Subprime Lending, Suboptimal Bankruptcy: A Proposal to Amend §§ 522(f)(1)(B) and 548(a)(1)(B) of the Bankruptcy Code to Protect Subprime Mortgage Borrowers and Their Unsecured Creditors

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Before the 1990s, home mortgage credit was available to only the most creditworthy of borrowers. Beginning in the early 1990s, however, lenders began to emerge that were willing to extend credit to borrowers with riskier credit profiles. Since then, so-called subprime mortgage lending has become big business.[1] Many commentators laud the rise of subprime[2] lending: the dream of owning a home is now a reality for an ever-increasing number of borrowers.

Others have noted, however, that subprime mortgages appear to be overpriced.[3] Although subprime loans, to the extent they service higher-risk borrowers, should compensate lenders for additional default risk and origination costs, subprime credit nevertheless appears to be

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1. In 1983, subprime lending comprised only 1.4% of the national mortgage market. By 1999, subprime mortgages had grown to represent 13% of mortgage originations. *See* Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 307 (2005). By 2004, subprime mortgages comprised 19% of the total market. Robert B. Avery & Glenn B. Canner, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, FED. RESERVE BULLETIN 344, 349 (Summer 2005). According to one estimate, between 1994 and 2004, the annual dollar volume of subprime loans increased from about $35 billion to more than $530 billion. *Id.*

2. "Subprime," at least insofar as it refers to higher-risk borrowers, is something of a misnomer in the home mortgage context. In fact, the subprime mortgage lending markets include a great many borrowers who could qualify for credit in the prime markets. *See* Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUSING POL'Y DEBATE 503, 516 (2004) (noting that of the largest single pool of subprime loans securitized as of 2004, 10,000 of 25,000 borrowers had a FICO credit score above 640, and 3,000 had a score above 700).

3. *See, e.g.*, White, *supra* note 2; Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 569–70 (2004); *see also infra* Part I.A (discussing excessive pricing in the subprime mortgage lending markets).

costlier than necessary to compensate for these increased costs. Excessive pricing in the subprime home mortgage market brings with it significant economic and social costs. According to one estimate, equity stripping, excessive interest rates, and foreclosures in the subprime market cost consumers $9.1 billion annually.[4] The decrease in financial security caused by subprime mortgage lending and rising foreclosure rates has taken its toll on borrowers, their families, and the communities in which they live. The high cost of subprime credit is making it increasingly difficult for subprime borrowers to make ends meet. Stretched to the limit, many subprime borrowers find that they are just one illness or other financial problem away from a bankruptcy.[5] Indeed, while homeowners, considered as a whole, are less likely to file for bankruptcy than renters,[6] the situation is very different for those racial minorities typically targeted by subprime mortgage lenders. These homeowners are at least as or more likely to file for bankruptcy than their renting counterparts.[7]

Notwithstanding that subprime mortgage borrowers find themselves in bankruptcy more often than their prime counterparts, the effects of subprime mortgage lending on bankruptcy policy have not been given a great deal of attention.[8] This is probably in part owing to the fact that

4. ERIC STEIN, CTR. FOR RESPONSIBLE LEARNING, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 2 (2001), http://www.responsiblelending.org/pdfs/Quant10-01.pdf.

5. Elizabeth Warren, *The Economics of Race: When Making It to the Middle Is Not Enough*, 61 WASH. & LEE L. REV. 1777, 1792–93 (2004).

6. "At a time when 67.7% of the general population owned homes, only about 52.9% of the families in bankruptcy were homeowners, making the overall bankruptcy-filing rate for homeowners below that of the national average." *Id.* at 1790.

7. The bankruptcy-filing rate for Hispanic homeowners is roughly the same as for Hispanic renters. The filing rate for black homeowners is almost 18% greater than the rate for black renters. *Id.* at 1791. One possible explanation for this greater filing rate among black and Hispanic homeowners as compared with renters is that black and Hispanic homeowners are disproportionately targeted by subprime lenders and consequently are saddled with loans that are too costly. *Id.* at 1794–95. Others have noted that the proliferation of adjustable rate mortgages and other alternative mortgage products in the subprime markets may well lead to an increased financial crunch on families as those mortgages adjust—a financial burden that may translate into an increased number of subprime borrowers that seek relief inside bankruptcy. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-06-1112T, ALTERNATIVE MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED 4–6 (2006); *see also* Jennifer Bjorhus, *Homeowners hit hard as adjustable-rate mortgages reset: can families absorb the shock? Some can; others prepare for bankruptcy court*, ST. PAUL PIONEER PRESS, July 22, 2006, at A1.

8. Although the proper regulatory response to the problem of home mortgage predatory lending has been examined in some detail, comparatively little attention has been paid to the impediment the subprime mortgage lending market presents to the proper functioning of consumer bankruptcy. For a noteworthy exception, see Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 452–55 (1994) (arguing that some of the special protection given

the enormous growth in the subprime mortgage lending market is a relatively recent phenomenon. When the Bankruptcy Code was adopted in 1978, policymakers were not concerned with the impact of mortgage lending on bankruptcy policy. Quite the opposite: in the environment of the late 1970s, in which home mortgage credit was highly rationed,[9] policymakers were concerned primarily with ensuring that the Code did not further discourage mortgage lenders from extending credit.

Consequently, in order not to discourage home mortgage lending, the Bankruptcy Code treats home mortgage lenders much more favorably inside bankruptcy than it treats other secured lenders.[10] Because a whole new industry of subprime mortgage lending has developed since 1978, and indeed grown mightily, it is time to reconsider the treatment of home mortgage lenders inside bankruptcy. More specifically, instead of continuing to worry about how consumer bankruptcy is impacting home mortgage lending, it is time to consider how subprime mortgage lending is affecting the proper functioning of consumer bankruptcy.[11]

In this Article, I examine how large-scale equity erosion in the subprime mortgage markets potentially impacts upon bankruptcy policy, both for those subprime borrowers who file for bankruptcy and for their unsecured creditors. As I explain in more detail below, subprime loans, unlike their prime counterparts, are very often structured in such a way that a large amount of equity value is siphoned away from the borrower. For example, a subprime loan might include excessive fees and charges that are financed by the lender, rather than paid up front by the borrower. The fees and charges increase the principal amount, resulting

to home equity lenders inside bankruptcy as compared with other secured lenders undermines consumer bankruptcy's fresh start policy).

9. Until the 1990s, lenders were not able accurately to quantify credit risks associated with particular loan applicants. This inability on the part of lenders to quantify credit risk encouraged participation in the market by high-risk borrowers, and lenders resorted to simple models to screen applicants—models based on their credit histories, employment histories, and other variables. This resulted in the virtual exclusion from the credit markets of all but the most qualified of borrowers. *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393–94 (1981) (arguing that rationing by qualification is a result of imperfect information about a borrower's credit risk); *see also* Michael Collins et al., *Exploring the Welfare Effects of Risk-based Pricing in the Subprime Mortgage Market* 2–3 (Joint Center for Housing Studies, Working Paper Series (BABC 04-8) (2004)) (noting lenders' development over the last decade of refined tools to predict systematic risks).

10. *See* Forrester, *Mortgaging the American Dream*, *supra* note 8, at 392–93 (discussing the special protections given to home mortgage lenders inside bankruptcy).

11. *See* Elizabeth Warren, *The New Economics of the American Family*, 12 AM. BANKR. INST. L. REV. 1, 37 (2004) ("As an aggressive new segment of the consumer lending market has emerged, a market that turns on high risks and high profits, it becomes increasingly difficult to explain why mortgage loans should be treated any differently in bankruptcy from car loans or credit card debts.").

in an increased return for the lender in the form of higher monthly interest payments. More importantly for our purposes, the fees and charges also immediately deplete borrower equity value. I argue that this equity erosion, so common to subprime mortgage lending, negatively impacts upon two of consumer bankruptcy's primary policy objectives.

The first of those policy objectives is consumer bankruptcy's "social insurance" objective. By functioning as a form of social insurance, bankruptcy serves as a social safety net of last resort that prevents debtors from bearing the full costs of insolvency.[12] The Bankruptcy Code achieves this social insurance objective in part by permitting the debtor to remove from the reach of unsecured creditors certain core assets (i.e., the debtor's "exemptions"). One of those exemptions is often the debtor's interest in at least a portion of her home equity. As subprime lenders drain home equity value, then, they potentially compromise the social insurance function of bankruptcy for subprime borrower-debtors by depriving those borrowers of an asset that would otherwise be available to protect them against the full costs of insolvency.

The second policy objective is consumer bankruptcy's objective of treating unsecured creditors fairly within the context of the federal debt-collection proceeding.[13] As I argue below, consumer bankruptcy accomplishes this goal in part by maximizing the amount of assets available for distribution to unsecured creditors. Because equity erosion in the subprime markets unreasonably reduces the size of the bankruptcy estate, subprime lending potentially impacts upon this policy objective of consumer bankruptcy as well.

I propose two amendments to the Bankruptcy Code to ensure that the subprime mortgage lending markets do not improperly interfere with either of these strands of consumer bankruptcy policy. Both proposals permit the debtor or the trustee, as the case may be, to avoid a portion of the subprime mortgage lender's lien on the debtor's principal residence. First, I argue that the debtor should be permitted to use § 522(f)(1)(B) of the Code to avoid that portion of an overreaching subprime mortgage lender's lien that impairs the debtor's ability to enjoy an exemption in home equity that the debtor would otherwise have enjoyed had the subprime lender not charged too much for credit (i.e., taken too much of the debtor's equity value).[14] In other words, to the extent the Bankruptcy Code and applicable nonbankruptcy law permit the debtor's

12. *See infra* Part II.A.
13. *See infra* Part II.B.
14. *See infra* Part IV.A.

home equity to be included among the assets that the debtor may remove from the reach of creditors (that is to say, an asset the debtor may keep in order to make a fresh financial start), a subprime mortgage lender should not be permitted to overreach and cheat the debtor out of the benefit of that asset inside bankruptcy. Amending § 522(f)(1)(B) would ensure that subprime borrowers do not receive less of a fresh start in bankruptcy as compared with prime borrowers just because they purchased their mortgage on the subprime market.

Second, the trustee should be permitted to use § 548(a)(1)(B) of the Code to avoid that portion of a subprime mortgage lien which, as a result of subprime lender overreaching, reduces distributions to unsecured creditors.[15] In the context of a federal debt-collection proceeding, in which distributions to unsecured creditors are already reduced as a result of bankruptcy's giving the debtor a fresh financial start, subprime mortgage lenders should not be permitted to employ questionable lending practices to take too big a bite from estate resources to the detriment of those unsecured creditors.

For both of my proposals, I am primarily concerned with overreaching subprime mortgage lenders whose lending practices tend to erode borrower equity. Rather than attempting to define "predatory" or "overreaching," I instead propose revisions to §§ 522(f)(1)(B) and 548(a)(1)(B) that are modeled on North Carolina's predatory lending law.[16] That law governs all high-cost loans, essentially using "high-cost" as an efficient, if imperfect, proxy for "predatory."[17] The North Carolina law prohibits certain loan terms and lending practices for these high-cost loans that tend to result in the erosion of home equity value. Similarly here, I argue that §§ 522(f)(1)(B) and 548(a)(1)(B) should be revised to permit a debtor to avoid a lien on his home to the extent the lien is the result of a high-cost loan, and to the extent the lien amount is the result of certain loan terms that generally have the effect of eroding home equity value.

I am not arguing in this Article that the proper regulatory solution to predatory lending is primarily a bankruptcy solution. Rather, I am arguing that the transfer of equity value from borrower to lender is a common feature of the subprime mortgage lending market as it is currently (un)regulated at the federal level and in many states. And

15. *See infra* Part IV.B.

16. N.C. GEN. STAT. § 24-1.1E (2005).

17. A "high-cost" loan is defined as a loan exceeding a specified interest rate or exceeding a fees and charges trigger above a certain percentage of loan principal. *See infra* notes 116–17 and accompanying text.

because that equity erosion potentially impacts upon bankruptcy policy, the Bankruptcy Code can, and should, step in to ensure that the effects of equity erosion do not impinge on bankruptcy policy objectives.

Part I of this Article describes the subprime mortgage lending markets in some detail, paying particular attention to home equity erosion in those markets. Part II sets out two of the primary policy objectives of consumer bankruptcy, and Part III discusses how the subprime mortgage lending markets frustrate those objectives. Part IV describes in detail my proposals to amend §§ 522(f)(1)(B) and 548(a)(1)(B) to permit the debtor or the trustee, as appropriate, to avoid some portion of an overreaching subprime mortgage lender's lien, thus mitigating the subprime market's negative impact upon bankruptcy policy.

I. THE SUBPRIME HOME MORTGAGE MARKETS

A. Description of the Subprime Market

Home mortgage credit is available on a much wider basis today than it was in the late 1970s when the Bankruptcy Code was enacted. Technological developments in underwriting and the rise of the secondary market,[18] coupled with historically low interest rates and the dismantling of state usury laws, have lead to the availability of home mortgage loans to an ever increasing number of borrowers. Today's home mortgage market is divisible into "prime" and "subprime" segments. The prime segment generally caters to the most creditworthy borrowers. Subprime lenders, on the other hand, cater to a greater number of higher-risk borrowers. Although emerging only over the last

18. For a general discussion of the securitization and sale of home mortgages as well as problems posed by insulating investors in such securities from any liability resulting from predatory lending, see Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?*, 15 HOUSING POL'Y DEBATE 715 (2004). Securitization disconnects the originator from the borrower, perhaps encouraging originators less rigorously to screen potential borrowers for default risk, in effect shifting that risk to investors. Thus, the secondary market may give originators and brokers incentives to lend without regard to a borrower's ability to pay or to engage in other similarly predatory activity. *See* Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 514 (2005) ("[N]ew opportunities to raise lendable capital through the so-called secondary mortgage market encourage subprime lenders to ignore a borrower's ability to repay or service a mortgage loan."). Some commentators have argued that the holder-in-due-course rule, which would otherwise serve to protect purchasers of these bundled mortgages from liability, should be abolished to give investors incentives to police abusive lending practices by originators. *E.g.*, Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177 (2003–2004).

decade and a half or so, the subprime segment of the market has become extraordinarily profitable.[19] Once the province of small community banks, many of the country's largest national banks now have subprime lending operations.[20]

As one would expect, subprime loans are more expensive—some of them a great deal more expensive—than their prime counterparts. At least part of these increased costs legitimately compensates subprime lenders for the increased default risks and origination costs associated with subprime loans. Commentators agree, however, that at least some subprime pricing is the result of abusive—even fraudulent—lending practices. While some have concentrated heavily on the so-called predatory segment of the subprime market, others have theorized that pricing in the subprime market as a whole is excessive. That is to say, subprime lenders, as a general matter, appear to be charging more for subprime credit than would otherwise be necessary to compensate those lenders for the increased default risk and higher origination costs associated with subprime credit.[21] Although one might expect the marketplace to weed out subprime lenders that charge too much, the subprime markets appear to be devoid of the sort of competitive pressures that would eliminate excessive pricing from the marketplace.[22] In other words, market breakdowns permit subprime lenders to charge more for subprime credit than it is actually worth, i.e., more than a competitive market would otherwise allow.[23]

19. *See supra* note 1.

20. Patricia A. McCoy, Banking on Bad Credit: New Research on the Subprime Home Mortgage Market 1 (July 26, 2005), http://www.chicagofed.org/cedric/files/2005_conf_discussant_session1_mccoy.pdf (noting that over the past five years, subprime lending has shifted from small independent lenders to large subprime mortgage subsidiaries of national banks).

21. *See infra* notes 23–34 (discussing excessive pricing in the subrime mortgage markets).

22. Professors Engel and McCoy argue that legitimate subprime lenders, because of reputational concerns or because of business models predicated upon widespread, impersonal marketing, service mainly financially sophisticated borrowers whose credit makes them ineligible for prime-rate loans. Without price competition from legitimate subprime lenders, the predatory segment is free to exploit those borrowers, who are less sophisticated and more easily victimized. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1296–98 (2002); *see also* Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1335–36 (2006) (discussing market failure in the subprime mortgage market); Silverman, *supra* note 18, at 582–86 (arguing for increased use of state or federal credit unions as a source of subprime lending in order to provide competitive pressures on private predatory lenders).

23. Other commentators argue that the subprime mortgage lending markets are efficiently priced—that is that the higher cost of subprime credit is the result of the higher default risk and origination costs associated with those loans. *See* White, *supra* note 2, at 504 (describing the efficient-pricing hypothesis that the pricing of subprime mortgages is risk-based); ROBERT E. LITAN, AM. BANKER'S ASS'N, A PRUDENT APPROACH TO PREVENTING "PREDATORY" LENDING

Because excessive pricing appears to be a feature of the subprime mortgage market generally—not just of the so-called predatory segment—I do not attempt in this Article to differentiate "legitimate" from "predatory" subprime lending.[24] I am concerned with potential effects of excessive pricing in the subprime market on bankruptcy policy, particularly excessive pricing that has the effect of draining borrower equity value. Whether or not all excessively priced loans are "predatory" under prevailing taxonomy, their impact on bankruptcy is no less real. For simplicity's sake, throughout this Article, I refer to lenders that price credit in excess of what would otherwise be required to compensate them for increased default risks and origination costs as "overreaching" lenders.[25]

One reason to suspect that the subprime market is not efficient, and thus that subprime mortgages as a whole are excessively priced, is the scarcity of available pricing information that would permit subprime borrowers to comparison shop. Unlike the prime market, in which going rates are published in the newspaper, borrowers have no easy way to find information about prevailing terms and rates in the subprime

1 (2001), http://www.aba.com/NR/rdonlyres/D881716A-1C75-11D5-AB7B-00508B95258D/13716/LitanReport993.pdf (arguing that high-cost lending appropriately reflects risk of lending to customers outside the prime market); *see also* MICHAEL STATEN & GREGORY ELLIEHAUSEN, AM. FIN. SERVS. ASS'N, THE IMPACT OF THE FEDERAL RESERVE BOARD'S PROPOSED REVISIONS TO HOEPA ON THE NUMBER AND CHARACTERISTICS OF HOEPA LOANS 2 (2001), http://www.aba.com/aba/PDF/abia_FRB_report.pdf (arguing that increased regulation would reduce the flow of credit to subprime borrowers). Of course, market efficiency is only one consideration in determining a proper regulatory response to the subprime market; even efficient subprime mortgage lending markets might raise potentially significant social policy concerns. White, *supra* note 2, at 528–29.

24. Perhaps too much emphasis is placed on defining "predatory." *See* Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 13 (2005) ("Predatory lending at its heart is nothing more than misappropriation of income or equity by financial subterfuge. Predatory lenders take more from borrowers than they are rightly entitled to. What is difficult to define is not predatory lending, but rather, the ethically acceptable commercial practices that demarcate entitlement.").

25. While most commentators refer to a laundry list of abusive lending practices to define the term "predatory," others include pricing in excess of the risk premium and origination costs within the definition of "predatory." *E.g.*, Forrester, *Still Mortgaging the American Dream*, *supra* note 22, at 1312 (describing as predatory, among other loans, those loans that "are characterized by high interest rates and points that exceed the amount necessary to cover the lender's risk"); Azmy, *supra* note 1, at 321 ("A subprime loan is predatory when it includes costs and fees that far exceed reasonable market return for the credit risk associated with that borrower. . . ."); Anna Beth Ferguson, Note, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. ST. L. REV. 607, 609 (2000) (defining "predatory" to include offering subprime credit to prime-eligible borrowers); *see also* Deborah Goldstein, Note, *Protecting Consumers from Predatory Lenders: Defining the Problem and Moving Toward Workable Solutions*, 35 HARV. C.R.-C.L. L. REV. 225, 231 (2000) ("Theoretically, predatory lending may be found in any loan where the borrower's expenses cannot be justified on the basis of the lender's additional risk and cost.").

market.[26] This lack of price transparency, coupled with the fact that subprime lenders tend to target borrowers who might not otherwise actively shop for credit,[27] strongly suggests that the subprime markets lack competitive pressures that might otherwise force lenders to price credit in line with actual default risk and origination costs.

This lack of competitive pressure suggests that subprime mortgage lenders have the *opportunity* to overreach; available pricing data appear to confirm that mortgage lenders are *in fact* exploiting that opportunity and charging too much for subprime credit.[28] Market prices in the overall home mortgage market (prime and subprime), from the worst credit histories (highest credit risks) to the best credit histories (lowest credit risks), are not continuous—as one might expect were subprime prices simply correlated to incrementally greater default risks. Rather, there is a gap of at least two percent between the highest prime rate and lowest subprime rate. This two-percent gap is best explained as excess profit eked out of subprime borrowers who are not aware that they could have done better.[29] The fact that subprime lenders are able to exploit informational asymmetries at the expense of borrowers is further evidenced by the number of borrowers with good or excellent credit scores who purchase subprime loans.[30] The best, perhaps only,

26. White, *supra* note 2, at 509–12 (discussing that although prime mortgage prices are published in the newspaper and on the Internet, subprime mortgage rates at the retail level are secret; "[b]rokers and retail lenders have the information to shop for prices; consumers do not"); *see also* Collins, *supra* note 9, at 9 (discussing potential market failures as the subprime market develops and indicating that "[i]n order for markets to be efficient, buyers and sellers must have complete information on both product quality and available pricing . . . . Clearly, the rise of the subprime market has led to very complex pricing structures which are difficult for even the most financially literate borrowers to fully understand and evaluate. Most sub-prime borrowers are ill equipped for the rigors of financial analysis. Brokers and other originators know these pricing algorithms well, and the potential for abuse is high.").

27. Subprime borrowers do not appear to shop for credit the same way that prime borrowers do. Prime borrowers tend proactively to search for the best rate. Subprime borrowers tend to search primarily for loan approval and low monthly payments. Subprime borrowers are also more likely than prime borrowers to respond to direct sales calls or advertisements offering guaranteed loan approvals. Lax et al., *supra* note 3, at 554–55.

28. Engel & McCoy, *Tale of Three Markets*, *supra* note 22, at 1265 (discussing the problem of rent seeking in at least a portion of the subprime market—"subprime lenders using their market power to charge rates and fees that exceed the rates and fees they would obtain in a competitive market").

29. White, *supra* note 2, at 513. Others have argued that the two-percent gap results from informational asymmetries on the lender side, i.e., that lenders charge more for less-risky borrowers because lenders are unable accurately to know which borrowers are in fact likely to default. Amy Crews Cutts & Robert A. Van Order, Office of Freddie Mac, *On the Economics of Subprime Lending* 8–9 (2003), http://gotequitygetcash.com/stats/quick_loan_fast_subprime.pdf.

30. White, *supra* note 2, at 516 ("[T]he presence in the subprime market of such a significant percentage of consumers with good or excellent credit scores is consistent with Freddie Mac's reports that many subprime borrowers could qualify for prime rate mortgages.").

explanation is that these borrowers simply do not know that they could have qualified for prime loans. Discontinuous prices in the subprime market and the number of prime-eligible borrowers with subprime loans suggest that subprime lenders are taking advantage of subprime borrowers and charging more for credit than it is actually worth.

These pricing data demonstrate that subprime mortgage pricing is not tightly correlated with actual default risk. Regression analysis would seem to confirm the point. Although credit risk is the strongest predictor, there are any number of variables not related to credit risk that are *independently* predictive of whether borrowers purchase a subprime loan. These variables range from the borrower's race, ethnicity, and age, to the borrower's knowledge of mortgage products and how the borrower searches for credit.[31] Again, this further suggests that subprime lenders are taking advantage of informational asymmetries and charging more for subprime mortgages than they otherwise could in a competitive market.

That subprime mortgage lenders are able to charge too much for credit is hardly surprising given the relative bargaining positions of subprime lenders and subprime borrowers. The lack of financial sophistication of subprime borrowers makes price gouging far too easy. Loan documents are lengthy, confusing, and written in barely decipherable legalese difficult for even the most sophisticated of consumers. In addition, subprime loans themselves are generally more complex than prime loans.[32] The disparity of bargaining position as between lender

31. Marsha J. Courchane et al, *Subprime Borrowers: Transitions and Outcomes*, 29 J. REAL EST. FIN. & ECON. 365, 370–71 (2004); Lax et al., *supra* note 3, at 564.

> [In addition to borrower risk,] we find that age and level of education, as well as being asked to pay off debts, being turned down by a lender, being less familiar with mortgage types, searching little for the best rates, and responding to an offer of guaranteed loan approval, all statistically increased the probability of getting a subprime mortgage.

Id.

There is some evidence as well that subprime lenders target borrowers on the basis of race. *See* Kirstin Downey, *Mortgage Lenders Analyzed for Bias; Action Could Lead to Broader Probe*, WASH. POST, October 1, 2005, at D1 (banking data reveal "that about a third of blacks got high-price loans when they bought a house in 2004, compared with about 9 percent of non-Hispanic whites. About 20 percent of Hispanics got the more costly loans."); Warren, *Economics of Race*, *supra* note 5, at 1794. *But see* Lax et al., *supra* note 3, at 564 (finding that race not independently correlated with purchasing a subprime loan).

32. *See* Panel Discussion of the Committee on Consumer Financial Services, *Re-Examining Truth in Lending: Do Borrowers Actually Use Consumer Disclosures?*, 52 CONSUMER FIN. L.Q. REP. 3, 3 (1998) (the chair of the committee explaining that "[t]here's this pile of disclosure papers at home; I keep them just in case. Recently I finally pulled them out, thinking I should read a few. But I got only as far as a full-page disclosure of the transfer of mortgage servicing rights before I decided I can't take this anymore."). Unlike typical subprime borrowers, the most

and borrower is even more stark considering that nearly half the adult U.S. population functions at rudimentary levels of literacy, to say nothing at all of financial literacy. According to the 1992 National Adult Literacy Survey, this means that nearly half the adult population cannot "extract information to determine the price difference between two items" or "integrate or synthesize several facts from a longer document."[33]

Sales practices common in the subprime mortgage lending industry further illustrate the disparity of bargaining power in a great many subprime transactions. Subprime lenders often engage in targeted marketing schemes geared toward borrowers who for any number of reasons have been disconnected from the credit market. Some of the more abusive lenders go door-to-door or solicit by telephone in particularly vulnerable neighborhoods. Especially troublesome are the refinance lenders that use publicly available foreclosure data to ascertain potential borrowers who are in foreclosure proceedings, desperate to avoid losing their homes whatever the costs. The elderly are also vulnerable to aggressive home mortgage lenders; elderly borrowers are prone to physical and mental limitations that leave them particularly susceptible to lenders who are eager to exploit vulnerable, equity-rich borrowers.[34]

The subprime mortgage lending markets provide ample opportunity for subprime lenders to overcharge for credit, and many subprime lend-

sophisticated of consumers will also typically be offered the simplest of mortgage products—a fixed-rate mortgage for a term of years that does not contain provisions for adjusting interest rates, balloon payments, prepayment penalties, credit insurance, or the like. *See* Engel & McCoy, *Tale of Three Markets*, *supra* note 22, at 1284 ("Most predatory loans contain terms that require borrowers to make difficult probabilistic computations about the likelihood and magnitude of future market events that are entirely outside their control."); *see also* Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 725–26 (2005) (considering experimental evidence from behavioral economics and suggesting that predatory lenders use clever marketing, distraction, and legal lack of transparency to manipulate homeowners' otherwise strong aversion to foreclosure).

33. Melanie Wallendorf, *Literally Literacy*, 27 J. CONSUMER RES. 505, 506 (2001) (citing the 1992 NALS).

34. *See* NATIONAL PREDATORY LENDING TASK FORCE, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT AND U.S. DEPARTMENT OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 71–73 (June 2000) [hereinafter PREDATORY LENDING TASK FORCE], *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf; Peterson, *supra* note 24, at 14–17; *see also* Warren, *Economics of Race*, *supra* note 5, at 1794 (indicating that predatory lenders are "glad to take a subprime mortgage from anyone, but they redouble their efforts to saddle families they see as vulnerable with burdensome mortgages . . . ."); Goldstein, *supra* note 25, at 237 ("Targeting vulnerable or protected groups for high-cost mortgages . . . is clearly a predatory practice because it identifies consumers for such products based on factors other than the quality of their credit."); *id.* (discussing the problem of subprime lending and elderly borrowers).

ers take full advantage of that opportunity. Excessive pricing can take many forms. Many subprime lenders, for example, set interest rates above what would otherwise be required to compensate those lenders for actual default risk.[35] In addition to charging high interest rates, overreaching subprime mortgage lenders commonly engage in lending practices that result in the erosion of home equity value or that seriously undermine the ability of the borrower to earn equity in his or her home. For purposes of this Article, it is this *equity eroding* aspect of the subprime mortgage lending markets that I will focus on as having the most direct impact on the proper functioning of consumer bankruptcy.

Excessive fees and charges, often associated with subprime mortgage lending, directly and immediately deplete borrower equity. Cash-poor borrowers are not in a position to pay loan fees and charges up front; consequently, subprime lenders in such cases will often include the fees and charges in the amount financed. By rolling those fees and charges into loan principal, the borrower does not feel the impact of the fees and charges. Loan principal is increased, and along with it, the borrower's monthly interest payments to the lender. More importantly, the financed fees and charges immediately drain potential equity value in the home. In order to increase their return on the loan, some subprime lenders engage in the practice of "loan flipping" to accumulate fees and charges over time: these lenders encourage borrowers repeatedly to refinance, oftentimes conferring little or no value to the borrower with each new loan.[36] And with each refinancing, the borrower loses more equity value.

35. As Baher Azmy has indicated, over the life of a thirty-year, $200,000 loan, a 3% difference (9% compared with 6%) results in an additional $148,000 in interest paid by the borrower and an additional $400 per month. *See* Azmy, *supra* note 1, at 321. Elizabeth Warren vividly describes the cost of interest on a subprime Citibank mortgage in 2001, a loan at a rate of 15.6% when the standard market was at about 6.5%:

> To put that in perspective, a family buying a $175,000 home with a subprime loan at 15.6% would pay *an extra $420,000* during the 30-year life of the mortgage—that is, over and above the payments due on a prime mortgage. Had the family gotten a traditional mortgage instead, it would have been able to put two children through college, purchase half a dozen new cars, and put aside money for retirement."

Warren, *Economics of Race*, *supra* note 5, at 1792–93 (emphasis in original).

36. In order to force borrowers to refinance, some lenders include loan terms that will virtually ensure default. A lender might, for example, use a balloon mortgage—a loan that does not fully amortize over the loan term (the loan might amortize over thirty years, but have a term of only fifteen years). The final payment on a balloon mortgage includes the remaining principal not paid over the term of the loan, and is therefore often too large for the borrower to afford. A borrower faced with an unaffordable balloon payment will likely be willing to refinance (and incur another round of fees and charges) in order to avoid losing his or her home.

Subprime fees and charges are often far in excess of what would otherwise be required to cover loan origination costs.[37] Accordingly, overpaying subprime borrowers are giving up more equity value than would otherwise be required to fairly compensate lenders. According to some estimates, subprime loans have fees on average around six times that of prime loans.[38] It has been suggested that between 1995 and 2001, the leading originator of subprime loans routinely charged 7.25 points on its loans.[39] Seven and a quarter points rolled into the loan principal would mean an additional $14,500 in loan principal for a $200,000 loan. That is $14,500 in principal that would accrue interest over the life of the loan for the lender, and more significantly for our purposes, an immediate $14,500 drain on borrower equity.

The inclusion of prepayment penalty provisions in subprime loans also potentially depletes borrower equity. Although uncommon in the prime markets, penalties for early repayment are common in the subprime markets.[40] If the borrower in a subprime lending transaction decides to refinance in order to take advantage of falling interest rates, or after becoming eligible (or discovering that he or she was *always* eligible[41]) for a prime loan, that borrower may incur a substantial prepayment penalty. When those prepayment penalties are included in the principal amount of the new loan, equity value is transferred from the borrower to the original lender.

Consider, for example, the not atypical example of a subprime loan with a prepayment penalty amounting to about five percent of the principal amount over the first five years of the loan.[42] If the borrower

37. Lenders may pad fees, charging more than the true costs of the services would warrant. More abusive lenders will include products in loan principal that do not benefit the borrower or that the borrower is not even aware of, most notoriously, single premium mortgage insurance. *See* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 517–18 (2002) (discussing loan "packing"); *see also* White, *supra* note 2, at 514 ("Because the interest rate component of mortgage prices seems to compensate subprime lenders amply for credit losses, there does not appear to be any risk-related cost that points and fees would cover.").

38. White, *supra* note 2, at 514 (explaining that average fees for subprime borrowers are 7% of the loan, as compared to 1.1% for prime borrowers).

39. *Id.* White cites another example of a subprime lender charging 20 points. In the subprime market, points often do not function to buy down interest rates as they do in the prime markets. In the prime market, points are typically paid up front in exchange for a reduction in the loan interest rate. *Id.*

40. According to an estimate in 2000, 70% of subprime loans contained a prepayment penalty, as compared with one or two percent of prime mortgages. PREDATORY LENDING TASK FORCE, *supra* note 34, at 93.

41. *See supra* note 2 (discussing the number of prime-eligible borrowers with subprime loans).

42. Marilyn Kennedy Melia, *The penalty for early payoff*, CHI. TRIB., Feb. 20, 2005, Real

were to refinance such a $200,000 loan within the first five years, the principal amount of the refinancing loan would need to include as much as an extra $10,000 to cover the penalty owed the original lender—a $10,000 drain on borrower equity. Notably, although prepayment penalties are typically defended as protecting lenders against prepayment risk, some of the data suggest that subprime borrowers are actually *less* likely to prepay than prime borrowers.[43] Here again, subprime mortgage lenders appear to be exploiting borrowers and charging more for subprime credit than true risks would otherwise warrant.

Negatively amortizing loans can also drain borrower equity. Negative amortization is not all that common, even in the subprime markets, and is considered almost per se predatory. Monthly payments in a negatively amortizing loan are insufficient to cover accumulating interest. Such loans actually permit the principal amount to increase over the life of the loan and equity value to decrease.

All of the loan terms described above result in the depletion of home equity. This can be extremely profitable for lenders: by increasing the amount of loan principal, lenders are able to earn more in interest with each monthly mortgage payment. In some cases, however, lenders pack loans with fees and charges, prepayment penalties, and the like, not only in an effort to earn more interest from the borrower, but in an effort to appropriate home equity as a profit generator in and of itself. These sorts of lenders extend credit without regard to the borrower's ability to pay because by appropriating so much equity value, the loans are profitable for the lenders even if the borrower defaults. So-called asset-based lenders are indifferent to default, and in some cases, might even prefer default.[44]

Loans originated by asset-based lenders are obviously very likely to end up in foreclosure. Indeed, foreclosures in the subprime market have garnered quite a bit of attention. Subprime loans appear to be entering into foreclosure at alarming rates—perhaps as much as ten times the rate of conventional loans.[45] The high rate of foreclosure and the quick

Estate, at 2 ("Nationwide, the typical prepayment penalty is in effect for the first five years of the loan and amounts to roughly 4 percent to 5 percent of the original loan amount.").

43. Engel & McCoy, *Predatory Lending*, *supra* note 18, at 735–38. Contrary to industry claims that prepayment penalties provide a trade-off against higher interest rates, such penalties are actually positively correlated with increased interest rates. *Id.* at 737.

44. *See* Warren, *The Economics of Race*, *supra* note 5, at 1795–96 ("The lender rakes in fees at closing and receives high monthly payments for a few years, waits for the family to fall behind, and then sweeps in to take the property. The lender wins in every possible way—high profits if the family manages to make all its payments and even higher profits if the family does not.").

45. Robert G. Quercia et al., *The Impact of Predatory Loan Terms on Subprime Foreclosures:*

time to foreclosure appear to suggest that a great many subprime mortgages are unaffordable at the time of origination.[46] It has been suggested that, rather than being a byproduct of subprime lending, foreclosures might in fact be caused by the way subprime loans are structured, *even when controlling for borrower default risk*.[47] In other words, subprime loans themselves, not the increased default risks associated with subprime borrowers, may be the cause of a significant number of subprime foreclosures. This trend is likely to continue as adjustable-rate mortgages reset. The connection between subprime credit and default will become important as we examine the effects of subprime mortgage lending on the objectives of consumer bankruptcy—in particular bankruptcy's objective of protecting consumers from bearing the full costs of insolvency.

B. The Regulation of the Subprime Mortgage Lending Markets

Although there have been attempts to regulate the subprime home mortgage markets at the local level, most regulatory efforts have been concentrated at the state and federal levels. Federal attempts to regulate predatory lending have focused primarily on requiring lenders to make certain disclosures to potential borrowers. For example, both the Truth in Lending Act[48] and the Real Estate Settlement Procedures Act of 1974[49] are predicated upon the notion that if consumers are provided sufficient information about loan products, including, for example, annual percentage rate, finance charges, payment schedules, settlement

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The Special Case of Prepayment Penalties and Balloon Payments, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill at 2 (2005), *available at* http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf.

46. Harold L. Bunce et al., *Subprime Foreclosures: The Smoking Gun of Predatory Lending?*, in HOUSING POLICY IN A NEW MILLENNIUM, at 265, *available at* http://www.huduser.org/publications/pdf/brd/12Bunce.pdf. Bunce synthesized studies of four metropolitan areas and concluded that:

> [I]n all three of these market areas, loans by subprime lenders reach foreclosure much more quickly. In fact, with most of these loans reaching foreclosure in 2 years or less from origination, it seems likely that the loans were not affordable for the mortgagors even at the time of origination.

Id.

See also Azmy, *supra* note 1, at 343–44 (arguing that the available data on subprime foreclosures suggest that, contrary to the standard description of subprime pricing behavior, excessive interest rates tend to drive unnecessarily higher risk of foreclosure, not the other way around).

47. Quercia, *Impact of Predatory Loan Terms on Subprime Foreclosures*, *supra* note 45, at 27–28 (looking at the first lien refinance market and concluding that extended prepayment penalties increase the odds of foreclosure by twenty percent and balloon payments increase the incremental odds of foreclosure by fifty percent, holding constant other risk factors).

48. Truth in Lending Act, 15 U.S.C. §§ 1601–1667f (2006).

49. Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601–2617 (2006).

costs and the like, they will have the information necessary to shop competitively for loans.[50]

The single notable exception at the federal level to the disclosure-only regime is the Home Ownership and Equity Protection Act (HOEPA), which substantially regulates nonpurchase high-cost home mortgage loans.[51] Under HOEPA, a loan is a high-cost loan if the annual percentage rate or fees and charges exceed a statutory threshold. With respect to these high-cost loans, HOEPA prohibits certain loan terms, including, for example, negative amortization, some balloon-payment provisions, interest rates that increase upon default, and certain prepayment penalty terms. In addition, HOEPA targets asset-based lending and loan flipping. Though the HOEPA provisions are a step in the right direction, away from the disclosure regime and toward substantive regulation, the HOEPA triggers are too high to provide any meaningful antidote to predatory lending.[52]

A number of states have attempted to fill the regulatory gap left by HOEPA, essentially enacting laws patterned on HOEPA, but lowering the triggers for what constitutes a high-cost loan. These state laws are designed to pull a larger segment of the subprime market within their purview than does HOEPA. Other states have predatory lending laws that do little more than track the scope of HOEPA, though perhaps adding to HOEPA's list of prohibited loan terms or lending practices. Other states do even less, or nothing at all.

Even for those states that have chosen aggressively to regulate predatory lending, federal regulatory authorities have not permitted state predatory lending laws to reach national banks, federally chartered credit unions, or federally chartered thrifts. The Office of the Comptroller of the Currency (OCC) issued an order on July 30, 2003, determining that the Georgia predatory lending law was preempted with respect to national banks and their subsidiaries engaged in real estate

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50. *See* Azmy, *supra* note 1, at 351.

> [The] normative preference for disclosure may be well-justified for products such as groceries, personal electronics, and even larger purchases like automobiles, because consumers can compare products within those categories relatively quickly and with few or no transaction costs. In the context of the subprime mortgage market, however, the theoretical premises of disclosure regulation seem quaint and utterly insufficient.

Id.

51. *See* Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, tit. 1, subtit. B, 108 Stat. 2160 (1994) (codified in scattered sections of 15 U.S.C.).

52. Although the HOEPA triggers have been reduced since the law was originally enacted, some commentators argue that the triggers remain too high. *See* PREDATORY LENDING TASK FORCE, *supra* note 34, at 85; Azmy, *supra* note 1, at 355.

lending.[53] The OCC followed that order with a formal rulemaking that provided for some substantive regulation of predatory lending by national banks, and specified the scope of OCC preemption of state predatory lending laws.[54] In practice, OCC preemption under these new rules effectively precludes any state effort to regulate loan terms and lending practices of national banks and their operating subsidiaries. The National Credit Union Administration and the Office of Thrift Supervision[55] have also taken the position that federal law preempts state predatory lending legislation with respect to federally chartered credit unions and thrifts.[56]

In sum, the regulatory landscape covering subprime mortgage lending, at least in some jurisdictions, permits lenders to siphon a great deal of home equity value from subprime borrowers.

II. PURPOSES OF CONSUMER BANKRUPTCY

As discussed in Part I, efforts to substantively regulate the subprime mortgage markets exist, where at all, primarily at the state level. In those states where the regulatory response is light, subprime lenders are able to charge a great deal more for credit than it is worth and to drain

53. *See* Preemption Determination and Order, 68 Fed. Reg. 46,264 (Aug. 5, 2003).

54. *See* Banking Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (Jan. 13, 2004) (codified at 12 C.F.R. pts. 7 and 34). The rulemaking specifically prohibits national banks (and their operating subsidiaries) from making real estate loans "based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms." *Id.* at 1917.

55. *See* 12 C.F.R. § 701.21(b) (NCUA preemption); *Preemption of New Jersey Predatory Lending Act*, OTS Opinion of Counsel, P-2003-5 (July 22, 2003) (indicating that "OTS occupies the field" for lending activities with respect to federal savings associations); *Preemption of New York Predatory Lending Law*, OTS Opinion of Counsel, P-2003-2 (Jan. 30, 2003) (same); *Preemption of Georgia Fair Lending Act*, OTS Opinion of Counsel, P-2003-1 (Jan 21, 2003) (same).

56. Proponents of preemption often point to the economic benefits of uniform federal regulation over predatory lending. *See* Howard N. Cayne & Nancy L. Perkins, *National Bank Act Preemption: The OCC's New Rules Do Not Pose a Threat to Consumer Protection or the Dual Banking System*, 23 ANN. REV. BANKING & FIN. L. 365, 408-09 (2004) (noting the costs and burdens associated with national banks attempting to comply with a patchwork of state and local regulation); Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 BUS. LAW. 1193, 1193 (2004). Others argue that the preemption of state predatory lending regulation leaves many state banks at a competitive disadvantage and undermines the effective enforcement of consumer protection laws against national banks and their operating subsidiaries. Arthur E. Wilmarth, *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 277–78, 363 (2004). For a discussion of preemption generally as well as an argument that "current efforts to preempt state laws have little or nothing to do with federalism in general or uniformity in particular, but are, in fact, simply efforts to deregulate," see Peterson, *supra* note 24, at 8.

equity value from borrowers. As will be explored in more detail in Part III, this large-scale erosion of home equity has ramifications for the quality of relief for subprime borrowers inside bankruptcy, as well as for those subprime borrowers' unsecured creditors. In short, equity erosion in the subprime markets may prevent consumer bankruptcy from doing what it was intended to do both for subprime debtors and for their unsecured creditors. Before exploring how the subprime mortgage markets frustrate the objectives of consumer bankruptcy, however, we turn to a discussion of just what those objectives are.

Consumer bankruptcy sits alongside state debtor-creditor laws, which establish priorities among a debtor's creditors and a means for collecting on those creditors' claims. There is a lively debate, especially in the commercial bankruptcy context, about the extent to which federal bankruptcy debt collection rules should alter the state debtor-creditor rules that generally govern over credit transactions.[57] The altering of nonbankruptcy law inside bankruptcy is perhaps most controversial where policymakers are attempting to advance some nonbankruptcy policy or another.[58] Altering nonbankruptcy rules inside bankruptcy is

57. Proceduralists have justified the federal debt collection regime for businesses primarily as a response to the collective action problem that would arise if creditors were to avail themselves of state collection remedies in those cases in which there are insufficient assets to pay each creditor in full. For these commentators, nonbankruptcy rules should be altered inside bankruptcy only to the extent nonbankruptcy rules exacerbate the common pool problem. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7–19 (1986) [hereinafter JACKSON, LOGIC AND LIMITS]. Traditionalists, on the other hand, while not necessarily articulating as tidy a theory of the purpose of bankruptcy, generally think of bankruptcy purposes more broadly. Commercial bankruptcy purposes for these scholars might include, for example, the protection of the communities surrounding the bankrupt business and the protection of the bankrupt business as a going concern. *E.g.*, Karen Gross, *Taking Community Interests Into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994); KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991) (explaining a normative theory of bankruptcy as responding to the "many aspects of financial distress—moral, political, personal, social, and economic—and in particular, to the grievances of those who are affected by financial distress"); *see also* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 811 (1987) (offering in contrast to the law and economics school, a "dirty, complex, elastic, interconnected view of bankruptcy from which [one] can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision"). For a discussion of the proceduralist and traditionalist schools, see Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998).

58. Consider for example, Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) amendments to the Code that limit the debtor's state homestead exemption if the debtor owes a debt arising out of, among other things, a violation of state and federal securities laws or any criminal act, intentional tort, or willful or reckless conduct causing serious physical injury or death within the preceding five years. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 322, 119 Stat. 23 (2005) (codified at 11 U.S.C. § 522(q)(1)(B) (2006)). The Bankruptcy Code may effectuate nonbankruptcy policy, perhaps less controversially, not by altering nonbankruptcy rules, but instead by exempting persons or

less controversial where those nonbankruptcy rules prevent bankruptcy from doing what Congress intended bankruptcy to do.

Indeed, consumer bankruptcy rules routinely trump nonbankruptcy rules to the extent necessary to accomplish its fresh start and creditor-protection policies. For example, the bankruptcy discharge prohibits a creditor from pursuing state collection remedies after bankruptcy in order to ensure that the debtor receives a fresh financial start.[59] Unlimited (or very high) state homestead exemptions give way to a federal cap in certain circumstances to prevent debtors from treating unsecured creditors unfairly. Chapter 13 repayment plans displace state contract rights and state remedies for the sake of advancing the debtor's fresh start.[60] Preference provisions scrutinize transactions otherwise nonproblematic under state law, in order to prevent one unsecured creditor from treating other unsecured creditors unfairly inside bankruptcy.[61]

If bankruptcy's claim to alter nonbankruptcy debtor-creditor rules is at its zenith when those rules prevent bankruptcy from doing what it was intended to do, what, then, are the appropriate policy objectives of consumer bankruptcy? Consumer bankruptcy is concerned with two primary policy objectives: (1) to give the honest but unfortunate debtor a fresh financial start and (2) to provide for the payment and fair treatment of creditors in the context of the federal debt-collection proceeding. These two goals are in tension. On the one hand, the Bankruptcy Code's discharge and exemption provisions,[62] the two provisions giving effect to the fresh start policy, require that certain creditors not be paid what they might otherwise be entitled to under state law. On the other hand, Congress has, especially in light of the recent amendments to the Bankruptcy Code, underscored the extent to

transactions from the scope of the Code. *See* 11 U.S.C. § 1322(b)(2) (2006) (rights of residence mortgage lenders not modified in bankruptcy in order to encourage home ownership); 11 U.S.C. § 523(a)(9) (2006) (removing from the scope of the discharge claims arising from the debtor's driving while impaired presumably in order to discourage such behavior); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907, 119 Stat. 23 (2005) (removing certain financial contracts from the bankruptcy regime in order to protect financial markets).

59. *See* 11 U.S.C. § 524(a) (2006); *see infra* note 67.

60. *E.g.*, 11 U.S.C. § 1322(b)(2) (plan may modify the rights of certain holders of secured claims); § 1322(b)(3) and (5) (plan may provide for the curing of defaults) (2006).

61. 11 U.S.C. § 547 (2006).

62. The discharge relieves the debtor from any further obligation on certain unsecured debts following the conclusion of the bankruptcy case, either after liquidation of non-exempt assets in a chapter 7 case or after completion of a repayment plan in a chapter 13 case. The debtor is permitted to exempt certain of his or her assets from the reach of unsecured creditors, and these are known as the debtor's exemptions. *See* 11 U.S.C. §§ 522, 524, 727, 1328 (2006).

which consumer bankruptcy is concerned that creditors are paid where possible and that unsecured creditors be treated fairly.[63]

I will examine each of these policy strands in turn before discussing in Part III how those strands are impacted by the subprime mortgage lending markets. Because the subprime markets negatively impact on these two policy objectives, the Bankruptcy Code can, and should, step in to ensure that bankruptcy does what it was intended to do. In Part IV, I propose revisions to the Code to do just that.

A. The Fresh Start: Bankruptcy as Social Insurance

Consumer bankruptcy provides debtors a mechanism to shed at least a portion of their financial obligations and to emerge with a fresh financial start. This fresh start is the defining characteristic of American consumer bankruptcy, and the Bankruptcy Code provides for the fresh start primarily through its exemption and discharge provisions.

When filing for bankruptcy, debtors may choose either chapter 7 or chapter 13. Whichever route the debtor chooses, the Code permits the debtor, through its exemption provisions, to remove certain core assets from the reach of unsecured creditors. In a chapter 7 case, the debtor's non-exempt assets are liquidated, and unsecured creditors are paid pro rata from the proceeds. By permitting the chapter 7 debtor to keep her exempt assets, the Bankruptcy Code provides the debtor a core group of assets with which to make a fresh financial start. In addition to the exemptions provided for by the Code,[64] state law also provides for the exemption of certain property. The Bankruptcy Code permits states to

63. The means testing provisions, the very heart of the BAPCPA, are "intended to ensure that debtors repay creditors the maximum they can afford." H.R. REP. NO. 109-31, pt. I, at 2 (2005). Even before the Code was amended to means test debtors, there existed various incentives to encourage debtors to enter into a repayment plan under chapter 13 rather than liquidate under chapter 7, again illustrating Congress's preference that creditors be paid. For example, the chapter 13 debtor is permitted to cure arrearages on, and reinstate, home mortgages, and strip down certain other secured debts. *See* 11 U.S.C. § 1322(b)(2), (3), & (5) and 1325(a)(5) (2006). Moreover, the Code has historically nudged debtors into chapter 13 by offering a more substantial discharge in chapter 13 than in chapter 7. *See* 11 U.S.C. § 1328 (2006). While on its face seeking to encourage debtors to pay unsecured creditors, the BAPCPA has nevertheless undercut some of those incentives in the Code for debtors to choose chapter 13 over chapter 7. Under the recent amendments to the Code, the "super" discharge of chapter 13 has been restricted, *see* § 314(b) of BAPCPA, Pub. Law. No. 109-8 (2005) (codified at 11 U.S.C. § 1328(a) (2006)), as has the debtor's ability to strip down secured claims in chapter 13. S*ee* § 306(b) of BAPCPA, Pub. L. No. 109-8 (codified at 11 U.S.C. § 1325(a) (2006)). As a result of these amendments, a chapter 13 debtor may not strip down (i.e., reduce a secured claim to the value of the collateral) a purchase-money security interest if the collateral securing the debt is (1) a car and the debt was incurred within two and a half years of filing or (2) something other than personal property and the debt was incurred within a year of filing.

64. The federal bankruptcy exemptions are enumerated at 11 U.S.C. § 522(d) (2006).

opt out of the federal exemption regime; in non-opt-out states, debtors may choose to take either the federal or the state exemptions, but debtors may not mix the two.[65]

In a chapter 13 case, the debtor is permitted to keep all of his assets in exchange for entering into a repayment plan. In order for the repayment plan to be approved by the bankruptcy court, however, the debtor's unsecured creditors must receive at least as much under the plan as they would have under a hypothetical chapter 7 liquidation.[66] Consequently, in a chapter 13 case, the exemptions contribute indirectly to the debtor's fresh financial start by reducing the amount of the debtor's monthly payments to unsecured creditors under the repayment plan.

The Bankruptcy Code's discharge provisions further contribute to the debtor's fresh start by prohibiting all future debt collection activity on prepetition claims following the bankruptcy. Consequently, to the extent unsecured creditors' claims are not paid in full by the chapter 7 liquidation or the chapter 13 repayment plan, a debtor's creditors may not pursue state remedies to collect any further on those claims.[67]

The fresh start offered to debtors in bankruptcy is most properly explained as a form of social insurance.[68] As a form of insurance, the fresh start in bankruptcy shifts risk, in this case, the risk of borrower default, from the borrower to the lender in exchange for a premium, which in this case is an increase in the cost of credit (i.e., higher interest rates).[69] As a descriptive matter, this economic account of consumer bankruptcy as social insurance is complete.[70]

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65. 11 U.S.C. § 522(b)(2). The federal exemptions are sometimes more generous than the applicable state exemptions and sometimes less. About three-quarters of the states have opted out of the federal exemption regime. For a discussion of exemptions generally, see GROSS, FAILURE AND FORGIVENESS, *supra* note 57, at 44–49.

66. *See* 11 U.S.C. § 1325(a)(4) (2006) (providing that unsecured creditors must receive at least much under a chapter 13 payment plan as they would in a chapter 7 liquidation).

67. 11 U.S.C. § 524(a)(2) (2006) (discharge "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover, or offset any [discharged debt] as a personal liability of the debtor, whether or not discharge of such debt is waived"). For exceptions to the discharge, see 11 U.S.C. § 523 (2006).

68. For a full discussion of how consumer bankruptcy functions as a form of social insurance and a discussion of the allocation of social insurance between consumer bankruptcy and other forms of social insurance, see Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129 (2005) ("Bankruptcy scholars generally agree that consumer bankruptcy functions, at least in part, as a form of social insurance.").

69. *See id.* at 129 (noting that the discharge satisfies the basic economic theory of insurance: "It transfers risk from a debtor (the insured) to his or her creditor (the insurer), for which the creditor seeks compensation in the form of an increased interest rate."). *But see* Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1066 (1987) ("[E]ven if we are prepared to concede that the costs of some credit losses are passed along, 'we

For a normative account of why bankruptcy *should* function as social insurance, many scholars have pointed to the policy objective underlying the social insurance function: to provide a social safety net of last resort. According to this line of thought, bankruptcy sits alongside other forms of insurance that serve to protect consumers from bearing the full cost of financial loss. For example, health insurance protects individuals from the full cost of illness, and unemployment compensation protects individuals from the full cost of job loss. When individuals fall through the cracks of existing forms of insurance, bankruptcy functions as a social safety net (or insurer) of last resort. In effect, the Bankruptcy Code provides this social safety net by shifting some of the costs of insolvency from the debtor (and the debtor's family and community) to the debtor's unsecured creditors. Consumer bankruptcy represents a policy judgment that, assuming existing social safety nets are not sufficient to protect all consumers, there ought to be a social safety net of last resort to protect those unfortunate consumers from bearing the full costs of insolvency.[71]

That the American consumer bankruptcy system serves as a social safety net to protect debtors from bearing the full costs of insolvency tends to illustrate American attitudes toward debt itself. The American system has not always provided for the discharge of consumer debt.

simply do not know' if these additional costs are significant.").

70. Many scholars prefer to think about consumer bankruptcy in these economic terms. *See* Feibelman, *supra* note 68, at 129–30 (noting that some scholars base the social insurance claim on formal economic theories of insurance while for others, the claim is more functional than economic). On this economic view, the discharge is best explained according to a risk-allocation analysis. The discharge shifts the risk of default to unsecured creditors because creditors are better bearers of that risk than are debtors. *See* Howard, *supra* note 69, at 1063 (discussing the economic theory of the discharge: default risk should be placed on the party better able to bear that risk, which in turn depends on which party is able to prevent default from occurring and which party is the superior insurer against the risk).

This sort of analysis does not, in and of itself, provide a sufficient *normative* explanation for the discharge. JACKSON, LOGIC AND LIMITS, *supra* note 57, at 230 and n.18 ("Even if we could determine whether the debtor or his creditor is more likely to be the superior risk bearer in any particular situation, risk-allocation analysis . . . yields no more than a presumption. Such an analysis cannot explain why the presumption should be frozen into a nonwaivable right to discharge. Indeed, businesses commonly contract out of the presumption that creditors are better risk bearers than the shareholders . . . . Individuals might well seek such limited liability by contract were it not provided by discharge."). Under the classic economic theory of insurance in contract, for example, risk should be allocated to the party most able to bear the risk (in an attempt to effectuate what the parties presumably would have intended) only where the contract is silent on the matter. For a discussion of the insurance function of contracts generally, see RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 104–10 (6th ed.).

71. *See e.g.*, TERESA A. SULLIVAN, ELIZABETH WARREN & JAY WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 3 (2000); *see also* Feibelman, *supra* note 68, at n.3 (citing various scholars, who have advocated this "insurer of last resort" view of bankruptcy).

Before the advent of modern bankruptcy law, default was criminalized and debtors imprisoned. The move from the criminalization of default to dischargeability reflects a sea change in view as to the nature of debt. Recent scholarship illustrates that default, far from being a moral shortcoming, is in many cases simply amoral—something that happens not because of debtor misbehavior, but instead because of something that happens *to* the debtor, like an illness, divorce, or layoff.[72] And indeed, there are persuasive economic and social reasons for providing individuals a cushion against financial loss and for rehabilitating such individuals to full participation in the economy, rather than requiring them to pay off creditors no matter how long it takes or whom it hurts.[73]

The discharge and exemption provisions may reflect a value judgment, then, that the debtor should be protected against the full costs of insolvency where the debtor's actions are least blameworthy—where the debtor is not a bad actor, but instead a victim of insolvency.[74] Under the recent amendments to the Code, debtors no longer enjoy presumptive dischargeability, but instead must demonstrate eligibility for relief under a new chapter 7 means test. While those amendments might reflect at least a partial return to the view of the moral culpability of the debtor, the chapter 7 discharge remains a viable alternative for the neediest of debtors.[75]

72. Howard, *supra* note 69, at 1052 ("The policy of rewarding the honest debtor with discharge represents a major departure from the view that defaulters are, simply because of default, deserving of punishment for their guilt, negligence, or indolence."); *see also* David U. Himmelstein, Elizabeth Warren, Deborah Thorne & Steffie Woolhandler, *Market Watch: Illness and Injury as Contributors to Bankruptcy*, HEALTH AFFAIRS: THE POLICY JOURNAL OF THE HEALTH SPHERE, Feb. 2, 2005, at W5-70, http://content.healthaffairs.org/cgi/reprint/hlthaff.w5.63v1.pdf (reporting that medical problems contribute to about half of all bankruptcies).

73. Posting of Debb Thorne to Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2006/08/perpetual_debt_.html (Aug. 4, 2006) (indicating that society is better off permitting debtors to grow their own wealth rather than forcing debtors to decades of repayment, in effect transferring that wealth to an already wealthy lending industry).

74. The Bankruptcy Act of 1898 underscored this moral neutrality with respect to at least some consumer debt when it made the discharge available to the "honest but unfortunate" debtor. *See* Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 364 (1991).

75. Although the Bankruptcy Code now provides for a means test, it is not at all clear that in practice the means-testing provisions will serve as a bar to chapter 7 relief. As Melissa Jacoby has pointed out, most filers before 2005 would have been eligible for relief under chapter 7 even under the new means-testing provisions. Also, many trustees were using some form of means testing before passage of the 2005 amendments. Melissa B. Jacoby, *Ripple or Revolution? The Indeterminacy of Statutory Bankruptcy Reform*, 79 AM. BANKR. L.J. 169, 171–72 (2005). Although the number of filings dropped after passage of BAPCPA, filings appear to be on the rise. *See* Elizabeth Razzi, *The Coming Credit Crunch: What's In Your Wallet?*, CHI. TRIB. MAG., October 15, 2006. The initial drop may owe more to the additional procedural hurdles to filing than to the new means-testing provisions.

B. The Avoidance Provisions: Fair Treatment of Creditors and the Maximization of Estate Resources

In addition to serving a social insurance function, consumer bankruptcy also functions to ensure the orderly distribution of the debtor's assets to creditors. And one way that the Code provides for the fair treatment of creditors is by permitting the trustee to avoid certain pre-bankruptcy transactions for the benefit of unsecured creditors. These avoidance provisions are generally justified as solving problems related to multiple creditors seeking payment from a single debtor.

By staying collection efforts and requiring creditors to collect on their claims under one set of rules, bankruptcy offers a more efficient resolution of claims than would otherwise obtain were creditors to proceed individually against the debtor's assets.[76] In the absence of a bankruptcy proceeding, individual creditors have incentives to rush to court to execute on the debtor's assets. This rush to collect is costly. Were there no coordinated collection proceeding, creditors would be forced to monitor debtors for signs of insolvency, or else run the risk of losing the race to the courthouse in the event of an insolvency.

In the business context, where there is no fresh start policy,[77] some scholars have argued that bankruptcy's primary purpose is to solve the collective action problem associated with multiple creditors seeking to collect against a single corporate debtor. Left to their individual state law remedies, creditors would dismantle the debtor, leaving fewer total assets to be distributed than if the debtor were operated as a going concern. Bankruptcy, under this theory, exists solely so that creditors can work together to maximize the size of the total distribution. For these scholars, also known as proceduralists, the avoidance provisions function essentially to prevent creditors from opting out of the bankruptcy proceeding.[78]

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76. *See* Feibelman, *supra* note 68, at 139.

77. Although there is a discharge for corporate debtors under chapter 11, that discharge is animated by policies different than those underwriting consumer bankruptcy's "fresh start" discharge. JACKSON, LOGIC AND LIMITS, *supra* note 57, at 190–92.

> A corporation, though, is a fictional legal entity and needs no fresh start in the same sense as does an individual. . . . A corporation can fully discharge its debts without bankruptcy, by merely dissolving the fictional corporate person. Thus, the Chapter 11 corporate discharge rests on grounds entirely different from those underlying an individual debtor's discharge.

Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Appraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 1003–04 (1997).

78. *See supra* note 57 (discussing the proceduralist and traditionalist schools).

Certain of the avoidance provisions make a great deal of sense when thinking about bankruptcy essentially as a procedural group debt-collection proceeding. Consider, for example, the Code's preference provisions.[79] The preference provisions provide generally that with certain exceptions, the trustee may unwind transfers to creditors made up to ninety days before the petition.[80] The trustee need not show any bad faith, fraudulent intent, or constructively fraudulent intent on the part of the debtor or the preferred creditor, in order to avoid a transaction as preferential.[81] Rather, the preference provisions simply prevent creditors from doing just before bankruptcy what they are prohibited from doing inside bankruptcy, namely relying on individual remedies to proceed against the assets of the debtor to the detriment of the creditor body as a whole. Were there no preference provisions, creditors would have incentives to bargain with the debtor on the eve of bankruptcy in order to better their positions inside bankruptcy. Each creditor would, therefore have incentives to monitor the debtor for insolvency—precisely the sort of costly monitoring that the group debt-collection proceeding was designed to prevent.

The procedural explanation for bankruptcy does not, however, adequately justify other avoidance provisions. Consider, for example, § 548(a) of the Code. Section 548(a) permits the trustee to avoid fraudulent, and constructively fraudulent, transactions. Notably, the trustee is empowered to avoid fraudulent and constructively fraudulent transactions even in cases where the same transaction would not be prohibited under applicable state law.[82] Considering only the procedural aspect of bankruptcy, there is no reason to permit the trustee to avoid transactions that would be permissible under state law. The § 548(a) avoidance power does not check opt-out behavior. On a procedural theory, there is no good reason for giving unsecured creditors greater rights to unwind fraudulent and constructively fraudulent transactions under § 548(a) inside bankruptcy than they would enjoy outside bankruptcy.[83]

79. *See* 11 U.S.C. § 547 (2006).

80. *Id.*

81. *Id.*

82. Section 544(b), on the other hand, permits the trustee to avoid transactions that are considered fraudulent conveyances under applicable state law. 11 U.S.C. § 544(b) (2006). Section 548 allows the trustee to avoid certain transactions as fraudulent conveyances, irrespective of whether those transactions are fraudulent under applicable state law. 11 U.S.C. § 548(a)(1) (2006).

83. According to Thomas Jackson:

> Such transactions are undesirable when the debtor is insolvent even in the absence of any common pool problem—such as when the debtor has only one creditor—and are

But even if commercial bankruptcy is merely procedural, as some would suggest, consumer bankruptcy certainly is not.[84] In addition to providing a means for reducing transaction costs associated with the collection of debts by multiple creditors, consumer bankruptcy *imposes* costs on creditors—costs resulting from consumer bankruptcy's substantive policy objective of providing debtors a fresh financial start. Debtors are permitted to exempt a portion of their assets from the reach of their creditors, and in some instances, the exemptions provided for in the Code are more generous than those provided for under state law. For debtors in non-opt-out states, creditors may receive less inside bankruptcy than they would had those creditors been permitted to proceed against the debtor's assets under state law. More importantly, consumer bankruptcy deprives creditors of any ability to proceed against a debtor's *future* assets—including human capital.[85]

> thought sufficiently undesirable that a flat ban is appropriate. Hence, the justification for fraudulent conveyance law is fundamentally broader than are the reasons for a bankruptcy proceeding.
>
> Fraudulent conveyance law, then, is distinctly less collectivist in its justification. It is, instead, a part of the warp and woof of debtor-creditor relations; in terms of bankruptcy law, it should be seen as part of the initial establishment of entitlements, not something that bankruptcy policy should itself have anything to say about.

JACKSON, LOGIC AND LIMITS, *supra* note 57, at 147–48; *see also* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 726 (1984):

> Whereas the [strongarm and preference] avoiding powers . . . adjust the rights of creditors vis-à-vis other creditors, fraudulent conveyance law adjusts the rights of creditors vis-à-vis the debtor. That the second group of avoiding powers does not spring from a need to implement bankruptcy's collective proceeding becomes evident when one observes that the fraudulent conveyance principle not only resides in [§ 548], but also operates dehors bankruptcy, as it has done for more than four hundred years, and retains its force in bankruptcy, as do other nonbankruptcy rights, through Section 544(b).

84. I should note that a great many commentators view business bankruptcy as much more than simply procedural as well. By discussing the proceduralist school at length, I do not mean to suggest that the proceduralists have the only, or the proper, view as to the purpose and scope of commercial bankruptcy. *See supra* note 57 (discussing alternatives to the procedural model of business bankruptcy). Thomas Jackson acknowledges that consumer bankruptcy is unique in that its *raison d'etre* is the fresh start—a "substantive bankruptcy policy designed to upset nonbankruptcy entitlements." JACKSON, LOGIC AND LIMITS, *supra* note 57, at 225. Jackson has argued that bankruptcy provisions that further the fresh start policy are valid in consumer proceedings even if they do not serve to check creditor opt-out behavior. The trustee's power to avoid liens that impair the debtor's exemptions, for example, is justifiable according to Jackson, even though it is not related to the common pool problem. *See* 11 U.S.C. § 522(f) (2006). Under Jackson's theory, § 522(f) protects debtors from the same frailties of human decisionmaking that the discharge itself seeks to protect against. JACKSON, LOGIC AND LIMITS, *supra* note 57, at 264–65.

85. Immediately after the debtor files her petition, the automatic stay by operation of law stops all debt collection activity. 11 U.S.C. § 362(a) (2006). Once the debtor receives her discharge, the discharge injunction prohibits any future debt collection activity by the debtor's pre-petition unsecured creditors. 11 U.S.C. § 524(a) (2006). The discharge significantly undermines

Consequently, unsecured creditors' claims are generally satisfied—or unsatisfied—from a much smaller pool of assets inside bankruptcy than would otherwise be available outside bankruptcy.

Consequently, while the maximization of estate resources may not be a legitimate bankruptcy objective in and of itself in the business context (at least to the extent one considers such a proceeding largely procedural), the maximization of estate resources may well be a legitimate goal in a consumer bankruptcy proceeding where the recovery of unsecured creditors has been slimmed by the debtor's fresh start. In other words, § 548(a), which permits the trustee to increase resources available for distribution to unsecured creditors, may be viewed, in the consumer context, as compensating creditors for the value they surrender on their claims in order that the debtor may be provided a fresh financial start.

In a consumer bankruptcy proceeding, there is a legitimate reason to scrutinize carefully prepetition fraudulent transactions and transactions that put estate resources at risk: such transactions further diminish estate resources inside bankruptcy that have already been diminished as a result of consumer bankruptcy's fresh start policy. This view of § 548(a) provides a reasonable basis for the Code's going further than otherwise applicable state law in permitting the trustee to avoid certain outright or constructively fraudulent transactions. The harm to unsecured creditors may not be significant outside bankruptcy where creditors have the ability to proceed against the debtor's future assets, including human capital. The harm of that same transaction may be much more significant inside bankruptcy where the Code has eliminated state law collection rights. It makes sense, then, that the Code would attempt, through § 548(a), to maximize the pool of assets that will constitute creditors' one-time recovery either upon liquidation in chapter 7 or over the course of a repayment plan in chapter 13.

In any event, in the consumer context, one of bankruptcy's policy objectives is the fair treatment of unsecured creditors. One way that the Code achieves this objective is by permitting the trustee to avoid certain pre-bankruptcy transactions, and in effect to maximize distributions to unsecured creditors. As will become clear in Part III, this objective of maximizing the size of the estate is potentially undermined by the current operation of the subprime mortgage lending markets.

creditors' state law collection rights, which generally include the right to garnish the debtor's future wages to satisfy a judgment.

III. OVERREACHING IN THE SUBPRIME MORTGAGE LENDING MARKETS AND ITS IMPACT ON CONSUMER BANKRUPTCY

I have articulated two of the primary functions of consumer bankruptcy: (1) to protect debtors against the full costs of insolvency and (2) to ensure the fair treatment of unsecured creditors within the context of the federal debt-collection proceeding by permitting the trustee to unwind for the benefit of unsecured creditors certain pre-bankruptcy transactions in order to maximize distributions to unsecured creditors. Large-scale equity erosion common in the subprime mortgage markets has the potential to frustrate both of these bankruptcy objectives. In other words, as a result of equity erosion in the subprime markets, bankruptcy might not be doing what it was intended to do, both for the subprime borrowers who file for bankruptcy and for their unsecured creditors.

Debtors are permitted to exempt some portion of their home equity from the reach of unsecured creditors under both the federal bankruptcy exemption regime and under most state law exemption provisions.[86] Home equity, then, is one of several assets inside bankruptcy that form the basis of the debtor's fresh financial start. By permitting debtors to exempt at least a portion of their home equity, the Bankruptcy Code furthers the first policy objective of consumer bankruptcy: by shielding home equity value from unsecured creditors, the Code provides a cushion to protect debtors from bearing the full costs of insolvency. Subprime loans that drain borrower equity, however, reduce the amount of the debtor's interest in his or her home that would otherwise be eligible for exemption, and thus leave the debtor without a critical asset that might otherwise soften the blow of insolvency.

It should be noted that *any time* a debtor encumbers property that might otherwise be eligible for exemption, the debtor's social safety net inside bankruptcy will be reduced. Certainly, the Code should not scrutinize every single transaction that results in a lien on property that

86. The federal homestead exemption currently permits a debtor to exempt the debtor's interest in his or her residence up to $18,450. *See* 11 U.S.C. § 522(d)(1) (2006). State homestead exemptions are sometimes more, and sometimes less, generous. Florida, Iowa, and Kansas, for example, all have unlimited homestead exemptions. With the passage of BAPCPA, Congress capped the state homestead exemption at $125,000 for any residence that was acquired by the debtor during the 1,215-day period (about three and a third years) preceding filing. *See* 11 U.S.C. § 522(p)(1)(A) (2006). For purposes of determining whether a debtor's exemption exceeds the cap, the debtor need not include in the calculation any interest in property transferred from the debtor's previous principal residence, acquired before the 1,215-day period, if the previous and current residences are located in the same state. *See* 11 U.S.C. § 522(p)(2)(B) (2006). At the other extreme are states, like Maryland and Pennsylvania, that have no homestead exemption at all.

might otherwise be eligible for exemption. As will become clear in Part IV, however, the Bankruptcy Code already prevents lenders from enforcing security interests in certain *personal* property eligible for exemption; that provision was designed to combat lender overreaching that would have cheated debtors out of their fresh start. Consequently, where a lender is able to exploit its superior bargaining position to take more from a borrower than it should (which appears to be the case in a great many subprime mortgage lending transactions), there is an existing theoretical basis in the Code for permitting the debtor to avoid at least some portion of that lien.

It is not only the equity-eroding effect of subprime mortgage lending that affects consumer bankruptcy policy. Consumer bankruptcy's social insurance objective is also implicated by those subprime mortgage loans that are unaffordable at the time of origination. Many of these loans may be associated with borrower insolvency. To the extent bankruptcy is designed to protect debtors from bearing the full costs of insolvency, it would make a great deal of sense, then, to address these loans inside bankruptcy to ensure that they do not work at cross purposes with bankruptcy's social insurance function by driving borrowers into financial trouble.[87]

Equity erosion in the subprime mortgage lending markets also potentially impacts upon the fair treatment of subprime borrower-debtors' unsecured creditors inside bankruptcy. Typically, if the debtor has any interest in her home above the applicable homestead exemption, that excess value is available for distribution to her unsecured creditors. Large-scale equity erosion in the subprime mortgage lending markets potentially reduces the amount of that distribution. Of course, *every* secured transaction results in a smaller distribution to unsecured creditors inside bankruptcy. As will be explained in Part IV, however, the harm to unsecured creditors should be cognizable inside bankruptcy where the amount of that security interest is *unreasonable* as compared to the value conferred upon the subprime borrower-debtor. Here, again, it remains significant that borrowers in the subprime markets tend to pay far more for credit than the risk premium and origination costs would otherwise warrant.

Regulatory responses to predatory lending in the mortgage lending markets vary according to the state jurisdiction in which the lender operates, as well as according to whether the lender is a federally

87. *See supra* notes 45–47 and accompanying text (discussing the high rate of default and foreclosure associated with subprime loans).

chartered bank, thrift, or credit union.[88] As discussed in Part I, although there are federal laws that apply to home mortgage lenders, those laws are generally disclosure oriented. And while HOEPA substantively prohibits certain abusive loan terms and practices, the HOEPA triggers are set too high to serve as a real deterrent to abusive lending. Consequently, for non-federally supervised lenders operating in jurisdictions where the state regulatory response is light, consumers remain vulnerable to overreaching lenders that would engage in lending practices that result in large-scale equity erosion. In the next Section, I propose two amendments to the Bankruptcy Code designed to ensure that this lack of regulation outside bankruptcy does not prevent consumer bankruptcy from operating the way Congress intended. In effect, my proposals attempt to counteract one result of the inadequate regulation of the subprime mortgage markets in some jurisdictions—diminished relief inside bankruptcy for subprime borrowers and diminished distributions for those subprime borrowers' unsecured creditors.

IV. Proposals: Protecting Subprime Borrowers and Their Unsecured Creditors Inside Bankruptcy

A. Social Insurance: Preserving the Social Safety Net of Bankruptcy

Bankruptcy fulfills its social insurance function primarily by permitting the debtor both to discharge her unsecured debts and to remove from the reach of unsecured creditors certain core assets deemed essential to the fresh start.[89] Both the federal bankruptcy exemptions and a great many state exemption provisions remove some portion of a debtor's interest in his or her residence from the reach of unsecured creditors.[90] By permitting debtors a homestead exemption either under federal or state law, the Bankruptcy Code provides debtors a cushion from bearing the full costs of insolvency. In this way, home equity forms an important part of bankruptcy's social safety net. Large-scale equity erosion in the subprime mortgage lending markets eats away at the subprime debtor's ability to take advantage of his or her homestead exemption. This, in turn, compromises bankruptcy's social insurance goal of protecting the debtor from bearing the full costs of insolvency.

88. *See supra* Part I.B (discussing subprime mortgage lending regulation).
89. *See supra* Part II.A (discussing bankruptcy's social insurance objective).
90. *See supra* note 86 and accompanying text.

1. Extending § 522(f)(1)(B) to Cover Overreaching in the Subprime Mortgage Lending Markets

Section 522(f) of the Bankruptcy Code provides a useful starting point for thinking about preserving consumer bankruptcy's social insurance function in the face of subprime lender overreaching that would otherwise drain borrower equity. Section 522(f)(1)(B) permits the debtor to avoid certain liens in personal property that impair the debtor's ability to enjoy an exemption in such property. The list of property with respect to which security interests may be avoided under § 522(f)(1)(B) does not currently include home equity. Nevertheless, the underlying rationale for § 522(f)(1)(B) applies to subprime mortgage liens, and § 522(f) should, therefore, be extended to cover such liens.

Congress enacted § 522(f) when it adopted the Bankruptcy Code in 1978. Section 522(f)(1)(B) permits a debtor to avoid a nonpurchase-money[91] security interest in certain of the debtor's personal property to the extent the security interest impairs an exemption in such property.[92] Currently, § 522(f)(1)(B) permits a debtor to avoid a security interest in certain enumerated household goods,[93] tools of the trade of the debtor (or dependent of the debtor),[94] and health aids for the debtor (or a dependent of the debtor).[95] By permitting the debtor to avoid consensual security interests impairing the debtor's exemptions in certain property, § 522(f)(1)(B) essentially makes it impossible for the debtor to waive his or her right to emerge from bankruptcy in possession of certain core assets that protect the debtor from bearing the full costs of

91. 11 U.S.C. § 522(f)(1)(B) (2006). For a discussion of the term "purchase-money security interest" and an argument that a definition of the term should be codified in the Bankruptcy Code, see Juliet M. Moringiello, *A Tale of Two Codes: Examining § 522(f) of the Bankruptcy Code, § 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 WASH. U. L.Q. 863, 865 (2001) ("The problem is ripe for a federal solution because the drafters of Revised Article 9 of the U.C.C. expressly refused to resolve the question of whether the purchase-money character of a security interest in consumer goods can survive refinancing or consolidation.").

92. 11 U.S.C. § 522(f)(1)(B) (2006). Section 522(f) also permits the debtor to avoid any judicial lien impairing any of the debtor's exemptions (other than a judicial lien securing a debt for a domestic support obligation). 11 U.S.C. § 522(f)(1)(A) (2006). Congress recognized that bankruptcy protection is designed to provide relief to the overburdened debtor and that even "[i]f a creditor beats the debtor into court, the debtor is nevertheless entitled to his exemptions." *See* H.R. REP. NO. 95-595, at 126–27 (1977). This provision is not relevant for purposes of this discussion.

93. 11 U.S.C. § 522(f)(1)(B)(i) (2006).

94. 11 U.S.C. § 522(f)(1)(B)(ii) (2006).

95. 11 U.S.C. § 522(f)(1)(B)(iii) (2006).

insolvency and that thus provide the wherewithal to make a fresh financial start.[96]

Why should the Bankruptcy Code permit a debtor to avoid (and thus preclude creditors from enforcing) consensual liens in certain property that would otherwise be eligible for exemption?[97] After all, the Code rarely steps in to alter security interests negotiated by debtors and lenders prepetition.[98] For Thomas Jackson, the § 522(f)(1)(B) power is best explained as protecting debtors from the human propensity for impulsiveness and incomplete heuristics in decisionmaking that might lead debtors to decide improvidently to bargain away the fresh start.[99] On this view, § 522(f)(1)(B) prohibits debtors from waiving the benefit of the discharge by granting security interests in certain exempt personal property because debtors are generally not able to make informed and rational decisions to waive.

96. Section 522(e) prohibits a *direct* waiver of the debtor's exemptions in favor of unsecured creditors. Even if the unsecured creditor cannot enforce a direct waiver, "she can accomplish the same end by conditioning her extension of credit on the grant of a security interest in the debtor's exempt property. Thus, by using the process of foreclosure, instead of execution, the creditor can avoid most of the restrictions on waiver. . . ." John T. Cross, *The Application of Section 522(f) of the Bankruptcy Code in Cases Involving Multiple Liens*, 6 BANKR. DEV. J. 309, 312–13 (1989). Section 522(f)(1)(B), then, ensures that the debtor does not waive one of the central benefits of bankruptcy—the ability to exempt certain property and thus to emerge from bankruptcy with a core group of protected assets. Section 522(f)(1)(B) also ensures that the debtor receives the full benefit of the discharge, the other principal bankruptcy provision that advances bankruptcy's social insurance function. In the absence of § 522(f)(1)(B), if the debtor wanted to keep her otherwise exempt assets, in chapter 7, she would more than likely be forced to reaffirm a portion of the debt that would have otherwise been dischargeable. *See* Michael G. Hillinger, *How Fresh A Start?: What Are "Household Goods" for Purposes of Section 522(f)(1)(B)(i) Lien Avoidance?*, 15 BANKR. DEV. J. 1, 3 (1998) ("The meaningfulness of the debtor's discharge is diminished to the extent a debtor reaffirms a debt otherwise dischargeable."). Note, however, that § 522(f)(1)(B) cannot be explained *merely* as an enforcement of the Code's prohibition on the direct waiver of the debtor's exemptions. Section 522(f)(1)(B) permits the indirect waiver of those exemptions applicable to property not listed in § 522(f)(1)(B) even though § 522(e) would prohibit the debtor from waiving those exemptions directly.

97. At first glance, it would seem that if the debtor may *sell* property pre-petition that is eligible for exemption, there should be no reason why the debtor ought not be permitted to encumber that property as well. *See* JACKSON, LOGIC AND LIMITS, *supra* note 57, at 264–65 (discussing the intuition that the power to alienate property would appear to include the power to grant a security interest in such property).

98. Indeed, unless the security interest is avoided under § 522(f) or another of the Code's avoidance provisions, even exempt property remains liable for debts secured by that property. *See* 11 U.S.C. § 522(c)(2) (2006). Hence the well-known, if overly simplistic, aphorism that liens survive bankruptcy.

99. JACKSON, LOGIC AND LIMITS, *supra* note 57, at 264–65. Jackson explains the discharge itself in part as protecting debtors against inherent frailties in human decisionmaking. *Id.* It makes sense, then, that § 522(f), which in effect makes the discharge nonwaivable, is grounded, for Jackson, in the same rationale.

Although Jackson frames the purpose of § 522(f)(1)(B) primarily as protecting the debtor from himself, Congress was at least as concerned with protecting the debtor from *overreaching lenders*. Congress adopted § 522(f)(1)(B) in response to the widespread practice in the late 1970s of blanket lien lending. Creditors were lending money to borrowers and taking blanket security interests in all of those borrowers' belongings. In doing so, these creditors were, in effect, obtaining a waiver of the borrowers' exemptions. Congress adopted § 522(f)(1)(B) to permit the debtor to avoid security interests in certain property that would have been exempt because "[i]n most of these cases, the debtor is unaware of the consequences of the forms he signs."[100] The avoidance provisions permit the debtor:

> [T]o undo the consequences of a contract of adhesion, signed in ignorance, by permitting the invalidation of nonpurchase-money security interests in household goods. Such security interests have too often been used by overreaching creditors. The bill eliminates any unfair advantage creditors have.[101]

Congress sought to curb blanket lien lending abuses by permitting the debtor to avoid nonpurchase-money security interests in certain assets "essential to a debtor's well-being, such as wearing apparel, which are of little or no value to a creditor, other than as a means of coercing payment."[102] One might characterize § 522(f)(1)(B), then, as prohibiting the waiver of exemptions in certain property, largely out of a concern that such a waiver might not be *meaningful*, either because of frailties in human decisionmaking, as Jackson would have it, or, as the legislative history of § 522(f)(1)(B) would suggest, because of creditor overreaching.[103] Congress intended the exemptions to protect debtors from bearing the full costs of insolvency, but bankruptcy's social safety net would be an empty promise were lenders simply able to coerce or dupe borrowers into waiving those exemptions. Section 522(f)(1)(B) protects that social safety net from certain overreaching lenders.

100. H.R. REP. NO. 95-595, at 127 (1977).

101. *Id.* Congress was concerned that a creditor's mere threat of foreclosure on important household goods (regardless of the fact that such collateral's low resale value made foreclosure unlikely) coerced the debtor into making payments to the creditor that the debtor in many cases simply could not afford. *Id.* at 127.

102. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES (Sept. 6, 1973), at 169.

103. *See* Lawrence Ponoroff, *Exemption Impairing Liens Under Bankruptcy Code Section 522(f): One Step Forward and One Step Back*, 70 UNIV. COLO. L. REV. 1, 37 (1999) ("As originally conceived, section 522(f) evinced Congress's concern over what it viewed as overreaching and even unconscionable credit practices utilized in the consumer lending industry.").

This underlying rationale for § 522(f)(1)(B) is equally applicable to overreaching purchase-money and home-equity subprime mortgage lenders that would jeopardize the value of the debtor's homestead exemption inside bankruptcy. Consider, for example, the prime-eligible borrower who finds herself purchasing credit in the subprime mortgage lending market in order to purchase a home.[104] Assume that the home is worth $200,000 and that the debtor is able to put $40,000 down. Assume further that the borrower could have obtained a prime loan with a competitive rate, and reasonable fees not financed into loan principal. Had she shopped in the prime market, she would have borrowed $160,000, and she would have had a $40,000 equity cushion immediately following the transaction. If the same borrower purchased a subprime mortgage instead with $15,000 in fees and charges financed into the loan principal, she would have borrowed $175,000, leaving an equity cushion of only $25,000.

That $15,000 in financed fees and charges represents a $15,000 decrease in equity value and a significant bite out of the borrower's social safety net in the event of a bankruptcy. As we have seen, in the subprime markets, that $15,000 in fees and charges may far exceed actual origination costs, the fees and charges may include overpriced or unnecessary services, and any points may not function to buy down the borrower's interest rate.[105] In short, the extra $15,000 might reflect pricing in excess of what the loan would be worth in a competitive market. In our example, where the borrower is prime eligible, the lender is certainly overreaching: the lender is unquestionably charging more for credit than it is worth. The extent of overreaching would be less quantifiable for nonprime-eligible borrowers, but the point remains that the lender would be overreaching to the extent the fees and charges are in excess of what would otherwise be required to compensate for actual origination costs. Section 522(f)(1)(B) should be extended to prevent subprime lenders from using their superior bargaining position to overreach and cheat borrowers of their social safety net inside bankruptcy.

Congress originally adopted § 522(f)(1)(B) to prevent lenders from using blanket liens to take advantage of vulnerable borrowers. Allowing lenders to overreach in those circumstances would have gutted the social insurance function served by the exemptions. Lending practices

104. This is commonplace. Recall that a great many 'subprime' borrowers in fact are prime-eligible. *See supra* note 2 and accompanying text.

105. *See supra* Part I.A (discussing the excessive fees and charges often charged in subprime markets).

in the subprime mortgage lending markets raise similar concerns. Because of overreaching in the subprime mortgage markets, borrowers are not able to make meaningful decisions to give up home equity value that would be eligible for exemption and which would thus provide a cushion against future financial insolvency. Section 522(f)(1)(B) should be extended to protect debtors from giving up the social insurance benefit of bankruptcy under these circumstances.

The collateral currently provided for in § 522(f)(1)(B), while of great value to debtors, generally has little or no resale value in the hands of creditors.[106] Although home equity has a high resale value for lenders, it should nevertheless be included among the assets protected by § 522(f)(1)(B), given both the critical role home equity plays in providing the debtor a fresh financial start and the extent to which many subprime lenders have overreached to take more of that home equity value than they are rightfully entitled to. Congress and most state legislatures have determined that a debtor's interest in home equity is an important asset for a fresh start. The benefits of home equity to a fresh start are potentially enormous, and the Code should not permit this critical asset (and the fresh start) to be bargained away lightly, especially where lenders have the upper hand.

Permitting chapter 7 debtors to exempt a certain amount of home equity from unsecured creditors potentially provides the debtor with critical cash with which to make a fresh financial start. If the trustee does not liquidate the property, the debtor maintains that equity value in his or her home—a critical asset that can be borrowed against or that can provide a long-term savings vehicle. If the chapter 7 trustee liquidates the property, the debtor will receive the cash value of its homestead exemption, and that cash could provide necessary resources for a family, the caregiver of which has resorted to bankruptcy as a result of a layoff, illness, divorce, death, or other family crisis. Those funds could also be rolled over to form an eventual down payment for a car or home for the chapter 7 debtor who has lost one or both.[107]

106. When it adopted § 522(f)(1)(B), Congress recognized that in the typical blanket lien transaction, the lender takes a security interest in all of the debtor's belongings, most of which have great value for the debtor, but little or no actual resale value for the lender. *See* H.R. REP. NO. 95-595, at 127 (1977).

107. Although primarily conceived of as protecting the debtor's residence, the homestead exemption benefits the debtor even if the debtor does not keep the home. Where the applicable homestead exemption exempts the debtor's interest in real property up to a specified dollar amount, the exemption might not (and often does not) function to protect the debtor's home itself from the effects of insolvency. Where there is equity in the home beyond the homestead exemption, the chapter 7 trustee will sell the home for the benefit of unsecured creditors, giving the debtor the value of her exemption and paying unsecured creditors any excess:

The importance of home equity for a fresh start in bankruptcy is even more pronounced for elderly homeowners, many of whom have nearly paid their home mortgages or own their homes outright. For these homeowners, home equity may comprise a primary vehicle for retirement savings or a means for paying for necessary expenditures, including medical expenditures, as wages decline.[108] Because of their accumulated equity wealth, elderly homeowners are particularly susceptible to abusive home-equity lending, equity skimming, and other abusive lending practices.[109] The Bankruptcy Code should not permit these borrowers to be cheated into giving up the value of perhaps their single-most valuable asset, an asset that, absent lender abuse, would be protected inside bankruptcy for the benefit of that borrower.

If § 522(f)(1)(B) were extended to subprime mortgage liens in an effort to address the effects of lender overreaching on home equity value and thus on bankruptcy's social safety net, § 1322 of the Code would also need to be amended.[110] Under § 1322(b)(2), a chapter 13 repayment plan may not modify the rights of a lender with a lien on the debtor's principal residence. This means that even if the debtor were permitted to avoid a portion of a lien on the debtor's residence under § 522(f)(1)(B), because the lender's claim could not be bifurcated into a

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> [If] . . . the 7 Trustee had moved to sell the property after the conversion to Chapter 7, the order approving the sale would have provided for the payment to the Debtor of her . . . homestead exemption out of the sale proceeds. The remaining proceeds would then be used to pay the creditors and any further balance would be paid to the Debtor . . . . *[S]uch a payment is routinely made to debtors as part of the administration of their bankruptcy case. It is done in recognition of the debtor's proper claim of a homestead exemption under Section 522 and in furtherance of the "fresh start" policy of the Bankruptcy Code.*

In re Bedell, 173 B.R. 463, 466 (Bankr. W.D.N.Y. 1994) (emphasis added).

108.
> The ability to access home equity is important to the well-being of many older homeowners. This is because after retirement, most older homeowners have the bulk of their nonpension wealth accumulated during working years in the form of home equity. This home equity can provide the resources needed to compensate for the decline in earnings that commonly accompanies retirement. In this way, homeowners can use accumulated wealth in the home to pay for medical expenditures and other necessities.

Robert G. Quercia, *House Value Appreciation among Older Homeowners: Implications for Reverse Mortgage Programs*, 8 J. OF HOUSING RES. Issue 2, at 201 (1997) (citation omitted). The Bankruptcy Code appears to be consistent in its treatment of retirement funds, whether they be in home equity or retirement accounts. *See* 11 U.S.C. § 522(d)(12) (2006) (providing for the exemption of certain retirement funds).

109. *See supra* note 34 and accompanying text (discussing the exploitation of elderly borrowers by some subprime lenders).

110. Others have advocated for the repeal of § 1322(b)(2)'s prohibition on the modification of claims secured by a lien on the debtor's principal residence. *E.g.*, Warren, *The New Economics of the American Family*, *supra* note 11, at 32–37; Forrester, *Mortgaging the American Dream*, *supra* note 8, at 452–53.

secured portion and an unsecured portion, the chapter 13 debtor would still be required to make payments on the full loan amount in order to keep the home.[111] In other words, absent amendments to § 1322, the chapter 13 debtor would not enjoy any benefit from the ability to avoid liens impairing his homestead exemption (provided the debtor intends to keep his home).

However, if § 1322 were amended to permit debtors to bifurcate an undersecured home mortgage lender's claim into a secured portion (which would be required to be paid in full) and an unsecured portion (which would be paid pro rata with other unsecured claims), extending § 522(f)(1)(B) to home mortgage liens could provide a significant benefit to chapter 13 debtors. The reduced lien would permit the chapter 13 debtor to make smaller payments to the mortgage lender under the plan than would have been required absent lien avoidance under § 522(f)(1)(B).[112] These savings could go a long way toward protecting the debtor against bearing the full costs of insolvency, and thus a long way toward advancing bankruptcy's social insurance function.

Extending § 522(f)(1)(B) to permit debtors to avoid at least a portion of the liens of overreaching subprime mortgage lenders would advance the social insurance function of bankruptcy in two significant ways. First, permitting debtors to avoid liens of overreaching subprime mortgage lenders—liens that impair those debtors' homestead exemptions—would ensure that the homestead exemptions function properly to protect debtors from bearing the full costs of insolvency. Second, by reducing lenders' ability to overreach, revising § 522(f)(1)(B) would make abusive subprime loans less profitable. Consequently, lenders might be less likely to originate loans that are unaffordable at the time of origination, and the number of foreclosures owing to subprime loans would potentially decrease.[113] By reducing the number of loans that tend to *cause* borrowers to default (and thus that tend to precipitate

111. *See* Nobelman v. Am. Sav. Bank, 508 U.S. 324, 329 (1993) (pursuant to § 1322(b)(2), rights of undersecured home mortgage lenders may not be modified, including "the right to repayment of the principal in monthly installments 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 petitioners' residence by foreclosure and public sale, and the right to bring an action to recover any deficiency remaining after foreclosure.").

112. Unsecured creditors must be paid at least as much under the repayment plan as they would have received under a hypothetical chapter 7 liquidation, and secured claims must be paid in full under the plan. *See* 11 U.S.C. § 1325(a)(4) & (5) (2006).

113. *See supra* notes 45–47 and accompanying text (discussing default and foreclosure associated with subprime lending and the hypothesis that many subprime loans are not affordable even at the time of origination).

insolvency), the proposed application of § 522(f)(1)(B) to the subprime mortgage lending markets would likely select out many of those mortgage loans that work at cross purposes with bankruptcy's objective of protecting debtors from bearing the full costs of insolvency.

2. North Carolina's Predatory Lending Law as a Model for Revising § 522(f)(1)(B)

Section 522(f)(1)(B) currently permits a debtor to avoid a security interest to the full extent such security interest impairs certain of the debtor's exemptions. That would be too great an avoidance power in the subprime mortgage lending context. If the debtor were permitted to avoid a lien to the full extent the lien impairs the debtor's homestead exemption, in those states where the homestead exemption is large or unlimited, the home mortgage lender might well be reduced entirely, or almost entirely, to unsecured status.[114] Too strong an avoidance power may well dry up the subprime markets in those jurisdictions with generous or unlimited homestead exemptions.

Section 522(f)(1)(B) should not be extended to permit the debtor to recoup the *entire* value of her homestead exemption, but rather only that portion of the exemption that has been taken from the debtor as the result of lender overreaching. In other words, to the extent home equity is included as part of the social safety net through the federal or a state homestead exemption, § 522(f)(1)(B) should be amended to avoid that portion of the subprime lender's lien attributable to loan features that drain equity value and that therefore permit overreaching lenders to take too much equity value from borrowers. Permitting the debtor to avoid the lien just to that extent would advance the social insurance goal of consumer bankruptcy while at the same time preserving legitimate subprime lending in states with generous or unlimited homestead exemptions.

Consequently, my proposal to protect equity value inside bankruptcy for subprime borrowers must somehow differentiate legitimate from overreaching lenders. Fortunately, we need not reinvent the wheel in

114. Forrester, *Mortgaging the American Dream*, *supra* note 8, at 454–55 (noting the possibility of extending § 522(f) to home equity liens, but arguing that that such a policy would be unworkable because, in those jurisdictions with high or unlimited homestead exemptions, subprime lenders would potentially lose their secured status entirely). Some commentators would not object to reducing at least certain subprime mortgage lenders to an unsecured status inside bankruptcy. For example, Mechele Dickerson argues that certain nonpurchase-money mortgage loans that convert dischargeable consumer debt into secured debt should be treated as unsecured inside bankruptcy because such debts are really no different in kind than unsecured consumer debts typically discharged in bankruptcy. *See* A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. MARSHALL L. REV. 19, 54–55 (2004).

formulating a method for determining which lenders have overreached and by how much. A handful of states have already enacted predatory lending legislation that, among other things, specifically protects the value of the debtor's home equity from lender overreaching. North Carolina was the first state to enact such legislation, and North Carolina's law serves as the model for my proposal to amend § 522(f)(1)(B) to protect the debtor's homestead exemption inside bankruptcy.[115]

The North Carolina law does not attempt to define "predatory" lending. Rather, using "high-cost" as a proxy for "predatory," the law covers *all* loans that exceed a certain interest rate threshold or for which fees and charges exceed a certain threshold.[116] For these high-cost loans, the North Carolina law prohibits a number of terms and practices that have the effect of draining home equity value. Most notably for our purposes, the North Carolina law prohibits the financing of points, fees, and charges and the financing of prepayment penalties under certain circumstances. The North Carolina law also prohibits negative amortization for high-cost loans.[117] Section 522(f)(1)(B) should be similarly structured.

Using similar cost triggers as provided for in the North Carolina law, § 522(f)(1)(B) should use high-cost as a proxy for overreaching loans, and the liens securing such loans should be subject to avoidance inside bankruptcy. While not all high-cost loans are abusive (and, conversely, not all non-high-cost loans legitimate), these high-cost loans most likely

115. N.C. GEN. STAT. § 24-1.1E (2006).

116. High-cost home loans are defined generally as residential home loans of $300,000 or less with (1) an annual percentage rate exceeding 8% more than the comparable Treasury bond rate, (2) total points and fees in excess of 5% of the loan amount, or (3) a prepayment penalty of more than 30 months or more than 2% of the amount prepaid. N.C. GEN. STAT. § 24-1.1E(a)(6) (2006).

117. High-cost loans may not include the financing of fees and charges, N.C. GEN. STAT. § 24-1.1E(c)(3) (2006):

> In making a high-cost home loan, a lender may not directly or indirectly finance:
>
> a. Any prepayment fees or penalties payable by the borrower in a refinancing transaction if the lender or an affiliate of the lender is the noteholder of the note being refinanced;
>
> b. Any points and fees; or
>
> c. Any other charges payable to third parties.

Fees and charges are prohibited altogether if the lender is refinancing another high-cost loan held by the same lender as noteholder. N.C. GEN. STAT. § 24-1.1E(c)(4) (2006). High-cost loans may not include negative amortization, N.C. GEN. STAT. § 24-1.1E(b)(3) (2006) ("No high-cost home loan may contain a payment schedule with regular periodic payments that cause the principal balance to increase"), and certain balloon mortgages. N.C. GEN. STAT. § 24-1.1E(b)(2) (2006) ("No high-cost home loan may contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments.").

cover, more or less, the universe of loans in which pricing exceeds the risk premium and true origination costs, and thus, cover much of the universe of excessively priced, or overreaching, loans. And when this excessive pricing has the effect of draining equity value, these loans are likely to have the greatest impact on bankruptcy's social insurance function. Just as the North Carolina law prohibits the financing of certain fees and charges that would otherwise erode equity value, § 522(f)(1)(B) should be amended to permit debtors to avoid high-cost mortgage liens *to the extent* those lien amounts reflect terms and practices that drain equity value. For the portion of the lien avoided under § 522(f), the overreaching lender would have an unsecured claim.[118] Moreover, the debtor would be permitted to use § 522(f)(1)(B) to avoid the lien only up to the value of the applicable homestead exemption.[119]

Probably the most common way that overreaching subprime lenders drain borrower equity is through the financing of fees and charges.[120] Just as the North Carolina law prohibits the financing of points, fees, and charges for high-cost loans, § 522(f)(1)(B) should be amended to permit the debtor inside bankruptcy to avoid a lien in connection with a high-cost loan on her home to the extent the lien amount is the result of financed fees and charges up to the amount of the applicable homestead exemption.

Similarly, just as the North Carolina law prohibits the financing of prepayment penalties with respect to high-cost loans in some circumstances, the debtor in bankruptcy should be permitted to use § 522(f)(1)(B) to avoid a lien to the extent the lien amount includes a prepayment penalty as the result of a refinance, if the refinancing lender or its affiliate holds the note being refinanced. Overreaching lenders should not be permitted to impair the value of the homestead exemption, and thus undermine the social insurance function of bankruptcy, by including costly prepayment penalties and recouping the

118. One might be inclined not only to reduce the lender to an unsecured status, but to eliminate the residual claim altogether. After all, one might well wonder why the lender should enjoy an unsecured claim against the debtor to (at least partially) recoup the profits of overreaching. Aside from various constitutional issues that such an approach might occasion, the Bankruptcy Code may not be the most appropriate place to articulate a federal policy of contract. The purpose of my § 522(f)(1)(B) proposal is not to create a federal law of unconscionability, but instead to preserve the value of the fresh start from lending practices that would undermine it.

119. To the extent lien avoidance in excess of the homestead exemption may yield a benefit to unsecured creditors, I argue in Part IV.B that the trustee should be permitted to avoid at least a portion of the lien for the benefit of unsecured creditors.

120. *See supra* notes 36–43 and accompanying text (discussing the financing of often-excessive fees and charges in the subprime market).

value of those penalties when the borrower refinances.[121] The debtor should also be permitted to use § 522(f)(1)(B) to avoid a lender's security interest with respect to a high-cost loan to the extent the loan principal has increased, and home equity value has decreased, as a result of negative amortization.[122]

By permitting debtors to avoid high-cost mortgage liens in these circumstances, § 522(f)(1)(B) would prevent the subprime mortgage lending markets from frustrating the social insurance function of bankruptcy. It would return to debtors a portion of their home equity value appropriated by overreaching lenders. And by making at least some overreaching subprime loans less profitable, it would encourage lenders to originate fewer unaffordable loans, potentially reducing the number of insolvencies caused by such subprime mortgage lending.[123]

Some would argue that although amending § 522(f)(1)(B) might substantially further the social insurance objective of consumer bankruptcy, it would do so at a potentially significant price: altering subprime liens inside bankruptcy might discourage even legitimate lenders from lending to subprime borrowers.[124] Indeed, policymakers should be wary of bankruptcy policies that result in credit availability for only the most creditworthy of borrowers.[125] Fortunately, available evidence from North Carolina suggests that its predatory lending law has not resulted in the rationing of home mortgage credit. One might expect a similar outcome if, using the North Carolina law high-cost

121. Recall that in addition to draining equity value, prepayment penalties may constitute a windfall to subprime lenders. Prepayment penalties in the subprime market may not be closely correlated with actual prepayment risk. *See supra* note 40–43 and accompanying text (discussing prepayment penalties in the subprime market).

122. *See supra* Part I.A (describing negative amortization).

123. *See supra* notes 45–47 and accompanying text (discussing the problem of subprime loans that are not affordable at the time of origination).

124. *See, e.g.*, Forrester, *Mortgaging the American Dream*, *supra* note 8, at 454–55 (recognizing that extending § 522(f) avoidance powers to home mortgage lending "would promote the fresh start policy," but arguing that there is a principled distinction between permitting avoidance with respect to personal property and not home equity, and that extending the avoidance power to home mortgage lending would "have a negative impact on credit availability, especially in states with generous homestead exemptions").

125. Congress's desire to encourage home-mortgage lending was precisely the impetus for carving home mortgage loans from the general rule that the rights of secured creditors may be modified by a chapter 13 repayment plan. *See* 11 U.S.C. § 1322(b)(2) (2006). It should be noted, however, that the vast majority of subprime lending is refinance lending, not purchase-money lending. *See* Warren, *Economics of Race*, *supra* note 5, at 1793 ("Fully 80% of subprime mortgages involve refinancing loans for families that already own homes."). Consequently, the negative impact of credit rationing on homeownership, while a legitimate concern, ought not be overstated.

triggers, § 522(f)(1)(B), targeted equity-eroding features of high-cost loans inside bankruptcy.

There appears to be near-universal agreement that the North Carolina lending law substantially reduced the volume of subprime credit in North Carolina. Some commentators have pointed to that decrease in credit as evidence that the North Carolina law reduced the flow of credit to subprime borrowers.[126] A closer look, however, suggests that the overall decline in subprime credit is attributable to a decline in predatory lending, rather than a decrease in subprime lending generally.[127] Contrary to the traditional economic orthodoxy that predatory lending laws will decrease the flow of credit to subprime borrowers, the North Carolina law does not appear either to have reduced the flow of credit to subprime borrowers or to have caused the cost of subprime credit to increase, relative to other states or to the nation as a whole.[128] All in all, the data suggest that the North Carolina

126. *See* Gregory Elliehausen & Michael E. Staten, *The Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. 411, 429 (2004) ("The decline in the number of closed-end mortgages . . . in North Carolina following the passage of its anti-predatory lending law was significant and large . . . [The law] reduce[d] the availability of credit, particularly among the least creditworthy consumers").

127. The reduction in subprime lending in North Carolina resulted not from a decline in purchase-money transactions, but instead almost entirely in the refinance market, the most abusive segment of the market. Roberto G. Quercia, Michael A. Stegman & Walter K. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE, 573, 588 [hereinafter *Impact of North Carolina's Predatory Lending Law*] ("With respect to first mortgage loans for home purchase, the postlaw experience of North Carolina borrowers with low credit scores is equal to or significantly better than that of equally credit-impaired borrowers in other states and regions."). More importantly, Quercia, Stegman, and Davis, analyzing the data by loan provisions, have concluded that almost 90% of the reduction in subprime lending may be attributed to a decline in predatory practices. *Id.* at 595.

128. *Id.* at 588–93; *see also* Allen Fishbein & Debby Goldberg, Editorial, *Wolf at the door; the vulnerable need protection against predatory lenders*, WASH. POST, Mar. 10, 2002, at B10 (using North Carolina as an example to rebut the claim that sources of credit to low-income and minority communities would dry up if strong anti-predatory lending laws are passed). Of course, if the North Carolina law were to have reduced the flow of credit to subprime borrowers, one would expect subprime interest rates to rise relative to those jurisdictions without predatory-lending legislation. *Impact of North Carolina's Predatory Lending Law*, *supra* note 127, at 590–91. There are various explanations for why North Carolina did not experience such a rise. The North Carolina law may have resulted in less aggressive marketing, and thus a decrease in borrower demand for subprime products. *See* Keith D. Harvey & Peter J. Nigro, *Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. 435, 453 (2004) (finding the decline in the level of North Carolina subprime mortgage lending was due to a decline in a loan application volume, not to a change in loan denial rates, which suggested less-aggressive marketing). Others have suggested that by reducing the universe of predatory loans, predatory-lending legislation might clear the market, making way for competition (legitimate lenders) that drives down the price of credit. *See* WEI LI & KEITH S. ERNST, THE BEST VALUE IN THE SUBPRIME MARKET: STATE

law substantially reduced lender abuses while leaving the legitimate subprime home lending market largely intact.[129] One might take comfort, therefore, that amending § 522(f)(1)(B) would not necessarily cause a reduction in the supply of credit to (or increase the cost of credit for) subprime borrowers.

B. Ensuring the Fair Treatment of Unsecured Creditors

1. Extending § 548(a)(1)(B) to Cover Subprime Mortgage Transactions That Put Unsecured Creditors at Risk

Overreaching subprime mortgage lenders affect not just the debtor's homestead exemption and therefore the social insurance function of bankruptcy, but also potentially the debtor's unsecured creditors. When a borrower enters into an agreement with a subprime lender that in effect siphons large amounts of home equity value from the borrower, the borrower's unsecured creditors potentially receive less in a chapter 7 liquidation, or in a hypothetical chapter 7 liquidation for chapter 13 purposes,[130] than they would have had the mortgage not been excessively priced.[131]

One of the chief objectives of consumer bankruptcy is to ensure that unsecured creditors be treated fairly within the context of the federal debt-collection proceeding. The Code accomplishes this in part by permitting the trustee to avoid certain pre-bankruptcy transfers in order to maximize the size of the bankruptcy estate for the benefit of unsecured creditors. As I explored in Part II.B, the ability of the trustee to avoid fraudulent conveyances under § 548(a), even certain fraudulent conveyances that might not be fraudulent under state law, makes particular sense in the consumer bankruptcy context where the augmentation of the estate in part compensates unsecured creditors for the value lost on their claims as a result of the fresh financial start provided to debtors.[132]

PREDATORY LENDING REFORMS 15 (Center for Responsible Lending), (2006) *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf (suggesting possible causes for lower rates).

129. *Impact of North Carolina's Predatory Lending Law*, *supra* note 127, at 596.

130. Recall that a bankruptcy court may not confirm a debtor's chapter 13 repayment plan unless unsecured creditors receive at least as much under the plan as they would have received if the debtor had liquidated under chapter 7. 11 U.S.C. § 1325(a)(4) (2006).

131. Of course, this depends to a great degree on the size of any applicable homestead exemption. Home equity would be used to pay the debtor the value of his homestead exemption before any equity value may be distributed to unsecured creditors. *See supra* note 107.

132. *See supra* Part II.B.

In addition to permitting the trustee to avoid actually fraudulent transactions,[133] § 548(a) permits the trustee to avoid constructively fraudulent transactions.[134] A transfer is constructively fraudulent if, even though the debtor may not have *intended* to defraud creditors, the debtor nevertheless "received less than reasonably equivalent value in exchange."[135] In determining whether the debtor received "reasonably equivalent value" in any given transaction, courts compare what the debtor received in the transaction with what the debtor gave up.[136]

The power to avoid constructively fraudulent transactions has seldom been used to avoid consumer home mortgage liens.[137] As a practical matter, the time between loan origination and bankruptcy filing often exceeds the two-year look-back period applicable to fraudulent transfers

133. Section 548(a) gives the trustee the power to avoid fraudulent transactions in which the debtor made the transfer within two years of filing the petition with the "actual intent to hinder, delay, or defraud" the debtor's creditors. 11 U.S.C. § 548(a)(1)(A) (2006).

134. For constructively fraudulent transactions, the trustee need not prove a fraudulent intent. Rather, the trustee need only show that the transaction (1) occurred within two years of the petition, (2) the debtor "received less than reasonably equivalent value in exchange for such transfer or obligation," and (3) the debtor was insolvent at the time of the transaction or became insolvent as a result of the transaction. 11 U.S.C. § 548(a)(1)(B) (2006). As an alternative to the third element, the trustee may also show that (1) the debtor was engaged (or about to engage) in a business while thinly capitalized, (2) the debtor intended to incur, or believed that the debtor would incur, debts beyond the ability of the debtor to repay, or (3) the debtor made the transfer to or for the benefit of an insider under an employment contract and not in the ordinary course of business. *Id.* These provisions are not relevant for present purposes.

135. 11 U.S.C. § 548 (a)(1)(B)(i) (2006).

136. *E.g.*, Rieser v. Hayslip (*In re* Canyon Systems Corp.), 343 B.R. 615, 639–40 (Bankr. S.D. Ohio 2006).

137. Although not commonly used to avoid liens in the mortgage lending context, § 548(a)(1)(B) has been used to set aside foreclosure sales in which the property did not sell for a reasonable value. Although the courts of appeal had formulated varying tests for determining whether a foreclosure sale was for "reasonably equivalent value," *see, e.g.,* Walker v. Littleton, (*In re* Littleton), 888 F.2d 90, 93–94 (11th Cir. 1989) (rejecting a bright-line rule requiring a minimum purchase price of 70% of the property's fair market value in finding that a 63.49% difference was reasonable based on the totality of the circumstances); Bundles v. Baker (*In re* Bundles), 856 F.2d 815, 821–25 (7th Cir. 1988) (adopting a totality of the circumstances test, using such factors as "whether there was a fair appraisal of the property, whether the property was advertised widely, and whether competitive bidding was encouraged"); Durrett v. Wash. Nat'l Ins. Co., 621 F.2d 201, 203–04 (5th Cir. 1980) (holding that sale was not for fair equivalent where property sold for slightly more than 50% of market value), the Supreme Court settled the question in *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 545 (1994) ("We deem, as the law has always deemed, that a fair and proper price, or a 'reasonably equivalent value,' for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with.").

For a general discussion of "reasonably equivalent value" after *BFP*, see Marie T. Reilly, *A Search for Reason in "Reasonably Equivalent Value" After* BFP v. Resolution Trust Corp., 13 AM. BANKR. INST. L. REV. 261, 286–94 (2005) (analyzing the effects of the decision in BFP on the definition of "reasonably equivalent value").

under § 548(a).[138] Moreover, where the debtor was solvent at the time of origination, as is usually the case, and where the debtor was not experiencing financial difficulty just after origination, as is also usually the case, courts may be reluctant to find that the debtor "became insolvent as a result of such transfer or obligation."[139] But while § 548(a)(1)(B) may not routinely reach liens in the subprime mortgage lending context, there are persuasive reasons for thinking it should.

Barry Zaretsky has argued that the constructive fraud provisions of § 548(a)(1)(B) in effect serve to protect unsecured creditors from unreasonable risk-taking by the debtor. Of course, secured transactions *always* put unsecured creditors at risk, but for Zaretsky, when that risk becomes unreasonable (i.e., when the estate does not receive reasonably equivalent value[140]), § 548(a)(1)(B) steps in to permit the trustee to avoid the transaction to that extent.[141]

138. 11 U.S.C. § 548(a)(1) (2006) ("The trustee may avoid any transfer . . . of an interest of the debtor in property . . . that was made . . . within 2 years before the date of the filing of the petition . . ."). There is some indication, however, that subprime mortgages proceed to foreclosure much more quickly (often in only two or three years) than their prime counterparts. *See* Bunce et al., *supra* note 46, at 265. Before passage of the BAPCPA, the look-back period was one year.

139. 11 U.S.C. § 548(a)(1)(B)(ii)(I) (2006).

140. Note that value to the estate may be monetary or otherwise. *See* Whitaker v. Mortgage Miracles, Inc. (*In re* Summit Place, L.L.C.), 298 B.R. 62, 73 (Bankr. W.D.N.C. 2002) (commenting on a transaction in which the debtor received far less cash than the $265,000 note: "The court cannot accept the Trustee's purely 'cash' value analysis, because to do so would potentially invalidate virtually every loan transaction; there are always fees associated with the loan and the borrower never gets in cash the full amount it borrows . . . . [The debtor] received 'reasonably equivalent value' because part of the 'value' it received was the avoidance of foreclosure and the chance to survive until it had an opportunity to refinance its project.").

141. Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1173–74 (1995).

> Thus, fraudulent transfer law does not bar debtors from taking risks with their creditors' funds. It does, however, regulate the permissible degree of risk. Under this view, the improper and unfair interference with creditors' rights that is addressed by fraudulent transfer law occurs when a debtor takes not merely risks, but unreasonable risks, with assets that would otherwise be available to satisfy creditors' claims.

Id.

Contrary to Zaretsky's view, the constructive fraud provisions are not always used to protect unsecured creditors from unreasonable debtor risk-taking. Notably, at least one court has declined to avoid pre-bankruptcy gambling transactions under § 548(a)(1)(B) on the theory that the debtor received reasonably equivalent value in the gamble. *See* Allard v. Flamingo Hilton (*In re* Chomakos), 69 F.3d 769, 771 (6th Cir. 1995) ("Where gambling is lawful . . . the placing of a bet gives rise to legally enforceable contract rights. These contract rights constitute 'property,' . . . and . . . the property has economic value."). The question is not whether the debtor received value or not, but rather whether the value was reasonably equivalent to the value surrendered by the debtor. The Sixth Circuit did not discuss that question at length. Whether the debtor has received reasonably equivalent value depends on the debtor's odds of winning. Although both are essentially gambling transactions, one would imagine that $1,000 invested in a futures

Section 548(a)(1)(B) has been used to remedy unreasonable pre-bankruptcy risk taking by debtors in cases where parties other than the debtor received the benefit of the pre-bankruptcy transaction.[142] In other cases, courts have avoided the transfer of a security interest, not because the value went to a party other than the debtor, but because, although the debtor received some value, he or she did not receive *sufficient* value in the underlying transaction.[143] Some courts have extended this logic to pawnbroker transactions where the debtor forfeited collateral upon default, the value of which far exceeded the amount of the loan.[144] In these pawnbroker transactions, because the costs of borrowing were disproportionate to the value conferred upon the estate, the transaction put estate resources (and unsecured creditors) at unreasonable risk.

A subprime mortgage loan that results in the erosion of large amounts of home equity puts estate resources—and unsecured creditors—at risk in the same way: in many subprime transactions, credit is overpriced, and the costs of borrowing thus often far exceed the benefit to the borrower. Permitting the trustee to augment the size of the estate by avoiding that portion of a home mortgage lien that puts unsecured

contract should not be treated the same as $1,000 paid by the debtor for lottery tickets. Even though they are both gambles, and they both potentially give rise to contract rights, the values of those gambles are not the same.

142. Courts have avoided guaranty agreements where the debtor provided the security for a third-party's debt, but received none of the loan proceeds. *See* Stillwater Nat'l Bank & Trust v. Kirtley (*In re* Solomon), 299 B.R. 626, 637–38 (B.A.P. 10th Cir. 2003) (finding that transfer was not of reasonably equivalent value where debtor executed a guarantee but did not receive any funds in exchange); Wessinger v. Spivey (*In re* Galbreath), 286 B.R. 185, 208 (Bankr. S.D. Ga. 2002) ("Transfers made or obligations incurred solely for the benefit of third parties do not furnish reasonably equivalent value, unless the debtor's net worth is unaffected because [he] received a direct or indirect *economic benefit* from the transfer") (emphasis in original) (quoting Coan v. Fleet Credit Servs. (*In re* Guerrera), 225 B.R. 32, 36 (Bankr. D. Conn. 1998)). Courts have also avoided highly leveraged buyouts. *See* United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 (3d Cir. 1986) (applying fraudulent conveyance law to certain leveraged buyouts); s*ee also* Zaretsky, *supra* note 141, at 1179 (discussing § 548(a)(1)(B) and leveraged buyouts). *But see* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 840 (1985) (arguing that leveraged buyouts are often economically beneficial and are not historically the kind of transactions covered by fraudulent conveyance law).

143. Koch v. Rogers (*In re* Broumas), 203 B.R. 385 (D. Md. 1996). In *Broumas,* the debtor transferred a $50,000 deed of trust securing the payment of legal fees to the debtor's lawyer. Although the securing of legal fees is unquestionably "value," 11 U.S.C. § 548(d)(2)(A) (2006), the bankruptcy court held, and the Fourth Circuit affirmed, that the trustee could avoid the transfer because the legal services rendered were not worth $50,000. *Koch*, 203 B.R. at 393.

144. *E.g.*, Jones v. Mayhall Enters., L.L.C. (*In re* Jones), 304 B.R. 462, 475 (Bankr. N.D. Ala. 2003) (debtor surrendered car worth $7,350 upon default on a loan worth $1,500); Bell v. Instant Car Title Loans (*In re* Bell), 279 B.R. 890, 898 (Bankr. N.D. Ga. 2002) ("A vehicle worth $10,000 is not reasonably equivalent in value to an obligation of $5,300.").

creditors at unreasonable risk makes eminent sense in the consumer bankruptcy context. With assets available for distribution already limited by consumer bankruptcy's fresh start policy,[145] one creditor should not be permitted to overreach pre-bankruptcy and, in effect, take an unreasonably large share of bankruptcy assets from other creditors.

Outside bankruptcy, it may be perfectly reasonable—from the unsecured creditor's perspective at least, if not from the borrower's perspective—to permit a certain amount of overreaching by subprime mortgage lenders. After all, outside bankruptcy, unsecured creditors are able to pursue future state law collection remedies, including collecting against the borrower's future human capital. But within the context of a collective debt proceeding where resources are reduced by the debtor's fresh start and future collection possibilities nonexistent, it makes sense to allow the trustee to use § 548(a)(1)(B) to scrutinize pre-bankruptcy transactions more carefully to minimize the harm to unsecured creditors caused by an overreaching lender taking too much.

2. North Carolina's Predatory Lending Law as a Model for Revising § 548(a)(1)(B)

Section 548(a)(1)(B) should be amended to permit the trustee to avoid that portion of an overreaching subprime mortgage lender's lien that results in a diminution in the size of the distribution to the borrower's unsecured creditors inside bankruptcy. Just as with my proposal for amending § 522(f)(1)(B),[146] § 548(a)(1)(B) should be amended using North Carolina's predatory lending law as a model, to permit the trustee to avoid for the benefit of unsecured creditors any portion of a lien on a high-cost loan resulting from loan terms that have the effect of eroding borrower equity value. Again, "high-cost" would be used as a proxy to capture overreaching lenders that charge more for subprime credit than it is worth, and a loan would be considered high-cost if it exceeds certain rate, fees, and charges thresholds. By permitting trustees to avoid a portion of those liens, § 548(a)(1)(B) would prevent overreaching home mortgage lenders from inducing subprime borrowers into taking unreasonable risks with estate resources, to the detriment of unsecured creditors.

Amended as I propose, § 548(a)(1)(B) would permit the trustee to avoid liens with respect to high-cost home loan transactions to the extent those liens effectively erode home equity: the trustee would be

145. *See supra* Part II.A (discussing bankruptcy's fresh start policy).

146. *See supra* Part IV.A.2 (arguing that § 522(f)(1)(B) should be extended to permit the debtor to avoid overreaching subprime mortgage liens).

permitted to avoid lien amounts that are the result of financed fees and charges, prepayment penalties included in a loan refinance where the refinancing lender or an affiliate of the lender is also the holder of the note being refinanced, and negative amortization.[147] Unlike with respect to my § 522(f)(1)(B) proposal, however, under § 548(a)(1)(B), the trustee would be permitted to avoid liens resulting from lender overreaching only to the extent that avoidance would free up equity value beyond any applicable homestead exemption and to the extent that unsecured creditors would benefit from such avoidance. In other words, any lien avoidance should inure first to the benefit of the debtor and then to the benefit of unsecured creditors. Amending § 548(a)(1)(B) in this way would prevent overreaching home mortgage lenders from having an unfair advantage inside bankruptcy vis-à-vis other creditors and would compensate unsecured creditors for some of the value they lose on their claims as a result of bankruptcy's fresh start policy.

Under my proposal, high-cost mortgage loans that erode borrower equity would be presumed to be constructively fraudulent. That is to say, such loans would be presumed not to have been made for reasonably equivalent value, and they would be presumed to have met the insolvency test of § 548(a)(1)(B)(ii)(I). Both presumptions are appropriate. As explained in Part I.A, there is a great deal of evidence that subprime mortgages are excessively priced. Because pricing in these high-cost transactions exceeds both the real risk premium and true origination costs, borrowers are paying more for credit than is necessary. In other words, as a general rule, borrowers are not receiving reasonably equivalent value. Moreover, at least some subprime mortgages appear to cause borrower default, independent of borrower default risk. Consequently, it is not unreasonable to presume, at least within the context of § 548(a)(1)(B), that high-cost mortgage loans as a general matter satisfy the insolvency test.

V. CONCLUSION

There are good reasons for believing that subprime mortgage credit is very often overpriced. Lenders are able to charge more for credit than would otherwise be permissible in a properly functioning competitive market. Excessive pricing in the subprime mortgage market often results in the siphoning of equity value away from subprime borrowers. As a result of widespread equity erosion, many subprime borrowers are

147. *See supra* Part IV.A.2 (proposing that § 522(f)(1)(B) be amended using the North Carolina predatory lending law as a model).

paying too much of their disposable income on housing and are having an extremely difficult time making into reality that central promise of homeownership: accumulating wealth and saving for the future.

For some of those families that cannot make it, for which the high cost of subprime mortgage credit (not to mention other family expenses, both anticipated and unanticipated) is simply too much, bankruptcy provides a social safety net of last resort. For those borrowers, however, who unwittingly give up more equity than would otherwise be required to compensate their lenders for default risk and origination costs, the quality of their relief inside bankruptcy may well be compromised. Indeed, by permitting subprime lenders in many jurisdictions to whittle away at borrower equity, state and applicable nonbankruptcy federal law in effect permit two tiers of bankruptcy relief: one for prime borrowers who are permitted to benefit fully from their applicable homestead exemption and another for subprime borrowers who are not.

One of consumer bankruptcy's primary objectives is to provide a social safety net for debtors when all of society's other social safety nets have fallen through. Where that bankruptcy goal is compromised by inadequate state and federal regulation of the subprime market, bankruptcy can, and should, step in to ensure that its social insurance function is being fulfilled. Accordingly, in this Article, I have proposed that § 522(f)(1)(B) be amended to ensure that subprime borrowers are treated similarly to prime borrowers inside bankruptcy. Prime and subprime borrowers alike should receive the benefit of their homestead exemption, to the extent applicable federal or state law deems home equity an important asset comprising part of the borrower's fresh financial start inside bankruptcy. Subprime borrowers should not be treated less favorably inside bankruptcy than prime borrowers simply because overreaching lenders are able to take advantage of market failures and siphon large amounts of equity.

Nor should equity erosion in the subprime mortgage lending market interfere with consumer bankruptcy's other critical function: the fair treatment of unsecured creditors. By permitting subprime lenders to erode equity value, as they currently are in many jurisdictions, subprime lenders are in effect permitted to induce borrowers into unreasonably shrinking the size of the estate and thus the size of the distribution available to unsecured creditors in the event that those subprime borrowers file for bankruptcy. This diminution of the estate may not be troublesome under state debt collection law, where unsecured creditors have available to them state collection remedies, including pursuing the debtor's future human capital. Unsecured creditors inside bankruptcy, however, do not have that option.

Inside bankruptcy, then, it makes sense to unwind certain pre-bankruptcy transactions that put estate resources at unreasonable risk—especially where those estate resources have already been reduced as a result of bankruptcy's giving the debtor a fresh financial start. In this Article, I have also proposed that § 548(a)(1)(B) be amended to treat high-cost mortgages as presumptively constructively fraudulent. As such, § 548(a)(1)(B) would ensure that the lack of substantive regulation over subprime mortgage lending in certain jurisdictions does not in effect permit subprime lenders to appropriate large amounts of home equity value to the detriment of borrowers' unsecured creditors inside bankruptcy.