F.2d at 1357.

111. *Id.* at 1356.

In the case of a residential mortgage, a court should also reach this result in the absence of an express provision regarding the required term of occupancy. Residential mortgages are contracts of adhesion, drafted by lenders. Lenders and borrowers who wish to contract for continued occupancy throughout the term of the mortgage are entitled to do so and in some cases actually do so. In *Smart*, for example,

the Debtors “covenant[ed] and agree[d] that . . . [the mortgage holder] may declare all sums secured by the Mortgage to be immediately due and payable upon the occurrence of any of the following”, *inter alia*: . . . (2) the Debtors do not make the Property their principal residence within sixty (60) days of the closing, and continue to occupy the Property as their principal residence “throughout the term of the Mortgage.”¹¹²

When a borrower has not contracted to continue occupancy, a court should interpret the silence as recognizing the borrower’s right to move out of the property and rent it. The borrower’s implied contractual right to move should be dispositive of a lender’s claim that moving is bad faith—not the other way around.

2. The Statutory Right to Move

Generally speaking, debtors have the right to arrange their affairs during the prefiling period in a manner that will benefit them postfiling.¹¹³ They can buy and sell property, incur and pay debts, move from state to state, change their residences, and change how they use their property. For example, debtors who own property that would not have been exempt in bankruptcy may exchange that property for property that will be exempt.

Bankruptcy law places a variety of limits on bankruptcy planning. The principal limit is fraudulent transfer law. Debtors may not transfer property with the actual intent to hinder, delay, or defraud their creditors.¹¹⁴ Bankruptcy law does not assume that debtors make transfers for the purpose of harming creditors merely because the transfers do harm creditors and benefit the debtors.¹¹⁵ This is how the House Judiciary Committee described a debtor’s right to plan for bankruptcy in 1977: “As under current law, the

112. *In re Smart*, 214 B.R. 63, 64–65 (Bankr. D. Conn. 1997) (first and second alterations in original).

113. 2 RAYMOND T. NIMMER ET AL., NIMMER’S COMMERCIAL ASSET-BASED FINANCING § 12:3 (rev. ed. 2013) (“As a first premise, the debtor is ordinarily permitted to transfer, sell, and use its own property prior to filing in whatever way it sees fit and to its own advantage. The competing theme is that acts of fraud or misrepresentations, pure concealment, or breach of fiduciary duty cannot occur without risk of some sanction or lost benefit in bankruptcy.”).

114. *E.g.*, 11 U.S.C. § 548(a)(1)(A) (2012).

115. *Norwest Bank Neb., N.A. v. Tveten*, 848 F.2d 871, 873–74 (8th Cir. 1988) (“It is well established that under the Code the conversion of non-exempt to exempt property for the purpose of placing the property out of the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise would be entitled.”); *see also* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. REV. 311, 333–38 (1982) (discussing bankruptcy planning).

debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.”¹¹⁶ In the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”),¹¹⁷ Congress placed several new limits on bankruptcy exemption planning but left “the other types of [bankruptcy] planning untouched.”¹¹⁸ Debtors continue to have the right to engage in legitimate bankruptcy planning, and that planning does not demonstrate lack of good faith.¹¹⁹

Borrowers who employ this Article’s recommendations will move out of their homes prior to filing bankruptcy in order to entitle themselves to strip down their mortgages after filing. The most closely analogous post-BAPCPA cases are those in which debtors have dismissed Chapter 13 cases filed less than 910 days after financing a car and then refiled more than 910 days after financing the car to allow themselves to strip down the car loan.¹²⁰ In both scenarios, the Chapter 13 debtor deliberately alters the debtor’s situation prior to filing to become eligible for an advantage against a secured creditor after filing.

For example, in *In re Robinson* the debtor filed bankruptcy only after she and her attorney thought that the 910-day period had run.¹²¹ They miscalculated the time period and inadvertently filed on the 904th day.¹²² Realizing her mistake, the debtor dismissed and refiled her case after the 910-day period had run.¹²³ The court applied the totality of circumstances test to hold that the second Chapter 13 case was filed in good faith. The court stated,

There is absolutely no evidence that Debtor here had any intent to defraud anyone, so her decision to either wait until the 911th day after buying a car to file, or, having miscalculated the days, dismissing and refiling soon thereafter to take advantage of the 910-day exception, is legitimate pre-bankruptcy planning.¹²⁴

116. H.R. REP. NO. 95-595, at 361 (1977) (citation omitted).

117. Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C. (2012)).

118. Juliet M. Moringiello, *Has Congress Slimmed down the Hogs?: A Look at the BAPCPA Approach to Pre-bankruptcy Planning*, 15 WIDENER L.J. 615, 629 (2006).

119. E.g., *In re Robinson*, No. 07-41562-13, 2008 Bankr. LEXIS 1569, *21–22 (Bankr. D. Kan. May 16, 2008) (“[A] debtor may legitimately engage in pre-bankruptcy planning so long as there is no intent to defraud creditors.”).

120. 11 U.S.C. § 1325(a) (2012).

121. *In re Robinson*, 2008 Bankr. LEXIS 1569, at *2.

122. *Id.* at *3 (“Only when Chrysler Financial objected to confirmation of Debtor’s plan did she apparently realize that either she or her attorney had miscounted the number of days between purchase and filing, and that she had actually filed five days too soon to take advantage of the 910-day provision . . .”).

123. *Id.* at *3–4.

124. *Id.* at *22.

In re Murphy provides a second example.¹²⁵ The debtor in *Murphy* filed his first Chapter 13 proceeding less than 910 days after the loan and proposed to strip down the amount of the loan to the value of the collateral.¹²⁶ The judge assigned to the case had a reputation for not permitting strip-down in that circumstance.¹²⁷ The debtor initially responded by amending his plan to pay the car loan in full.¹²⁸ He made four months of payments, dismissed the case, waited a little over one month, and then filed a second Chapter 13 case on the 915th day after obtaining the car loan.¹²⁹ The lender again objected. The court held that the debtor had not filed the second case in bad faith and that the debtor was entitled to strip down the car loan.¹³⁰

Moving out is weaker evidence of bad faith than is dismissing and refiling. Moving out is an economically significant act that requires considerable sacrifice on the part of the debtor. Dismissing and refiling is purely a legal gambit with little or no impact on a debtor's life. Courts should therefore be more willing to accept that a debtor moves out in good faith than that a debtor dismisses and refiles in good faith.

Moving out renders the mortgage eligible for strip-down.¹³¹ That the debtor's purpose in moving was to become eligible is not an indication of bad faith. The debtor is merely exercising rights under the mortgage contract and the Bankruptcy Code. Congress could have excluded from modification any mortgage secured by real property that was the debtor's principal residence at the time the debtor granted the mortgage. Instead, it excluded any mortgage secured by real property that was the debtor's principal residence at the time the debtor filed bankruptcy. The plain meaning of the provision is that the mortgage is not excluded from modification if the debtor ceases to use the real property as the debtor's principal residence prior to bankruptcy. That meaning is not inconsistent with Congress's apparent intention to protect home lenders against mortgage modification. Instead, the language Congress chose provides a safety valve for debtors whose need for modification is so great that they are willing to move out of their homes prior to bankruptcy.

Even though a move-out to create eligibility to strip down a mortgage is not alone bad faith, it can occur in conjunction with other conduct that does demonstrate bad faith. An example might be a move-out by a debtor

125. 375 B.R. 919 (Bankr. M.D. Ga. 2007).

126. *In re Murphy*, 375 B.R. at 920–21 (“During the 2006 Chapter 13 case, CAF undisputedly held what is commonly called a 910 claim—a purchase money security interest, for a debt incurred during the 910 days prior to the bankruptcy filing, secured by a motor vehicle purchased for the personal use of the debtor.”).

127. *See id.* at 921 (“Because Chief Judge Hershner and I follow different interpretations of the hanging paragraph with respect to 910 claims, counsel initially filed a plan proposing a cram down . . . and later amended the plan to treat CAF's claim as fully secured after Judge Hershner was assigned to the case.”).

128. *Id.* at 920.

129. *Id.* at 921.

130. *Id.* at 923.

131. *See supra* Section II.B.1.

who obtained the mortgage in exchange for a promise to personally occupy the house as her principal residence for the mortgage term. In addition, some debtors who move out of their homes prior to bankruptcy in good faith may nevertheless file their bankruptcy cases or propose their plans in bad faith for unrelated reasons.

III. LEGISLATIVE HISTORY

Most arguments against home mortgage modification rely in whole or in part on legislative history. These arguments' core assertion is that the legislative history shows that Congress made all principal residence mortgages unmodifiable to attract capital to the home mortgage market. This Part makes three points regarding those arguments.

First, the language of the antimodification provision is unambiguous with respect to timing, and a large majority of courts addressing the issue have so held.¹³² If the collateral is not a debtor's principal residence at the time of the bankruptcy case, the antimodification provision does not apply and the debtor is entitled to modify the mortgage. Because the statute is unambiguous, courts should not consult legislative history. Thus the history is irrelevant.

Second, as others have pointed out, the claimed legislative history does not exist.¹³³ Neither Congress nor any member or agent of Congress made any statement linking the antimodification provision to the attraction of capital.

Third, instead of inferring congressional intent from legislative history, some courts and commentators have sought to infer congressional intent from the statute itself. But the courts that have used this method have ignored possible congressional purposes other than attracting capital. I discuss each of these three points separately.

A. Irrelevance

The Supreme Court has repeatedly stated that "when the statute's language is plain, the sole function of the courts—at least where the disposition

132. See *supra* Section II.B.

133. Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 424–25 (1994) ("[T]here is no explicit legislative history on point . . ."); Gary Klein, *Legislative Intent or Judicial Myth-Making?: No Legislative History Supports Policy Arguments Advanced Against Stripdown*, AM. BANKR. INST. J., Dec.–Jan. 2000, at 1, 30 ("In short, despite Justice Stevens's concurrence, there is no valid legislative history that supports policy-based limits on the plain language of § 1322(b)(2)."); Levitin, *supra* note 18, at 573–75 ("Justice Stevens's assertion has scant support in the legislative history, but has nonetheless become the dominant explanation for the Bankruptcy Code's mortgage antimodification provision." (footnote omitted)); Michael S. Polk, *The Chapter 13 Cramdown: New Nightmare for the Lender*, 19 REAL EST. L.J. 279, 290 (1991) ("[T]o a large degree the legislative history of Section 1322(b)(2) is silent . . .").

required by the text is not absurd—is to enforce it according to its terms.”¹³⁴ Resorting to legislative history is unnecessary when the statutory text is clear.¹³⁵

The Bankruptcy Code provision at issue here is unambiguous. The Ninth Circuit BAP said precisely that in *Abdelgadir*:

Reliance on legislative history is unnecessary when the statute’s language is unambiguous. The plain language of § 1123(b)(5) excepts a particular type of claim from modification. As discussed above, a creditor’s right to payment, whether it later is deemed secured or unsecured depending on the value of the collateral, is fixed at the petition date. Therefore, our statutory analysis leads us to conclude that the determinative date for whether a claim is secured by a debtor’s principal residence is, like all claims, fixed at the petition date.¹³⁶

As previously noted, the *Smart* court proposed an alternative reading of the antimodification provisions. The alternative reading, however, is grammatically incorrect, so it does not identify an ambiguity.¹³⁷

Although the antimodification provisions may be ambiguous in other respects, they are not ambiguous with respect to the timing problem. Resorting to legislative history is therefore contrary to the law.

B. *Nonexistence*

The preference for literal interpretation of statutes results in large part from the limitations of legislative history. Justice Scalia, no fan of legislative history, explained some of its shortcomings in *Milavetz*:

The Court first notes that statements in the Report of the House Committee on the Judiciary “indicate concern with abusive practices undertaken by attorneys.” Perhaps, but only the concern of the author of the Report. Such statements tell us nothing about what the statute means, since (1) we do not know that the members of the Committee read the Report, (2) it is almost certain that they did not vote on the Report (that is not the practice), and (3) even if they did read and vote on it, they were not, after all, those who made this law. The statute before us is a law because its text was approved by a majority vote of the House and the Senate, and was signed by the President. Even indulging the extravagant assumption that Members of the House other than members of its Committee on the Judiciary read the Report (and the further extravagant assumption that they agreed with

134. *Lamie v. U.S. Tr.*, 540 U.S. 526, 534 (2004) (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000)) (internal quotation marks omitted); accord *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340 (1997) (quoting *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240 (1989)).

135. *E.g.*, *Milavetz, Gallop & Milavetz, P.A. v. United States*, 559 U.S. 229, 236 n.3 (2010) (“[R]eliance on legislative history is unnecessary in light of the statute’s unambiguous language . . .”).

136. *BAC Home Loans Servicing, LP v. Abdelgadir* (*In re Abdelgadir*), 455 B.R. 896, 903 (B.A.P. 9th Cir. 2011) (citations omitted).

137. See *supra* text accompanying notes 82–84.

it), the Members of the Senate could not possibly have read it, since it did not exist when the Senate passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. And the President surely had more important things to do.¹³⁸

The limitations of legislative history with respect to the antimodification provisions are even greater because what probative legislative history exists with respect to home mortgage modification consists entirely of testimony to Congress rather than statements made *on behalf of Congress*.¹³⁹

Even if mere testimony constituted legislative history and resorting to it were appropriate, the testimony is silent with respect to the timing issue. Congress enacted the Chapter 13 antimodification language in 1978, and that language has remained unchanged since then. Because the “principal residence” language was added to the bill late in the legislative process, no one testified about it.¹⁴⁰ Except for a paraphrase of its language,¹⁴¹ the provision does not appear in the House or Senate reports.¹⁴² Nor were the floor statements in either chamber at all enlightening.¹⁴³

138. *Milavetz, Gallop & Milavetz*, 559 U.S. at 253 (Scalia, J., concurring in part and concurring in the judgment).

139. *Nobelman* contained no direct citation to legislative history. In his concurring opinion, Justice Stevens cited *Grubbs v. Houston First American Savings Ass’n*, 730 F.2d 236, 245–46 (5th Cir. 1984). *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 332 (1993) (Stevens, J., concurring). The *Grubbs* pages Stevens cited contain references to the statements of three witnesses who testified before the Subcommittee on Improvements of the Judicial Machinery of the Senate Committee on Judiciary. See *Grubbs*, 730 F.2d at 245 & n.13. The cited pages contain only one reference to the committee report. *Id.* at 245 n.15. *Grubbs* quoted the report in full. The report did nothing more than track the language of section 1322(b). The only other reference to legislative history in *Grubbs* was a reference to floor statements explaining the last-minute amendment to subsection 1322(b)(2). *Grubbs* set forth the floor statements in full. The floor statements said that the subsection is a compromise, tracked the language of the antimodification provision, and ended by stating, “It is intended that a claim secured by the debtor’s principal residence may be treated with under [sic] section 1322(b)(5) of the House amendment.” *Id.* at 246 n.16 (internal quotation marks omitted). None of this history explained the intent of the antimodification provision or addressed the timing issue.

140. Senate Bill 2266, 95th Cong. (1977) was the subject of the last hearing held on the topic. See *Grubbs*, 730 F.2d at 245 & n.13 (noting that Senate Bill 2266 was introduced after the 1975 hearings but before the 1977 hearings). The version of subsection 1322(b)(2) of the Bankruptcy Code contained in the bill read that the plan may “modify the rights of holders of secured claims (other than claims wholly secured by mortgages on real property) or of holders of unsecured claims.” *Id.* at 245 n.14 (emphasis omitted).

141. See *id.* at 245 n.15 (quoting the Senate Report statement “in full”).

142. S. REP. NO. 95-989, at 141 (1978).

143. *Grubbs* stated,

The floor-statements explaining these amendments are as follows: “Section 1322(b)(2) of the House amendment represents a compromise agreement between similar provisions in the House bill and Senate amendment. Under the House amendment, the plan may modify the rights of holders of secured claims other than a claim secured by a security interest in real property that is the debtor’s principal residence. It is intended that a claim secured by the debtor’s principal residence may be treated with under [sic] section 1322(b)(5) of the House amendment. 124 Cong.Rec.H. 11,106 (Sept. 28, 1978); S 17,243 (Oct. 6, 1978).”

Congress added the antimodification language in Chapter 11 in 1994 to provide the same treatment for principal residence mortgages in Chapter 11 that Congress provided in Chapter 13. That history states only as follows:

This amendment conforms the treatment of residential mortgages in chapter 11 to that in chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor's principal residence. . . . [The added antimodification language] does not apply to a commercial property, or to any transaction in which the creditor acquired a lien on property other than real property used as the debtor's residence.¹⁴⁴

A footnote at the end of that text cites two cases, *Hammond v. Commonwealth Mortgage Co. of America (In re Hammond)*¹⁴⁵ and *In re Ramirez*.¹⁴⁶ Neither case raised the timing issue, and neither court said anything about it. As a result, no legislative history exists with regard to the timing issue.

Some courts have, nevertheless, purported to rely on legislative history in resolving the timing issue.¹⁴⁷ The source of their error is almost invariably Justice Stevens's concurring opinion in *Nobelman*. This is the entire opinion:

At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market. See *Grubbs v. Houston First American Savings Assn.*, 730 F.2d 236, 245–46 (CA5 1984) (canvassing legislative history of Chapter 13 home mortgage provisions). It therefore seems quite clear that the Court's literal reading of the text of the statute is faithful to the intent of Congress. Accordingly, I join its opinion and judgment.¹⁴⁸

As previously noted, the *Grubbs* pages that Stevens cited reference no statement by the House, the Senate, any committee of Congress, or any member of Congress regarding the antimodification provision.

Grubbs made no claim to the contrary. *Grubbs* merely speculated—in a single sentence—as to what might have persuaded Congress to adopt the language it did: “[The antimodification provision] was apparently in response to perceptions, or to suggestions advanced in the legislative hearings, that, home mortgagor lenders, performing a valuable social service through

730 F.2d at 246 n.16.

144. H.R. REP. NO. 103-835, at 46 (1994), reprinted in 1994 U.S.C.C.A.N. 3340, 3354.

145. 27 F.3d 52 (3d Cir. 1994).

146. 62 B.R. 668 (Bankr. S.D. Cal. 1986).

147. E.g., *In re Bulson*, 327 B.R. 830, 846 (Bankr. W.D. Mich. 2005) (establishing in dicta a “temporal” rule that the “status of the debtor's property when the mortgage loan is made” is controlling to achieve “Congress’ purpose in enacting the home mortgage exception”); *In re Smart*, 214 B.R. 63, 68 (Bankr. D. Conn. 1997) (“Reading Section 1322(b)(2) to refer to a property's status at the time of the creation of the subject security interest is consistent with, and wholly supportive of, Congress’ ‘flow of capital’ purpose.”).

148. *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 332 (1993) (Stevens, J., concurring).

their loans, needed special protection against modification thereof (*i.e.*, reducing installment payments, secured valuations, etc.).”¹⁴⁹ Thus, Stevens’s claim is not based on legislative history but rather on his and the *Grubbs* court’s speculation about what Congress’s purpose might have been.¹⁵⁰

C. Legislative Purpose

The case law and commentary is rife with speculation regarding Congress’s purpose. For example, shortly after the effective date of the Bankruptcy Code, Bankruptcy Judge Saul wrote in *United Cos. Financial Corp. v. Brantley*,

Although the legislative history is silent, the plain intent of the exception is to provide stability in the residential long-term home financing industry and market. It is to specifically protect institutional lenders engaged only in providing long-term home mortgage financing and not lenders primarily engaged in consumer or other areas of financing but who take security interests in a residence or homestead to secure non-home financing debts.¹⁵¹

In this passage, the court was not using legislative history to determine the meaning of the statute. The court acknowledged that there is no legislative history. Instead, the court determined the legislative purpose from the statute’s face and then interpreted the statute to achieve that legislative purpose. This technique is tautological. The only purpose that can be gleaned from a statute’s face is to achieve the consequences that would follow from literal application of the statute.

In quick succession, two other cases cited *Brantley* and embellished their account of Congress’s intention—without examining legislative history.¹⁵²

149. *Grubbs v. Hous. First Am. Sav. Ass’n*, 730 F.2d 236, 246 (5th Cir. 1984) (citation omitted).

150. See, e.g., Levitin, *supra* note 18, at 573–75 (“Justice Stevens’s assertion has scant support in the legislative history, but has nonetheless become the dominant explanation for the Bankruptcy Code’s mortgage antimodification provision.” (footnote omitted)). Stevens ignored the Second Circuit, which has previously refused to speculate about congressional intent:

The legislative history therefore indicates only that § 1322(b)(2) was designed to provide greater protection to home mortgage lenders than other secured creditors in the Chapter 13 context. This is, of course, plain on the face of the statute itself. No further guidance may be gleaned from the legislative history on the question presented here: the extent to which such creditors are to be accorded greater protection, *i.e.*, whether modification includes bifurcation.

Bellamy v. Fed. Home Loan Mortg. Corp. (*In re Bellamy*), 962 F.2d 176, 182 (2d Cir. 1992), *abrogated by Nobelman*, 508 U.S. 324.

151. 6 B.R. 178, 189 (Bankr. N.D. Fla. 1980).

152. *In re Morphis*, 30 B.R. 589, 593 (Bankr. N.D. Ala. 1983) (quoting the above passage from *Brantley* and adding that “[a]lthough the statute is not limited to lenders engaged only in home financing it is intended to specifically apply to actual, long-term home financing loans, regardless of the lender”); *In re Neal*, 10 B.R. 535, 536–37 (Bankr. S.D. Ohio 1981) (referring to the legislative history as “sparse” but continuing, “There apparently was a fear on

Later, courts began to claim that there was legislative history, and a dispute developed over whether that history limited protection to the “traditional mortgage lenders” or included the holders of subordinate and short-term mortgages against debtors’ principal residences.¹⁵³ These inferences quickly gave rise to a myth that legislative history revealed a congressional intent to encourage the flow of capital into the home lending market. As reflected in this passage, the myth was full blown by 1985:

[T]he statute as finally enacted by Congress clearly evidences a concern with the possible effects the new bankruptcy act might have upon the market for homes. If any other policy objective of Congress was adequate to compete against the objective of protecting wage earners generally, it was a policy to encourage the increased production of homes and to encourage private individual ownership of homes as a traditional and important value in American life. Congress had to face the reality that in a relatively free society, market forces and the profit motive play a vital role in determining how investment capital will be employed. Every protection Congress might grant a homeowner at the expense of the holders of security interests on those homes would decrease the attractiveness of home mortgages as investment opportunities. And as home mortgages decrease in attractiveness, the pool of money available for new home construction and finance shrinks.¹⁵⁴

That myth grew increasingly influential over time, ultimately leading to the Supreme Court’s decision in *Nobelman*.

Congress may have intended for the antimodification provision to benefit home lenders and encourage home mortgage lending. But the antimodification provision would have accomplished both of these goals regardless of the outcome in *Nobelman* and regardless of how the timing issue was resolved. The difference *Nobelman* made was in the *extent* to which the antimodification provision would benefit lenders and attract capital. The logical fallacy is that if Congress intended to benefit lenders and attract capital, it intended *only* to benefit lenders and attract capital.¹⁵⁵

the part of the drafters of the legislation . . . of a wholesale revision of the repayment terms of home mortgages to the substantial financial detriment of the lending institutions”).

153. *Compare* 1st 2nd Mortg. Co. of NJ, Inc. v. Ferandos (*In re Ferandos*), 402 F.3d 147, 151 (3d Cir. 2005) (“This court concurs with the cases that hold that the true congressional intent behind the Section 1322(b)(2) exception for claims secured only by an interest in the debtor’s principal residence is to protect the traditional mortgage lender who provides long-term financing that enables individuals to purchase their home” (quoting *In re Williams*, 109 B.R. 36, 42 (Bankr. E.D.N.Y. 1989)) (internal quotation marks omitted)), *with* Allied Credit Corp. v. Davis (*In re Davis*), 989 F.2d 208, 210 (6th Cir. 1993) (“As noted by the courts below, the language of § 1322(b)(2) is clear and unambiguous on its face and does not permit the interpretation that the statute has application only to ‘enabling’ loans.”).

154. *Fed. Land Bank of Louisville v. Glenn* (*In re Glenn*), 760 F.2d 1428, 1434 (6th Cir. 1985).

155. The fallacy is apparent in *Smart*, where the court first concluded that “favorable statutory treatment of homestead mortgagees was intended to encourage and sustain a flow of affordable capital into the home lending market” and then construed “Section 1322(b)(2) so as to give maximum effect to the intentions of Congress” without first determining whether

But there are alternative explanations for the language Congress chose. Each assumes that Congress intended to benefit home mortgage lenders and thereby attract capital to the home mortgage market. Each also explains why Congress limited that benefit to cases in which a debtor continued to occupy the home at the time of bankruptcy instead of extending it to all home mortgage cases.

One such alternative conclusion is that, in addition to attracting capital to the home mortgage market, Congress also sought to preserve the ability of bankruptcy courts to provide relief based on conditions at the time of bankruptcy. The latter is a strong policy that pervades the provisions of the Bankruptcy Code.¹⁵⁶ The reason for this strong, pervasive policy is that bankruptcy relief is designed to rehabilitate honest debtors and enable them to resume productive lives. If contracts entered into years before bankruptcy could limit the availability of relief, rehabilitation might no longer be possible.

Allowing debtors who move out of their houses to keep them gives those debtors an advantage over debtors who do not move out. This discrimination may seem unfair. But Congress chose language that suggests an intent that the policy that favors granting relief based on circumstances at bankruptcy overrides the policy that favors attracting capital to the housing market. Discrimination based narrowly on circumstances at filing is common in bankruptcy because the bankruptcy system seeks to provide relief to all honest debtors. Debtors who owe large amounts of debt get more relief than debtors who owe small amounts. Debtors who own more exempt property at the time of bankruptcy get a head start over those who own less exempt property. Debtors whose creditors have given them chance after chance can discharge their debts just as readily and to the same extent as debtors whose creditors refused them even a second chance.

Congress's second possible purpose for granting relief to mortgagors who move out, while denying it to those who do not, may have been to limit mortgage modification to those with the greatest need for it. Conditioning

that was Congress's only relevant intention. See *In re Smart*, 214 B.R. 63, 68 (Bankr. D. Conn. 1997).

156. The amounts of creditors' claims are determined as of the filing of the petition, 11 U.S.C. § 502(b) (2012) ("[T]he court . . . shall determine the amount of such claim . . . as of the date of the filing of the petition . . ."), the extent to which claims are treated as secured is determined as of the time of bankruptcy, *id.* § 506(b) ("[S]uch value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition . . ."), and what property is exempt in bankruptcy is determined based on state law as of the filing of the petition, not as of the time the creditors extended credit, *id.* § 522(b)(3)(A) (exempting "property that is exempt under Federal law . . . or State or local law that is applicable on the date of the filing of the petition"). Numerous other examples exist. To list just a few, the rights that can or cannot be modified under subsection 1322(b)(2) or cured and paid under subsections 1322(b)(3) and 1322(b)(4) are determined as of the filing of the petition. So are the transfers that can be set aside as preferences, *id.* § 547(b), and the appropriate venue for the filing of a case, 28 U.S.C. § 1408 (2006).

mortgage modification on moving out would accomplish that purpose because only those with the greatest need would make the move. If interest rates on home mortgages were at 6%, those with interest rates of 7% to 8% would tend not to move out. But those with interest rates of 12% to 18% would tend to move out. The same kind of separation would occur between those whose mortgages were only 10% to 20% underwater and those whose mortgages were 40% or more underwater.¹⁵⁷ Perhaps most importantly, it would occur between those who saw their houses as mere investments and those with strong emotional attachments to their houses. In short, Congress may have intended the move-out limitation on the antimodification provision to act as a safety valve to provide relief in egregious cases.

The third possible purpose may have been to leave the determination of whether debtors would have the right to move out of their homes and modify their home mortgages to private contracting and the market. A rule that flatly prohibited the modification of home mortgages would have prevented contracting by lenders and borrowers at the time of the mortgage. The terms of the mortgage would have made no difference. The rule Congress adopted instead left lenders and borrowers free to contract regarding mortgage modification. If a mortgage requires that a debtor occupy the home, the debtor cannot modify the mortgage in a bankruptcy filed during the period of required occupancy. To render a mortgage permanently nonmodifiable, a mortgage holder would require that a debtor occupy the home during the entire time the mortgage remains outstanding. The rule Congress adopted also left mortgage market regulators free to use, permit, or require particular mortgage provisions regarding debtors' rights to move out. Regulators can use that freedom to determine the level of mortgage modification in the system as a whole.

The mortgage in *Smart* is an example of contracting for nonmodification. The *Smart* mortgage was due on move-out.¹⁵⁸ Presumably, the lender and the borrower agreed that the borrower should occupy the house as long as the mortgage remained outstanding. By contrast, one of the "uniform covenants" in the Fannie Mae and Freddie Mac California single family mortgage form provides,

Borrower shall occupy, establish, and use the Property as Borrower's principal residence within 60 days after the execution of this Security Instrument and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender otherwise agrees in writing, which consent shall not be unreasonably withheld, or unless extenuating circumstances exist which are beyond Borrower's control.¹⁵⁹

157. See Goodman et al., *supra* note 6, at 29 ("Across all product types, the loans with higher mark-to-market CLTVs transition to default at a much higher rate than do loans with lower mark-to-market CLTVs." (emphasis omitted)).

158. See *supra* note 112 and accompanying text.

159. DEED OF TRUST, *supra* note 109, at 7–8.

Presumably, Fannie Mae and Freddie Mac adopted this term and imposed it on lenders. The language Congress employed in the antimodification provisions expresses Congress's apparent intention that such provisions determine the extent of a debtor's right to move out and modify.

IV. PLAN CONFIRMABILITY

As discussed in Part II, the house-swap strategy will entitle most debtors to move out of their houses, file Chapter 13 cases, and modify their home mortgages. The last step necessary for these debtors to confirm plans is for them to propose payment schedules for their modified mortgages.

Section 1322(d) of the Bankruptcy Code limits plan payments to a maximum period of five years.¹⁶⁰ The problem for most debtors will be that they cannot afford to pay even the reduced amounts of their mortgages over such a short period.

Debtors may use three types of plans to solve this problem. No single type is likely to succeed in all jurisdictions. But at least one is likely to succeed in any given jurisdiction. Debtors should proceed by proposing the type they consider best for the particular jurisdiction and, if that type fails, seeking leave to file another type.

A. *Modification and Payment Maintenance*

A modification and payment maintenance plan solves the problem in two steps. The plan first provides for modification of the mortgage debt, pursuant to subsection 1322(b)(2) of the Bankruptcy Code, by reducing the mortgage debt to the value of the collateral as authorized by section 506(a).¹⁶¹ The plan then provides that the debtor will maintain payments on the reduced amount during the plan period. "Maintaining payments" means that each payment during the plan period must be in the amount provided by the mortgage. The plan cannot provide for the payments that mortgage requires to be paid after the plan's five-year period.¹⁶²

Bankruptcy will not discharge the payments that the mortgage requires to be paid after the plan's five-year period.¹⁶³ Nor will bankruptcy law protect the debtor from foreclosure after the plan's five-year period.¹⁶⁴ State law, however, will protect the debtor from foreclosure after the plan period if the

160. 11 U.S.C. § 1322(d)(1) (2012) ("[T]he plan may not provide for payments over a period that is longer than 5 years.").

161. See *infra* notes 166–167 and accompanying text.

162. 11 U.S.C. § 1322(d).

163. *Id.* § 1328(a)(1) ("[T]he court shall grant the debtor a discharge of all debts provide for by the plan . . . except any debt . . . provided for under section 1322(b)(5).").

164. Upon the grant of the discharge, the permanent injunction of 11 U.S.C. § 524(a) replaces the automatic stay. But debts provided for under 11 U.S.C. § 322(b)(5) are not discharged. See *id.* § 1328(a).

debtor is current on the payments required under the original mortgage terms.¹⁶⁵

The plain language of the Bankruptcy Code authorizes this solution. Subsection 506(a)(1) of the Bankruptcy Code provides that “[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of [the collateral] . . . and is an unsecured claim to the extent [of the deficiency].”¹⁶⁶ Section 1322(b) of the Bankruptcy Code further provides that

the plan may . . .

(2) modify the rights of holders of secured claims . . . or of holders of unsecured claims [and] . . .

. . . .

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any . . . secured claim on which the last payment is due after the date on which the final payment under the plan is due.¹⁶⁷

Congress’s use of the word “and” to join the subparagraphs of section 1322(b) makes clear that a single plan may do the things described in both subparagraphs. Use of the phrase “notwithstanding paragraph (2)” in subsection 1322(b)(5) makes clear that a plan may apply both subsections to the same mortgage debt. That is, a plan may provide for the maintenance of payments on a secured claim, notwithstanding that the plan is modifying the claim under subsection 1322(b)(2).

This sound reasoning was rejected by the Ninth Circuit in *Enewally v. Washington Mutual Bank (In re Enewally)*.¹⁶⁸ In that case, the court held that “a chapter 13 debtor may not invoke both a modification of a secured creditor’s claim under § 1322(b)(2) and the right to ‘cure and maintain’ over the life of the original loan as authorized under § 1322(b)(5).”¹⁶⁹ Although apparently conceding that the bankruptcy court’s opinion, which had allowed the debtor to invoke both subsections, was the better reading of the statute, the court felt constrained by the Supreme Court’s opinions in *Dewsnup* and *Nobelman* to adopt what the Ninth Circuit itself considered a worse reading.¹⁷⁰

165. The debtor will be current because the debtor maintained payments during the case on the secured portion (i.e., the debt “provided for by the plan”) and received a discharge of the unsecured portion. *Id.* § 1328(a).

166. *Id.* § 506(a)(1).

167. *Id.* § 1322(b).

168. 368 F.3d 1165 (9th Cir. 2004).

169. *In re Enewally*, 368 F.3d at 1171 (quoting *Enewally v. Wash. Mut. Bank (In re Enewally)*, 276 B.R. 643, 651 (Bankr. C.D. Cal. 2002)) (internal quotation marks omitted).

170. See *id.* (“Although the bankruptcy court’s analysis is arguably much closer to the original vision of the Bankruptcy Code than the district court’s holding, we are not writing on a clean slate. The Supreme Court has spoken directly in *Dewsnup* and *Nobelman*.”).

To explain why it did not follow the better reading, the Ninth Circuit began by noting that “*Dewsnup* cautioned against courts fashioning a ‘broad new remedy’ under § 506(a) where the remedy was not ‘mentioned somewhere in the Code itself or in the annals of Congress.’”¹⁷¹ The court then continued,

In order to hold that the debtor’s lien stripping proposal is viable under the “cure and maintain” provision of § 1322(b)(5), we would have to hold that § 506(a) coupled with § 1322(b)(5) provides a new remedy allowing modification of secured debts in Chapter 13 independent of § 1322(b)(2). The logic of *Dewsnup* and *Nobelman* do not permit this construction.¹⁷²

The first problem with the court’s reasoning is that the remedies invoked in *Enewally*—modification under subsection 1322(b)(2) and maintenance of payments under subsection 1322(b)(5)—are both “mentioned . . . in the Code itself.”¹⁷³

The second defect in the Ninth Circuit’s reasoning is that the modification of secured debt does not occur “independent of [subsection] 1322(b)(2).” It occurs pursuant to subsection 1322(b)(2). The debtors in *Enewally* sought to apply two subsections of section 1322(b) to the same mortgage debt. Nothing in the Bankruptcy Code prohibits that application. As already explained, section 1322(b) authorizes it. There is nothing new about the application of the two subsections of section 1322(b) to the same mortgage debt. The authorizing language has been in the Code since 1978,¹⁷⁴ and many cases had previously applied the two subsections of section 1322(b) to the same debt.¹⁷⁵ Speaking of the interpretation later adopted by the court in *Enewally*, one court stated in 1998 that “the interpretation . . . flies in the face of the decisions rendered by virtually every bankruptcy court in the First Circuit that has addressed the question.”¹⁷⁶

Third, there is no “logic [in] *Dewsnup* and *Nobelman*” that bars the application of subsections 1322(b)(2) and 1322(b)(5) to the same claim.¹⁷⁷ Because the *Nobelman* mortgage was against a principal residence, the court had to decide whether the antimodification exception applied. The Court

171. *Id.* at 1171–72 (quoting *Dewsnup v. Timm*, 502 U.S. 410, 420 (1992)).

172. *Id.* at 1172.

173. *Id.* (quoting *Dewsnup v. Timm*, 502 U.S. 410, 420 (1992)) (internal quotation marks omitted).

174. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 101, 92 Stat. 2549, 2648–49 (enacting 11 U.S.C. § 1322).

175. *E.g.*, *Fed. Nat’l Mortg. Ass’n v. Ferreira (In re Ferreira)*, 223 B.R. 258, 262 (D.R.I. 1998) (“In short, subsections (b)(2) and (b)(5) are not mutually exclusive and a Chapter 13 plan may include a provision for curing default and maintaining payments with respect to the secured portion of an under-secured claim that has been bifurcated pursuant to subsection (b)(2) and § 506(a).”); *In re Pruett*, 178 B.R. 7, 9 (Bankr. N.D. Ala. 1995); *In re McGregor*, 172 B.R. 718, 719 (Bankr. D. Mass. 1994) (allowing a debtor to bifurcate a secured claim and then maintain payments on the secured portion only), *cited in In re Pruett*, 178 B.R. at 9.

176. *In re Ferreira*, 223 B.R. at 262.

177. *In re Enewally*, 368 F.3d at 1172.

held that the exception did apply because modification of the unsecured portion of the mortgage modified the “rights” of the mortgagee.¹⁷⁸ Because the *Enewally* mortgage was not against a principal residence, the antimodification provision did not apply. As a result, the issue decided in *Nobelman*—what rights or claims were modifiable—did not matter in *Enewally*. Subsection 1322(b)(2) is clear that unless the antimodification exception applies, a plan can modify any or all rights of the mortgagee.

The *Enewally* court’s mention of “logic” may be a reference to this passage in *Nobelman*:

The bank’s contractual rights are contained in a unitary note that applies at once to the bank’s overall claim, including both the secured and unsecured components. Petitioners cannot modify the payment and interest terms for the unsecured component, as they propose to do, without also modifying the terms of the secured component. Thus, to preserve the interest rate and the amount of each monthly payment specified in the note after having reduced the principal to \$23,500, the plan would also have to reduce the term of the note dramatically. That would be a significant modification of a contractual right.¹⁷⁹

The “logic” would be that the modification and payment maintenance sought in *Enewally* would reduce the term of the note in the same manner that the prohibited modification would have in *Nobelman*. But that logic of *Nobelman* does not apply to *Enewally*. By the Court’s reasoning, modification was prohibited in *Nobelman* because the mortgage was against a principal residence. But modification was not prohibited in *Enewally* because the mortgage was not against a principal residence.

Despite the poor quality of its reasoning, *Enewally* is the law of the Ninth Circuit. As a result, modification and payment maintenance is not likely to succeed in that circuit. Some courts in other parts of the country have followed the *Enewally* view.¹⁸⁰ Others have rejected that view.¹⁸¹ Most courts, however, have not yet ruled on the issue in a reported opinion. Hence, before employing the strategy advocated here, attorneys should attempt to determine how judges on the local panel are likely to rule.

178. *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 328 (1993) (“[Subsection 1322(b)(2)] does not state that a plan may modify ‘claims’ or that the plan may not modify ‘a claim secured only by’ a home mortgage. Rather, it focuses on the modification of the ‘rights of holders’ of such claims.”).

179. *Id.* at 331.

180. *E.g.*, *JPMorgan Chase Bank, Nat’l Ass’n v. Galaske*, 476 B.R. 405, 410–13 (D. Vt. 2012) (reversing a bankruptcy court’s order confirming a plan that bifurcated a mortgage and then reamortized the secured portion over a period longer than the plan); *In re Russell*, 458 B.R. 731, 737–38 (Bankr. E.D. Va. 2010) (discussing *Enewally* and concluding that the Fourth Circuit would follow it); *In re Plourde*, 402 B.R. 488, 491 (Bankr. D.N.H. 2009) (“If the debtor chooses to modify the terms of the claim, he must pay the amount of the secured claim as valued by the court in full within the life of plan [sic].”).

181. *See In re Elibo*, 447 B.R. 359, 364 (Bankr. S.D. Fla. 2011) (rejecting *Enewally* but refusing to confirm the plan because it reamortized the secured debt over a period longer than the plan); *see also* cases cited *supra* note 175.

B. Balloon Payment Plans

A second possible solution to the five-year limit on payments under the plan is to propose a balloon payment plan. A balloon payment plan is a plan that provides for amortization of the mortgagee's secured claim over a period beyond the plan—often thirty years—with a single “balloon” payment of the balance owing at the end of five years. The debtor proposes to make the balloon payment by selling or refinancing the house.

1. Feasibility

Feasibility is often an issue with balloon payment plans.¹⁸² A debtor proves feasibility by proving the ability “to make all payments under the plan and to comply with the plan.”¹⁸³ As one court put it, “Although plans requiring balloon payments are not necessarily unfeasible, courts view such plans with suspicion unless the debtor can show through definite and credible evidence that he will have the financial ability to make the balloon payment.”¹⁸⁴ To determine feasibility, courts consider a variety of factors.¹⁸⁵ The evidence will likely include expert testimony indicating that the house is likely to appreciate in value over the plan period to a sufficient extent that the debtor will be able to refinance or sell the house for an amount sufficient to pay the balance owing on the mortgage.¹⁸⁶

182. See, e.g., *In re Gillis*, 333 B.R. 1, 9 (Bankr. D. Mass. 2005) (positing that a proposed balloon payment plan is feasible); *In re St. Cloud*, 209 B.R. 801, 809 (Bankr. D. Mass. 1997) (“The majority of courts does not reject balloon payment plans as unfeasible *per se* and instead carefully scrutinizes plans with balloon payment provisions on a case-by-case basis, reviewing a plan’s feasibility based upon the totality of the circumstances.”).

183. 11 U.S.C. § 1325(a)(6) (2012).

184. *IRS v. Rader (In re Rader)*, No. TH 01-217-C-T/H, 2002 U.S. Dist. LEXIS 11057, at *5–6 (S.D. Ind. Apr. 17, 2002).

185. For example, one court provided this list:

To determine feasibility of a plan where a balloon payment on a secured debt is proposed, courts look to a number of factors. The factors include the future earning capacity and disposable income of the debtor, whether the plan provides for payment of interest to secured creditors, the debtor’s perseverance and motivation to execute the plan successfully, the type of employment in which the debtor is engaged or may become engaged, whether the plan includes a cushion for unexpected expenses, the equity in the property, whether the plan provides for recurring charges against the property, and whether the plan provides for payments to the creditor which will significantly reduce the debt and enhance the prospects for refinancing at the end of the plan.

Chelsea State Bank v. Wagner (In re Wagner), 259 B.R. 694, 701 (B.A.P. 8th Cir. 2001); see also *In re Rader*, 2002 U.S. Dist. LEXIS 11057, at *5–6 (listing six factors).

186. See, e.g., *In re New Midland Plaza Assocs.*, 247 B.R. 877, 887 (Bankr. S.D. Fla. 2000) (finding balloon payment plan feasible based on expert’s testimony that “the value of the property would increase between 2% and 3% per year”); *In re St. Cloud*, 209 B.R. at 810 (finding balloon payment plan feasible based on expert’s testimony that the debtor would have sufficient equity to refinance after five years of payments).

The necessary equity will typically come from two sources: (1) house value appreciation and (2) mortgage pay down. To illustrate the latter, assume that the house has a retail market value of \$200,000 at the time of bankruptcy and is subject to a mortgage that was initially in the amount of \$240,000, payable over thirty years at 8% interest. The monthly payment on that mortgage would initially have been \$1,761. Further, assume that the current balance is \$270,000.

Because the creditor seeks to sell the house and the debtor seeks to sell or refinance it, the house arguably should be valued net of selling expenses.¹⁸⁷ If those selling expenses are estimated at 7% of value, the house should be valued at \$186,000.¹⁸⁸ If the debtor maintains payments of \$1,761 per month at 8% interest for sixty months, the balance owing will be \$147,614.¹⁸⁹ Even if the house has not appreciated at all over the plan period, the debtor will have built up an equity of \$38,386 over the liquidation value net of selling expenses (21% of the \$186,000 value).¹⁹⁰

For 2013, market researcher CoreLogic predicts an increase in home prices of 6%,¹⁹¹ and Freddie Mac reported that home prices rose up to 4% over in 2012.¹⁹² If the value of the debtor's home in this example increased by 3% per year for each of the five years of the plan, the total increase would be from \$186,000 to \$215,625, an increase of 15.9%.¹⁹³

If the debtor made the plan payments and the house appreciated in value at the rate of 3% per year, at the end of five years, the house would be worth \$215,625, and the debtor would owe \$147,614 against it. The debtor would have an equity of \$68,011 over the liquidation value net of selling expenses (31%). With so large an equity, the debtor would likely be able to refinance before the end of the five-year period and make the balloon payment. Actual results could fall far short of these projections without rendering the plan infeasible.

187. See 11 U.S.C. § 506(a)(1) ("Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.").

188. \$200,000 less 7% of \$200,000 is \$186,000.

189. This is the amount shown as owing on a schedule for the amortization of \$186,000 with interest at 8%, in payments of \$1,761, at the end of five years.

190. \$186,000 less \$147,614 is \$38,386.

191. Julie Schmit, *Forecast: Home Prices Will Rise 6% in 2013*, USA TODAY (Jan. 15, 2013, 1:16 PM), <http://www.usatoday.com/story/money/business/2013/01/13/home-prices-corelogic-forecast/1827723/> ("Home prices . . . will rise 6% in 2013, market researcher CoreLogic predicts.").

192. Dunstan Prial, *Freddie Mac Sees Traction in 2013 Housing Recovery*, FOX BUSINESS (Feb. 8, 2013), <http://www.foxbusiness.com/economy/2013/02/08/freddie-mac-sees-traction-in-2013-housing-recovery/> ("U.S. housing prices are finally rising: up 4% over the past 12 months, according to Freddie Mac, but still down 22% from their peak around 2005.").

193. \$186,000 multiplied by 1.03 is \$191,580. \$191,580 multiplied by 1.03 is \$197,327.40. \$197,327.40 multiplied by 1.03 is \$203,247.20. \$203,247.20 multiplied by 1.03 is \$209,334.60. \$209,334.60 multiplied by 1.03 is \$215,625.

2. Periodic Payments

BAPCPA added the following requirement to subsection 1325(a)(5)(B) of the Bankruptcy Code: “[I]f . . . property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly amounts.”¹⁹⁴ Read literally, this provision does not prohibit balloon payment plans. The provision applies only to plan payments “in the form of periodic payments.”¹⁹⁵ Had the drafters intended it to prohibit both balloon payments and periodic payments, the drafters would have said “all plan payments” instead of “such payments.”

“Periodic payments” are payments that occur “repeatedly or regularly.”¹⁹⁶ Balloon payments do not fit that definition. One court put it as follows:

Authoritative dictionaries, however, universally agree that the word “periodic” simply refers to an event that occurs repeatedly or regularly. *See Webster’s Third New International Dictionary* 1680 (1981) (“occurring at regular intervals”); *Merriam–Webster Online Dictionary* (“occurring or recurring at regular intervals; occurring repeatedly from time to time”); *Black’s Law Dictionary* 1165 (8th ed.2004) (defining “periodic payment” as “[o]ne of a series of payments made over time instead of a one-time payment for the full amount”).¹⁹⁷

The payments that precede balloon payments are repeated and regular, but balloon payments are not. By definition, a balloon payment is always a last payment. Debtors make balloon payments by selling or refinancing. As a result, debtors do not make balloon payments on any schedule that can fairly be described as “periodic.” Debtors make balloon payments when the sales or loans close—irrespective of when they make their periodic payments.

Before and after the enactment of subsection 1325(a)(5)(B)(iii) of the Bankruptcy Code, debtors used formulae to specify the timing and amounts of periodic plan payments. For example, a formula might call for equal monthly payments over the plan period or 100 dollars a month over the first year and then equal semi-annual payments over the plan period’s remainder. The language of subsection 1325(a)(5)(B)(iii) indicates an intention to standardize these formulae.

The effort to standardize these formulae has nothing to do with balloon payments because the formulae do not apply to balloon payments. Balloon

194. 11 U.S.C. § 1325(a)(5)(B)(iii)(I) (2012).

195. *Id.*

196. *Hamilton v. Wells Fargo Bank, N.A.*, 401 B.R. 539, 544 (B.A.P. 1st Cir. 2009); *see also Bureau of Consumer Financial Protection—12 CFR Part 1026 (Regulation Z)—Truth in Lending*, BANKERSONLINE, <http://www.bankersonline.com/regs/12-1026/12-1026-036.html> (last visited Sept. 21, 2013) (showing that, effective January 10, 2014, 12 C.F.R. § 1026.36(c)(1)(i) will define “periodic payment” as used in the regulations as the “amount sufficient to cover principal, interest, and escrow (if applicable) for a given billing cycle”).

197. *Hamilton*, 401 B.R. at 544.

payments are one-time payments. The amount of a balloon payment is always the entire amount owing.

Only a few courts have interpreted subsection 1325(a)(5)(B)(iii) of the Bankruptcy Code. The plans in those cases were all poorly drafted in one crucial respect: the balloon payments were “in the form of periodic payments.” That is, in each case, the plan described the balloon payment as the last monthly payment in a series of payments. The provisions were merely the result of drafting errors because the debtors could not actually have intended to make the balloon payments on the periodic dates. The debtors would have had to make them whenever the sales or loans closed.

Most of these courts held that balloon payments were periodic. Unfortunately, most also stated that the periodic payments provision prohibits balloon payments.¹⁹⁸ As a result, balloon payment plans will be high risk in most jurisdictions.

Congress has never expressed an intention to ban balloon payments. In rejecting balloon payment plans, however, some courts cite this statement of the purported “remedial purpose” of the periodic payment provision:

Prior to BAPCPA, it was not uncommon for some Chapter 13 plans to provide for backloaded payments, such as balloon payments. Another form of backloading involved graduated or step-up payment plans, where the payments started out smaller and increased over time. Secured creditors, particularly those secured by a vehicle, viewed this as unfair, exposing them to undue risk in light of the constant depreciation of their collateral.

Other plans, filed by debtors whose employment is seasonal, provided for reduced payments or no payments at all during certain months of the year, or called for payments to be made quarterly or semi-annually, rather than monthly, based upon the peculiarities of the debtor's income stream. Secured creditors had similar complaints with those plans.

In response to those creditor concerns, Congress enacted the equal payment provision and a companion provision extending the concept of adequate protection, formerly a preconfirmation requirement, to postconfirmation plan payments. 11 U.S.C. § 1325(a)(5)(B)(iii)(II). The equal payment provision prevents debtors from backloading payments to secured creditors or paying them other than on a monthly basis.¹⁹⁹

198. *Id.* at 546; *In re Cupolo*, No. 12-51633, 2013 Bankr. LEXIS 486, at *4 (Bankr. E.D. Ky. Feb. 5, 2013); *In re Bollinger*, No. 10-62344-fra13, 2011 WL 3882275, at *4 (Bankr. D. Or. Sept. 2, 2011); *In re Luckett*, No. 07-24706-SVK, 2007 WL 3125278, at *2 (Bankr. E.D. Wis. Oct. 24, 2007); *In re Erwin*, 376 B.R. 897, 901 (Bankr. C.D. Ill. 2007); *In re Lemieux*, 347 B.R. 460, 464 (Bankr. D. Mass. 2006); *In re Wagner*, 342 B.R. 766, 772 (Bankr. E.D. Tenn. 2006); *In re DeSardi*, 340 B.R. 790, 810 (Bankr. S.D. Tex. 2006). *Contra In re Vause*, No. 6:09-bk-06224-ABB, 2010 Bankr. LEXIS 831, at *3 (Bankr. M.D. Fla. 2010); *In re Cooper*, 2009 Bankr. LEXIS 3737, at *7–8 (Bankr. M.D. Fla. 2009); *In re Davis*, 343 B.R. 326, 328 (Bankr. M.D. Fla. 2006). *But see* William J. McLeod, *Trick or Treat: A (Not-So)-Scary Look at Equal Monthly Payments Under § 1325(a)(5)*, AM. BANKR. INST. J., Oct. 2008, at 14, 71 (“[I]t appears that so long as the court determines that step payment plans or balloon payment plans do not run afoul of § 1322 or 1325(a), those plans may be confirmed in the absence of an objection.”).

199. *In re Erwin*, 376 B.R. at 901.

This statement is not formal legislative history. It is apparently merely one court's understanding of what Congress might have intended. The formal legislative history does not support that court's reading.²⁰⁰

Even assuming that the quoted passage correctly describes the problem that Congress sought to address, it does not follow that Congress intended to ban balloon payments. The language Congress used indicates a more limited purpose: to standardize the formulae for specifying periodic payments, without banning balloon payments. Congress may have thought that such standardization would make it easier for courts to assess and control the backloading problem, while at the same time continuing to allow balloon payments as a safety valve.

C. House-Distribution Plans

In jurisdictions where courts have rejected balloon payment plans, the solution may be for a debtor to distribute the debtor's house to the mortgage holder under the plan, subject to the debtor's option to repurchase it on or before the due date of the last plan payment. Such a plan does not propose a balloon payment. Instead, the plan proposes to transfer the house to the mortgage holder in equal monthly distributions, reserving in the debtor the right to repurchase the transferred portion by paying an amount equal to, or greater than, the mortgage debt.

To illustrate, such a plan might propose that the debtor will make sixty equal monthly distributions of property to the secured creditor, having an aggregate value, as of the effective date of the plan, equal to or greater than the amount of the secured claim. Each payment will consist of (1) a periodic payment of cash in the amount necessary to amortize the secured claim over a period of thirty years and provide adequate protection and (2) the transfer of a one-sixtieth ownership interest in the house, subject to the debtor's right to possession during the plan period. The plan would also provide the debtor the option, exercisable at any time prior to the due date of the last payment under the plan, to extinguish the mortgage debt and repurchase any ownership interest previously transferred by paying the mortgage holder an amount equal to, or greater than, the mortgage holder's secured claim.

The debtor can fix the option price by a provision in the plan.²⁰¹ Because the debtor is already proposing to pay the mortgage holder the amount of the secured claim, no minimum option price is required. The

200. See H.R. REP. NO. 109-31, pt. 1, at 71-74 (2005). The history states only as follows:

Section 309(c)(1) amends Bankruptcy Code section 1325(a)(5)(B) to require that periodic payments pursuant to a chapter 13 plan with respect to a secured claim be made in equal monthly installments. Where the claim is secured by personal property, the amount of such payments shall not be less than the amount sufficient to provide adequate protection to the holder of such claim.

Id. at 73.

201. See 11 U.S.C. § 1322(b)(11) (2012) ("[T]he plan may . . . include any other appropriate provision not inconsistent with this title.").

debtor may choose to offer a nominal amount in cash, or a significant amount in the form of a right in the creditor to share in the house's future appreciation, subject to the rights of any future buyer or future financier.

Such a plan complies with subparagraph B of subsection 1325(a)(5) of the Bankruptcy Code because the value of the property to be distributed under the plan "is not less than the allowed amount of [the secured] claim," and the payments—whether "payments" is interpreted to mean only monetary payments or distribution of any type of property—are in equal monthly amounts.²⁰²

V. ADVANTAGES OF SWAPPING

The legal strategies presented in this Article are equally applicable to debtors who lease each other's houses and to debtors who merely move out of their own houses and lease other houses. But the swap offers some advantages.

In a swap, two debtors live in similar houses in the same neighborhood. Each moves out of the debtor's own house and moves into the other's house. Each signs a lease agreeing to pay a market, or slightly below market, rental rate. If the debtors are well matched, the houses will be of the same size and quality, and the rent payments can be made by set-off.²⁰³ The risk of non-payment of rent is minimal because so long as the debtors remain in the houses, neither need make a cash payment.²⁰⁴

Swapping also has other advantages. First, the swapping debtors will file in the same bankruptcy court, will likely receive the same rulings, and therefore will likely need the properties for the same periods. Second, both debtors can be assured of suitable rental housing at the time they commit to the swap strategy. Third, financially distressed debtors may have difficulty qualifying for rental housing on the open market. But a bankruptcy attorney can, in effect, qualify swapping debtors as tenants for each other. Fourth, swapping enables the debtors to rent homes that are similar to, and physically close to, those that they own. Moving will not disrupt the debtors' patterns of living, commuting, or shopping, or require changes in the schools their

202. *Id.* § 1325(a)(5)(B). By relying solely on subparagraph B, the debtor avoids the issue of whether a debtor may use a combination of property distribution under B and surrender under C. *See, e.g., In re Gunten*, No. 10-21227, 2011 Bankr. LEXIS 2357, at *4–5 (Bankr. D. Wyo. June 14, 2011); *In re Elkins*, No. 04-67961, 2005 Bankr. LEXIS 2900, at *9 (Bankr. S.D. Ohio Aug. 16, 2005) ("The Court concludes—like the *Williams*, *Covington* and *Schwartz* courts—that § 1325(a)(5) sets forth mutually exclusive options for the treatment of secured claims, not alternatives that may be combined to form a composite remedy."), *cited in In re Gunten*, 2011 Bankr. LEXIS 2357, at *4.

203. Each of the two debtors would owe the other the same amount of money for rent each month. Both debts would be cancelled without the necessity of payment because payment of both debts would have no net effect. Neither debtor would make a payment to the other. The tax treatment of the rentals is beyond the scope of this Article.

204. The debtors could nevertheless default on their leases in respects other than non-payment. For example, one of the debtors might damage the house in a manner not covered by insurance.

children attend. Rental homes may not be available in the same neighborhood at a reasonable price.

Chapter 13 debtors can reject unexpired leases in their Chapter 13 plans.²⁰⁵ Two kinds of rejection are possible. First, a debtor may reject a lease under which the debtor is the lessor. Debtors can virtually eliminate that risk by filing simultaneously and commencing their leases immediately prior to filing. Once a lease term commences, the occupying debtor cannot be dislodged through lease rejection.²⁰⁶

Second, a debtor may reject the lease under which the debtor is the lessee. That risk would be small because the debtor would have made the decision to lease very recently and would have just incurred the expense of moving and filing the bankruptcy case. One can imagine, however, situations in which a debtor unexpectedly loses a job or an employer transfers the debtor to another city. Debtors can limit this risk by combining the leases in a single agreement that provides for an exchange of occupancy of the houses.

Either debtor could reject the exchange agreement and abandon the property, but rejection would release the other debtor from the reciprocal obligation to continue leasing the rejecting debtor's house. The effect would be that the rejecting debtor would be free to move to a new job, the rejecting debtor's lender would be free to foreclose, and the nonrejecting debtor would be free to return to the nonrejecting debtor's own house. An added benefit is that the return could occur immediately upon breach instead of at the end of the one-year term of the lease.

The nonrejecting debtor could still qualify for mortgage modification because the nonrejecting debtor did not occupy the rented house on the petition date. If, at the time of rejection, the nonrejecting debtor was concerned about the court's perception of these events, the nonrejecting debtor could prove good faith by remaining in the rental house and finding a substitute tenant.

The analysis is similar for the situation in which one debtor is able to confirm a plan (the "Successful Debtor"), but the other debtor is not (the "Unsuccessful Debtor"). If the Unsuccessful Debtor loses the house to foreclosure, the purchaser at the foreclosure sale could eject the Successful

205. 11 U.S.C. § 1322(b)(7) ("[A] plan may . . . provide for the . . . rejection . . . of any . . . unexpired lease of the debtor . . .").

206. *Id.* § 365(h)(1)(A)(ii) ("If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and . . . if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.").

Debtor.²⁰⁷ But the Successful Debtor could evict the Unsuccessful Debtor and move back into the Successful Debtor's own house.

Swapping has the obvious disadvantage of requiring a match of two debtors. High-volume Chapter 13 attorneys are the most likely matchmakers. It is unlikely that debtors who could benefit from home mortgage modification in Chapter 13 would be aware of this possibility. Attorney advertising may be an effective way to spread the word that bankruptcy mortgage modification is available.

CONCLUSION

Mortgage modification through bankruptcy is the best solution to the foreclosure crisis. It will enable debtors who can afford their homes to stay in them, assure mortgage holders greater returns than they would get through foreclosure, and relieve the downward pressure on housing prices that results from the resale of foreclosed houses.

Other institutions could modify home mortgages. But the bankruptcy system is preferable. Bankruptcy mortgage modification will not deprive mortgage holders of the substantial cash flow that they receive from Can-Pay-Loan-Balance Borrowers on underwater mortgages because only Can-Pay-Value Borrowers qualify for bankruptcy relief. The standards for bankruptcy relief are well developed and the bankruptcy judiciary is experienced in administering them.

The move-out, strip-down strategy provides a way around *Nobelman*. It takes advantage of the flexibility that Congress apparently intended in the antimodification exception. For the strategy to work will require the combined efforts of debtors desperate to save their homes, attorneys capable of administering a complex strategy, and judges willing to follow the law even though it disadvantages powerful interests. If a few debtors succeed, their success will inspire others. If enough succeed, their success may sufficiently embarrass the country's political leaders so that they will legislate an end to *Nobelman*.

207. Under the law of most states, mortgages have priority over leases unless the parties agree otherwise. See, e.g., *Reilly v. Firestone Tire & Rubber Co.*, 764 F.2d 167, 171 (3d Cir. 1985) ("The general rule in Pennsylvania is clear and is not disputed by the parties: a tenant for years loses his right of possession relative to a purchaser at a judicial sale when the foreclosure is on a mortgage recorded prior to the making of the lease.").