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Back to the Future with Chapter 13: A Response to Professor Scarberry

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Professor Mark Scarberry has put forth a formidable critique of my empirical study of mortgage market sensitivity to bankruptcy modification risk. As this response shows, however, his critique does not hold up under scrutiny.

Professor Scarberry argues that my study design is invalid because, as he reads the current state of the law, cramdown is virtually impossible. Therefore, he contends, we should not expect markets to exhibit sensitivity to cramdown risk, so no policy conclusions can be derived from my finding of market insensitivity.

Regrettably, Professor Scarberry overreads the state of the law. The law is in fact unsettled, and that is all that is necessary to uphold the validity of my study's design because the market can be expected to price for uncertainty about the law, and the absence of such a premium is significant.

This response article also challenges Professor Scarberry's contention that Chapter 13 relief should be limited lest it engender "resentment" of debtors. The article questions whether prevention of resentment even provides a sound basis for limiting bankruptcy relief, much less when relief would further an important macroeconomic goal of housing market stabilization.

More broadly, the article takes issues with claims about the sanctity of secured credit. Debates about the efficiency of secured credit have all played out in the business context. In the consumer context, however, the inefficiency is manifest. Treating secured credit as inviolable would take us back to the unhappy future of Chapter XIII with higher costs for unsecured credit and the abusive consumer finance world of Williams v. Walker-Thomas.

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INTRODUCTION

Professor Mark S. Scarberry's recent article, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13 Bankruptcy*,[1] takes sharp issue with my argument that permitting judicial modification of mortgages in bankruptcy would be an important step in resolving the foreclosure crisis and likely have little or no impact on the cost of mortgage credit or mortgage credit availability. My argument about judicial modification of mortgages was developed in several forms: Congressional testimony,[2] a short online article,[3] and, in its most fully developed form, in a full-length print article, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*.[4] Reference herein is to the print article.

At the core of *Resolving the Foreclosure Crisis* are a set of three natural experiments on market pricing that exploited variation in legal treatment of different types of mortgages to examine market price sensitivity to legal rules.[5] The article is premised on the existence of a variation in legal treatment of different types of mortgages in bankruptcy—it is possible to

1. 37 PEPP. L. REV. 635 (2010).

2. *The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform?: Hearing Before the S. Judiciary Comm., Subcomm. on Administrative Oversight and the Courts*, 111th Cong. (2009) (statement of Professor Adam J. Levitin); *Helping Families Save Their Homes in Bankruptcy Act of 2009, and the Emergency Homeownership and Equity Protection Act: Hearing on H.R. 200 and H.R. 225 Before the H. Comm. on the Judiciary*, 111th Cong. 35–37 (2009) (statement of Professor Adam J. Levitin); *Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing on the Bankruptcy Act, S.61 Before the S. Judiciary Comm.*, 110th Cong. (2008) (statement of Professor Adam J. Levitin).

3. Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3. HARV. L. & POL'Y REV. 1 (2009), http://www.hlpronline.com/Levitin_HLPR_011909.pdf.

4. Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. 565 (2009).

5. *Id.*

modify mortgages on multifamily homes, second homes, and vacation homes, but not mortgages secured solely by single-family principal residences. In spite of this difference in legal treatment, I find that pricing in the secondary mortgage market and private mortgage insurance market does not reflect a risk premium, while there is a small one for high-risk borrowers in the primary market.

I explain this apparent market indifference to variations in bankruptcy modification risk by showing that lenders typically lose more in a foreclosure than if a mortgage is modified in bankruptcy. Therefore, I argue, there would be no reason for the market to price adversely to the ability to modify a mortgage in bankruptcy. Accordingly, I contend, permitting modification of all mortgages in Chapter 13 should not be expected to result in more than a *de minimis* increase in the cost of credit or decline in credit availability.

Professor Scarberry contends that my study relies "on incorrect understandings of current and past bankruptcy law and of the proposed legislation."[6] In particular, he argues that under existing law, there is functionally no ability to cramdown *any* property in bankruptcy. Therefore, Professor Scarberry claims, there is no real variation in legal treatment, and we should not expect any market pricing variations, which means that my experiments do not provide evidence of market indifference to bankruptcy modification risk. Thus, Professor Scarberry observes that for my experiments to validly predict the impact of permitting judicial modification of single-family principal residence mortgages, two conditions must be met:

> (1) the kind of Chapter 13 strip down permitted under the proposed legislation must be the same kind as the kind currently available, or at least very similar to the kind currently available, and (2) the likelihood of such a Chapter 13 strip down actually being accomplished under current law must be the same, or at least very similar, to the likelihood of strip down being accomplished under the proposed legislation. Unless both those conditions can be established, we cannot say that the risk imposed on lenders will be the same, and we thus cannot say that their response in terms of

6. Scarberry, *supra* note 1, at 644. I will not address Professor Scarberry's claims that I misunderstand the proposed legislation beyond stating that I consulted in its drafting and believe that my understanding of the legislation speaks for itself.

higher interest rates or reduced mortgage availability will be the same.[7]

In Professor Scarberry's analysis, these two conditions largely merge; he contends that stripdown is almost never feasible given the current constraints on stripdown for multifamily homes, second homes, and vacation homes.[8] From this Professor Scarberry concludes that the status quo is preferable to a situation in which mortgage modification were more generally available in Chapter 13.[9]

This would be a powerful critique, if correct. It is not, however. Professor Scarberry is wrong on the law, wrong on the economics, and wrong on the policy animating bankruptcy. The current state of the law does not contain the constraints on cramdown alleged by Professor Scarberry. Instead, the law is unsettled, and for my study to be valid, all that is needed is uncertainty about the law because the market can be expected to price for uncertainty about the law and the chance that mortgages can in fact be modified. Therefore, the absence of an observable risk premium is significant. Perhaps more critically, market behavior shows that the *market* believes that there are variations in modification risk, and ultimately it is what the market, not Professor Scarberry, believes about the law that matters.

This response is organized as follows. Part I shows that the differences between existing and proposed Chapter 13 modification are quite minimal.[10] The major difference alleged by Professor Scarberry—whether a modified mortgage must be paid off in full within five years—is an unsettled matter of law. There is no textual support for Professor Scarberry's position in the Bankruptcy Code; there is no policy basis for his position; the scant case law is not unanimous on the issue and should hardly be taken as an indication of bankruptcy practice; and the secondary sources cited by Professor Scarberry (including one authored by me) do not say what he believes they mean.

Part II explains that even if Professor Scarberry were correct about the state of the law, that does not provide evidence of market sensitivity to bankruptcy modification of mortgages, and there is strong reason to believe that it would not be price sensitive.[11] It also explains that even if markets are price sensitive to bankruptcy modification, this alone is not a reason to oppose modification.[12]

7. *Id.* at 721–22.

8. *See id.* at 721–25.

9. Underlying Professor Scarberry's reasoning is an unstated argument in favor of the status quo in the absence of evidence. It is unclear why in such circumstances the status quo should be preferable.

10. *See infra* notes 14–34 and accompanying text.

11. *See infra* notes 35–40 and accompanying text.

12. *See infra* notes 35–40 and accompanying text.

Part III examines Professor Scarberry's concern that permitting Chapter 13 mortgage modification would result in harmful resentment of debtors. It questions whether protecting debtors from intangible resentment is a sound basis for denying them real monetary relief, and whether resentment is ever a sound basis for policy, much less a reason that would trump pressing macroeconomic concerns.

The response concludes by evaluating the implications of opposing mortgage modification in bankruptcy, which takes us to a world in which secured credit is sacrosanct.[13] Treating secured credit as inviolable would take us back to the unhappy future of Chapter XIII (referred to now as "Roman 13"), higher costs for unsecured credit, and the abusive consumer finance world of *Williams v. Walker-Thomas*.

I. PROFESSOR SCARBERRY'S DOCTRINAL READING IS WRONG

Professor Scarberry claims that under current bankruptcy law it is impossible to modify not only a mortgage loan on a single-family principal residence, but also mortgages on any other type of residential property, except in rare cases. The basis for Professor Scarberry's claim is that a Chapter 13 "plan may not provide for payments over a period that is longer than 5 years."[14] As Professor Scarberry notes:

> Does a debtor belong in bankruptcy who is so flush with cash that he or she can afford to pay off the entire value of his or her home with interest over a mere five years? A Chapter 13 plan, under which the debtor would do so, would be proposed in bad faith, and thus not confirmable, at least unless it also provided for full payment of all unsecured claims.[15]

Therefore, in Professor Scarberry's view, almost no mortgages can functionally be modified in bankruptcy because almost no debtor can pay off a mortgage within five years without running afoul of other Bankruptcy Code provisions.[16]

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13. *See infra* notes 48–64 and accompanying text.

14. 11 U.S.C. § 1322(d).

15. Scarberry, *supra* note 1, at 665 (footnote omitted).

16. To emphasize this point, Professor Scarberry observes that "the quotes Professor Levitin obtained for his study were for quite substantial mortgages." Scarberry, *supra* note 1, at 723. The implication is that for smaller mortgages—which could be paid off within five years—my findings do not hold. This is incorrect. Professor Scarberry mistakes the thirty quotations given in an illustrative appendix as evidence of the extent of my research. My study had a sample of 530

Professor Scarberry is wrong regarding the state of the law. Rather than clearly supporting his position, it is unsettled. A plain reading of the relevant statutory text plus a rational understanding of policy embodied in the text indicates that a modified mortgage need not be paid in full within five years. Instead, the mortgagee must merely receive the net present value of the mortgage, which could take the form of a new secured note.

A. *A Plain Reading of the Bankruptcy Code Indicates a Broad Ability to Modify Most Mortgages*

There are several problems with Professor Scarberry's claim about the status of the law. First, the law is simply not clear on whether a mortgage debt must be paid off in full by the end of the Chapter 13 plan. While the Bankruptcy Code requires that payments under a plan be made within no more than five years, the Code does not say what it means by "payments." The term payment does not necessarily mean cash payments, as Professor Scarberry assumes.

Other provisions in Chapter 13 show that the term "payments" is clearly not limited to cash payments.[17] First, Chapter 13 explicitly calls for cash payments in the context of payments made on claims entitled to priority under section 507 of the Bankruptcy Code: "The plan shall . . . (2) provide for the *full payment, in deferred cash payments*, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim."[18] The explicit reference to "full payment" as well as to "deferred cash payments" contrasts with the Code's requirement for repayment of allowed secured claims, such as home mortgages, for which the mortgagee must receive "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."[19] This distinction was noted by Justice Thomas in his concurrence in *Till v. SCS Credit Corporation*: "nothing in § 1325 suggests that 'property' is

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quotations, half of which were for less than the conforming loan amount. Levitin, *supra* note 4, at 587. I did not report the loan amounts for all price quotations, but they went as low as $100,000—less than half the national average—and showed no change. The particular illustration given included a loan for $320,000 in California, which is less than the average California mortgage amount of $331,926. Mortgage Bankers Association, *Stop the Cramdown Resource Center*, http://www.mortgagebankers.org/StopTheCramDown (last visited Jan. 31, 2010). The phenomenon of pricing indifference in the primary market does not depend on loan size.

In fairness, Professor Scarberry does note the possibility that a mortgage could simply be refinanced within the term of the plan. Scarberry, *supra* note 1, at 666 n. 131.

17. Since October 2005, the Bankruptcy Code has contained additional language that further constraints Chapter 13 plans, but the new language does not change the meaning of the terms "payments" or "value."

18. 11 U.S.C. § 1322(a)(2) (emphasis added).

19. 11 U.SC. § 1325(a)(5)(b)(ii).

limited to cash. Rather, 'property' can be cash, notes, stock, personal property or real property; in short, anything of value."[20]

Accordingly, from a plain language reading of the text, there is no requirement that secured claims receive "full payment" during the course of the plan or that the payments be made in cash. Rather, the secured lender is entitled to the "value" of its claim, as of the effective date of the plan. If the property can be "crammed down," then the "value" of the claim is the value of the collateral. This value could be in the form of a new mortgage note, so long as it provided for equivalent net present value to the lender. Section 1325(a)(5)(b)(ii) is a net present value test for a Chapter 13 plan payment—precisely what Professor Scarberry believes to be essential for Chapter 13 to be fair to creditors.[21]

B. Professor Scarberry's Textual Reading Would Result in a Policy Absurdity

My reading of the text comports with a reasonable policy directive: that Congress wanted to favor single-family principal residence mortgages in order to encourage single-family homeownership but did not want to encourage multifamily, rental, or vacation homeownership. To accept Professor Scarberry's reading of current doctrine—that payment in full for a modified mortgage must be made within the term of the plan—we would have to assume a nearly absurd policy directive from Congress: that Congress, in its infinite wisdom, wanted to forbid all mortgage modifications except modifications of mortgages of multifamily residences, vacation homes, and rental properties, if the modified mortgage could be paid off within three to five years. There is absolutely nothing in the legislative history that supports the belief that Congress wanted this peculiar outcome, and there is no compelling policy reason for it. Yet this is the absurdity that Professor Scarberry's reading would force on the text.

C. Caselaw and Secondary Sources Are Inconclusive

Professor Scarberry marshals a number of sources to support his reading of the law. First, he turns to caselaw.[22] He relies heavily on the Ninth Circuit's ruling in *Enewally v. Washington Mutual Bank*[23] and dicta in the

20. 541 U.S. 465, 488 (2004).
21. Scarberry, *supra* note 1, at 636–48.
22. Scarberry, *supra* note 1, at 661–67.
23. *In re Enewally*, 368 F.3d 1165, 1172 (9th Cir. 2004).

Second Circuit's ruling in *Bellamy v. Federal Home Loan Mortgage Corporation*.[24] He also cites for support a passing line in an academic article[25] and a sentence in a report by the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP).[26]

Neither the primary nor secondary sources cited by Professor Scarberry are anywhere close to dispositive. At best, what can be said is that the law is unclear on the issue. That uncertainty is all that is necessary for my experiments to be valid, because the market can be expected to price for the downside risk in an uncertain outcome.

There are three problems with reliance on *Enewally* and *Bellamy*. First, there is countervailing law.[27] *In re McGregor*, a bankruptcy court decision from 1994, suggested that a debtor might amend a plan to provide for payments on stripped-down principal at the original contract interest rate in the amount called for by the mortgage contract until the total principal payments equaled the allowed amount of the secured claim.[28] Admittedly, it is only a single bankruptcy court's opinion, but it is still good law; a ruling by a single appellate panel is hardly a definitive and final expression of the state of the law.

Second, *Enewally* was decided too late to affect all of my experiments. *Enewally* was decided in 2004. The data for one of my three experiments is from 1989–1993, so *Enewally* is irrelevant to its outcome. I do not have pre-*Enewally* data from my other experiments, but there is no reason to think that mortgage insurance or GSE delivery fee pricing changed in response to *Enewally*. There are some other earlier lower court opinions that align with *Enewally*, but all they do is point to the uncertainty of the issue.

Just as *Enewally* is too recent to affect all of my experiments, *Bellamy* is too old and not on point. *Bellamy* is a pre-*Nobelman* decision and its three sentences regarding whether a modified loan must be paid off in five years are dicta; the debtors were not attempting to pay a modified loan off over more than five years, but to strip the lien to the value of the collateral.[29]

Third, reported case law may be a poor guide to actual Chapter 13 practice. Most of bankruptcy law exists outside of reported case law, especially in the Chapter 13 context. Judges will frequently rule orally from the bench, and most issues are resolved consensually, if they are contested at

24. *In re Bellamy*, 962 F.2d 176. (2d Cir. 1992).

25. Scarberry, *supra* note 1, at 707 (citing John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123).

26. Scarberry, *supra* note 1, at 669 (citing CONGRESSIONAL OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION 54 (2009) [hereinafter WORKING TOWARD A SOLUTION], http://cop.senate.gov/ documents/cop-030609-report.pdf).

27. *See* Levitin, *supra* note 4, at 580 n.40.

28. 172 B.R. 718, 721 (Bankr. D. Mass. 1994).

29. 962 F.2d at 177.

all. Relative to other areas of law, Chapter 13 is the Wild West; much is done informally and is negotiated. Bankruptcy courts are courts of the deal, and we assume legal practice from a handful of reported cases or dicta at our peril. Opinions like *Enewally* are merely starting points for the negotiations that are the heart of bankruptcy.

The secondary sources relied upon by Professor Scarberry are also thin support for his position.[30] A passing reference in an academic article cannot be taken as a considered opinion on the state of the law on this issue. Likewise, a single sentence in a 198-page monthly government report provides scant support.

Professor Scarberry attempts to disguise the weakness of these sources by appealing to the prestige of the authors,[31] but that does not affect the quality of the sources as support.[32] Moreover, as Special Counsel to the Congressional Oversight Panel, I was the drafter of the report in question. The cited line does not bear the meaning dragooned onto it by Professor Scarberry. It says what it means and means what it says—that payments under a plan must be made in five years. It does not address what is meant by a "payment." Reading it as "full cash payment" is Professor Scarberry's gloss.

D. *The Market Believes There Is a Broad Ability to Modify Mortgages in Chapter 13*

Professor Scarberry overreads the present state of the law. But whether my reading or Professor Scarberry's reading of the existing law is correct is ultimately irrelevant. What matters is what the market believes. And the evidence indicates that the market at least believes the law to be unsettled.

30. Among Professor Scarberry's primary authorities is himself. Thus, when Professor Scarberry states, "Even though serious flaws in his empirical studies have been pointed out, Professor Levitin continues to claim in congressional testimony that 'the clear finding from [his] research is that mortgage prices are largely insensitive to bankruptcy modification risk.'" Scarberry, *supra* note 1, at 643–644 (footnote omitted). The "serious flaws" are merely the claims of Professor Scarberry. My failure to agree with Professor Scarberry cannot possibly determine the merits of my argument.

31. Scarberry, *supra* note 1, at 669 (gratuitously invoking that the Congressional Oversight Panel is chaired by Harvard Law Professor Elizabeth Warren); *id.* at 716 (same); *id.* (referring to "the authors of a recent and impressive empirical study, including Professor Katherine Porter," the second, but perhaps academically best known, of three co-authors).

32. I caution readers in general not to assume that Congressional Oversight Panel reports reflect the views of any particular Panelist, including the Chairperson. Reports are produced under significant time constraints on a consensus basis, and the Panel does not issue legal opinions.

The mortgage market itself evinces an awareness of variation in modification risk. Many securitization deals provide for a separate loss-sharing mechanism for losses above a minimum threshold caused by bankruptcy modification as opposed to losses caused by normal defaults.[33] There is no reason for such a distinct mechanism if there is no meaningful risk of modification.

Likewise, if Professor Scarberry is correct, why are debtors bringing cases that seek to modify mortgages on multifamily properties? What good would this do them? Are they simply misguided? If so, why are creditors fighting them over the right to modify if it is a meaningless right?

Whether Chapter 13 requires that a modified mortgage be paid off within five years is an open question, not open-and-shut as Professor Scarberry alleges.[34] Responsible counsel would not advise a lender that there is no risk of judicial modification in Chapter 13 regardless of type of property. And that is all that is necessary to uphold the validity of my empirical study, as we can expect the market to price for risk when there is uncertainty due to unsettled law. As the following section explains, the fact that such a premium is not observable is a function of the relationship between foreclosure risk and modification risk.

II. PROFESSOR SCARBERRY'S CRITIQUE MISSES THE BIGGER POINT

Even if Professor Scarberry is right about the state of the law, his argument only goes to the design of my natural experiments.[35] It does not say anything about the ultimate question of whether permitting bankruptcy modification of single-family principal residence mortgages would result in higher costs and lower availability of credit.

Even if my natural experiments could not support a finding of market indifference to bankruptcy modification risk, it would not follow that markets are sensitive to the risk, only that indifference has not been proven. Professor Scarberry proclaims a credo of: bankruptcy losses = higher costs of credit = less credit availability, as if it were self-evident:

> Interest rates and mortgage availability are sensitive to expected losses. Expected losses from strip down would seem undoubtedly

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33. Levitin, *supra* note 4, at 649 n.302; *see also, e.g.*, Pooling and Servicing Agreement, Chase Mortgage Finance Trust, Series 2007-A1, Feb. 1, 2007, Article I (providing for special distribution of bankruptcy losses among tranches).

34. *See also* Posting of Robert Lawless to Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2007/12/equal-footings.html#more (Dec. 17, 2007 12:21 PM) (arguing that modified mortgage can be paid off in over five years).

35. I use the term "natural experiment" to refer to any situation in which real world events create the opportunity for comparing two groups. The term is sometimes reserved for situations in which there is a mechanism for randomly assigning units to conditions.

> to be higher where strip down is used by debtors who cannot afford to pay their current contractual monthly mortgage payments as compared to those who can afford to make that payment and more, or even afford to pay off the entire mortgage in five years. This additional flaw makes it even less likely that Professor Levitin's empirical studies could provide reliable evidence that enactment of the proposed legislation would have little effect on mortgage interest rates and mortgage availability.[36]

In fact, Professor Scarberry has the economics of lending backwards. The expected losses would be *smaller* if stripdown were available not only to those who can already afford to pay their mortgages (or pay them off within five years), but to those who cannot afford to pay. If a debtor can afford to pay the mortgage, then from a creditor's perspective, stripdown is pure loss.

Professor Scarberry is so focused on bankruptcy doctrine that he fails to recognize that bankruptcy is a not a universe unto itself. Bankruptcy outcomes must always be compared with nonbankruptcy outcomes. In this case, the appropriate baseline for evaluating bankruptcy is foreclosure. If a debtor cannot afford to pay the mortgage, then a foreclosure will result. Therefore, we must compare the losses a lender will incur in foreclosure with those the lender would incur with a bankruptcy modification. The lender will undoubtedly incur a loss in bankruptcy, but as long as that is smaller than that which would attain in foreclosure, the magnitude of the bankruptcy loss is irrelevant; the lender will not price against the ability to modify in bankruptcy. My article provides a fair amount of empirical support for this; more recent empirical work by Professor Alan White confirms it.[37] This is the major argument of my article; the empirical work merely provides support for it, yet Professor Scarberry focuses on the empirics and misses the bigger point.

Incredibly, for someone who has just engaged in an exacting critique of empirical research, Professor Scarberry feels free to engage in a wild reverie of speculation. If judicial modification were allowed, he prophesizes that "the typical borrower would be forced to pay at least a half percent and perhaps a full one percent higher mortgage interest rate, and the higher risk

36. Scarberry, *supra* note 1, at 724.

37. *See* Alan M. White, *November 26, 2009 Columbia Collateral File Summary Statistics*, http://www.valpo.edu/law/faculty/awhite/data/nov09_summary.pdf (finding an average loss on foreclosure of $143,987–$151,000, equivalent to 64–65% loss severity, as compared with 6–10% loss severity in modification).

borrower would pay an interest rate two or three percent higher than the rates that otherwise would be charged."[38]

To put the extravagance of his predictions in perspective, the average rate on the 30-year fixed rate mortgage for the past 20 years has been 7.36%, a mere 166 basis points above the average 10-year Treasury bond yield.[39] Thus, the *entire* risk premium, on average, for a 30-year fixed rate mortgage for the past two decades is but 166 basis points, yet Professor Scarberry is positing an average impact of 50–100 basis points, and 200–300 for high risk borrowers. Even if bankruptcy did result in greater losses than foreclosure, it is a much rarer event and would likely remain so even if mortgage modification were permitted in Chapter 13, as Chapter 13 still requires plan feasibility. Most financially distressed homeowners do not file for bankruptcy; the belief that permitting Chapter 13 modification of mortgages would result in an increase in mortgage interest rates of 50–100 basis points on average is simply ludicrous. Professor Scarberry's predictions are not in the realm of possibility.

Still, it's worth playing out the scenario that animates Professor Scarberry's thinking. What if permitting judicial modification of mortgages would result in a higher cost of credit or less credit availability? Would this be a bad thing? Professor Scarberry's reflexive answer is yes. I suggest that the answer is more complicated and depends on the magnitude of the impact and the distribution of the cost.

Bankruptcy functions like mandatory insurance against financial distress; the cost is borne by everyone ex-ante in the form of a "premium" for higher costs of credit, even though only a small number of "policyholders" ever file a "claim" on the "policy."

Consider Chapter 13 cramdown, which reduces the allowed amount of a secured claim to the value of the collateral (leaving the rest of the claim as unsecured). For a mortgage this is just a type of property depreciation insurance. Property depreciation is an insurable event—it is a fortuitous occurrence beyond the borrower's *control* if the national (or local) housing market slumps. The borrower even pays a "deductible" here in the form of its lost down payment plus any other previously accrued equity, which reduces moral hazard. We should only require such mandatory insurance if it is socially efficient, and that depends on its pricing—the cost/availability of credit impact. The evidence I have previously adduced points strongly towards its efficiency,[40] but further research would enhance our understanding.

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38. Scarberry, *supra* note 1, at 726.

39. Ten-year Treasuries are the typical comparison for 30-year fixed rate mortgages because the average mortgage is prepaid in 7–10 years.

40. *See generally* Levitin, *supra* note 4.

III. RESENTMENT AS A BASIS FOR POLICY?

Professor Scarberry never takes a firm normative position on Chapter 13 mortgage modification in his article. He suggests ways that modification legislation might be made more palatable,[41] but that is hardly an endorsement of the modification concept, and the changes he would have make would geld Chapter 13 as a mortgage modification tool, allowing only "modest modifications in limited circumstances."[42] At best, this is a grudging, nominal endorsement of Chapter 13 modification. Such a watered-down form of Chapter 13 modification would be ineffective at addressing the collapse of the housing market.

Professor Scarberry argues that these limitations are necessary to address "moral hazard, self-cure risk, redefault risk, and creation of resentment."[43] Plan feasibility requirements[44] already cover redefault risk. The other elements basically boil down to resentment of the granting of debt relief debtors who can afford their mortgage or who stand to gain a free option on future appreciation of their property.[45]

Professor Scarberry's emphasis on resentment is puzzling.[46] Chapter 13 is hardly a "drive-by" process,[47] and no evidence has ever been adduced of a systematic problem of debtors gaming the bankruptcy system to get unmerited relief. How many people would really resent their neighbors for having to live for five years on a strict, court-supervised budget? How many people would agree to live on such a budget (and have their credit score damaged for ten years) simply to have the *chance* that they might capture some potential appreciation on their property? I think very few indeed.

What is this resentment then? Is it a resentment of profligate individuals who bought more home than they really could afford getting able to keep their McMansions? Is it a resentment of *potentially* higher future mortgage

41. Scarberry, *supra* note 1, at [283-291—basically the conclusion section of Scarberry's article]

42. *Id.*, at [291—this should be the last or second to last page of his article].

43. *Id.* at 285 [this is in the Conclusion].

44. 11 U.S.C. § 1325(a)(6).

45. This concern is largely theoretical. There is little likelihood of substantial future appreciation over the next five years; certainly housing price futures do not anticipate it. The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform?, Hearing Before the Senate Committee on the Judiciary Subcommittee on Administrative Oversight and the Courts, 111th Cong., July 23, 2009 (written testimony of Adam J. Levitin), at 6, *available at* http://judiciary.senate.gov/pdf/07-22-09LevitinTestimony.pdf. Moreover, any appreciation after the term of a plan would always be the debtor's.

46. Professor Scarberry uses the term "resentment" repeatedly. Scarberry, *supra* note 1, at [give page cites for the 9 times Scarberry mentions resentment]

47. *Id.* at 11.

prices because of mandatory bankruptcy "insurance"? Why would this engender more resentment than using federal tax dollars to subsidize the ineffective HAMP modifications Professor Scarberry supports?

No one likes the thought of profligate parvenus using Chapter 13 to retain ownership of houses that are out of the reach of hardworking yeomen who live within their means. But should minimization of the resentment that would engender really be the basis for federal bankruptcy policy? Protecting debtors from generalized, intangible resentment is not a compelling reason for limiting their relief from real monetary obligations. Chapter 13 mortgage modification can contribute substantially to housing market stabilization, and, as my research indicates, it comes at little or no cost to future borrowers. Surely pressing macroeconomic concerns, like stabilizing the housing market trump any neighborly resentments.

IV. BACK TO THE FUTURE WITH CHAPTER 13?

Irrespective of whether Professor Scarberry ultimately supports Chapter 13 mortgage modification in any meaningful sense, it is important to recognize the implications of opposition to mortgage modification in bankruptcy. Opposing mortgage modification is tantamount to expressing a belief in the inviolability of secured credit. Since the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), a good deal of secured credit has been inviolable. BAPCPA made many auto loans untouchable.[48] Principal residence single-family mortgages are inviolable too,[49] and functionally, Professor Scarberry argues, so are all other mortgages. Homes and cars account for the bulk of secured credit. Non-purchase money security interests in consumer goods are illegal,[50] and most major consumer goods are purchased using unsecured credit cards. The only major exception would be for boats, off-road vehicles,[51] and aircraft. Thus, in the world as described by Professor Scarberry, secured lenders are safe unless they are lending against boats, snowmobiles, and aircraft.

This is functionally a return to Chapters XII and XIII (now called "Roman 12" and "Roman 13," respectively) under the Bankruptcy Act of 1898. Chapter XII permitted "arrangements" that would modify non-

48. 11 U.S.C. § 1325(a)(9) (hanging paragraph).

49. 11 U.S.C. § 1322(b)(2).

50. 12 C.F.R. § 227.13(d) (2009) (all banks except savings banks that are members of the Federal Home Loan Bank System); 12 C.F.R. § 535.2(a)(4) (2009) (federal thrifts and federally insured thrifts); 12 C.F.R. §706.2(a)(4) (2009) (federal credit unions and federally insured credit unions); 16 C.F.R. § 444.2(a)(4) (nonbanks).

51. 49 U.S.C. §30102(a)(6) (2006) ("'[M]otor vehicle' means a vehicle driven or drawn by mechanical power and manufactured primarily for use on public streets, roads, and highways, but does not include a vehicle operated only on a rail line.").

corporate debts secured by real property.[52] Most home mortgages were ineligible for Chapter XII arrangements,[53] and for those that were, the mortgagee nearly always had the power to veto any plan.[54] Chapter XIII permitted wage earners' plans that allowed for modification of unsecured debt,[55] but required the consent of any secured creditor, unless that creditor was paid 100 cents on the dollar or the collateral was surrendered.[56] Thus under Chapters XII and XIII only unsecured debts could be modified absent creditor consent. Given the limited value of these provisions, there were few filings under either Chapter. From 1965–1974, annual Chapter XII filings averaged 86, and Chapter XIII filings averaged 29,166.[57]

Not surprisingly, given the divergent treatment of secured and unsecured credit under the Bankruptcy Act, secured credit was far more common. Creditors were incentivized to lend against collateral. Household items like washing machines, kitchen furniture, and babies' cribs were all commonly financed using secured credit, rather than with unsecured credit cards, like today.

Because of the frequency of secured credit, unsecured credit was more expensive. If more lenders lend against collateral, then there will be fewer assets available to satisfy judgments of unsecureds, who have to protect themselves with a price premium.[58] The more favored the treatment of secured credit, the higher the cost of unsecured credit.

52. Chandler Act of June 22, 1938, ch. 575, 52 Stat. 840, 916–30 (1938).

53. Chapter XII excluded from its coverage all mortgages insured by the Federal Housing Administration, guaranteed by the Veterans' Administration, or held by the Home Owners' Loan Corporation, Federal Home Loan Banks, or the savings and loans that were members of the Federal Home Loan Banks. 11 U.S.C. § 517 (1976) (repealed 1978). This effectively made most home mortgages ineligible for Chapter XII arrangements.

54. An arrangement could only be confirmed, however, if it was approved by the holders of two-thirds of the affected debt. 11 U.S.C. § 468 (1976) (repealed 1978). For a consumer mortgagor, this meant an effective veto power over arrangements by first mortgagees (and potentially by junior mortgagees) because they were likely to hold at least one-third of the mortgage debt.

55. Chandler Act of June 22, 1938, Ch. 575, 52 Stat. 840, 930–38 (1938).

56. Chapter XIII placed no statutory limitations on the ability to modify a secured debt, including a mortgage, as part of a wage earner's plan. 11 U.S.C. § 646 (1976) (repealed 1978). A wage earner's plan that affected a secured debt could not be confirmed, however, without the consent of the affected secured creditor. *Id.* § 1052(1) (repealed 1978). Therefore, it was impossible under Chapter XIII to modify a mortgage or any other secured debt without the consent of the impaired creditor.

57. *Annual Report of the Director of the Administrative Office of the United States Courts* 161, Table 18 (1974).

58. Unsecureds might also have insisted on a price premium because of their more limited bargaining leverage upon distress and because of informational disadvantages relative to secured creditors.

Moreover, while secured credit was cheaper than unsecured credit, it came with its own cost—abusive lending, as secured consumer lenders lend for hostage value, rather than resale value on repossessed assets (there isn't much of a market for used bed sheets or sofas).[59] Secured credit operates via self-help repossession—the legally-sanctioned private use of force. This is a system that is easily abused by lenders' agents (most likely big burly guys) threatening consumers.

Not surprisingly both courts[60] and administrative agencies[61] have recoiled from treating secured credit as inviolable in the consumer context. There is a long-standing debate about the efficiency of secured credit, but it has played out almost entirely in the business credit context. In the consumer context, however, the inefficiency of inviolable secured credit is manifest.[62]

Prohibition on the modification of secured debt in Chapter 13—perilously close to what Professor Scarberry would allow—would take us back to the world of *Williams v. Walker-Thomas*.[63] Perhaps this is an advance on what we might call the original "Roman 13"—the practice in ancient Rome of selling a debtor into slavery or physically dividing the debtor's body among creditors[64]—but it is hardly the way we should want our consumer finance system to operate. Surely Professor Scarberry doesn't really want to go back to this future.

59. *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997); *see also* RALPH A. YOUNG & ASSOCIATES, *PERSONAL FINANCE COMPANIES AND THEIR CREDIT PRACTICES* 77 (1940), *available at* http://www.nber.org/books/youn40-1.

60. Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

61. *See supra* note 43.

62. For a review of the debate see Robert Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1437 n.1 (1997).

63. *Williams*, 350 F.2d 445.

64. *See* Donald E. Phillipson, *Development of the Roman Law of Debt Security*, 20 STAN. L. REV. 1230, 1232–33 (1968); *see also* LEX DUODECIM TABULARUM, Tabula III ("tertiis autem nundinis capite poenas dabant, aut trans Tiberim peregre venum ibant. tertiis nundinis partis secanto. si plus minusve secuerunt, se fraude esto.") (prescribing that if a debtor does not pay a judgment for sixty days, the debtor is to be held in bondage and brought before the court in the forum on three successive market days and the amount of the debt publicly announced. Then, "On the third market day, [the debtor] shall suffer capital punishment or be sold [into slavery] across the River Tiber. On the third market day [if there are multiple creditors] they may cut [the debtor to] pieces.").