HOME IMPROVEMENT? HOME MORTGAGES AND THE BANKRUPTCY REFORM ACT OF 1994

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INTRODUCTION

In October 1994, Congress enacted the Bankruptcy Reform Act of 1994 ("BRA"), a broad package of amendments to the Bankruptcy Code. The BRA includes important changes to the treatment of home mortgages under Chapters 11 and 13. This Article examines the 1994 amendments regarding home mortgages.

More than half of individual debtors in bankruptcy are homeowners with mortgages, and many debtors have not one, but two or three mortgages. Yet most of these homeowners are determined to keep their homes. Even in bankruptcy, however, debtors normally have to pay their home mortgage lenders in full to keep the home. Six years ago, three scholars observed:

In current bankruptcy policy, home ownership is not the protected status; mortgage lending is.... In bankruptcy, all creditors give up something.... Home mortgage lenders, however, give up less....

Special solicitude for the home mortgage lender has been premised on the belief that such solicitude was necessary to keep home mortgage funds flowing.

Prior to the BRA, home mortgage lenders enjoyed at least three advantages. First, most creditors faced modification of their claims in

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3. Id.

4. Federal Land Bank of Louisville v. Glenn (In re Glenn), 760 F.2d 1428, 1434 (6th Cir. 1985), cert. denied, 474 U.S. 849 (1985). The United States Court of Appeals for the Sixth Circuit stated, "Congress had to face the reality that... 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 reduce the availability of home mortgage loans. Glenn, 760 F.2d at 1434. See Grubbs v. Houston First Am. Sav. Ass'n, 730 F.2d 236, 245-46 (5th Cir. 1984) (en banc).
reorganization, and, if undersecured, possible lien stripping. Home mortgage lenders, by contrast, achieved virtual immunity from modification and lien avoidance in Chapters 7 and 13. Second, in some jurisdictions, debtors had to file bankruptcy petitions to fend off foreclosure on a home earlier than to halt foreclosure on other property. Third, home mortgage lenders were the principal, though not the only, beneficiaries of a recent United States Supreme Court case requiring that interest on arrearages be cured in bankruptcy.

The 1994 amendments do not fundamentally alter the rule that home mortgage lenders give up less; in fact, the BRA extends the rule by barring home mortgage modification in Chapter 11 and giving mortgage lenders more control over interest rates on arrearages. However, debtors make important gains as well. The Chapter 13 debt ceiling is more than doubled, allowing more debtors to use Chapter 13's cure provisions. Time limits for initiating cure are extended, and limited modification of mortgages with a short remaining term is permitted.

This Article discusses under four headings the BRA provisions relevant to home mortgages: 1) Chapter 13 debt limits, 2) treatment of undersecured claims, 3) cure of defaults, and 4) interest rates on cure. For each of these areas, this Article first reviews pre-BRA developments to show where these developments left the debtor and mortgage lender and, second, examines the changes the BRA makes.5

I. RAISING THE ROOF IN CHAPTER 13

A. THE PROBLEM: LOW CEILING

The first of the 1994 amendments addressed in this Article changes Chapter 13's eligibility provisions. Since 1978, Chapter 13 had been open only to individuals and their spouses who had 1) a regular income, and 2) prepetition debts no greater than $100,000 unsecured and $350,000 secured, not counting unliquidated or contingent debts.6 If these figures were ample in 1978 to cover Chap-


6. 11 U.S.C. § 109(e)(1988). The pre-BRA version at § 109(e) provided in pertinent part: Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than $100,000 and noncontingent, liquidated, secured debts of less than $350,000, or an indi-
ter 13’s intended beneficiaries, inflation has since taken its toll. By the early 1990s, many consumer debtors with sufficient disposable income to succeed in Chapter 13 found themselves ineligible for Chapter 13 because they had too much debt. This was especially true on both coasts, where high housing costs meant very sizable mortgage debts.7

Several adverse consequences flowed from the low debt limits. First, increasing numbers of consumer debtors wanting to save their homes were not able to do so in Chapter 13. Those debtors with too much debt for Chapter 13 had to choose between liquidating in Chapter 7 or trying to reorganize in Chapter 11. These choices were often disadvantageous to both debtors and creditors. Over 90% of consumer Chapter 7 cases are no-asset cases in which general creditors receive nothing. Thus, pushing more debtors into Chapter 7 might not help creditors.

Debtors also encounter additional problems in Chapter 7. Chapter 7 debtors with disposable income may face dismissal under section 707(b) for “substantial abuse.”8 Further, Chapter 7, unlike Chapter 13, gives the debtor no right to cure defaults and reinstate regular payments on long-term debts. While reaffirmation, or even just keeping the checks in the mail, may allow a Chapter 7 debtor to keep the debtor’s home in and after bankruptcy, that determination depends on the creditor’s consent. For debtors in default on the home mortgage, consent may not be forthcoming. Chapter 11 is also disadvantageous; its complex procedures mean added expense for debtors and creditors alike and make successful reorganization less likely for consumers.9

7. For example, the median price of owner-occupied single-family housing units reached $487,000 in New York City and $298,000 in San Francisco by 1990, almost five years before the passage of the BRA. See 1994 CITY AND COUNTY DATA BOOK, U.S. Dept. of Commerce, Top 25 County Ranking by Selected Subject (12th ed. 1994).


9. See Toibb v. Radloff, 501 U.S. 157 (1991) (stating that individual debtors not engaged in business are eligible to file in Chapter 11). Even if eligible for Chapter 13, some debtors preferred Chapter 11 because: 1) before the 1994 amendments, stripping the lien on undersecured home mortgages was allowed in Chapter 11; and 2) Chapter 11, unlike Chapter 13, does not require the debtor to devote all disposable income to the plan. Compare 11 U.S.C. § 1129 (1994) (not requiring the debtor to devote all disposable income to the plan) with 11 U.S.C. § 1325(b) (1994) (requiring debtor to devote all disposable income to the plan).
Another regrettable result of the low ceilings in Chapter 13 was wasteful litigation over classification of debt. Where a debtor's eligibility was challenged on debt limit grounds, the bankruptcy court's time was spent litigating which debts were sufficiently liquidated and noncontingent and how much was of the debt secured and unsecured for purposes of Chapter 13 eligibility.\textsuperscript{10}

\section*{B. The Statutory Solution: Raise the Roof}

Congress' solution to the low ceiling in Chapter 13 was to raise the roof, more than doubling the Chapter 13 debt limits to $1 million dollars — $250,000 unsecured debts and $750,000 secured debts.\textsuperscript{11} To avoid future obsolescence through inflation, these dollar figures were tied to the Consumer Price Index. The recent amendment adjusts the figures every three years without the need for congressional attention.\textsuperscript{12}

\textsuperscript{10} For purposes of Chapter 13 eligibility, a debt is treated as secured only to the extent of the value of the collateral; the rest is unsecured. \textit{See In re Ballard}, 4 B.R. 271, 275 (Bankr. E.D. Va. 1980).

A debt is contingent if the debtor's legal duty to pay "does not come into existence until triggered by the occurrence of a future event" that was reasonably within the presumed contemplation of the parties at the time the original relationship between the parties was created. \textit{In re All Media Properties, Inc.}, 3 B.R. 126, 133 (Bankr. S.D. Tex. 1980), aff'd, 646 F.2d 193 (5th Cir. 1981) (per curiam).

"A debt is liquidated if it is capable of ready determination and precision in computation of the amount due," \textit{In re Nichols}, 184 B.R. 82, 89 (9th Cir. 1995); \textit{Postvedt v. Dow} (\textit{In re Postvedt}), 823 F.2d 305, 306 (9th Cir. 1987).

\textsuperscript{11} \textsuperscript{11} U.S.C. \textsection 109(e)(1994). Section 109(e) provides in pertinent part:

(\textit{e}) only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than $250,000 and noncontingent, liquidated, secured debts of less than $750,000, or an individual with regular income and such individual's spouse . . . that owe, on the date of the filing of the petition [total debts not exceeding the preceding figures] may be a debtor under Chapter 13 of this title.

\textit{Id.}

\textsuperscript{12} 11 U.S.C. \textsection 104(b)(1) (1994). Section 104(b)(1) provides in pertinent part:

On April 1, 1998, and at each 3-year interval ending on April 1 thereafter, each dollar amount in effect under sections 109(e), 303(b), 507(a), 522(d) and 523 (a)(2)(C) immediately before such April 1 shall be adjusted —

(A) to reflect the change in the Consumer Price Index for All Urban Consumers, published by the Department of Labor, for the most recent 3-year period ending immediately before January 1 preceding such April 1, and

(B) to round to the nearest $25 the dollar amount that represents such change.

\textit{Id.}

The BRA doubled the federal homestead exemption from $7500 to $15,000, or $30,000 in a joint case. 11 U.S.C. \textsection 522(d)(1) (1994). This exemption, along with the federal bankruptcy exemptions, \textsection 522(d), is subject to automatic adjustment under \textsection 104(b)(1). 11 U.S.C. \textsection 104(b)(1) (1994).

While most states have opted out of the federal exemptions, changes to those exemptions may spur similar revisions to state exemptions. For example, a Nebraska State Bar Association Committee is redrafting that state's exemptions and will likely propose an automatic escalator clause like that of the BRA.
The new debt limits are effective for cases filed after October 4, 1994.\footnote{13}

The text of this amendment does not mention home mortgages, and the House Report accompanying the bill says only that the intent was to encourage more debtors to choose Chapter 13 over Chapter 7 because “[c]reditors generally benefit when a debtor elects Chapter 13.”\footnote{14} However, the higher ceiling will clearly help consumer debtors with large home mortgages, especially those in default who need Chapter 13’s cure provisions.

A few caveats are in order at this juncture. First, even though debtors with a much greater debt load may now enter Chapter 13, these debtors are not granted additional time to handle their debt, and the Chapter 13 failure rate was very high even under the old debt limits.\footnote{15} Second, courts may now be even more willing to use a section 707(b) dismissal for substantial abuse against higher income debtors, because those debtors may now elect Chapter 13 as well as Chapter 11.\footnote{16}

This amendment does not seem to raise new interpretive questions, and the more generous limits should reduce, though not eliminate, debt classification litigation for Chapter 13 eligibility purposes. Existing case law remains relevant in this area.

\footnote{13. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 702, 108 Stat. 4106 (codified as amended at 11 U.S.C. § 101 (1994)). Section 702 of the BRA provides, with exceptions not relevant to Chapter 13’s debt ceilings, that “the amendments made by this Act shall not apply with respect to cases commenced under Title 11 before the date of the enactment of this Act.” Id. This would seem to make the new Chapter 13 debt ceilings unavailable to debtors who filed under Chapters 7 or 11 before the BRA but who wish to convert to Chapter 13 after Oct. 4, 1994.}


\footnote{15. See, e.g., William Whitford, The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy, 68 AM. BANKR. L.J. 397, 410-12 (1994); Jean Braucher, Lawyers and Consumer Bankruptcy: One Code, Many Cultures, 67 AM. BANKR. L.J. 501, 534-37 (1993); Sullivan, Warren & Westbrook, supra note 2, at 215. On a national basis, a recent study found that only 31% of Chapter 13 cases filed ended successfully with the debtor completing all payments under a confirmed plan. Id. Some districts, including Nebraska, have relatively high success rates for Chapter 13. Id. However, many of these districts may routinely confirm Chapter 13 plans paying very little to unsecured creditors. The disappointing success rate has led some to call for substantial changes to Chapter 13.}

\footnote{16. Cf. In re Mastroeni, 56 B.R. 456 (Bankr. S.D.N.Y. 1986) (finding that substantial abuse did not exist when a Chapter 7 debtor was not eligible for Chapter 13 because of high debts).}
II. STRIPPING LIENS ON UNDERSECURED CLAIMS: CATCHING THE LENDER WITH HIS EQUITY DOWN

Home mortgage lien stripping has been a bankruptcy battleground in recent years. Many home mortgages are undersecured — some from the outset, usually junior liens, and others due to subsequent, possibly temporary, declines in property values. As a general rule, the Bankruptcy Code reflects economic reality by dividing, or "bifurcating," undersecured claims into two parts: 1) a secured claim equal to the value of the collateral, and 2) an unsecured claim for the balance of the debt.¹⁷

Let’s look at an example of an undersecured claim and how it might be stripped in a bankruptcy reorganization:

EXAMPLE ONE

Ron and Rhonda Redfern bought Property X for $150,000 in 1988. After a $30,000 downpayment, the Redferns borrowed the $120,000 balance and gave Lender a security interest in Property X. The loan was payable in monthly installments of $1,053.09 over thirty years.

In 1991, after three years of timely payments, Ron’s severe illness interrupted the Redferns’ income, and they missed several payments. Lender has initiated replevin or foreclosure. Property X, by 1991, had a fair value of only $40,000. The unpaid principal of the loan was $117,781.98.¹⁸

If Property X is forty bushels of bubblegum, an antique car collection, a small office building, a vacation condominium, or anything other than Ron and Rhonda’s principal residence, the filing of a petition in Chapters 11 or 13 will give the debtors expansive powers to deal with Lender and to retain Property X. First, even if Lender has a judgment of foreclosure or possession in replevin but has not yet sold the property, a bankruptcy petition will be in time to stop the sale, effectively giving Ron and Rhonda time to negotiate with Lender and to propose a plan of reorganization under which they will keep Property X.¹⁹ Second, in Chapters 11 and 13 and to a much more limited extent Chapter 7, debtors may be able to force Lender to sell the prop-

erty to them for its current fair market value free and clear of liens, rather than for the full unpaid balance of the debt.\textsuperscript{20}

Lender will be treated as having a secured claim of $40,000 and an unsecured claim for the remaining $77,781.98. Debtors may free Property X from the security interest and become its owners free and clear by paying Lender only the present value of the secured claim. They could do this in Chapter 13 over five years at say 9% with monthly payments of only $830.33. Lender's unsecured claim would be paid, if at all, only by the same percentage due to other general creditors.\textsuperscript{21}

Reorganization would enable Ron and Rhonda to keep Property X by reducing both the monthly payment (down almost $200) and the term (down to five years with twenty-seven years yet to go). They have saved $77,781.98 in principal and many thousands more in interest.\textsuperscript{22}

There are many justifications for such treatment of undersecured claims. First, claim bifurcation merely reflects economic realities that predated and were not created by bankruptcy. The creditor was undersecured regardless of bankruptcy. If the creditor went ahead with foreclosure, the creditor could recover only the value of the collateral, at least in the near term, and would be left with an unsecured claim for the deficiency. To bifurcate and then pay off the creditor in installments, with a present value equal to the collateral's value, gives the creditor the economic equivalent of foreclosure while benefitting the debtor.

Second, bifurcation promotes equality of treatment among similarly situated creditors. Undersecured creditors are, to the extent of the deficiency, unsecured in fact and should be treated as such in law. Allowing undersecured creditors to extract extra dollars from the estate merely because they took a partly or mostly unsecured security interest gives these undersecured creditors an unfair share of the assets of the estate. In effect, some undersecured creditors would get a larger piece of the pie than other undersecured creditors.


\textsuperscript{21} 11 U.S.C. § 1325(a)(4) (1994) (stating that, in Chapter 13, the unsecured portion of an undersecured claim must be paid at the same percentage as if debtor had filed a Chapter 7). Often, this percentage is zero. Chapter 13 also requires, in most cases, that the debtor pay into the plan all his disposable income; however, most or all of this disposable income may be used to pay secured and priority claims. 11 U.S.C. § 1325(b) (1994).

\textsuperscript{22} The loan amortization figures used in Examples One through Five in this Article were calculated and cross-checked using computer programs FSTBUCKS and TVALUE.
Third, not bifurcating would promote the taking of collateral for its hostage value rather than as a true secondary source of repayment. If the lien of an undersecured claim could not be reduced in bankruptcy to the collateral value, then creditors would have incentive to take a security interest in whatever property the debtor valued — even if that property had little resale value or was already heavily encumbered. The lien has value to the creditor, not because repossession and resale would bring any real recovery, but because the mere threat of those acts might lead the debtor to heroic efforts to pay one creditor instead of another, especially unsecured creditors.

A. **But Can You Do That to the Home Mortgage Lender?**

Suppose Property X in Example One was Ron and Rhonda's principal residence. Let's see how that changes the outcome.

For reasons ranging from recession to changes in lending practices, some home mortgage lenders in the late 1980s and early 1990s found their portfolios full of undersecured home mortgages. Often the debtors on such loans were in bankruptcy. In many cases, both debtor and creditor expected the home to rise in value relatively soon, and each side tried to capture that increase. Debtors aimed the weapon of lien stripping at their undersecured home mortgages, primarily in Chapters 7 and 13.

B. **Home Mortgage Lien Stripping in Chapter 7: The Deedsnup Dilemma**

Let's follow developments in Chapter 7 first. In Chapter 7, if the creditor's post-bankruptcy lien could be limited to the home's value at time of bankruptcy, several advantages would accrue to the debtor. First, if property values rose before a foreclosure sale, the creditor would be entitled to only the proceeds that equaled the home's value set in bankruptcy; any more would belong to the debtor. Second, if the debtor wanted to keep the home, the limits on the creditor's lien gave the debtor leverage to negotiate refinancing at less than the full unpaid balance.

Section 506 was the statutory basis for Chapter 7 lien stripping. Subsection (a) of section 506 clearly mandates dividing an undersecured claim into an allowed secured claim and an allowed unsecured claim, defining those terms in relation to the value of the collateral.\(^2\)

The second crucial step in Chapter 7 lien stripping is to avoid the lien

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23. 11 U.S.C. § 506(a) (1994). Section 506(a) provides in pertinent part: (a) An 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 such creditor's interest in the estate's interest in such property, . . . and is an un-
to the extent that the lien exceeded the collateral’s value. The power to do this, according to some debtors’ attorneys, lay in subsection (d) of section 506, which provides, “To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void. . . .”\(^{24}\)

Because subsection (a) describes “allowed secured claim” as excluding the part of any debt not actually backed by collateral value, one could reasonably argue that use of the same three words in subsection (d) carried the same meaning. Thus, some claimed that subsection (d) authorized voiding the lien to the extent the lien was undersecured. The lien could be stripped down to collateral value.

Many courts, including the United States Courts of Appeals for the Third and Eleventh Circuits, accepted this argument in Chapter 7 cases.\(^ {25}\) However, the mortgage loan industry mounted a powerful, and eventually successful, defense. In 1992, the United States Supreme Court decided the case of Dewsnup v. Timm.\(^ {26}\) Mr. and Mrs. Dewsnup, Chapter 7 debtors, owed $120,000 to their mortgagee on Utah real estate valued at only $40,000 and sought to limit their lender’s post-bankruptcy lien to that amount.

In a 6-2 opinion written by Justice Harry A. Blackmun, the United States Supreme Court held that, on these facts, lien stripping was not authorized by section 506(d). To reach that result, the Supreme Court adopted the lender’s view that the phrase “allowed secured claim” used in 506(d) was “not . . . an indivisible term of art defined by reference to 506(a). . . . Rather the words should be read term-by-term to refer to any claim that is, first, allowed, and, second, secured.”\(^ {27}\) Because this claim had been allowed and the underlying debt was partly secured, the claim, in the Court’s view, was both allowed and secured so as to bar avoidance under section 506(d).\(^ {28}\)

The Court departed from the plain language of the Bankruptcy Code, stating that section 506 was ambiguous, therefore justifying a study of the legislative history and the pre-Code practice under the old Bankruptcy Act of 1898.\(^ {29}\) The Court found that pre-Code practice


\(^{25}\) See, e.g., Gaglia v. First Fed. Sav. & Loan Ass’n, 889 F.2d 1304, 1306-11 (3rd Cir. 1989); In re Folendore, 862 F.2d 1537, 1539 (11th Cir. 1989) (stating that lien stripping under § 506 is the majority view).


\(^{28}\) Dewsnup, 502 U.S. at 417.

\(^{29}\) Id. at 417-18.
was to leave the lien attached to the collateral for the full amount of the debt in liquidation bankruptcy. The Court noted that the legislative history was silent as to any intent to change that practice. From that silence, the Court presumed a congressional intent to continue prior practice.\textsuperscript{30}

Justice Antonin Scalia, joined by Justice David H. Souter, dissented. In this dissenting opinion, Justice Scalia argued that "allowed secured claim" had the same meaning in all subparts of section 506 and, indeed, throughout the Bankruptcy Code. Justice Scalia was especially critical of the majority's reliance on pre-Code practice where "the statutory language plainly reveals Congress' intent to alter pre-Code regimes."\textsuperscript{31}

The Court in \textit{Dewsnup} slammed the door on lien stripping in Chapter 7. In Chapter 7, the Court stated that "[t]he creditor's lien stays with the real property until the foreclosure. . . . Any increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor. . . ."\textsuperscript{32}

Returning to Example One, the \textit{Dewsnup} decision indicates that, when the stay is lifted after Ron and Rhonda's Chapter 7, Property X is still encumbered by a lien for the full unpaid balance of $117,781.98. Ron and Rhonda's personal liability for the debt will have been discharged, but Lender's \textit{in rem} rights remain in full as a lien on Property X. Debtors can retain their home only if Lender agrees, and the price of that agreement will likely be reaffirmation for more than the property's bankruptcy valuation. Unless Property X's value rebounds, however, foreclosure will not net Lender more than $40,000. This gives Ron and Rhonda leverage to push the price of reaffirmation below the unpaid balance.

C. HOME MORTGAGE LIEN STRIPPING IN CHAPTER 13: NIPPED BY \textit{NOBELMAN}

After \textit{Dewsnup}, the focus shifted from Chapter 7 to the reorganization chapters, which are premised on allowing the debtor to keep the property and to pay debts out of ongoing income. In reorganization chapters, liens normally are stripped down to collateral value. The debtor then "buys" the collateral from the creditor by repaying, over the life of the plan, only the amount of the secured claim.

\textsuperscript{30} \textit{Id.} at 419-29.


\textsuperscript{32} \textit{Dewsnup}, 502 U.S. at 417.
In Chapter 13, there were two barriers to using this technique to guard against foreclosure on the family home. First, Chapter 13 contains an express “no modification” rule for home mortgages, and, second, it was unclear whether Dewsnup barred lien stripping beyond Chapter 7.

D. CHAPTER 13'S NO MODIFICATION TO THE HOME MORTGAGE CLAUSE

Section 1322(b)(2) allows Chapter 13 plans to “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. . .”

Section 1322(b)(5) provides an important exception to the no modification rule. “Notwithstanding paragraph (2) of subsection (b),” this section allows the plan to “provide for the curing of any default . . . and maintenance of payments while the case is pending on any . . . claim on which the last payment is due after the date on which the final payment under the plan is due.” Long-term debts cured under section 1322(b)(5) are excepted from the Chapter 13 discharge awarded to a debtor who successfully makes all payments under a confirmed plan.

Debtors and their counsel soon found ways to limit the no modification rule in Chapter 13. Some loans were declared outside the rule's reach for the following reasons: 1) there was collateral in addition to “real estate that is the debtor's principal residence”, and 2) senior liens used up all collateral value, so the junior lien was not “secured.” Some courts found that section 1322(b)(2) was intended to

35. See 11 U.S.C. § 1328(a) (1994). Section 1328(a) provides in pertinent part:
(a) As soon as practicable after completion by the debtor of all payments under the plan, . . . the court shall grant the debtor a discharge of all debts provided for by the plan . . . , except any debt —
(1) provided for under section 1322(b)(5) of this title; . . .

Id.

37. See infra note 43. The number of totally underwater “secured loans” may be growing for reasons unrelated to recession. For example, Professor Douglas Baird notes that tax considerations encourage taking a lien on the debtor's residence even if there is no equity to support it. DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 59 (2d ed. 1993). After the 1986 tax reforms, “interest on loans secured by the debtor's principal
protect only the long-term residential loan industry and therefore excluded junior liens held by personal finance companies from its protection.\textsuperscript{38}

For liens squarely within the no modification clause, a more direct tactic was used; namely, the claim that lien stripping was not prohibited by section 1322(b). Some argued that the words "secured claim" in the no modification rule meant the same as "allowed secured claim" in section 506(a), so that a lien on the debtor's principal residence was protected from modification only if and to the extent that the lien was in fact secured. Unsecured portions were simply outside the scope of 1322(b)(2)'s protection. Eventually four circuit courts of appeal agreed that section 1322(b)(2)'s no modification clause did not bar strip-down of an undersecured mortgage.\textsuperscript{39} In the view of these courts, all that section 1322(b)(2) required was that the debtor continue making the regular monthly payments. Of course, where the claim had been substantially undersecured, those payments could cease much earlier, as soon as the debtor had paid off only the allowed secured claim. Remember Example One, where strip-down to current collateral value would have shortened the remaining term from twenty-seven years to five years.

This issue came before the United States Supreme Court in 1993 in \textit{Nobelman v. American Savings Bank}.\textsuperscript{40} Mr. and Mrs Nobelman's condominium, valued at an "uncontroverted" $23,500, was subject to a purchase money mortgage of $71,000. Debtors proposed to strip the residence remained . . . deductible . . . while interest on other consumer loans did not."

\textit{Id.}


\begin{quote}
[T]he purpose of Section 1322(b)(2) is to protect the long-term home mortgage industry. Junior liens are not thought to be protected.

Although the legislative history is silent, the plain intent of the exception is to provide stability to the 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 to 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.
\end{quote}

\textit{Id. at 65.}


\textsuperscript{39} Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123, 127 (3d Cir. 1990); Hougland v. Lomas & Nettleton Co. (\textit{In re Hougland}), 886 F.2d 1182 (9th Cir. 1989); Hart v. Hart (\textit{In re Hart}), 923 F.2d 1410 (10th Cir. 1991); Bellamy v. Federal Home Loan Mortgage Co. (\textit{In re Bellamy}), 962 F.2d 176, 180-81 (2d Cir. 1992) (holding that \textit{Dewsnup} did not bar lien stripping in Chapter 13).

\textsuperscript{40} 113 S. Ct. 2106 (1993).
lien down to a $23,500 secured claim on which the debtors would con-
tinue payments. No payments would be made on the unsecured
balance.

The Supreme Court, in an opinion by Justice Clarence Thomas, re-
jected the view that such treatment was allowed by section
1322(b)(2)'s "no modification" clause. Justice Thomas began by ad-
mitting that, for purposes of Chapter 13, section 506(a) limited the value
of the mortgagee's secured claim to $23,500. However, Justice
Thomas stated that section 1322(b)(2) did not focus on a creditor's
"claim" so much as on the creditor's "rights." The bank was the
holder of a secured claim on the debtor's residence, and even though
that claim was limited in amount, the "rights" the bank enjoyed as a
mortgagee were not limited by that amount. The bank's rights, which
may not be modified:

are reflected in the relevant mortgage instruments. . . . They
include the right to repayment of the principal in monthly in-
stallments over a fixed term at specified adjustable rates of
interest, the right to retain the lien until the debt is paid off,
the right to accelerate the loan upon default and to proceed
against petitioner's residence by foreclosure and public sale,
and the right to bring an action to recover any deficiency re-
mainng after foreclosure. These are the rights that were
"bargained for . . .", and are rights protected from modifica-
tion by [s]ec. 1322(b)(2).

Justice Thomas' broad recitation of the unmodifiable rights of the
home mortgage lender clearly barred lien stripping for senior home
mortgages within section 1322(b)(2)'s "no modification" clause. The
Court did not discuss junior liens; however, the opinion's general lan-
guage could sweep junior liens into section 1322(b)(2)'s protection.

Because Nobelman was based on Chapter 13's no modification clause
rather than on Dewsnup, Nobelman left Dewsnup's reach uncertain.
For liens outside the no modification clause and home mortgages in
Chapter 11 that lack a "no modification to the home mortgage" provi-
sion, Dewsnup left doubts as to lien stripping.

42. Nobleman, 113 S. Ct. at 2110 (citations omitted).
43. A number of courts, even after Nobelman, have allowed lien stripping on
wholly undersecured liens on the debtor's principal residence on the basis that a com-
pletely undersecured debt is not "secured" within the meaning of § 1322(b)(2). See, e.g.,
In re Williams, 161 B.R. 27, 29 (Bankr. E.D. Ky. 1993); In re Hornes, 160 B.R. 709, 713-
16 (Bankr. D. Conn. 1993); In re Plouffe, 157 B.R. 198, 199-200 (Bankr. D. Conn. 1993);
In re Kidd, 161 B.R. 769, 770-71 (Bankr. E.D.N.C. 1993); In re Lee, 161 B.R. 271, 272-74
(Bankr. W.D. Okla. 1993); In re Brown, 1993 WL 544385, at *1-2 (Bankr. E.D.N.C.
1993).
E. The Dewsnup Penumbra — Would It Spread to Reorganization?

The three little words dealt with in Dewsnup, “allowed secured claim,” are used throughout the reorganization chapters. Dewsnup raised the possibility that previously well accepted meanings may not survive. Justice Harry A. Blackmun in Dewsnup gave little express guidance; for example, one cryptic footnote states that “we express no opinion as to whether the words ‘allowed secured claim’ have different meanings in other provisions of the Bankruptcy Code.”

Even before Nobelman, courts wrestled with Dewsnup’s possible extension to Chapter 11. After Nobelman, more undersecured home mortgage cases found their way into Chapter 11 because it did not have a no modification clause. Initially, a few lower courts held that section 506 must apply the same way in all chapters, so that if lien avoidance was barred in Chapter 7, it must be barred in reorganization as well. Other better reasoned decisions, however, such as Wade v. Bradford from the United States Court of Appeals for the Tenth Circuit and Dever v. Internal Revenue Service, held that Dewsnup could not be imported into the reorganization chapters. These cases noted that the United States Supreme Court in Dewsnup had considered only liquidation in its discussion of the statute, legislative history, and pre-Code practice and that Dewsnup had taken pains to make clear that reorganization was a question not reached. These courts stated that, at least in Chapter 11 statutory context, legislative history and established practice all clearly supported lien stripping.

In Dever, a married couple first filed a Chapter 7 and sought to strip $140,000 in tax liens from their home, which was encumbered by three deeds of trust. Their case was still pending when the Supreme

44. Dewsnup, 502 U.S. at 417 n.3.
45. See Taffi v. United States (In re Taffi), 144 B.R. 105, 114 (Bankr. C.D. Cal 1992), rev’d on other grounds, 1993 WL 558844 (C.D. Cal. 1993), aff’d in part, rev’d in part, 95 WL 592800 (9th Cir. 1995) (stating that Dewsnup governs even in Chapter 11 because § 506(a) has the same meaning in all chapters); Blue Pacific Car Wash, Inc. v. St. Croix (In re Blue Pacific Car Wash), 150 B.R. 434, 435 (W.D. Wis. 1992) (discussing the unreasonableness of applying different meanings to § 506 in Chapters 7 and 11).
46. 39 F.3d 1126 (10th Cir. 1994).
49. See Wade, 39 F.3d at 1128; Dever, 164 B.R. at 137.
50. Wade, 39 F.3d at 1128; Dever, 164 B.R. at 137.
Court's decision in *Dewsnup* was handed down. The Devers promptly converted their case to Chapter 11 to escape *Dewsnup*. Their debts were too high to convert to Chapter 13. The *Nobelman* case was decided after conversion but before the bankruptcy court ruled on confirmation of the Devers' plan.51

After a detailed review of lien stripping in Chapters 7, 11, 12, and 13, the court in *Dever* concluded that lien stripping was central to reorganization and that sections 1129 and 1111(b) could not be read sensibly if lien stripping were prohibited.52 The court explained:

Modifying the rights and interests of secured creditors is at the heart of most reorganizations. Many Chapter 11 cases would be pointless . . . if debtors could not reduce secured debt on property that had declined in value. . . . To hold that debtors remain burdened by exactly the same liens after confirmation as before, would radically change life as we know it in Chapter 11 cases.53

The *Dever* court recognized the anomaly of allowing debtors to “achieve opposite results merely by the tactic of converting a case from Chapter 7 to Chapter 11 and doing a liquidating plan.”54 But the *Dever* court found it “even harder to envision Chapter 11 without lien-stripping powers.”55 The court confirmed the plan that stripped down the tax liens on the debtors' home.

After *Dewsnup* and *Nobelman* but before the BRA, a debtor's options for dealing with the home mortgage lender were clearly limited. First, the debtor could opt for Chapter 11, which did not then contain a no modification clause and where strip down was still a possibility. While Chapter 11 is much more complex and expensive than Chapters 7 and 13 with creditors getting to vote on the plan, the savings from stripping a substantially undersecured mortgage might offset the disadvantages.

If the debtor chose Chapter 7, the creditor's lien survived for the full amount of the debt. Only if the creditor agreed might the debtor retain the home after the stay was lifted. Where the debtor was not seriously in default, the creditor would likely allow reaffirmation or even retention without a formal reaffirmation so long as the checks kept rolling in on schedule.56

52. *Id.* at 145.
53. *Id.* at 143.
54. *Id.* at 145.
55. *Id.*
56. The secured creditor need not agree to a reaffirmation and instead, after the debtor's Chapter 7 discharge is granted or denied, may initiate a foreclosure sale of the home. The secured creditor may either accept a third party's bid or purchase the prop-
In Chapter 13, the debtor's options were only a little more open. The debtor could seek to take his mortgage out of the no modification clause if the mortgage was entirely undersecured, there was other security, or the security was not his principal residence. If successful, the debtor might be able to strip a lien. Assuming the no modification clause controls, however, the debtor must continue to meet the regular payments during and after the Chapter 13 case. If the debtor is in default at the outset of the case, the debtor might have the right to de-accelerate, cure the defaults within a reasonable time, and thus fend off foreclosure. But the debtor must make the regular contract payments as well.\textsuperscript{57}

\textit{Dewsnup} and \textit{Nobelman} may have substantially increased the value of taking a mortgage on the home, even if there is little equity to support it. Even if the lien was so junior that only 1% of the debt was secured at the outset and that percentage has not grown, these cases arguably hold that the creditor's lien on the home cannot be reduced in or after bankruptcy except through payment or surrender of the home to the creditor.

F. THE LIEN STRIPPING FIX — EXTEND THE NO MODIFICATION CLAUSE TO CHAPTER 11

The BRA's answer to these quandaries was minimal. Once again, home mortgage lenders were singled out for special protection as Congress simply added a "no modification to the home mortgage" clause to Chapter 11, effective for cases filed after October 4, 1994. Section 1123 of the Bankruptcy Code, on the contents of the reorganization plan, now contains language identical to that in section 1322(b)(2), prohibiting modification of claims "secured only by a security interest in real property that is the debtor's principal residence."\textsuperscript{58} The House Report states that this "conforms the treatment of residential mortgages in Chapter 11 to that in Chapter 13" and adds that the Chapter 11 provision should apply only when the debtor is an individual, presumably because other entities do not have a principal residence as used here.\textsuperscript{59}

Under new section 1123(b)(5), home mortgages are protected from lien stripping to the same extent as in Chapter 13; the language would seem to come into Chapter 11 carrying the \textit{Nobelman} gloss as well as...
the statutory limits. For example, where there is other collateral, the no modification rule would not apply. Case law developed under Chapter 13 is relevant here.

When the higher Chapter 13 debt limits and the no modification clause in Chapter 11 are taken together, they all but eliminate incentives for most individual homeowners to use Chapter 11.

More problematic is the BRA's failure to address remaining uncertainties about *Dewsnup* and junior liens. One can, of course, argue that no modification clauses are quite unnecessary in either Chapter 11 or 13 if *Dewsnup*’s reading of section 506(d) independently barred lien stripping in reorganization. Nobelman’s reliance on the Chapter 13 no modification clause, rather than on the year old precedent of *Dewsnup*, also casts doubt on the United States Supreme Court’s willingness to extend *Dewsnup* beyond liquidation. But under section 103, the provisions of section 506 are applicable not only in Chapter 7 but also in Chapters 11, 12, and 13.60 The BRA did not end the *Dewsnup* problem.

Further, neither Nobelman nor the BRA address the extent to which the no modification clauses protect undersecured junior liens. An earlier reform bill, Senate bill 540, included provisions protecting undersecured junior liens only if, and to the extent that, these liens had been backed by real collateral value at the time the loan was made.61 That is, junior liens would have been strippable if they had been undersecured from the outset. This provision was not included in the BRA. Its exclusion is ambiguous; it could mean that Congress believed junior liens were included in and completely protected by the no modification clause. On the other hand, it could mean that Congress believed junior liens not only were not so protected, but should not be, and for that reason the proposal was dropped.

III. O.K., IF CURING DEFAULTS IS THE MOST DEBTORS CAN HOPE FOR IN CHAPTER 13, JUST WHAT DOES THAT ENTAIL?

Nobelman’s broad reading of Chapter 13’s no-modification-to-home-mortgages clause focused increased attention on the one big exception to that rule: the debtor’s right to cure defaults and thereafter maintain payments under section 1322(b)(5). Section 1322(b)(5) allows the debtor's Chapter 13 plan:

notwithstanding [the no-modification-to-home-mortgages clause in § 1322(b)(2)], [to] provide for the curing of any de-

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fault within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due.\textsuperscript{62}

The extent of this right to cure is a third important area addressed in the BRA. Two main difficulties arose under the pre-BRA case law. First, how long did the right endure? That is, at what stage in the state law foreclosure process did the debtor lose the right to cure in a subsequent Chapter 13 by making up late payments and continuing to make the ongoing payments under the original loan contract? Second, was cure allowed on loans with fewer than three to five years yet to run?

A. \textbf{When is it Too Late to Take the Cure?}

\textbf{EXAMPLE TWO}

Hannah Homeowner missed four monthly payments of $225 each to Friendly Finance, which held a second mortgage on her home to secure a loan with an unpaid balance of $15,175 and more than sixty payments still to go. Friendly gave notice of acceleration and filed a foreclosure proceeding in state court before Hannah filed a Chapter 13 petition.

For secured debts such as home mortgages, section 1322(b)(5) allows both \textit{cure} of defaults, usually by making up missed payments, and \textit{reinstatement} — that is, the right to retain the collateral by making those easy monthly payments.\textsuperscript{63} But how long, before the BRA, did that right last? If the creditor accelerated, got a judgment, or otherwise became entitled under state law to immediate payment of the full unpaid balance before the debtor filed bankruptcy, was it too late to invoke Chapter 13’s cure and reinstatement right?

Before the BRA, Chapter 13 contained no express federal rule, and case law developed wide variations, some cutting off the right as soon as the lender accelerated or got a judgment\textsuperscript{64} while others allowed cure much longer, even past a foreclosure sale if state law allowed post-sale redemption.\textsuperscript{65} The earliest cutoffs eventually became

\begin{itemize}
\item \textsuperscript{62} Id. § 1322(b)(5).
\item \textsuperscript{63} Id. § 1322(b)(5).
\item \textsuperscript{65} See, e.g., \textit{In re Ragsdale}, 155 B.R. 578, 586 (Bankr. N.D. Ala. 1993) (stating that the debtor’s Chapter 13 right to cure and reinstate regular monthly payments extends to the end of state law post-sale redemption period); \textit{In re Carr}, 52 B.R. 250, 262-63 (Bankr. E.D. Mich 1985) (noting that as soon as the debtor comes under “protection of
a minority view, with most jurisdictions following the United States Court of Appeals for the Second Circuit's holding in *Di Pierro v. Taddeo* that section 1322(b)(5) overrides state law to give debtors a federal right to "de-accelerate." Allowing cure to be cut off merely by acceleration or the filing of a foreclosure action "would prompt unseemly and wasteful races to the courthouse" and undermine "the overriding rehabilitative purpose of Chapter 13."67

Eventually, the majority of courts allowed cure and reinstatement at least until a foreclosure sale. For example, the United States Court of Appeals for the Sixth Circuit held in *Federal Land Bank of Louisville v. Glenn* that cure and reinstatement were allowed until a foreclosure sale but not thereafter, even if state law afforded a post-sale redemption period. The Sixth Circuit stated that, after the sale, third-party rights and other considerations cut off the right. Before the sale, debtors would have had notice and opportunity to obtain counsel and a reasonable chance to refinance.69 The Sixth Circuit in *Glenn* offered a uniform federal rule not dependent on widely variant state laws.

The United States Court of Appeals for the Third Circuit, however, declined to follow *Taddeo* and *Glenn*; instead, the Third Circuit adhered to a more restrictive view. In *In re Roach*,70 a Chapter 13 debtor proposed to cure and reinstate a mortgage after a foreclosure sale but before the state law redemption period had run. The Third Circuit not only refused to confirm the plan but also held that the right to cure had been cut off as soon as the judgment of foreclosure was entered, well before sale.71

**B. THE BRA ALLOWS CURE AT LEAST UNTIL FORECLOSURE SALE**

Congress' response in the BRA was to add subsection (c)(1) to section 1322 which provides that:

> notwithstanding subsection (b)(2) [the no-modification clause] and applicable nonbankruptcy law — (1) a default with respect to, or that gave rise to, a lien on the debtor's principal residence may be cured under paragraph (3) or (5) of subsection (b) until such residence is sold at a foreclosure

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66. 685 F.2d 24 (2d Cir. 1982).
70. 824 F.2d 1370 (3rd Cir. 1987).
sale that is conducted in accordance with applicable nonbankruptcy law; . . . .

The legislative history indicates that Congress intended specifically to overrule *In re Roach* with this provision.73

The new rule on curing home mortgage defaults leaves several questions open. First, the statutory fix applies only to cure of defaults in regard to the debtor's principal residence. The statutory fix does not reach cures on other long-term loans to which Chapter 13's cure provisions apply. For example, if a debtor defaulted on a mortgage on a duplex he held as rental property rather than as the debtor's residence, new section 1322(c)(1) would not apply to determine whether a Chapter 13 filing was in time to allow cure and reinstatement.

Second, while the amendment clearly establishes a federal rule that it is never too late to cure until the foreclosure sale has been held, the new provision does not provide a uniform federal definition of "foreclosure sale" nor does it expressly say that the date of sale is always the cut-off. When is the foreclosure sale completed for this purpose? Nebraska, for example, has no post-sale redemption period. However, foreclosure sales must be judicially confirmed, and arguably, a sale has not been completed "under applicable nonbankruptcy law" until the creditor obtains that judicial seal of approval.74 Thus, a pre-BRA decision that a Chapter 13 filed after sale but before sale confirmation was in time for full cure and reinstatement would seem to be good law.75 A post-BRA decision agrees.76

What about states that allow a lengthy post-sale redemption period? The House Report accompanying the BRA indicates an intent to allow debtors the benefit of these periods as well, stating:

[T]his section of the bill safeguards a debtor's rights in a Chapter 13 to cure home mortgage defaults at least through completion of a foreclosure sale under applicable nonbankruptcy law. However, if the State provides the debtor more extensive "cure" rights (through, for example, some later

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Until the Third Circuit's decision in *Matter of Roach*, all of the Federal Circuit Courts of Appeal had held that such right continues at least up until the time of the foreclosure sale. . . . The Roach case, however, held that the debtor's right to cure was extinguished at the time of the foreclosure judgment, which occurs in advance of the foreclosure sale. This decision is in conflict with the fundamental bankruptcy principle allowing the debtor a fresh start. . . .

Id. (citations omitted).
76. *In re Fischbach*, No. BK95-80727 (Bankr. D. Neb, July 19, 1995) (holding that a Chapter 13 filed before judicial confirmation of foreclosure is time to allow cure and reinstatement under § 1322(c)(1)).
redemption period), the debtor would continue to enjoy such rights in bankruptcy.77

Some commentators see section 1322(c)(1) as clearly allowing debtors to cure until state law redemption periods expire.78 In support, these commentators cite the fact that foreclosure sale is apparently left for definition under state law, arguing that a foreclosure sale is therefore not complete under state law until the debtor has been completely divested of any legal or equitable rights to the property. Where the debtor retains a state law right of redemption, arguably the foreclosure sale process has not been completed within the meaning of new section 1322(c)(1). Some also look to a Depression-era United States Supreme Court decision interpreting a statute intended to help debtors save their homes after default. In Wright v. Union Central Life Insurance Co.,79 the Supreme Court stated that:

[t]he person whose land has been sold at foreclosure sale and now holds a right of redemption is, for all practical purposes, in the same debt situation as an ordinary mortgagor in default: both are faced with the same ultimate prospect, either of paying a certain sum of money, or of being completely divested of their land.80

There is reason to question, however, whether courts will extend the right to cure so far. First, of course, some may not find sufficient ambiguity in section 1322(c)(1) to justify looking at the legislative history.81 Those who do may note that the House Report's reference to post-sale redemption periods was apparently written to explain an earlier proposal, one which Congress did not adopt. The earlier version would have allowed cure and reinstatement so long as the debtor, at time of filing Chapter 13, still had "any legal or equitable interest, including a right of redemption, in real property securing a claim. . . ."82 Further, the same House Report cited, with apparent approval, the Sixth Circuit's ruling in Glenn that the date of the fore-

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78. See, e.g., Barry Zaretsky, Real Estate Issues in the Code Amendments, N.Y.L.J., Nov. 17, 1994; 5 Collier on Bankruptcy, 1322.34-1322.36 (15th ed. 1995) (noting that the BRA strengthened arguments that "the right to cure should extend to the end of state law any redemption period").

79. 304 U.S. 502 (1938).


81. United States v. Ron Pair Ent., Inc., 489 U.S. 235, 240-41 (1989) (stating that, when the text of the statute is coherent and unambiguous, there is no need to look at legislative history).

82. See S. 540, 103d Cong., 2d Sess., § 301 (1994). There is no explanation in the legislative history of the change in wording before final enactment of the BRA.
closure sale was the cut-off, regardless of post-sale redemption rights under state law. While Congress clearly extended cure rights up to the date of sale, it is less clear that Congress extended these rights further. One thing is clear — Hannah, in Example Two, who filed her Chapter 13 petition before a date had even been set for foreclosure sale of her home, would be allowed to de-accelerate her mortgage, cure by making up the missed payments, and reinstate the regular monthly payments through and after her Chapter 13.

In any event, factors other than section 1322(c)(1) may often prevent cure after foreclosure sale. For a debtor's plan to be confirmed, a debtor must show that it is feasible: (1) to cure; that is, make up all the missed payments, usually with interest, within a reasonable time not to exceed the life of the plan; (2) to maintain regular mortgage payments as the case progresses; and 3) to make all the payments Chapter 13 requires to other creditors. The further behind the debtor is on the mortgage payments, the less likely it is that the debtor will be able to carry these multiple burdens. Chapter 13’s high failure rate should raise a flag of caution. On a national basis, two-thirds of Chapter 13 debtors never finish a plan so as to qualify for the Chapter 13 discharge. These debtors either fail to get a plan confirmed or are unable thereafter to make the required payments. Their cases are eventually dismissed or converted to Chapter 7.

C. WHAT ABOUT SHORT-TIME LOANS — IS CURE ALLOWED ON THESE?

A second cure problem arose because section 1322(b)(5) expressly applies only to long-term loans whose original payment schedule extends at least three to five years into the future, longer than the debtor's proposed Chapter 13 plan. There was no exception to the no modification clause for short-term home mortgages. This left some debtors without a right to cure.

Let's look at two examples:

**EXAMPLE THREE**
Madame X bought a $75,000 home, subject to a fifteen-year mortgage. After thirteen years of timely (for the most part) payments, she missed four payments and filed a Chapter 13.

85. See supra note 15.
EXAMPLE FOUR
Sally Sanford owned a home worth $83,000, subject to Bank's first mortgage of $80,000 on which she was current, and Nadir Home Improvement's second mortgage of $5,000 securing a loan for vinyl siding on the home on which she had missed three monthly payments. This loan has a final balloon payment of $1500 due in one year.

Because the final payment on the delinquent loans in these examples falls due in less than three years, neither Madame X nor Sanford had the right to cure and reinstate under pre-BRA section 1322(b)(5). The automatic stay offered temporary respite from foreclosure, but no other modification was possible without the lender's consent. In Madame X's case, this seems particularly tragic; she likely has considerable equity that may be lost in a forced sale.87 The second example may also be a situation in which consumer debtors need special protection. Mortgages with a short original term, especially non-purchase money loans, often carry very high interest rates and other burdensome terms. In fact, Congress recently subjected such loans to special disclosure and substantive limitations.88

D. NOT JUST CURE BUT MODIFICATION TOO ON SHORT-TERM MORTGAGES

The BRA offers relief for both debtors in new section 1322(c)(2) which provides:

[I]n a case in which the last payment on the original payment schedule for a claim secured only by a security interest in real property that is the debtor's principal residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5). . . .89

Interestingly, the relief is not limited to cure and reinstatement of the original payment schedule, as it is for long-term loans. Instead, the BRA expressly authorizes debtors to "modify" these short-term mortgages under section 1325(a)(5). Modification would seem to include power to extend the term, reduce the periodic payments, and change

87. Of course, in a Chapter 13 plan, the debtor who has nonexempt equity must make payments to unsecured creditors under § 1325(a)(4), the so-called best interests of creditors provision. 11 U.S.C. § 1325(a) (1994). If Madame X lives in a state with a relatively low homestead exemption, this may require sizeable payments to unsecured creditors in addition to payments to cure and service the mortgage. This may put a Chapter 13 plan out of her reach.
the interest rate. Section 1325(a)(5), part of the confirmation require-
ments, provides in pertinent part:

With respect to each allowed secured claim provided for by
the plan —

(B)(i) the plan provides that the holder of such claim retain
the lien securing such claim; and
(ii) the value, as of the effective date of the plan, of property
to be distributed under the plan on account of such claim is
not less than the allowed amount of such claim. ... 90

This would afford both debtors in Examples Three and Four sig-
ificant relief. Madame X, facing a fully secured claim, may pay off
the unpaid balance in equal installments over the life of her plan. She
could stretch the loan out for as long as five years, the maximum term
of a Chapter 13 plan, if necessary and thus significantly reduce her
monthly payments. 91 Sanford could do the same, avoiding the balloon,
payment and instead setting level payments to run through the three
to five years of her plan.

E. JUST HOW MUCH MODIFICATION ARE WE TALKING ABOUT?

Sanford's case, however, raises another question. Does new sec-
tion 1322(c)(2) allow a far greater modification as well; that is, strip-
ning liens on undersecured short-timer mortgages? If so, Sanford
could reduce the lien of Nadir's second mortgage from $5000 to $3000
and then free her home of the lien by paying off the $3000 plus inter-
est through the plan.

For undersecured claims with liens on collateral other than the
home, such lien stripping is, of course, the usual fate under section
1325(a)(5). 92 That section speaks of "allowed secured claims" and of
paying the creditor the present value of that claim under the plan.
"Allowed secured claim," as we have seen, for section 1325(a)(5) pur-
poses is normally interpreted according to its section 506(a) meaning
to include only that part of the creditor's total claim that is in fact
backed by collateral value. 93 While Dewsnup interpreted the term dif-
ferently in the Chapter 7 context, that holding has not clearly been

90. Id. § 1325(a)(5).
91. Chapter 13 plans usually extend for three years, although a court may for
cause allow up to five years. See 11 U.S.C. § 1322(d)(1994). Except as permitted under
§ 1322(b)(5), or unless the creditor consents, Chapter 13 plans may not stretch out pay-
ments to secured creditors beyond the three to five year life of the plan. See In re Moli-
tor, 133 B.R. 1020, 1022-23 (Bankr. D.N.D. 1991) (citing 5 COLLIER ON BANKRUPTCY,
1322.15 (15th ed. 1982)); In re Thomas, 123 B.R. 552, 554 (Bankr. W.D. Tex. 1991); In re
92. See supra notes 17-23 and accompanying text.
93. See supra note 23.
extended to Chapter 13; Nobelman relied exclusively on Chapter 13’s “no modification” clause.

It is unclear whether Congress intended to allow stripping of these short-term undersecured loans. The House Report accompanying the BRA indicates only that the purpose here was to overrule a specific United States Court of Appeals for the Third Circuit case,94 First National Fidelity Corp. v. Perry.95 In Perry, the debtor filed a Chapter 13 after her mortgage lender got a foreclosure judgment.96 Cure and reinstatement were unavailable to her, not because the loan was originally short term, but rather because of the Third Circuit’s earlier ruling in Roach that a foreclosure judgment cut off normal cure rights under section 1322(B)(5).97 The debtor in Perry therefore proposed an alternative plan; she would pay off the full $13,562 balance at the 10% judgment rate of interest in installments over the five years of her plan.98 The Third Circuit adhered to the Roach rule that the foreclosure judgment turned the loan into one requiring immediate full payment.99 Under this view, paying the judgment over five years under the plan was no better than reinstating the original payment schedule; both were impermissible modifications of the lender’s right to full and immediate payment.100

Perry involved a fully secured loan, so no issue of lien stripping was raised there. Because new section 1322(c)(2) is preceded by the words “notwithstanding subsection (b)(2) and applicable nonbankruptcy law,” Chapter 13’s no modification clause as read in Nobelman would not apply.101 The plain language of the amendment seems to allow lien stripping in this limited context. It would tend to target only those riskier mortgages which were probably undersecured from the outset. If the debtor is near the end of the payments on a long-term purchase money mortgage before she defaults, as in Example Three, the remaining unpaid balance will almost certainly be fully secured. If the mortgage was originally short-term, however, and is undersecured at the time of bankruptcy, as in Example Four, it may well have been undersecured from the time it was made. Such loans were, after all, expressly targeted for stripping in an earlier reform bill.102

Despite this apparently plain language and narrow focus, some courts may hesitate to strip a home mortgage lien here in the belief

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95. 945 F.2d 61 (3d Cir. 1991).
96. First Nat'l Fidelity Corp. v. Perry, 945 F.2d 61, 62 (3rd Cir. 1991).
97. Roach, 824 F.2d at 1371-79.
98. Perry, 945 F.2d at 62.
99. Id. at 65.
100. Id.
that, for home mortgages at least, *Dewsnup* might be extended to
Chapter 13. Further, while the other home mortgage provisions of the
BRA open Chapter 13 to more debtors and extend the time to cure and
pay, these provisions do not allow the debtor to pay less than the full
unpaid balance.

IV. THIS MAY PIQUE YOUR INTEREST: *RAKE V. WADE* AND
THE COST TO CURE

The fourth and final BRA topic to be examined here is interest on
cure of arrearages on home mortgages. Let's start by reviewing the
Bankruptcy Code's general treatment of interest on claims.

The statutory basis for requiring interest on claims in bankruptcy
depends on the stage of the proceeding. Three periods are relevant:
pre-filing, post-filing to date of confirmation, and post-confirmation.
Liability for interest accrued before the filing of a bankruptcy petition
is, of course, controlled by nonbankruptcy law and the underlying
agreement. When the debtor files a bankruptcy petition, pre-petition
interest becomes part of the creditor's claim. If that claim is over-
secured, under section 506(b), interest continues to accrue post-pet-
tion and increases the creditor's secured claim until the debtor's plan
is confirmed or the debt has grown to equal the value of the collateral;
that is, when the claim is no longer oversecured.\(^{103}\) On the other
hand, if the claim is undersecured on date of filing, no additional inter-
est accrues between the filing and confirmation dates.\(^{104}\)

Once the plan is confirmed, the authority for post-confirmation in-
terest lies in section 1325(a)(5), which requires that the holder of a
secured claim receive the present value of that claim in deferred pay-
ments under the plan. Present value, of course, means adding inter-
est to the creditor's claim to compensate for the further delay in
receiving his due.

A. *RAKE V. WADE* REQUIRED INTEREST ON CURE EVEN IF THE LOAN
DOCUMENTS AND STATE LAW DO NOT

Until 1993, debtors argued with some success that these general
rules simply did not apply to cure of arrearages. Debtors argued that

\(^{103}\) 11 U.S.C. § 506(b) (1994). Section 506(b) provides in pertinent part:
(b) To the extent that an allowed secured claim is secured by property the
value of which . . . is greater than the amount of such claim, there shall be
allowed to the holder of such claim, interest on such claim, and any reasonable
fees, costs, or charges provided for under the agreement under which such
claim arose.

Id.

\(^{104}\) Thompson v. Kentucky Lumber Co. (*In re* Kentucky Lumber Co.), 860 F.2d 674,
676-77 (6th Cir. 1988) (stating that there is an exception for a solvent debtor).
cure under section 1322(b)(5) was quite different from the normal treatment of secured creditors under section 1325(a)(5) because only the arrearages and not the balance of the debt were paid through the plan and that Congress had not intended to require interest on cure.105 Debtors also pointed out that, because the arrearages themselves contained pre-petition interest and fees, state law in some cases prohibited interest on interest.106

In 1993, the United States Supreme Court decided the case of Rake v. Wade.107 In Rake, the debtor was in default on a home mortgage that did not require or provide for interest on amounts in default. The debtor's Chapter 13 plan proposed to pay the arrearages without interest. The lender objected. The lender argued and the Supreme Court agreed that the Code required interest to be paid both before and after confirmation without regard to the agreement or state law.

Writing for a unanimous court in Rake, Justice Clarence Thomas held first that section 506 entitled all oversecured creditors to post-filing pre-confirmation interest.108 Justice Thomas stated:

While sec. 1322(b)(5) authorizes a Chapter 13 plan to provide for payments on arrearages . . ., nothing in that provision dictates the terms of the cure. In particular, 1322(b)(5) provides no indication that the allowed amount of the arrearages cured under the plan may not include interest otherwise available as part of the oversecured claim under sec. 506(b).109

Further, in the post-confirmation period, Justice Thomas found that the amounts being cured were provided for by the plan within the meaning of section 1325(a)(5) and that the “plain language” of that section entitled the creditor to interest on the cured amounts.110

The decision in Rake was a clear victory for secured creditors and especially mortgage lenders, the usual recipients of cure payments in Chapter 13. The Court in Rake granted them some protection from the real economic costs of an extended cure in bankruptcy. However, the decision was criticized for many reasons. First, where neither the underlying agreement nor state law required interest on cure, Rake

109. Rake, 113 S. Ct. at 2192.
110. Id. at 2192-93.
was seen as a windfall for already favored creditors. Second, even if the debtor could afford it, paying interest on cure transferred more of the debtor’s dollars to the mortgage lender, often at the expense of unsecured creditors. Third, many debtors could not afford it. Adding interest on arrearages to all the other payments required by Chapter 13 was simply too much for these debtors, especially where the arrearages were large, the time to cure was long, or the court-imposed interest rates were high. *Rake* was seen as preventing cure, causing debtors to lose their homes, and often forcing them into Chapter 7, again a detriment to unsecured creditors.¹¹¹

B. THE STATUTORY FIX: *RAKE* OVERRULED. BANKERS, CALL YOUR DRAFTERS

The solution adopted in the BRA was to overrule *Rake* and to return control of interest and other charges on cure to the underlying agreements and nonbankruptcy, mostly state, law in all three reorganization chapters. New subsection (e) added to section 1322, Chapter 13’s cure provision, for example, provides in pertinent part, “Notwithstanding . . . sections 506(b) and 1325(a)(5) . . . , if it is proposed . . . to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.”¹¹² However, the new rule applies only to agreements entered into after the BRA; loans already outstanding are still subject to the rule of *Rake*.¹¹³ The House Report on the bill indicates that the new rule should also apply to loans refinanced after October 4, 1994, even if originally made earlier.

The House Report emphasizes an intent to avoid *Rake’s* unbarred benefits to mortgage lenders more than a wish to expand debtor’s cure rights. The House Report states that *Rake* is overruled to avoid giving secured creditors “a windfall at the expense of unsecured creditors” and “to limit the secured lender to the benefit of the initial bargain. . . .”¹¹⁴


While this statutory overruling of *Rake* will limit unbargained for interest, it raises other problems and certainly is no unalloyed victory for debtors or unsecured creditors. First, because the new rule is entirely prospective, it creates a two-tiered system for years to come with cure of older loans still subject to interest as a matter of federal bankruptcy law and cure of post-BRA loans controlled by other law.

Second, new section 1322(b) certainly does not free debtors from interest on cure. Instead, section 1322(b) simply shifts the focus from federal bankruptcy law to other law and invites bankers to call their drafters. Interest and other charges will now become part of the cost of cure in bankruptcy so long as 1) the underlying agreement provides for the interest and fees, and 2) the charges are not prohibited by applicable nonbankruptcy law.

C. HOW MUCH WILL BE DUE?

It is quite possible that standard loan documents redrawn in light of the BRA will include higher interest charges than the bankruptcy courts would have imposed as a matter of federal law under section 506 following *Rake*. *Rake* did not decide the proper rate of interest. The practice has been for the court to set a rate, and that rate was often tied to current market rate rather than the original contract or contract default rate even after *Nobelman*. The 1994 amendments would seem to require payment of a higher default rate if the agreement contains one, and nonbankruptcy law does not bar it. Thus, pre-*Rake v. Wade* cases so holding become again good law.

To gauge the impact of these developments, let's use an example.

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115. *Rake*, 113 S. Ct. at 2187 n.8. The footnote stated that “[b]ecause the issue is not presented in this case, we express no view on the appropriate rate of interest that the Debtors must pay on arrearages cured pursuant to 1322(b)(5).”

116. For example, *In re Crawford*, No. 95CV80204 slip op. (Bankr. S.D. Iowa June, 1995), is a post-*Rake*, pre-BRA decision that applied a 7% market rate to $10,000 in home mortgage arrearages to be cured in Chapter 13, following the Eighth Circuit’s decision in *In re Doud*, 869 F.2d 1144 (8th Cir. 1989). The court refused the lender’s requests to use either the contract’s regular rate of 8.25% or the default rate of 12.25% on the arrearages. The district court affirmed on appeal. See *Hawkeye Bank & Trust v. Crawford*, No. 95CV80204 slip op. (Bankr. S.D. Iowa June, 1995).


EXAMPLE FIVE

In 1987, Dirk and Diana Debtor borrowed $84,625.60 at 8.25% for twelve years and two months and gave Lender a purchase money mortgage on their home. Monthly payments were $921.79. In early 1994, Debtors filed a Chapter 13 plan, listing Lender as holding a fully secured claim of $81,195.81. Of that, $10,733 was arrearages.119

If Debtors in Example Five were not required to pay interest on arrearages, they could cure over three years at only $298.14 a month. If a market rate of interest is applied, then 7%, they could cure with thirty-six payments of $331.41. If Debtors must pay the regular contract rate of 8.25, it will take $337.57 a month to cure. If the contract’s default rate of 12.25% is applied, required cure payments rise to $357.77, and the total interest on cure will be $2146.68.

Two commentators noted that, unlike section 506, new section 1322(e) does not even contain a reasonableness limit on interest and other charges that could be imposed under the terms of the contract.120 While lenders might not want to deter cure and reinstatement in general, high fees and rates could be used to bar cure on loans that bear interest rates far below current market, giving the lender leverage to renegotiate a higher ongoing rate in exchange for waiving some of the onerous default provisions.121

A question sure to arise is whether a default rate will be applied only to the late payments being cured or to the full principal balance as well while cure is in progress or even after. One could argue that, if the agreement levies a default rate on the entire balance and nonbankruptcy law allows the default rate, section 1322(e) would obligate the bankruptcy court to enforce the agreement in full. Arguably,

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119. The example is based on the facts of Hawkeye Bank & Trust v. Crawford, No. 495CV80204 slip op. (Bankr. S.D. Iowa June, 1995).
120. See SMITH & HAINES, supra note 117, at 15.
121. SMITH & HAINES, supra note 117, at 15.

One new federal limit on default rates of interest is found in the 1994 Home Ownership & Equity Protection Act of 1994 (“HOEP”), 15 U.S.C. § 226.32 (1994). HOEP prohibits the imposition of a default rate on loans categorized as “high rate mortgage loans,” a category limited to closed-end, non-purchase-money loans with an original, nondefault, annual percentage rate that exceeds, by more than 10%, the rate on Treasury securities of the same maturity. Id. Loans with high fees, that is in excess of the greater of $400 or 8% of the loan amount, are also within the default rate ban. Id. HOEP, of course, is part of the “applicable nonbankruptcy law” that controls rates for loans made after the BRA.

the default rate is among the home mortgage lender's rights protected from modification under *Nobelman.*

However, the better view would limit the default rate to the cure payments and would not extend it to the regular on-going payments in and after bankruptcy. First, extending the default rate beyond the cure payments is not authorized by new section 1322(e), which excepts from section 506 and section 1325 only "the amount necessary to cure the default" rather than the creditor's secured claim or some equally expansive term. Second, extending the default rate beyond the cure payments is inconsistent with the concept of cure. Cure, as mentioned above, is really cure and reinstatement. Cure includes not only compensating the creditor for a past default, but also forgiving that default and removing its consequences for the debtor. The debtor who cures is to be restored to his pre-default position and rights. As the House Report on the BRA says, "[A] cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred."

Home mortgage lenders are probably the greatest winners here. Congress did not adopt the pre-*Rake* view that no interest is payable on cure under section 1322(b)(5). Instead, the BRA makes interest on cure dependent on the initial contract and nonbankruptcy law, but does so only prospectively. That protects the interest entitlement of existing loans, while giving lenders the chance to redraft their documents for post-BRA loans and refinancings to provide for all interest allowed under nonbankruptcy law. For pre-BRA loans, interest is a matter of federal law and will be set by the court. For loans made or refinanced after October 4, 1994, interest is determined under the contract and nonbankruptcy law.

CONCLUSION

The Bankruptcy Reform Act of 1994 ("BRA") made important changes to the treatment of home mortgages in bankruptcy. The BRA raised the debt ceiling in Chapter 13, allowing more homeowners access to that chapter's helpful cure provisions. The BRA extended the ban on lien stripping of home mortgages to Chapter 11, thus removing

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124. See *Florida Partners Corp. v. Southeast Co.* (*In re Southeast Co.*), 868 F.2d 335 (9th Cir. 1989), a pre-*Rake* Chapter 11 decision refusing to impose default rates of interest on the entire unpaid balance of a debt being cured. *Southeast Co.*, 868 F.2d at 338. Cure, in the court's view, allowed more than just reversing acceleration. *Id.* at 338.
the possibility for debtors to do an end run around *Dewsnup* and *Nobelman* in that chapter. The BRA also ensured that the debtor’s right to cure lasts at least until a foreclosure sale and allowed modification on short-term mortgages as well. Finally, *Rake* was overturned, making interest rates dependent on the agreement and nonbankruptcy law.

The home mortgage lender’s favored position in bankruptcy still stands. The home mortgage lender remains virtually immune from lien stripping in reorganization, unlike other undersecured creditors. And, while the debtor gained some extra time to start a cure under the BRA, it comes at the likely cost of added interest.

Further, the BRA did not address the biggest Chapter 13 issue of all, the problem of debtor failure in that chapter. If anything, the higher debt ceilings combined with the longer time to initiate cure and the interest rate changes may tend to increase the failure rate by increasing the amounts the debtor will undertake to pay.