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# Mortgage Modification, Equitable Subordination, and the Honest But Unfortunate Creditor

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# MORTGAGE MODIFICATION, EQUITABLE SUBORDINATION, AND THE HONEST BUT UNFORTUNATE CREDITOR

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*Mortgage foreclosures are at an all-time high and property values in many parts of the country have declined precipitously. Yet bankruptcy, which is often a last resort for individuals in financial distress, provides little relief to a homeowner who finds that her mortgage debt exceeds the value of her home. The reason for bankruptcy's inadequacy in this regard is the Bankruptcy Code's prohibition on the modification of home mortgages, a prohibition that became part of bankruptcy law in 1978 when most home mortgage loans were thirty-year fixed rate loans made by savings and loan associations. While most secured loans can be stripped down in bankruptcy, reflecting the payment that the lender would receive if it were forced to foreclose on the collateral, a home mortgage loan must be paid in full, giving the lender more than it would receive under state law.*

*In recent years, abusive mortgage practices have proliferated. These abusive practices, which have prevented homeowners from building equity in their homes, harm not only the debtor but also the debtor's other creditors. Despite their behavior, however, home mortgage lenders who engage in these practices continue to receive favorable treatment in bankruptcy. In this Article, I argue that creditors should be denied special treatment in bankruptcy unless they behave in an "honest but unfortunate" manner. Judges can deny this special treatment by using a time-honored bankruptcy principle, the principle of equitable subordination, to subordinate the unsecured portion of a home mortgage loan to all secured and priority claims. While equitable subordination, by itself, will not solve the foreclosure crisis, it may, by reducing the claims of abusive mortgagees, deter abusive lending practices in the future.*

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## INTRODUCTION

Bankruptcy, with its underlying policy of relief for the honest but unfortunate debtor, is an important mechanism for relieving financial distress. In the current mortgage crisis, however, bankruptcy is an inadequate tool because of the special treatment of home mortgage creditors under the Bankruptcy Code (Code). Chapter 13 of the Code prohibits the modification of claims secured only by a security interest in the debtor's principal residence.[1] The effect of this prohibition is particularly severe on homeowners who owe more on their mortgage loans than their homes are worth. Many of these "underwater" mortgages are products of the abusive lending practices that have proliferated in the past decade, but regardless of the mortgage lender's behavior, the lender is entitled to favorable treatment in Chapter 13.

Most creditors are guaranteed only their state law property rights in bankruptcy, but home mortgage creditors can receive far more—they are entitled to full payment of their claims according to the original terms of the mortgage loan.[2] Therefore, a debtor who owes $350,000 on a house worth only $250,000 must pay the entire $350,000 after filing for bankruptcy. This favorable treatment is unique to home mortgagees; other secured creditors are guaranteed full payment of only the value of their collateral, and if their collateral is worth less than they are owed, they are treated as unsecured creditors for the amount by which the outstanding loan exceeds

1. 11 U.S.C. § 1322(b)(2) (2006). This prohibition is discussed in Part II.A, *infra*.
2. *Id.*

the value of the collateral.[3] This bifurcation of an undersecured creditor's claim reflects that creditor's foreclosure distribution because a foreclosing secured creditor receives the value of its collateral at the foreclosure sale and must pursue the debtor personally for the often uncollectible deficiency.[4]

Today, a staggering number of homeowners are struggling to pay mortgage obligations that exceed the value of their homes. At the end of the third quarter of 2010, 22.5% of all residential properties with mortgages were encumbered by mortgages that exceeded the property's value.[5] Although declining home prices in many parts of the country contributed to this situation, the abusive lending practices that proliferated in the years preceding the recent foreclosure crisis exacerbated the problem. Thirty years ago, most home loans were amortized over thirty years with a fixed rate of interest. Lenders required full documentation of the borrower's income, and monthly payments bore a reasonable relationship to the borrower's income. Immediately before the recent mortgage meltdown, many mortgage loans were non-amortizing (meaning that the monthly payments included no payments towards the principal amount of the loan), large in relation to both the borrower's income and the value of the home, and were made with little or no documentation of the borrower's financial status.[6] Rather than helping homeowners build wealth by building equity in their homes, these lending practices diminished homeowner wealth.

Home mortgage creditors are entitled to full payment regardless of their behavior in the initiation of the loan because the Code has no explicit policy of providing relief only to the honest but unfortunate creditor. The recent mortgage crisis has led to calls to allow debtors to modify their home mortgages in Chapter 13. Several bills to ameliorate the effects of the anti-modification provision have been introduced in Congress—all failed to pass.[7] There was also a robust debate in the press about mortgage modification, with some arguing that modification would result in a

3. *Id.* §§ 506(b), 1325(a)(5). Some automobile lenders are also entitled to full payment of their claims regardless of the value of their collateral, but those lenders are not entitled to their original loan terms. *Id.* § 1325(a)(5)(*) (the "hanging paragraph" at the end of § 1325(a)).

4. In some states, anti-deficiency laws would prevent the mortgage lender from collecting the deficiency regardless of the borrower's financial condition. *See, e.g.*, ARIZ. REV. STAT. ANN. § 33-814 (2007) (prohibiting deficiency judgments on loans secured by a single-family or two family residence on 2.5 acres or less); CAL. CIV. PROC. CODE § 580b (West 1976 & Supp. 2010) (prohibiting deficiency judgments on purchase-money mortgage loans secured by a one to four family residence).

5. Press Release, CoreLogic, New CoreLogic Data Shows Third Consecutive Quarterly Decline in Negative Equity (Dec. 13, 2010), *available at* http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/Q3_2010_Negative_Equity_FINAL.pdf. The CoreLogic report notes that the decline in negative equity was due primarily to foreclosures of underwater mortgages rather than rising home prices. *Id.* The states with the highest percentage of negative equity mortgages during that period were Nevada (67%), Arizona (49%), and Florida (46%). *Id.*

6. I explain the changes in lending practices in Part II.B, *infra*.

7. *See infra* notes 42–46 and accompanying text.

windfall for homeowners and great losses for lenders.[8] The Obama Administration, through the Home Affordable Modification Program (HAMP),[9] tried to encourage mortgage holders to modify mortgages outside of bankruptcy, but that program has been a dismal failure, with only a fraction of eligible homeowners receiving permanent modifications,[10] and a high rate of re-default among those receiving permanent modifications.[11] There is little doubt that the number of mortgage foreclosures will remain at historically unprecedented levels[12] and that a bankruptcy filing will not help many debtors remain in their homes unless home mortgages can be modified.[13]

The Code may already allow judges to modify some home mortgages, however. In this Article I encourage judges to use existing Code provisions to modify home mortgages in cases in which the mortgage lender engaged in abusive lending practices. My thesis is that in order for a creditor to take

8. *See, e.g.*, Alan Schwartz, Op-Ed., *Don't Let Judges Fix Loans*, N.Y. TIMES, Feb. 27, 2009, at A27 (arguing that permitting mortgage modification will swamp the bankruptcy courts); Todd J. Zywicki, Op-Ed., *Don't Let Judges Tear up Mortgage Contracts*, WALL ST. J., Feb. 13, 2009, at A13 (arguing that mortgage modification will result in a windfall to borrowers and an increase in bankruptcy filings). *But see* David M. Abromowitz, *Cram Down Crunch Time*, HUFFINGTON POST (Mar. 4, 2009, 9:13 AM), http://www.huffingtonpost.com/david-m-abromowitz/cram-down-crunch-time_b_171721.html (noting that "[f]ew Americans realize that single family homeowners living in their own primary residence are the only real estate owners without cram down protections in bankruptcy").

9. *See* MAKING HOME AFFORDABLE, http://makinghomeaffordable.gov/ (Feb. 14, 2011).

10. In his October 2010 Quarterly Report to Congress, Neil Barofsky, the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), reported that "HAMP borrowers may . . . be worse off than before they participated." SIGTARP QUARTERLY REPORT TO CONGRESS 171 (2010), *available at* http://www.sigtarp.gov/reports/congress/2010/October2010_Quarterly_Report_to_Congress.pdf; *see also* Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons From the Lackluster First Year of the Home Affordable Modification Program (HAMP)*, 52 ARIZ. L. REV. 727 (2010); Paul Kiel & Olga Pierce, *Homeowner Questionnaire Shows Banks Violating Gov't Program Rules*, PROPUBLICA (Aug. 16, 2010, 8:02 AM), http://www.propublica.org/article/homeowner-questionnaire-shows-banks-violating-govt-program-rules.

11. CONG. OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT: A REVIEW OF TREASURY'S FORECLOSURE PREVENTION PROGRAMS 95–96 (2010), *available at* http://cop.senate.gov/documents/cop-121410-report.pdf.

12. In late 2009, the foreclosure rate was nearly four times the historic average. CONG. OVERSIGHT PANEL, OCTOBER OVERSIGHT REPORT: AN ASSESSMENT OF FORECLOSURE MITIGATION EFFORTS AFTER SIX MONTHS 6 (2009), *available at* http://cop.senate.gov/documents/cop-100909-report.pdf. More than 15% of subprime mortgages and 24% of subprime adjustable rate mortgages were in foreclosure. *Id.*

13. *See* John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123, 1125 (explaining that the bankruptcy process will not allow many struggling families to keep their homes because such families "cannot keep up with their ongoing mortgage payments or cannot do so while curing the defaults on their mortgage loans"); Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 571 (noting that the bankruptcy system "is incapable of handling the current home-foreclosure crisis because of the special protection it gives to most residential-mortgage claims"); Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 176 (2008) (noting, in the context of high and unexpected fees charged by mortgage holders, that "the amounts of mortgage proofs of claim have direct effects on bankruptcy's usefulness as a home-saving device").

advantage of Code provisions that give it more than that to which it would be entitled under state law, that creditor must act in an "honest but unfortunate" manner. It is well established that debtors must be both honest and unfortunate to take advantage of bankruptcy's benefits,[14] and many sections of the Code explicitly reflect that policy. Absent from statements of bankruptcy policy, however, is the idea that *creditors* must be honest but unfortunate in order to receive the full benefits of bankruptcy. Nevertheless, such a requirement is implicit in the Code's equitable subordination provision, § 510(c), which allows a court to subordinate all or part of a creditor's claim to other claims using "principles of equitable subordination."[15] In this Article, I discuss equitable subordination, a tool used primarily in business bankruptcy to subordinate the claims of corporate insiders to the claims of non-insider creditors, and argue that judges can and should use this tool to modify the claims of home mortgage creditors who engage in abusive lending practices.

To develop this argument, in Part I I discuss the special treatment of home mortgagees in Chapter 13 and explain the major changes in lending practices in the three decades since that special treatment was codified. In Part II, I explore bankruptcy history to explain how bankruptcy evolved as a system that punishes undesirable pre-bankruptcy behavior by debtors, while ignoring such behavior by most creditors. In Part III, I explain equitable subordination in detail and show that although it has historically been used to subordinate the claims of corporate insiders, nothing in its history limits it to that use. In Part IV, I discuss the use of equitable subordination to subordinate the claims of abusive mortgage lenders and also address some possible objections to its use. I conclude this Article by urging courts to both alleviate the current mortgage crisis and discourage reckless lending in the future by using equitable subordination to modify home mortgage claims.

## I. HOME MORTGAGES AND CHAPTER 13

### *A. The History of the Anti-Modification Provision*

A key component of the bankruptcy reforms in 1978 was Chapter 13 of the Code, which allows individual debtors to pay off a portion of their debts while retaining their assets. Chapter 13 was a debtor-friendly alternative to its predecessor, Chapter XIII of the Bankruptcy Act of 1898,[16] which required the consent of every secured creditor to every plan of reorganization.[17] A debtor who wishes to keep her home in bankruptcy

14. *See, e.g.*, Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1047 n.1 (1987) (citing Neal v. Clark, 95 U.S. 704, 709 (1877), as the first case to state the bankruptcy goal of providing relief to the "honest citizen").

15. 11 U.S.C. § 510(c)(1) (2006).

16. ch. 541, 30 Stat. 544.

17. *See* Eggum, Porter & Twomey, *supra* note 13, at 1154; Robert M. Zinman & Novica Petrovski, *The Home Mortgage and Chapter 13: An Essay on Unintended Consequences*, 17 AM. BANKR. INST. L. REV. 133, 135 (2009).

would likely file under Chapter 13 because generally a Chapter 13 debtor keeps all of her property and pays her creditors some portion of their claims over a three- to-five-year repayment plan.[18]

Because home mortgages are typically payable over fifteen to thirty years, it is unlikely that the typical debtor would be able to pay her mortgage debt in full in a Chapter 13 plan. Chapter 13 allows such a debtor to pay her mortgage debt over the term of the original mortgage; if the debtor has twenty-six years left to pay on her mortgage loan, she can pay the debt over the remaining twenty-six years of the term. The debtor is also permitted to cure any pre-bankruptcy payment default by paying all mortgage arrears during the plan term.[19]

Although Chapter 13 gives the homeowner two benefits—the ability to pay her loan over its original term and the ability to cure defaults—it denies her a significant benefit that bankruptcy debtors receive with respect to other loans—loan modification. A Chapter 13 plan can "modify the rights of holders of secured claims, *other than* a claim secured only by a security interest in real property that is the debtor's principal residence."[20] There is not much legislative history explaining the reasons for this section, but its often-stated justification is to preserve the flow of funds into the home mortgage lending market.[21]

This anti-modification provision bestows unusual treatment on home mortgagees. The Code allows debtors to modify their other creditors' pre-bankruptcy deals in several ways. As a general rule, the terms of the debtor's Chapter 13 plan replace the terms of her pre-bankruptcy contracts.[22] For instance, a debtor may propose in her Chapter 13 plan to pay a creditor a lower interest rate than she was paying under the original contract, thus reducing the amount of her monthly payments. Most secured creditors are entitled to the present value of their secured claims,[23] and the

18. 11 U.S.C. § 1325(b)(4).

19. *Id.* § 1322(b)(5) (allowing a debtor to cure defaults and maintain payments on long-term debt).

20. *Id.* § 1322(b)(2) (emphasis added). For an excellent discussion of the special treatment of home mortgagees under the Code, see generally Marianne B. Culhane, *Home Improvement? Home Mortgages and the Bankruptcy Reform Act of 1994*, 29 CREIGHTON L. REV. 467 (1996).

21. *See, e.g.*, Nobelman v. Am. Sav. Bank, 508 U.S. 324, 332 (1993) (Stevens, J., concurring); Culhane, *supra* note 20, at 467; Levitin, *supra* note 13, at 573 n.26 (setting forth the scant legislative history, which consists of a discussion in a Senate hearing among Edward J. Kulik of the Massachusetts Mutual Life Insurance Company, his counsel Robert E. O'Malley, and Senator Dennis De Concini); Zinman & Petrovski, *supra* note 17, at 137–38 (adding that, with its appeal to those who decried "red lining"—the practice of refusing to make loans in low-income or minority neighborhoods—the anti-modification provision was also "an experiment in social engineering").

22. 11 U.S.C. § 1327(a) (stating that the "provisions of a confirmed plan bind the debtor and each creditor"); 8 COLLIER ON BANKRUPTCY ¶ 1327.02[1][b] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010), *available at* LexisNexis.

23. 11 U.S.C. § 1325(a)(5).

U.S. Supreme Court has held that the interest rate in the original loan contract is not the interest rate used to calculate present value.[24]

It is often said that bankruptcy preserves state law property rights,[25] and this is reflected in the Code's provisions governing claims. Generally, a secured creditor who is owed more than the value of the collateral securing its claim must receive in a Chapter 11 or 13 plan at least the present value of the secured portion of its claim, plus at least the same percentage of its unsecured claim as it would receive in a Chapter 7 case.[26] The Code thus bifurcates undersecured claims by giving undersecured creditors two claims: a secured claim in the amount of the collateral value and an unsecured claim in the amount by which the outstanding loan amount exceeds the value of the collateral.[27] If a debtor owns a four-year-old car worth $10,000 on which she owes $15,000, she will be required to pay the present value of $10,000 in her Chapter 13 plan.[28] The remaining $5000 claim will be paid pro-rata with the other non-priority unsecured claims against her.[29] This full payment of only the secured portion of a secured lender's claim is often referred to as "cramdown."[30] Cramdown reflects a foreclosure distribution because if the debtor had decided not to file for bankruptcy but to let the car lender exercise its state law rights, that creditor would be guaranteed only the value of the collateral. [31]

A debtor cannot modify the terms of a home mortgage loan, however. Therefore, the debtor cannot modify the interest rate or the amount of the monthly payments.[32] During her plan, she must cure all arrears by paying

24. The Supreme Court has held that the interest rate to be used to pay present value is the prime rate plus an "appropriate risk adjustment." Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004). The loan at issue in *Till* was a subprime truck loan that carried a 21% interest rate. *Id.* at 471.

25. *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law.").

26. 11 U.S.C. §§ 1129(a)(7), 1325(a)(5). The 2005 amendments to the Code appear to bestow special treatment to several other creditors in Chapter 13 under the "hanging paragraph" to 11 U.S.C. § 1325(a) (stating that § 506, which provides for the bifurcation of undersecured loans into secured and unsecured claims, does not apply to purchase money-secured loans obtained within 910 days of the bankruptcy petition to acquire an automobile for the personal use of the debtor and all secured loans incurred within one year of the petition). The hanging paragraph prohibits only bifurcation; a debtor may modify such loans in other ways, such as by lowering the interest rate. *See In re* Johnson, 337 B.R. 269, 273 (Bankr. M.D.N.C. 2006).

27. 11 U.S.C. § 506(b).

28. *Id.* § 1325(a)(5). I use a four-year-old car as an example to avoid the application of the hanging paragraph discussed in note 26, *supra*.

29. 11 U.S.C. § 1325(a)(4).

30. It is also referred to as "lien stripping" or "strip down." ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 284–85, 301 (6th ed. 2009). Another use of the term "cramdown" refers to the Chapter 11 plan that is confirmed over the objection of a class of creditors or interests. *See* Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 HARV. L. & POL'Y REV. ONLINE 8 n.32 (Jan. 19, 2009), http://www.hlpronline.com/Levitin_HLPR_011909.pdf.

31. *See* U.C.C. § 9-615(a) (2000).

32. *See* 11 U.S.C. § 1322(b)(2) (forbidding modification of home mortgages); *id.* § 1322(b)(5) (allowing debtor to cure defaults and maintain payments on long-term debt); *id.*

all missed payments,[33] so the plan payments will likely exceed her regular payments.

Until the Supreme Court's 1993 decision in *Nobelman v. American Savings Bank*[34] it was not clear that the prohibition on modifying home mortgages meant no cramdown. When Congress considered amendments to the Code in 1991 and 1992 to clarify the anti-modification provision to specifically allow cramdown, representatives of the lending industry voiced opposition, claiming that cramdown would reduce lending in lower-income communities[35] and have a negative effect on the mortgage-backed securities market.[36]

In *Nobelman*, the Court held that the proscription against modification of the mortgagee's rights prohibited not only changes to the interest rate and payment schedule but also prohibited cramdown. In its opinion, the Court discussed the rights that a mortgagee holds under a mortgage and noted that one right of any secured creditor is the right to retain its lien for the full amount of the debt owed to it until the debt is paid in full.[37] As explained above, the Code permits debtors to modify this right with respect to most undersecured creditors. As a result of *Nobelman*, however, a debtor who owes $350,000 on a home worth $250,000 will not be able to bifurcate the lender's claim into a secured and an unsecured claim.[38] Her entire $350,000 debt will be treated as a secured claim despite the fact that the house is worth only $250,000. If she does not pay the $350,000 in full, she will likely lose her house.

The anti-modification provision gives home mortgage creditors more than they would receive under state law.[39] By requiring the debtor to pay the home mortgage creditor the full amount outstanding on the loan regardless of the home's value, the Code grants a property right that exists only in bankruptcy.[40] Only the creditor holding the mortgage on the

§ 1328 (excepting long-term debt from discharge). These restrictions on modification also apply to home mortgages in Chapter 11. *Id.* § 1123(b)(5).

33. *Id.* § 1322(b)(5).

34. 508 U.S. 324 (1993).

35. *See* Veryl Victoria Miles, *The Bifurcation of Undersecured Residential Mortgages Under § 1322(b)(2) of the Bankruptcy Code: The Final Resolution*, 67 AM. BANKR. L.J. 207, 257–58 (1993) (discussing the Government National Mortgage Association's (GNMA) concern that lenders would "perhaps reduce home lending activities to individuals in communities where the property values are at 'potential cramdown risk'").

36. *See id.* at 266–67 (discussing concerns raised by representatives of the Mortgage Bankers Association of America).

37. *Nobelman*, 508 U.S. at 329.

38. *Id*. at 326–27.

39. *See supra* notes 30–31 and accompanying text.

40. In *Dewsnup v. Timm*, 502 U.S. 410, 419–20 (1992), the Supreme Court held that § 506 of the Code did not allow a debtor to void the undersecured portion of a secured creditor's lien, notwithstanding the Code's statement, in § 506(d) that "to the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." For detailed critiques of *Dewsnup*, see generally David Gray Carlson, *Bifurcation of Undersecured Claims in Bankruptcy*, 70 AM. BANKR. L.J. 1 (1996); Margaret Howard, Dewsnup*ping the Bankruptcy Code*, 1 J. BANKR. L. & PRAC. 513 (1992). Notwithstanding the *Dewsnup* holding, undersecured creditors are paid only the value of their collateral, either after foreclosure or at the time a plan of reorganization is confirmed. Chapter 13

debtor's principal residence gets this special treatment; a creditor with a mortgage on a vacation home or on business property does not.[41]

Since 2007, Congress has considered at least five bills that would have allowed home mortgage modification,[42] none of which became law. The bills took several different approaches to mortgage modification, ranging from a neutral approach that would have allowed modification of all mortgages,[43] to an approach favoring unfortunate debtors by allowing modification only if the debtor had insufficient income to make payments,[44] to an approach punishing "bad" mortgagees by allowing modification of only "non-traditional" mortgages.[45] One proposal would have allowed modification only of those mortgage loans initiated before September 2007.[46] As legislative action to treat home mortgage creditors like other secured creditors seems unlikely, it is imperative that courts find a way to deny this special treatment to abusive mortgage lenders.

### *B. Twenty-First Century Mortgage Lending*

Mortgage and other consumer lending today looks little like the lending of the 1970s, when the Code was enacted. By the beginning of the recent mortgage crisis, many home loans had such high loan-to-value ratios that the amount of mortgage debt exceeded the value of the home.[47] The

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requires the debtor to make payments equal to the outstanding amount of the loan. Therefore, the preservation of the home mortgagee's entire lien by requiring full payment is the grant of a property right that is non-existent under state law.

41. Courts have held that a debtor who wishes to pay a stripped-down mortgage on property that is not his primary residence must do so within the statutory Chapter 13 plan period. Enewally v. Wash. Mut. Bank (*In re* Enewally), 368 F.3d 1165, 1172 (9th Cir. 2004). I address this case in more detail in Part IV, *infra*.

42. Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong.; Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong.; Homeowners Mortgage and Equity Savings Act, S. 2133, 110th Cong. (2007); Home Owners Mortgage and Equity Savings Act of 2007, H.R. 3778, 110th Cong.; Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. The version of the Helping Families Save Their Homes Act of 2009 that ultimately passed, Pub. L. 111-22, 123 Stat. 1632 (2009), does not contain a provision allowing modification of home mortgages in bankruptcy.

43. The version of House Bill 3609 that was introduced in Congress deleted the prohibition on modification contained in § 1322(b)(2). *See* Mark Scarberry, *Detailed Chart Comparing Provisions of Current Bankruptcy Bills Dealing With Modification of Home Mortgages, as of 12/13/2007*, AM. BANKR. INST., *available at* http://www.abiworld.org/pdfs/UpdatedMortgageModificationLegislationChart.pdf [hereinafter *Scarberry Chart*].

44. S. 2136; *see Scarberry Chart*, *supra* note 43.

45. H.R. 3609 (as amended); *see Scarberry Chart*, *supra* note 43; *Markup of H.R. 3609 and H.R. 3753 Before the H. Comm. on the Judiciary*, 110th Cong. 41 (2007) (statement of Rep. Brad Sherman, Member, H. Comm. on the Judiciary), *available at* http://judiciary.house.gov/hearings/transcripts/transcript071212.pdf (defining "nontraditional" mortgage loan as one that permits periodic payments that include only the interest due or that do not include the full amount of interest due).

46. S. 2133; *see Scarberry Chart*, *supra* note 43.

47. *See* Eggum, Porter & Twomey, *supra* note 13, at 1158. At the end of the second quarter of 2010, 23% of all residential properties with mortgages were encumbered by mortgages that exceeded their value. Press Release, CoreLogic, Negative Equity Report Q2

abusive practices that contributed to the current financial crisis[48] are well-chronicled elsewhere,[49] so this section briefly summarizes these practices and compares them to traditional lending practices.

In the years preceding the mortgage crisis, new terms, such as "predatory" and "subprime," entered the lending lexicon. "Subprime" is a term that describes both borrowers and loans. Borrowers who have weak credit histories because of late payments, charge-offs, or bankruptcies, or who have low credit scores or high debt burdens, fall into the subprime borrower category.[50] "Predatory" refers to loan terms. Professors Kathleen Engel and Patricia McCoy concisely define predatory lending as "exploitative high-cost loans to naïve borrowers."[51] According to Engel and McCoy, a loan that is "structured to result in seriously disproportionate net harm to borrowers" is predatory.[52] The loans often made to subprime borrowers, with their high fees, low teaser rates of interest, high overall interest rates, and high loan-to-value ratios,[53] can be considered predatory. In this Article, I refer to lending practices that tend to decrease the borrower's wealth as "abusive" lending practices.[54]

There are several key ways in which modern mortgage loans differ from traditional ones. In the 1930s, the average down payment on a home was 40%.[55] In later years, people considered 20% to be a "standard, moderate down payment."[56] By 2006, that down payment had declined to 2% for

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2010 (Aug. 26, 2010), *available at* http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/CL_Q2_2010_Negative_Equity_FINAL.pdf. Nevada had the highest percentage of underwater mortgages, with 68% of its residential mortgages in negative equity. *Id.*

48. Even the bankers admit this. *See First Public Hearing Before the Fin. Crisis Inquiry Comm'n* 9 (2010) (testimony of Jamie Dimon, Chairman & CEO, JPMorgan Chase & Co.), *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Dimon.pdf (stating that "new and poorly underwritten mortgage products" proved costly for the entire financial system); *see also* Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271, 299 (2008).

49. *See, e.g.*, Kristen David Adams, *Homeownership: American Dream or Illusion of Empowerment?*, 60 S.C. L. REV. 573 (2009); Brescia, *supra* note 48; Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002); *see* Alan M. White, *The Case for Banning Subprime Mortgages*, 77 U. CIN. L. REV. 617 (2008).

50. Brescia, *supra* note 48, at 287.

51. Engel & McCoy, *supra* note 49, at 1257.

52. *Id*. at 1260.

53. Brescia, *supra* note 48, at 287.

54. I use the term "abusive" because some states have regulated predatory lending and have defined the regulated loans in varying ways. *See, e.g.*, N.Y. BANKING LAW § 6-l (McKinney 2008) (regulating "high-cost home loans"); N.C. GEN. STAT. ANN. § 24-1.1E (West 2006) (restricting "high-cost home loan[s]"); 63 PA. CONS. STAT. ANN. §§ 456.503, 456.511 (West 2010) (prohibiting certain loan terms in mortgage loans less than $100,000). For purposes of equitable subordination, however, a court's ability to equitably subordinate a home mortgage claim should not depend on whether the debtor's home state has defined that loan as predatory.

55. Adams, *supra* note 49, at 601 n.156.

56. *Id.* at 601–02 (tracing mortgage terms from the 1930s to the present). The average down payment for repeat homebuyers in 2006 was 16%. *Id.* at 602.

first-time homebuyers.[57] One popular loan product was the "80/20 loan", which allowed a borrower to obtain both a first mortgage loan for 80% of the purchase price and a second mortgage loan for 20% of the price, with the borrower contributing nothing as a down payment.[58]

At the time that Chapter 13 was enacted, most home mortgage loans were made by savings and loan associations and tended to be fixed-rate loans with 30-year repayment periods.[59] The fact that the rates were fixed is significant because one traditional measure of housing affordability is based on the relationship between monthly mortgage and other debt payments to the borrower's monthly income.[60] When this relationship is calculated on an adjustable rate loan, a loan that was affordable at its inception becomes unaffordable when the rate resets.[61]

Adjustable rate mortgage loans have proliferated in recent years. These loans carry a low fixed introductory rate and then reset to an adjustable rate of interest after the expiration of the introductory period. According to one estimate, nearly 75% of all securitized subprime mortgage loans originated in 2004 and 2005 carried a low fixed teaser rate for two or three years.[62] These adjustable rate loans gave the appearance of affordability because the borrowers' ability to pay the loans was determined using the teaser rate, but such affordability was often lost when the rate reset.[63] Although the teaser rate was a lower rate than the ultimate interest rate, subprime loans carried higher rates of interest than prime loans. According to one study, there is a two percentage point difference between the highest interest rate on prime loans and the lowest rate on subprime loans.[64]

Traditionally, mortgage loans were amortized over a thirty year period. Therefore, monthly payments on these loans included interest and an increasing amount of principal, enabling the homeowner to slowly build equity even in the absence of appreciation.[65] In recent years, however,

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57. *Id.*

58. Allan N. Krinsman, *Subprime Mortgage Meltdown: How Did It Happen and How Will It End?*, J. STRUCTURED FIN., Summer 2007, at 13, 15.

59. Eggum, Porter & Twomey, *supra* note 13, at 1156.

60. *See* Adams, *supra* note 49, at 579–80 (citing the widely used 28/36 rule, under which monthly mortgage payments are affordable if they make up no more than 28% of the borrower's gross income, and if mortgage payments, combined with all other debt payments, make up no more than 36% of the borrower's gross income).

61. For this reason, Professor Kristen Adams suggests that more attention be paid to another traditional measure of affordability, the relationship of home purchase price to family income. Under that measure, a home is affordable if it costs no more than 2.5 times family income. *Id.* at 584.

62. *On Possible Responses to Rising Mortgage Foreclosures, Before the Comm. on Fin. Servs.*, 110th Cong. 4 (2007) (statement of Sheila C. Bair, Chairman, FDIC), *available at* http://financialservices.house.gov/hearing110/htbair041707.pdf.

63. *See* Eggert, *supra* note 49, at 1291; Krinsman, *supra* note 58, at 14–15.

64. R. Stephen Painter Jr., *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*, 38 LOY. U. CHI. L.J. 81, 89 (2006).

65. *See* REAL ESTATE FINANCING § 3E.02[1] (Matthew Bender 2010), *available at* LexisNexis (describing an alternative mortgage transaction as any mortgage that does not conform to the "traditional fully amortized, fixed interest rate mortgage loan" (citing First Gibraltar Bank, F.S.B. v. Morales, 19 F.3d 1032, 1037 (5th Cir. 1994))).

many borrowers took out interest-only loans. Borrowers with interest-only loans are required to make monthly payments of interest only (as the name implies) for the first few years of the loan term. After that period, the loan "resets" to an amortizing loan with higher monthly payments including both interest and principal.[66] Because it was unlikely that borrowers would be able to afford payments after the loan converted to an amortizing loan, lenders relied on the borrower's ability to sell the home for at least the loan amount, or alternatively to refinance the loan.[67]

Even more onerous than the interest-only loan was the option adjustable rate mortgage, or "Option ARM." The Option ARM allowed the borrower a choice of monthly payments ranging from payments that would amortize the loan over fifteen years on the high end to payments that would not be sufficient to pay the monthly interest on the loan at the low end.[68] These loans, originally intended for sophisticated investors and persons who expected an increase in income, were often offered to homebuyers who could be described as "average."[69] Instead of enabling borrowers to build wealth, negative amortization loans deplete home equity and therefore harm the debtor's other creditors because the shortfall in interest is added to the outstanding principal of the loan.[70]

Another major development in mortgage lending was the reduced documentation of a borrower's income and assets. Traditionally, borrowers were required to provide full documentation of their financial condition, but banks would sometimes excuse borrowers who were self-employed professionals from the obligation to provide full financial documentation. In recent years, subprime and first-time borrowers were offered these no- and low-documentation loans.[71] According to one estimate, 46% of all subprime mortgage loans in 2006 were no-documentation loans.[72]

Abusive loans often carry high fees. It is estimated that the fees on subprime loans are six times greater than those on prime loans.[73] Subprime lenders often charged above-market prices for credit reports and document preparation and sometimes charged for services that were never provided.[74] Because cash-poor subprime borrowers were often unable to pay these fees upfront, lenders included these high fees in the amount financed, thus

66. Interest-only loans were rare until recently. In 2004, almost half of all homebuyers in California used an interest-only loan to purchase their homes. David Streitfeld, *The House Trap: As an Exotic Mortgage Resets, Payments Skyrocket*, N.Y. TIMES, Sept. 9, 2009, at B1.

67. *See* Adams, *supra* note 49, at 606.

68. *See, e.g.*, Eggum, Porter & Twomey, *supra* note 13, at 1159; John Leland, *Loans That Looked Easy Pose Threats to Recovery*, N.Y. TIMES, Aug. 27, 2009, at A12.

69. *See* Leland, *supra* note 68.

70. *See* Eggum, Porter & Twomey, *supra* note 13, at 1159–60 (explaining that a borrower with a negative amortization loan will not build equity in her home); Painter, *supra* note 64, at 94 (explaining negative amortization loans).

71. *See* Eggert, *supra* note 49, at 1285; Krinsman, *supra* note 58, at 15.

72. *See* White, *supra* note 49, at 634.

73. Painter, *supra* note 64, at 93.

74. Engel & McCoy, *supra* note 49, at 1266.

further decreasing the homeowner's chance of building equity in the home.[75]

A major factor contributing to the proliferation of questionable mortgages was securitization. Mortgage brokers and originators were rewarded for quantity, not quality: the more loans made, the more money for the originator.[76] Securitization fueled some of the abusive practices described above; for instance, low documentation loans enabled originators to hide the true riskiness of a loan.[77] In addition, securitization also led to the overappraisals that contributed to high loan-to-value ratios. In the securitization market, loan originators had an incentive to overappraise so that the loan-to-value ratios on the loans they sold would look more attractive.[78]

Home mortgagees were given special protections in 1978 to preserve the flow of funds into the home mortgage lending market.[79] When discussing whether this policy requires that today's subprime lenders receive that same protection, it is important to consider the purposes for which many subprime loans were made. Most subprime mortgage loans were not used by first-time homebuyers, nor were they used to purchase a home at all; rather, they were used to refinance an existing loan.[80] Because a portion of most refinance loans is used to pay for non-housing related items, these loans are only loosely related to any policy of encouraging homeownership.[81]

With their high rates of interest, high fees, and high loan-to-value ratios, these abusive loan products prevented homeowners from building equity in their homes. Moreover, lax underwriting standards led banks to lend money to borrowers who had little ability to repay without refinancing or selling their homes.[82] The debtors/homeowners are not the only ones harmed by these abusive practices. By depleting the debtor's assets and hindering his ability to build wealth, these abusive lending practices harmed the debtor's other creditors as well.

Congress prohibited the modification of home mortgages in 1978 and the Supreme Court interpreted this prohibition to give mortgage lenders full payment regardless of home value in 1993.[83] It strains belief to think that Congress and the Court intended that lenders that engage in abusive lending practices be entitled to these protections. Requiring home mortgagees to

75. Painter, *supra* note 64, at 92.

76. Krinsman, *supra* note 58, at 13–14.

77. Eggert, *supra* note 49, at 1286.

78. *Id.* at 1287.

79. *See supra* note 18 and accompanying text.

80. *See* A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. MARSHALL L. REV. 19, 25 (2004); White, *supra* note 49, at 621.

81. In fact, a good argument can be made that subprime lending has reduced homeownership because from 1998 to 2006, "the number of completed subprime mortgage foreclosures exceeded the number of first-time homebuyers who used a subprime mortgage." White, *supra* note 49, at 622.

82. *See* Eggert, *supra* note 49, at 1268–70.

83. *See supra* notes 34–38 and accompanying text.

come to bankruptcy court as honest but unfortunate creditors would reserve Chapter 13's favorable treatment to those lenders whose loans assist homebuyers in achieving the desirable status of homeowner.

## II. HONEST BUT UNFORTUNATE DEBTORS AND CREDITORS

Both debtors and creditors come to bankruptcy court to ask for something that they would not receive under non-bankruptcy law. A debtor comes to court looking to discharge pre-petition debts[84] and also wants the court to stay collection actions against him.[85] These requests invoke a major bankruptcy policy: relief for the honest but unfortunate debtor. The Code's rules reflect this policy, and only a debtor who plays by the Code's rules governing his behavior both before his bankruptcy filing and during the bankruptcy case is eligible for this relief.

Creditors also come to court seeking favors. Unsecured creditors want to stop the race to collect from the debtor in order to preserve some chance of recovery.[86] They seek the full benefit of the automatic stay, which, by halting all collection efforts against the debtor and the debtor's property, ensures that all creditors have a chance at the debtor's assets. They also want to make sure that their claims are afforded appropriate priority.[87] These requests invoke another policy, that of the equal treatment of similarly situated creditors. Creditors are also required to play by the Code's rules, but these rules focus on creditor behavior affecting the administration of the bankruptcy case rather than on their behavior in their pre-bankruptcy relationships with borrowers.

Undersecured home mortgagees come to bankruptcy court looking for a big favor: they ask the court to give them greater protection than that provided under state law. To receive such special treatment, the home mortgage creditor's pre-bankruptcy behavior should be carefully scrutinized. Yet there is no explicit policy of requiring creditors to be honest but unfortunate to receive bankruptcy's benefits.

The Code contains rules governing debtor and creditor behavior. The rules can be characterized as either administrative or moral, with administrative rules punishing actions during the bankruptcy case that hinder the administration of the case and the moral rules punishing primarily pre-bankruptcy behavior that we consider to violate some standard of acceptable conduct. The Code's sections are explicit in requiring both administrative and moral compliance from the debtor, thus granting relief only to the "honest but unfortunate" debtor. At first glance, however, it seems that any requirement that a creditor behave in a prescribed manner is primarily based on administrative factors. Thus, the Code does not appear to embody any policy of affording relief only to

84. 11 U.S.C. § 523 (2006) (excepting listed debts of individuals from discharge).

85. *Id.* § 362(a) (stating that all collection efforts against the debtor and its property must cease upon a bankruptcy filing).

86. *Id.*

87. *Id.* § 507.

honest but unfortunate creditors. While hundreds of articles about bankruptcy law refer to the "honest but unfortunate debtor,"[88] not one in either the Lexis or HeinOnline databases contains the phrase "honest but unfortunate creditor."[89]

Historically, bankruptcy has included a "bad debtor" story. The Code's rules governing debtor behavior reflect this story. There is no corresponding general "bad creditor" story, however, and the Code's rules regarding creditor behavior reflect this absence. There are two Code sections that allow a court to take a creditor's pre-bankruptcy dealings with the debtor into account, however: § 522(f), which allows the debtor to avoid non-purchase money, non-possessory security interests in enumerated household goods and § 510(c), which gives the court the power to equitably subordinate the claims of creditors who engage in inequitable behavior that harms other creditors. The first sets forth a narrow rule that punishes a specific type of undesirable lender behavior, but the second could allow a court to deny full bankruptcy relief to creditors who engage in a wide range of questionable behavior.

### *A. Ensuring That Debtors Are Both Honest and Unfortunate*

Bankruptcy law grants relief to the honest but unfortunate debtor. Although this statement was first found in American case law in the late 1800s,[90] even the earliest bankruptcy laws distinguished between honest and dishonest debtors. In ancient times and in the early United States, insolvency for all reasons, honest and dishonest, was considered to be the result of moral failure or some kind of malfeasance.[91] Early bankruptcy laws therefore were punitive because persons who failed to pay their debts were viewed as wrongdoers, even criminals.

Despite this generally-held view of debtors as bad actors, early debtor-creditor laws distinguished debtors rendered insolvent by misfortune from those rendered insolvent by bad acts. Insolvency laws throughout history have punished dishonest debtors more severely than honest ones, an important distinction when the punishment for dishonest debtors could be

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88. A very unscientific search found 355 articles (including student comments and notes) in the Lexis U.S. Law Reviews and Journals database that mentioned "honest but unfortunate debtor" at least once, LEXIS TOTAL RESEARCH SYSTEM, www.lexis.com (last visited Feb. 23, 2011), and 431 articles (including student articles and notes) in the HeinOnline Core U.S. Journals that contained the same phrase, HEINONLINE, www.heinonline.org (last visited Feb. 23, 2011).

89. A search of "honest but unfortunate creditor" on January 23, 2011 found no articles on either HeinOnline or Lexis.

90. *See* Howard, *supra* note 14, at 1047 & n.1 (tracing the use of a similar statement to Neal v. Clark, 95 U.S. 704, 709 (1877)).

91. *See* BRUCE H. MANN, REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE 2–3 (2002) (describing views on insolvency in the early United States); Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 237 (1917) (describing the ancient view of insolvency as something "irregular and fraudulent"); Painter, *supra* note 64, at 103.

imprisonment,[92] slavery,[93] or even capital punishment.[94] Better treatment for unfortunate debtors did not mean discharge, however, because early debtor-creditor law granted no forgiveness to debtors.[95]

Discharge became part of debtor-creditor laws because courts need accurate information about a debtor's financial affairs in order to administer a bankruptcy case. The original idea behind discharge, which became part of English bankruptcy law in the early 1700s, was to encourage the debtor's cooperation in the dismantling of his own financial affairs because the debtor was in a better position than his creditors to know his financial condition and transactions.[96] Likewise, the earliest American federal bankruptcy law denied relief to those who withheld assets or information.[97] Therefore, honesty during the bankruptcy case was required of debtors for administrative reasons.

The Code's discharge provisions illustrate this administrative component of the honest but unfortunate debtor. The Code allows a court to deny discharge to the debtor who does not keep adequate books and records of her pre-bankruptcy transactions,[98] the debtor who makes a false oath in connection with the case,[99] and the debtor who withholds information about her finances from the trustee or the court.[100] All of these debtors are punished severely for taking actions that impede a fair distribution of assets to creditors, as a discharge denial means that they will be denied bankruptcy relief and will emerge from bankruptcy liable for all of their pre-petition debts. Discharge denial in this context furthers the original purpose of the discharge: to encourage debtor cooperation.[101]

Remnants of the old view of debt as the product of moral failure can still be found in the Code's debtor conduct requirements. Debtors are punished not only for financial misconduct but also for some types of non-financial misconduct. The Code punishes financial misconduct by allowing a court to deny discharge to a debtor who made fraudulent transfers in anticipation

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92. *See* Levinthal, *supra* note 91, at 238 (explaining the Roman *cessio bonorum*, a voluntary composition with creditors which allowed an "innocent insolvent" to avoid arrest and imprisonment).

93. *See* MANN, *supra* note 91, at 65 (explaining that many American colonies permitted insolvent debtors to be forced into servitude to their creditors for as long as seven years); Levinthal, *supra* note 91, at 230, 237–38 (discussing the treatment of insolvent debtors by the Code of Hammurabi and in ancient Rome).

94. *See* Emily Kadens, *The Last Bankrupt Hanged: Balancing Incentives in the Development of Bankruptcy Law*, 59 DUKE L.J. 1229, 1261–65 (2010) (describing the Act of 4 & 5 Anne, which made fraudulent bankruptcy a capital offense).

95. *See* MANN, *supra* note 91, at 2–3.

96. *See* Howard, *supra* note 14, at 1049; Kadens, *supra* note 94, at 1269–70 (discussing discharge and capital punishment as two methods by which the debtor's cooperation was encouraged in early English bankruptcy law).

97. *See* MANN, *supra* note 91, at 223.

98. 11 U.S.C. § 727(a)(3) (2006) (denying discharge to a debtor who has failed to keep or preserve any recorded information from which her financial condition can be ascertained).

99. *Id.* § 727(a)(4)(A).

100. *Id.* § 727(a)(4)(D).

101. *See* Howard, *supra* note 14, at 1053.

of bankruptcy.[102] That debtor did not hinder the administration of the estate, rather, she depleted it before bankruptcy. This conduct can be punished under state law,[103] but the Code provides for a harsher punishment: no bankruptcy relief.[104] A debtor's morally objectionable financial misconduct can also result in non-dischargeable debts. Many of the "rifle shot" exceptions, which except individual claims from discharge, are based on bad debtor financial behavior in the claim's creation. For instance, the Code excepts from discharge debts obtained by "false pretenses, a false representation, or actual fraud."[105] This provision allows credit card companies to contest the discharge of charges that were made by a debtor who, at the time she used her card, either had no intention to pay the charges or knew that she "would be unable to live up to the obligation and pay the charges."[106] A claim arising out of the debtor's fraud while acting in a fiduciary capacity is likewise non-dischargeable.[107]

Several non-dischargeable debts are unrelated to financial misconduct, however. For example, debts for "willful and malicious injury" to another person or to the property of another person[108] and debts for death or personal injury caused by the debtor's drunk driving[109] are non-dischargeable. These exceptions, while not punishing pre-bankruptcy financial dishonesty, reflect the view that there is some bad behavior that renders a debtor unworthy of bankruptcy relief.[110]

In short, debtors have long been required to be "honest but unfortunate" in order to receive the benefits of bankruptcy for two reasons: the court needed the cooperation of the debtors in the bankruptcy case and debtors were the "bad guys." Although bankruptcy law is no longer based on the view that debtors are undeserving merely because they are in financial distress,[111] bankruptcy relief remains reserved for those debtors who deal

102. 11 U.S.C. § 727(a)(2) (denying a discharge to a debtor who, within one year of the bankruptcy petition, transfers property with the intent to hinder, delay, or defraud a creditor); *see In re* Reed, 700 F.2d 986, 988–89 (5th Cir. 1983) (denying discharge to a debtor who had transferred about $35,000 of non-exempt property to pay down a mortgage on his exempt homestead).

103. *See, e.g.*, UNIF. FRAUDULENT TRANSFER ACT § 7, 7A U.L.A. 155–56 (2006).

104. *See supra* notes 95, 99–102 and accompanying text.

105. 11 U.S.C. § 523(a)(2)(A).

106. *See, e.g.*, Am. Express Travel Related Servs. v. Dorsey (*In re* Dorsey), 120 B.R. 592, 596 (Bankr. M.D. Fla. 1990). The facts in *Dorsey* show some questionable behavior on the part of both the debtor and the credit card company. The debtor, who had not been employed in the decade before she filed for bankruptcy and who lived on $480 a month in Social Security payments, managed to charge over $100,000 on seven American Express cards. *Id.* at 593–94. She paid only the minimum amounts due each month under the American Express "Travel & Sign" program. *Id.* at 594–95. After American Express argued that $50,000 of its claim should be excepted from discharge, the court held that about $25,000 of her debt to American Express was non-dischargeable. *See id.* at 593–97.

107. 11 U.S.C. § 523(a)(4).

108. *Id.* § 523(a)(6).

109. *Id.* § 523(a)(9).

110. *See* Howard, *supra* note 14, at 1052–53.

111. *See id.* at 1052. *But see* Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 385 (2008) (referring to the

honestly with the court and who behave in a morally acceptable manner before filing for bankruptcy.

### *B. Code Provisions Designed To Ensure Good Creditor Behavior*

At first glance, the Code does not appear to require that creditors also be "honest but unfortunate" to take advantage of bankruptcy's benefits. The American respect for freedom of contract in both consumer[112] and business[113] transactions may be one reason why there is not a pervasive bankruptcy story line of the dishonest creditor. In cases in which a creditor arguably acted negligently, it is often the case that the debtor's behavior is seen as worse. Cases involving credit card debt are good examples of this, with courts balancing imprudent extensions of credit against the behavior of debtors who may have borrowed money that they had no intention of repaying.[114] Stories of credit card companies that distributed pre-approved cards without inquiring into the creditworthiness of the individual receiving the card[115] are often drowned out by stories of debtors who borrowed money far in excess of their ability to pay and used bankruptcy to escape their obligations.[116] As a result, bankruptcy law has not been influenced by an often-repeated "bad creditor" story.

The idea that creditors do not act in morally objectionable ways is reflected in the Code provisions that deny creditors the full benefit of bankruptcy. These provisions primarily punish administrative misconduct. For example, a creditor who receives timely notice of the debtor's petition but nevertheless files a late proof of claim will find its claim subordinated to all other unsecured claims.[117] This is an administrative rule that punishes a creditor whose failure to act hinders the orderly distribution of the debtor's assets.

When creditors are punished for their pre-bankruptcy actions, they are punished for administrative, not moral, reasons. The trustee's power to

media debates preceding the adoption of the 2005 amendments to the Code, which portrayed debtors as "deadbeats who abused the system").

112. Other countries are more aggressive about policing consumer loan contracts. *See* John A. E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 405, 421–22 (explaining foreign laws that place special responsibilities on lenders).

113. One example of a failed attempt to impose an "honest but unfortunate" standard on creditors can be found in the 1980s lender liability litigation boom. These suits tended to fail as they were brought by sophisticated parties against their lenders. The reported cases favor the lenders in these cases by a margin of three to one. A. Brooke Overby, *Bondage, Domination and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 FORDHAM L. REV. 963, 966 (1993).

114. *See supra* note 106 and accompanying text.

115. *See* Margaret Howard, *Shifting Risk and Fixing Blame: The Vexing Problem of Credit Card Obligations in Bankruptcy*, 75 AM. BANKR. L.J. 63, 143 (2001) (suggesting that "the bankruptcy system has a legitimate stake in requiring the card issuer to show that prudent lending practices were followed").

116. *See* Melissa B. Jacoby, *Negotiating Bankruptcy Legislation Through the News Media*, 41 HOUS. L. REV. 1091, 1097 (2004) (discussing media reports of abuse of easy credit and permissive bankruptcy laws).

117. 11 U.S.C. § 726(a)(3) (2006).

avoid preferential transfers[118] is an example of such an administrative punishment. Any secured creditor who perfects its interest within ninety days before the bankruptcy filing and who would improve its position in bankruptcy by doing so stands to have its security interest avoided.[119] This is a harsh punishment, as a valid state law property right is set aside because it was obtained too close in time to the debtor's bankruptcy filing. Secured parties are punished both for the innocent failure to perfect their interests until the eve of bankruptcy and for knowing attempts to improve their positions on the eve of bankruptcy. This avoiding power protects the common pool and furthers the policy of equal treatment of creditors. While the trustee might be punishing "dishonest" creditor behavior by exercising the power to avoid preferential transfers, the undesirable creditor behavior is related more closely to the imminent bankruptcy case than to the initial lending transaction. Therefore, this rule is purely administrative because it equally punishes both innocent and culpable behavior.

Sometimes, bankruptcy law favors creditors for their moral worthiness. Bankruptcy treats some creditors more harshly than others when one creditor is paid a smaller percentage of its claim than another. When types of debts are singled out in bankruptcy, it is because they are more deserving rather than less deserving.[120] Priority creditors include those with claims for taxes,[121] wages,[122] and spousal and child support.[123] The dischargeability provisions also incorporate the idea of creditor worthiness, by including taxes,[124] spousal and child support claims,[125] and student loans[126] on the list of non-dischargeable debts. Even these provisions straddle a line between punishing a debtor for dishonest behavior and rewarding a particularly deserving creditor.[127] Bankruptcy law today

118. *Id.* § 547.

119. Creditors are also punished for receiving payments within the ninety day preference period. *See id.* § 547(b) (the trustee can avoid transfers of an interest of the debtor in any property if it satisfies the requirements of a voidable preference).

120. Others have noticed this discrepancy as well. *See, e.g.*, Howard, *supra* note 14, at 1050–59 (noting that the exceptions from discharge for tax claims and support claims are based not on the debtor's behavior, but on a belief that the creditors owed these claims are more worthy than other creditors); Philip Schuchman, *An Attempt at a "Philosophy of Bankruptcy"*, 21 UCLA L. REV. 403, 432 (1973) ("We assert that every debt is like every other debt unless the law declares it to be different (as in the case of taxes and secured creditors).").

121. 11 U.S.C. § 507(a)(8).

122. *Id.* § 507(a)(4).

123. *Id.* § 507(a)(1).

124. *Id.* § 523(a)(1).

125. *Id.* § 523(a)(5).

126. *Id.* § 523(a)(8). This exception has an undue hardship exception, designed to assure that a debtor who tries to discharge a student loan obligation is truly unfortunate. This undue hardship exception is rarely granted. *See, e.g.*, Rafael I. Pardo & Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Educational Debt*, 74 U. CIN. L. REV. 405 (2005).

127. For instance, someone who files for bankruptcy with outstanding student loan debt could be classified as "dishonest" because the student loan allowed her to amass human capital. Howard, *supra* note 14, at 1085–86.

rewards creditors whose claims are seen as more worthy, but in only rare instances are less-worthy creditors punished.

Viewed in the most positive light, home mortgage creditors in 1978 were seen as worthy creditors because their loans furthered the desirable goal of homeownership, and Congress rewarded them with protection from modification of their claims. While one way to view this special treatment is as a mere gift from Congress to banks,[128] the beneficiaries of the special treatment warned that cutting off the flow of mortgage credit would harm those who had the hardest time achieving the American dream of homeownership, particularly those in minority groups.[129] Congress treated the entire class of home mortgagees as worthy creditors and made no exception in the Code for home mortgagees who acted in a morally objectionable manner.

Despite the fact that bankruptcy law contains bankruptcy-specific punishments for morally objectionable debtor behavior, it yields to state and other federal law to punish morally objectionable creditor behavior. If a creditor would be denied recovery under state law because the debtor can claim a defense such as illegality or unconscionability, that creditor's claim will not be allowed in bankruptcy.[130] This rule is not a special bankruptcy rule; it merely recognizes that a creditor who does not have a valid claim outside of bankruptcy does not have a claim in bankruptcy.

If an abusive loan contract is enforceable under non-bankruptcy law, the lender's claim will be allowed in bankruptcy.[131] In 1975 Professor Vern Countryman, concerned about the explosion in consumer credit at that time, suggested changes to non-bankruptcy law that would render the claims of abusive lenders unenforceable both in and out of bankruptcy.[132] Recently,

128. *See, e.g.*, David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1710 (2004) ("Mortgage lenders insisted that the [anti-modification] provisions were more than simply a valentine from Congress . . . ."); Zinman & Petrovski, *supra* note 17, at 136 (describing the political climate in 1978 and opining that then-President Jimmy Carter and the Democrats in Congress were "not people who would normally be pictured as being involved in a cabal with lenders against homeowners").

129. *See* Miles, *supra* note 35, at 257–58 (discussing the argument made by GNMA during the hearings on the 1994 amendments to the Code that lenders would "perhaps reduce home lending activities to individuals in communities where the property values are at 'potential cramdown risk'"); Skeel, *supra* note 128, at 1711 (discussing the argument by the lending community that the protection of home mortgages would "ensure a steady stream of affordable financing to ordinary Americans who wished to buy their own homes"); Zinman & Petrovski, *supra* note 17, at 137–38 (noting that the argument that allowing modification of home mortgages would restrict credit in harmful ways "obviously struck a chord with those who decried 'red lining'").

130. *See* 11 U.S.C. § 502(b)(1) (stating that a creditor's claim will be disallowed to the extent that "such claim is unenforceable against the debtor and property of the debtor, under any . . . applicable law"); Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161 (1946) ("What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law.").

131. 11 U.S.C. § 502(b)(1).

132. Vern Countryman, *Improvident Credit Extension: A New Legal Concept Aborning?*, 27 ME. L. REV. 1 (1975). More recently, in response to today's credit crisis, John Pottow has suggested that courts recognize a cause of action for "reckless lending." Pottow, *supra* note

state courts have found ways to deny abusive home mortgage creditors foreclosure relief.[133] In the absence of non-bankruptcy law punishing abusive creditors, however, those creditors will be treated like all others in bankruptcy. If they are home mortgage creditors, they will receive favorable bankruptcy treatment.

In only two sections does the Code punish objectionable creditor behavior in the transaction creating the claim against the debtor. The first, § 522(f), is very narrow. Applicable only in consumer bankruptcy cases, this section allows an individual debtor to avoid a security interest if it is a non-possessory, non-purchase money security interest in exempt household goods, tools of the debtor's trade, or professionally prescribed health aids.[134] The second, § 510(c), is the equitable subordination provision, which appears to be narrow because it has been used primarily to subordinate the claims of a debtor's corporate insiders.[135]

Section 522(f) is a unique section in the Code in that it explicitly punishes lending practices that are considered predatory. This section was designed to deter the practice of taking low value personal items as collateral for a loan other than a loan that enabled the debtor to purchase those items. A creditor who takes household furniture and other household items as collateral for a loan is likely doing so not because such items have great foreclosure value, but because such items have great leverage value.[136] Unsecured creditors enforcing judgment liens cannot reach these

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112, at 420. Pottow analogizes creditors who extend credit knowing that the debtor will not be able to pay to debtors who accumulate credit card debt by purchasing luxury goods immediately before bankruptcy. *Id.* Creditors who would be punished under Pottow's proposal are those who "know, or are reckless to the likelihood, that the debtor has no realistic prospect of repaying his loan within a reasonable period of time." *Id*. at 463. Alan White has urged an outright ban on subprime lending. White, *supra* note 49.

133. In *Indymac Bank, F.S.B. v. Yano-Horoski*, a New York court cancelled the mortgage indebtedness owing to a creditor who had acted abusively after the debtor's default by not pursuing loan modification in good faith. 890 N.Y.S.2d 313 (Sup. Ct. 2009). The court described the mortgage at issue as "'sub-prime' or 'high cost' in nature." *Id.* at 315. The same judge barred another subprime mortgage creditor from collecting interest on the loan after the date of default as well as legal fees and expenses because of its lack of good faith in its post-default modification negotiations. Emigrant Mortg. Co. v. Corcione, 900 N.Y.S.2d 608 (Sup. Ct. 2010). In addition, the Massachusetts Attorney General has successfully brought enforcement actions under state consumer protection law to force subprime lenders to work with the Attorney General's office to restructure certain subprime loans before pursuing foreclosure. *See, e.g.*, Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548 (Mass. 2008).

134. 11 U.S.C. § 522(f).

135. *Id.* § 510(c).

136. *See* WARREN & WESTBROOK, *supra* note 30, at 194–95 (explaining that § 522(f) "was adopted largely in response to a growing concern about the use of security interests by certain finance companies to prey on the poor" and that the Federal Trade Commission (FTC) promulgated its rule to "limit any special incentive to file bankruptcy"). Today, non-purchase money loans secured by household goods are rare because after Congress enacted § 522(f) as part of the Bankruptcy Code of 1978, the FTC promulgated a rule under which a non-possessory, non-purchase money loan secured by certain personal items is considered an unfair trade practice. FTC Credit Practices Rule, 16 C.F.R. § 444.2 (2010). The FTC rule is based on § 522(f). *See* Lawrence Ponoroff, *Exemption Impairing Liens Under Bankruptcy*

low value household items in many states because of state exemption laws.[137] Exemption laws, however, do not affect the rights of secured creditors.[138] The avoidance provision in § 522(f) therefore preserves the debtor's "fresh start" by allowing her to keep property that would be exempt but for the debtor's grant of a security interest in an undesirable lending transaction. One author has suggested extending this protection to debtors harmed by abusive home mortgage practices by allowing such debtors to avoid a subprime mortgage lien.[139]

By authorizing a court to subordinate all or part of an allowed claim to another allowed claim using "principles of equitable subordination," § 510(c) of the Code permits courts to deny relief to creditors who are not honest but unfortunate.[140] A court thus has the ability to punish a creditor for morally objectionable pre-bankruptcy behavior. While the practical result of equitable subordination is often nonpayment of the subordinated claim, legally the claim is allowed, but pushed to the end of the distribution line.[141] The most common use of this power is to subordinate claims of corporate insiders,[142] but nowhere is the power limited to insider claims. Therefore, equitable subordination may be appropriate when the creditor's claim is enforceable under non-bankruptcy law but the creditor's conduct begs an equitable remedy.[143]

Because home mortgage creditors come to bankruptcy court seeking a favor, bankruptcy law can and should intervene to determine whether the home mortgage creditor is worthy of its special bankruptcy remedy.[144] The home mortgage creditor is given a "super-priority" in that its entire claim, supported by collateral or not, is treated as secured, and thus entitled to full payment, and its original loan terms are enforced. This super-priority may originally have been granted based on the worthiness of home mortgage lenders, but today's lending practices have introduced some particularly unworthy creditors.

A court using its equitable subordination power could strip down home mortgages so that the lender's allowed secured claim would be equal to the

*Code Section 522(f): One Step Forward and One Step Back*, 70 U. COLO. L. REV. 1, 8 n.32 (1999).

137. *See, e.g.*, WIS. STAT. ANN. § 815.18 (West 2007).

138. *See, e.g.*, *id.* §§ 815.18(2)(h), (12).

139. *See generally* Painter, *supra* note 64.

140. 11 U.S.C. § 510(c).

141. 4 COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 510.05.

142. David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157, 199 (2003); *see also* Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 269–70 (1941) (denying compensation to a mortgage bondholders' committee under the Bankruptcy Act because of undisclosed conflicts of interest involving committee members who were employees of one of the underwriters of the bonds who in turn had an equity interest in the mortgaged property); Pepper v. Litton, 308 U.S. 295, 303–09 (1939) (subordinating salary claims of a corporate officer that were not enforced until the company was in financial difficulty).

143. 4 COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 510.02.

144. *See In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 869 (E.D. Pa. 1966) (explaining that "equitable scrutiny attaches" when a creditor asks for "affirmative aid of the bankruptcy court to secure its preferred position in the bankruptcy").

market value of the home. The lender would then be entitled to an unsecured claim in the amount by which the outstanding loan exceeds the value of the home. A court using this power could also reduce the interest rate on the loan. In the remainder of this Article, I explain equitable subordination in detail and discuss why it is well suited to remedying the harms caused by creative lending practices.

## III. EQUITABLE SUBORDINATION

### *A. A Brief History of Equitable Subordination in Bankruptcy*

The courts' power to equitably subordinate claims was made explicit when Congress passed the Code in 1978. Congress intended, in including an equitable subordination provision in the Code, that courts would both rely on pre-existing case law and continue to develop standards for equitable subordination.[145] The recent proliferation of abusive lending practices that are currently protected by the Code's anti-modification provision gives bankruptcy courts an ideal opportunity to identify and remedy inequitable conduct in home mortgage lending transactions.

The Code's predecessor, the Bankruptcy Act of 1898 (the Act) contained no specific equitable subordination provision. Because the Act contained no specific equitable subordination provision, courts deciding cases under the Act found their power to subordinate claims in the Act's grant to courts of "such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings."[146] This grant led many courts to describe bankruptcy courts as courts of equity.[147] Broadly, courts interpreted the Act as requiring them to use the rules and principles of equity jurisprudence in adjudicating the rights of the parties involved in a bankruptcy case.[148] Historically, the equity system treated access to its remedies as a privilege, not a right.[149] This equitable principle is clear in the discharge provisions of the Code, which grant relief only to well-behaved debtors. Another hallmark of equity is that it is "flexible rather

145. *See* Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators), 926 F.2d 1458, 1464 (5th Cir. 1991); 4 COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 510.05 (citing to legislative history); Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 421 (1985).

146. *Pepper*, 308 U.S at 304 (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934)).

147. *See, e.g.*, Heiser v. Woodruff, 327 U.S. 726, 732 (1946) (stating that "[i]t is true that a bankruptcy court is also a court of equity"); *Pepper*, 308 U.S. at 304 (noting the Act's grant of equity jurisdiction to bankruptcy courts); *Local Loan*, 292 U.S. at 240 ("Courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity."); Larson v. First State Bank of Vienna, S.D., (*In re* Eggen) 21 F.2d 936, 938 (8th Cir. 1927) (stating that "[a] court of bankruptcy is a court of equity"). *But see* Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court, Not a Court of Equity*, 79 AM. BANKR. L.J. 1, 11 (2005) (explaining that while bankruptcy courts are not courts of equity, bankruptcy judges have specific equitable powers conferred by statute); Marcia S. Krieger, *"The Bankruptcy Court is a Court of Equity": What Does That Mean?*, 50 S.C. L. REV. 275, 310 (1999) (discussing the history of equity and bankruptcy and concluding that bankruptcy courts are not courts of equity).

148. *Larson*, 21 F.2d at 938.

149. 1 DAN B. DOBBS, LAW OF REMEDIES 57 (Practitioner Treatise Series 2d ed. 1993).

than rigid, its interest justice rather than law."[150] Courts that equitably subordinate claims apply these equitable principles to creditor behavior.

The Supreme Court's opinion in *Pepper v. Litton*[151] provides the classic example of an individual claim subordinated because of creditor misconduct. In that case, a corporate insider, described as the "dominant and controlling stockholder" of the debtor corporation, had caused the corporation to confess a judgment on salary claims due to him while another creditor's lawsuit was pending.[152] In subordinating the insider's claim to the claims of the general unsecured creditors, the Court construed the Act's grant of equity jurisdiction to allow it to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."[153]

While creditor misconduct is a necessary element of an equitable subordination claim, the injustice or unfairness required by *Pepper* is unfairness in the distribution results, not unfairness to the debtor. Courts find unjust or unfair results when the conduct of one creditor negatively affects the claim position of another creditor.[154] A good example of this is found in *Miller v. Borton* (*In re Bowman Hardware & Electric Co.*),[155] in which a non-insider creditor, Miller, insisted that the debtor keep the loan arrangement between them secret. A second creditor, Van Camp, made a loan to the debtor, relying on the debtor's false statements about its financial condition.[156] The court found that because Miller induced the debtor's misstatements, Miller's claim should be subordinated to the claim of Van Camp.[157] In subordinating the claim, the court cited the general rule of equity that "he who has done iniquity shall not have equity,"[158] and listed three categories of acts that could deprive a creditor of equal treatment: those involving moral turpitude, those involving breach of duty, and misrepresentations that deceive other creditors to their detriment.[159]

Courts view their ability to equitably subordinate claims as primarily remedial, not punitive. Only a creditor or the trustee, but not the debtor, has standing to bring an equitable subordination claim.[160] Equitable subordination gives a court the power to remedy injustices that would result

150. *Id*. at 63.

151. 308 U.S. 295 (1939).

152. *Id*. at 296–97.

153. *Id*. at 307–08; *see also* Bostian v. Schapiro (*In re* Kansas City Journal-Post Co.), 144 F.2d 791, 800 (8th Cir. 1944) (describing equitable subordination as "an exercise of the court's general power under the statute to adjust equities among creditors in relation to the liquidation results").

154. *Bostian*, 144 F.2d at 800.

155. 67 F.2d 792 (7th Cir. 1933).

156. *Id.* at 795.

157. *Id.*

158. *Id.* at 794.

159. *Id.*

160. Balcor/Morristown P'ship v. Vector Whippany Assocs., 181 B.R. 781, 791 (D.N.J. 1995); Weeks v. Kinslow (*In re* Weeks), 28 B.R. 958, 960 (Bankr. W.D. Okla. 1983).

from allowing a claim to its full extent with its statutory priority.[161] In one early case, the court described its equitable subordination power as the authority to "go no farther than to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible."[162] The end result of equitable subordination is not recovery for wrongdoing, but rather removal of any disadvantage in claim positions caused by a creditor's conduct.[163] Although the creditor must have acted in an objectionable way to have its claim subordinated, the objectionable behavior is punished for its effect on other creditors, not its effect on the debtor. This reflects the policy goal of equitable distribution, and when courts find that the distribution mandated by the Code's priority provisions will be unfair to some creditors, they use their equitable powers to subordinate claims of creditors who acted badly "to the ethically superior claims asserted by other creditors."[164]

Courts have recognized several important limitations on their equitable powers. Pre-Code courts recognized that their equitable powers were not plenary but instead confined to the powers granted to the court by the Act, such as the allowance and disallowance of claims and the collection and distribution of the bankruptcy estate.[165] The equitable subordination cases refine this limitation, drawing a clear line between denying individual claims their statutory priority because of creditor misconduct, and subordinating entire classes of claims based on a general distaste for the class of claims at issue.[166]

It is important to stress the limits on a court's power to reorder priorities. The Act, like the Code, established a hierarchy of priority claims.[167] Principles of equity did not allow a court to ignore that mandate by subordinating an entire class of claims to another in clear contravention of the Act. For example, under the Act, there was only one class of administrative expenses, and all such expenses were treated equally whether they were incurred during an attempted reorganization or during the subsequent liquidation after the reorganization attempt failed.[168] In *United States v. Killoren*,[169] the court thus rejected the trustee's request to subordinate reorganization period taxes to liquidation period administrative expenses because the classification of claims is a job for Congress, not the courts.[170]

This prohibition on the wholesale reordering of priorities by courts remains an important limitation on the equitable subordination power. The

161. Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 113 (1961).

162. *Bostian*, 144 F.2d at 801.

163. *Id.*; *In re* Automatic Washer Co., 226 F. Supp. 834, 836 (S.D. Iowa 1964).

164. Benjamin v. Diamond (*In re* Mobile Steel), 563 F.2d 692, 699 (5th Cir. 1977).

165. Pepper v. Litton, 308 U.S. 295, 304 (1939).

166. United States v. Noland, 517 U.S. 535, 540–41 (1996); United States v. Killoren, 119 F.2d 364, 366 (8th Cir. 1941).

167. Bankruptcy Act of 1898, § 64, 30 Stat. 544.

168. *Killoren*, 119 F.2d at 366. Today, the Code grants a higher priority to liquidation period administrative expenses. 11 U.S.C. § 726(b) (2006).

169. 119 F.2d 364 (8th Cir. 1941).

170. *Id.* at 366.

Supreme Court addressed this issue under the Code in *United States v. Noland*.[171] In that case, the bankruptcy court had subordinated the government's claim for a post-petition non-compensatory tax penalty to claims of the unsecured creditors, not because of any inequitable conduct by the government, but because of "the Code's preference for compensating actual loss claims."[172] Because subordination in such a case "runs directly counter to Congress's policy judgment that a post-petition tax penalty should receive the priority of an administrative expense," the Supreme Court refused subordination.[173]

A concise statement of the equitable principles relied on by courts in equitably subordinating claims can be found in the U.S. Court of Appeals for the Fifth Circuit's opinion in *Benjamin v. Diamond* (*In re Mobile Steel Co.*).[174] In this opinion, the court combined many of the equitable principles announced by the pre-Code courts into the most commonly used test for equitable subordination. Under the *Mobile Steel* test, three conditions must be satisfied before the court can equitably subordinate a claim: the claimant must have engaged in some type of inequitable conduct, the misconduct must have resulted in injury to the debtor's creditors or conferred an unfair advantage on the claimant, and equitable subordination must not be inconsistent with the provisions of the bankruptcy statute.[175] The creditor's conduct must be somehow culpable; it is not sufficient that the *result* of a creditor's actions proves inequitable.[176] In addition, a claim should be subordinated "only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct."[177] While this test does not distinguish between insider and non-insider creditors, courts have had the opportunity to apply it more frequently in insider cases. As I discuss below, non-insider claims can be subordinated under *Mobile Steel*, and the test should be used to subordinate the claims of home mortgage lenders that engaged in abusive lending practices.

### *B. The (Perhaps False) Distinction Between Insider and Non-Insider Equitable Subordination Cases*

Equitable subordination cases appear to fall into two broad categories: cases involving claims held by corporate insiders and those involving claims held by other creditors. Most successful equitable subordination actions have involved the claims of insider creditors. This abundance of precedent has led courts and commentators to draw a clear line between

171. 517 U.S. 535 (1996).

172. *In re* First Truck Lines, Inc., 141 B.R. 621, 629 (Bankr. S.D. Ohio 1992), *aff'd sub nom.* I.R.S. v. Noland, 190 B.R. 827 (S.D. Ohio 1993), *aff'd sub nom.* United States v. Noland (*In re* First Truck Lines), 48 F.3d 210 (6th Cir. 1995), *rev'd*, 517 U.S. 535 (1996).

173. *Noland*, 517 U.S. at 541.

174. 563 F.2d 692 (5th Cir. 1977).

175. *Id.* at 699–700.

176. *Noland*, 517 U.S. at 539.

177. *In re Mobile Steel*, 563 F.2d at 701.

insider cases and non-insider cases.[178] At first blush the distinction appears to be significant, with courts in the non-insider claim cases stressing that the misconduct necessary in those cases must be "more egregious" in order for such claims to be subordinated.[179] A review of equitable subordination opinions, however, shows that the distinction between insider cases and non-insider cases is less significant than it first appears.

### 1. The Insider Cases

Many equitable subordination cases involve corporate insiders. An officer, director, or controlling stockholder of a corporation is a fiduciary who must come to the bankruptcy court with clean hands in presenting a claim.[180] Under corporate law, an insider's dealings with a corporation must be undertaken in good faith and must be inherently fair to the corporation.[181] In determining fairness, a court must determine whether the transaction carries "the earmarks of an arm's length bargain."[182] This search for fairness extends to courts in bankruptcy cases, which have the power to "sift the circumstances surrounding *any* claim to see that injustice or unfairness is not done in administration of the bankrupt estate."[183]

The insider's position in the corporation gives that person many opportunities to engage in conduct that a court might find inequitable. The misconduct that led to subordination in *Pepper v. Litton* was a typical misuse of an insider's fiduciary status to elevate his position in the bankruptcy distribution chain over the other creditors of the corporation.[184] Because the Court was dealing with fiduciary misconduct, it gave several

178. *See, e.g.*, *In re* Lifschultz Fast Freight, 132 F.3d 339, 343 (7th Cir. 1997) ("Equitable subordination typically involves closely-held corporations and their insiders."); Wilson v. Huffman (*In re* Missionary Baptist Found. of Am.), 818 F.2d 1135, 1144 (5th Cir. 1987) ("This case is unlike most equitable subordination cases in that the claimant . . . is not the officer/director/controlling shareholder of a debtor . . . ."); Waslow v. MNC Commercial Corp. (*In re* M. Paolella & Sons, Inc.), 161 B.R. 107, 119 (E.D. Pa. 1993) (noting that "[e]quitable subordination has seldom been invoked, much less successfully so, in cases involving non-insiders and/or non-fiduciaries"); 80 Nassau Assocs. v. Crossland Fed. Sav. Bank, 169 B.R. 832, 838 (Bankr. S.D.N.Y. 1994) (explaining that "[t]raditionally, equitable subordination did not apply to ordinary creditors"); DeNatale & Abram, *supra* note 145, at 424 (arguing that in defining the offending creditor conduct, "the relationship of the creditor to the debtor is an essential factor"); Timothy A. French, *The Rise and Fall of the Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 4 J. BANKR. L. & PRAC. 257, 257 (1995) (claiming that equitable subordination was originally developed by the courts "as a means of reclassifying or subordinating claims held by corporate insiders").

179. *See, e.g.*, Henry v. Lehman Commercial Paper, Inc. (*In re* First Alliance Mortg. Co.), 471 F.3d 977, 1006 (9th Cir. 2006) (stating that gross and egregious conduct is required before the court will equitably subordinate a non-insider, non-fiduciary claim); Estes v. N&D Props., Inc. (*In re* N&D Props., Inc.), 799 F.2d 726, 731 (11th Cir. 1986) (explaining that "[i]f the claimant is not an insider or fiduciary . . . the trustee must prove more egregious conduct such as fraud, spoliation or overreaching").

180. Herzog & Zweibel, *supra* note 161, at 101.

181. *See* JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 10.01 (2d ed. 2003).

182. Pepper v. Litton, 308 U.S. 295, 306–07 (1939).

183. *Id.* at 308 (emphasis added).

184. *See supra* notes 151–53 and accompanying text.

examples of categories of fiduciary behavior that could lead to subordination of that fiduciary's claim, most of which involved the fiduciary using his position to prefer himself to the disadvantage of the persons to whom his duties run.[185] The Court explained why claims of corporate insiders could be subject to equitable subordination, focusing on the importance of fiduciary duties. The Court in *Pepper* did not limit courts' equitable subordination power to claims of corporate insiders, but said that a court's duty to scrutinize claims was "especially clear" in such cases.[186]

A court's power to equitably subordinate insider claims is especially clear because of the ability that an insider has to manipulate the affairs of a corporation for his own benefit and to the detriment of the corporation's creditors.[187] As a result, in an insider case, the courts have a ready set of rules on which to rely: if the corporate insider has breached a fiduciary duty owed under state law, that insider's claim can be subordinated under bankruptcy law. The insider is, in effect, not "honest but unfortunate;" she has taken advantage of her insider position pre-bankruptcy to the detriment of the corporation's creditors in bankruptcy.

There is no precise definition of the inequitable conduct required to satisfy the first prong of the *Mobile Steel* test for equitable subordination. Because most equitable subordination cases have dealt with insider claims, the required conduct has been defined with reference to insider behavior. Courts faced with challenges to insider claims have thus developed lists of behavior that they consider inequitable. For instance, in *Mobile Steel* the court focused on initial undercapitalization,[188] mismanagement, breach of fiduciary duties and abuse of fiduciary position.[189] These categories were specific to the claims being challenged, which arose from loans to the debtor corporation by insiders and the purchase by the debtor of real property from insiders.[190]

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185. *See Pepper*, 308 U.S. at 311 ("He who is in such a fiduciary position cannot serve himself first and his *cestuis* second.").

186. *Id.* at 308.

187. *Id.* at 311.

188. Although *Mobile Steel* lists undercapitalization as an example of inequitable behavior, courts almost uniformly hold that undercapitalization must be combined with other questionable conduct in order for the court to subordinate a claim resulting from an insider's transaction with an undercapitalized corporation. *See, e.g.*, *In re* Lifschultz Fast Freight, 132 F.3d 339, 345 (7th Cir. 1997) (stating that undercapitalization does not, on its own, justify equitable subordination); Mach. Rental, Inc. v. Herpel (*In re* Multiponics, Inc.), 622 F.2d 709, 717 (5th Cir. 1980) (stating that undercapitalization can tip the equities toward subordination); Diasonics, Inc. v. Ingalls, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (holding that initial undercapitalization, without additional inequitable conduct, is "not a sufficient basis for the equitable subordination of a claim"). *But see* Herby's Foods, Inc. v. Summit Coffee Co. (*In re* Herby's Foods, Inc.), 134 B.R. 207, 211 (Bankr. N.D. Tex. 1991) (stating that undercapitalization "constitutes a form of inequitable conduct"). Undercapitalization was described by two commentators as a "bedfellow" of other insider misconduct. Herzog & Zweibel, *supra* note 161, at 94.

189. Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 702–05 (5th Cir. 1977).

190. *Id.* at 695–98.

Courts applying *Mobile Steel* have expanded this list of inequitable conduct to include fraud, illegality, and the claimant's use of the debtor as an alter ego or mere instrumentality.[191] This list is not necessarily exclusive, and illustrates the scenarios in which courts have equitably subordinated claims. Again, this list includes the types of bad behavior engaged in by corporate insiders.

A corporate insider's access to information about the corporation and ability to control corporate affairs gives her ample opportunity to engage in the inequitable conduct supporting subordination. For example, an insider has the ability to mislead lenders about her company's financial health by disguising pre-existing loans. If the outside lender would have no way of learning of that disguised debt, the insider's claim will be subordinated to the claim of the outside lender.[192] Likewise, courts have subordinated insider claims when the insider induced other creditors to abstain from collecting on past debts.[193] An insider's knowledge and control of a corporation's finances also gives him the opportunity to enrich himself and other insiders at the expense of the outside creditors. Courts also find this type of behavior to satisfy the inequitable conduct prong of *Mobile Steel* and have subordinated insider claims when the insider caused the corporation to redeem the shares of another insider when the corporation was in a shaky financial condition.[194]

Insider status, however, is not a sufficient basis for subordination. The insider relationship simply gives an individual numerous opportunities to engage in fraud and other improper conduct.[195] Insider status, therefore, is not a factor in a successful equitable subordination claim, as such status must always be combined with inequitable conduct. In an insider case it is relatively easy to find some inequitable conduct justifying subordination of claims because the questionable conduct by the claimant often involves some breach of a fiduciary duty.[196] Breach of fiduciary duty, however, is just one form of inequitable conduct.

In equitably subordinating claims of insiders who breached fiduciary duties, courts recognized that the insiders did not come to court as honest but unfortunate creditors. In these cases, creditors who used their inside position to attempt to gain an advantage over other creditors found their claims subordinated to those of other creditors.

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191. *In re Lifschultz Fast Freight*, 132 F.3d at 344–45; Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1467 (5th Cir. 1991); Wilson v. Huffman (*In re* Missionary Baptist Found. of Am.), 712 F.2d 206, 212 (5th Cir. 1983).

192. *See In re Lifschultz Fast Freight*, 132 F.3d at 346.

193. *See Fabricators*, 926 F.2d at 1467.

194. Mach. Rental, Inc. v. Herpel (*In re* Multiponics, Inc.), 622 F.2d 709, 720 (5th Cir. 1980).

195. *Fabricators*, 926 F.2d at 1465; George Ashe, *Subordination of Claims: Equitable Principles Applied in Bankruptcy*, 72 COM. L.J. 91, 92 (1967).

196. Corporate officers and directors have well-established fiduciary duties, including the duty of care and the duty of loyalty. *See* COX & HAZEN, *supra* note 181, § 10.01, at 476 ("[D]irectors owe a three-fold duty to the corporation . . . . they must be obedient . . . . they must be diligent . . . . they must be loyal." (citations omitted)).

### 2. The Non-Insider Cases

Although *Pepper v. Litton* is cited as the classic equitable subordination case,[197] the courts in pre-Code cases recognized that their power to equitably subordinate claims was not limited to the claims of corporate insiders. Most of the cases in which courts subordinated claims involved breaches of fiduciary duties, but the courts did not, in defining the parameters of their equitable subordination power, limit that power to the subordination of insider claims. For example, one court gave a non-exclusive list of the uses of equitable subordination, which included "to nullify the effect of any fraud that a creditor has committed."[198]

When the claim sought to be subordinated is held by a non-insider, inequitable conduct is often defined in terms of what it is not. This lack of definition stands in stark contrast to the list of inequitable conduct developed by courts in insider cases. Part of the reason for this may be the context in which several of the unsuccessful equitable subordination cases arose. Many of the lender liability cases of the 1990s involved claims of overreaching by creditors after default.[199] Courts in cases involving arm's-length loans to businesses tended to stress that in order for a lender's claim to be subordinated using the principle of equitable subordination, the lender must do something other than act in the way that lenders traditionally act.[200] Because the average lender owes no fiduciary duty to the debtor or its creditors, defining the level of inequitable conduct necessary to subordinate a non-insider claim is difficult.[201] In a recent case, *Henry v. Lehman Commercial Paper* (*In re First Alliance Mortgage Co.*),[202] the court held that the claimant's conduct was not inequitable because it did not contribute to bringing about the debtor's bankruptcy filing, nor did it determine the ordering of creditors in the bankruptcy estate.[203]

Some of these lender liability cases involved lenders who terminated lines of credit knowing that the debtor would be unable to pay the loan in full, thus hastening the demise of the debtor's business. The loan transaction in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*[204]

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197. *See* Carlson, *supra* note 142, at 198 (describing *Pepper v. Litton* as the case that invented equitable subordination); Harry S. Gleick, *Subordination of Claims in Bankruptcy Under the Equitable Power of the Bankruptcy Court*, 16 BUS. LAW. 611, 614 (1961) (describing *Pepper v. Litton* as the best known of all equitable subordination cases).

198. Bostian v. Schapiro (*In re* Kansas City Journal-Post Co.), 144 F.2d 791, 800 (8th Cir. 1944).

199. *See, e.g.*, Kham & Nate's Shoes No. 2, Inc., v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990); Waslow v. MNC Commercial Corp. (*In re* M. Paolella & Sons, Inc.), 161 B.R. 107 (E.D. Pa. 1993).

200. *See Kham & Nate's Shoes*, 908 F.2d at 1358 ("Bank did not create Debtor's need for funds, and it was not contractually obliged to satisfy its customer's desires."); *In re Paolella*, 161 B.R. at 120 (finding that the bank "acted within its contractual rights in monitoring the debtor's operations and in ceasing to advance funds because the loan was out of formula").

201. 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (*In re* 80 Nassau Assoc.), 169 B.R. 832, 839 (Bankr. S.D.N.Y. 1994).

202. 471 F.3d 977 (9th Cir. 2006).

203. *Id.* at 1007.

204. 908 F.2d 1351 (7th Cir. 1990).

is typical of the type of transaction for which an equitable subordination argument fails. The lender in that case had provided both pre-petition and post-petition financing to the debtor company. About two months after the debtor's bankruptcy filing, the lender stated that it would cease advancing funds to the debtor. The contract between the two provided for cancellation of the credit line on five days notice to the debtor.[205] The Bankruptcy Court subordinated the creditor's claim, finding that the creditor was "fully aware of the Debtor's plight, and its reliance upon the line of credit, and disregarded the consequences for the Debtor and its creditors,"[206] but the Seventh Circuit reversed, citing the need to enforce contracts according to their terms.[207] In the bad faith cases such as *Kham & Nate's*, courts rejected the argument that lenders, by enforcing their loan terms to the letter, violate some standard of fairness or decency toward their borrowers.[208]

Courts faced with an equitable subordination attack on a non-insider claim purport to hold the claimant to a higher standard of misconduct than that required of those objecting to insider claims. Courts have held that plaintiffs must show that the arm's length creditor's conduct was "gross or egregious," and that the plaintiff must prove gross misconduct tantamount to "fraud, overreaching or spoliation."[209] One court however has recognized that, despite the claims of courts to the contrary, there is no different standard by which to judge non-insider conduct, but rather the traditional grounds, based on fiduciary duties, are not available when the claim sought to be subordinated is held by a non-insider.[210]

From the opinions granting equitable subordination of a non-insider claim, one can draw the conclusion that conduct that is harmful to the other creditors will be considered inequitable if that conduct veers from normal lending practices. The opinion in *Bank of New Richmond v. Production*

205. *Id.* at 1353–54.

206. *Id.* at 1356.

207. *Id.* at 1357.

208. *Id.* at 1357–58; Clark Pipe & Supply Co., Inc. v. Assocs. Commercial Corp. (*In re* Clark Pipe and Supply Co.), 893 F.2d 693, 701 (5th Cir. 1990) (recognizing that "[t]hrough its loan agreement, every lender effectively exercises 'control' over its borrower to some degree" and that the purpose of equitable subordination is to "distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation, or the exercise of . . . total control over the debtor"); Waslow v. MNC Commercial Corp. (*In re* M. Paolella & Sons, Inc.), 161 B.R. 107, 120 (E.D. Pa. 1993) (denying equitable subordination when faced with a lender who exercised enhanced monitoring rights over its borrower pursuant to the terms of its loan agreement); Speth v. Whitham Farms Feedyard, L.P. (*In re* Sunbelt Grain WKS, LLC), 406 B.R. 918, 934 (Bankr. D. Kan. 2009) ("Indeed, the record suggests nothing more than [the creditor's] apparent exercise of its rights under the loan documents . . . ."); Overby, *supra* note 113, at 1014.

209. *In re Paolella*, 161 B.R. at 119; *see also* Henry v. Lehman Commercial Paper, Inc. (*In re* First Alliance Mortg. Co.), 471 F.3d 977, 1006 (9th Cir. 2006) (stating that gross *and* egregious conduct on the part of the outside claimant is necessary for equitable subordination).

210. 80 Nassau Assocs. v. Crossland Fed. Sav. Bank. (*In re* 80 Nassau Assocs.), 169 B.R. 832, 838 (Bankr. S.D.N.Y. 1994).

*Credit Ass'n* (*In re Osborne*)[211] nicely illustrates the distinction between normal and unusual lending practices. The complaining creditors in *Osborne* urged the court to subordinate the claim of the Production Credit Association (PCA) for two reasons: the PCA controlled the debtor's business and the PCA misrepresented the degree of support that it would give to the debtors.[212] To prove control, the complaining creditors (who supplied farm supplies to the debtor) showed that the PCA gave the debtor instructions on how to spend the loan funds.[213] The court found, however, that this is not the type of control required under the various equitable subordination tests; it was control that arose out of the PCA's status as a creditor with a security interest in most of the debtor's assets.[214] Because the court found no control, the court required the other creditors to show "gross misconduct."[215]

The plaintiff's use of "control" as an example of inequitable conduct is a good example of a plaintiff straining to fit non-insider conduct into one of the fiduciary misconduct categories. Control, even if found, is relevant only to the extent that it allows the claimant to engage in inequitable conduct. Because the PCA in *Osborne* was making payments directly to some of Osborne's creditors on Osborne's account, it had such an opportunity because it was in regular contact with some of the other creditors. The PCA assured one of the complaining creditors that the creditor would be paid even though the PCA knew of the debtor's dire financial condition and that it would be terminating support for the debtor.[216] The court thus found the requisite level of inequitable conduct, because the PCA had superior knowledge regarding the debtor's financial condition and used that knowledge to induce the creditor to continue supplying feed to the debtor.[217] Compared to the other creditors, the PCA was less "honest but unfortunate" and therefore found its claims subordinated to those of the creditors who relied on its misstatements.

Even inside information allowing a creditor to gain an advantage over other creditors is not necessary if that creditor's actions improperly allow it to gain priority over the debtor's other creditors. The subordinated claimant in *First National Bank of Gatlinburg v. Charles Blalock & Sons, Inc.* (*In re Just for the Fun of It of Tennessee, Inc.*)[218] was one of many contractors on an amusement park project. That creditor, Botkin, filed a notice of completion in the public record as general contractor for the project. Once the notice was filed, other contractors had a short period of time within which to file any lien notices. Because Botkin misrepresented both that he was the general contractor and that the project was complete, the court subordinated his claim to those of the creditors who were deceived to their

211. 42 B.R. 988 (W.D. Wis. 1984).
212. *Id.* at 989.
213. *Id.* at 990.
214. *Id.* at 997.
215. *Id.*
216. *Id.* at 999–1000.
217. *Id.*
218. 7 B.R. 166 (Bankr. E.D. Tenn. 1980).

detriment by the false notice.[219] Again, the subordinated creditor was deemed "dishonest" and undeserving of its statutory priority.

Courts have been open to arguments that the non-insider's conduct at the outset of the lending relationship might be inequitable if the loan is unusual enough. The facts in *Nicholson v. Core* (*In re Carolee's Combine, Inc.*)[220] could be said to illustrate a creative lending practice. Carolee's Combine was organized to conduct an auction of architectural antiques. Because of the high cost of acquiring and refurbishing the goods to be sold and the difficulty of raising funds through conventional means, the principals of the company embarked on what the bankruptcy court described as "an inventive money raising scheme."[221] To attract investors in the auction company, the principals promised investors that their money would be returned on the first day of the auction with ten percent annual interest. In addition, those investors would receive at the same time a "finder's fee" equal to ten percent of their investment. The auction company's obligation to each investor was evidenced by two documents: a promissory note and a "Finder's Fee Letter."[222] In subordinating the investors' claims to the claims of the debtor's trade and other creditors, the court stressed that the investors "advanced monies to a speculative venture for the promise of a high return," and while that in itself is not inequitable, the court added that the investors "shifted the risk of that speculation to general creditors by arranging to be paid in advance."[223]

Courts have also discussed whether a lender whose loan agreement contains onerous terms has engaged in inequitable conduct warranting subordination. The opinion in *In re Elkins-Dell Manufacturing Co.*[224] supports the argument that equitable subordination might be used to combat abusive lending practices. The questioned loans in *In re Elkins-Dell* were business loans that carried high rates of interest and gave the creditors a great deal of control over the debtor's finances. One lender, Fidelity, required that the debtor finance only through it and through no other lenders.[225] Fidelity also reserved the power to unilaterally change the terms of the loan agreement by giving notice of the changes by certified mail. The trustee, in seeking equitable disallowance of Fidelity's claim, argued that the loan contract was unconscionable.[226]

219. *Id.* at 180–81.
220. 3 B.R. 324 (Bankr. N.D. Ga. 1980).
221. *Id.* at 326.
222. *Id.*
223. *Id.* at 328.
224. 253 F. Supp. 864 (E.D. Pa. 1966).
225. *Id.* at 866.
226. *Id*. at 866–67. Because there was no specific equitable subordination provision in the Act, courts applied the same standards to both equitably subordinate and equitably disallow claims. *See* Pepper v. Litton, 308 U.S. 295, 308–09 (1939) (explaining that the "Deep Rock" doctrine, as set forth in *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939), allows claims of corporate insiders to be disallowed or subordinated when courts "are satisfied that allowance of the claims would not be fair or equitable to other creditors").

The court declined to disallow Fidelity's claim, remanding for further development of the factual record on unconscionability.[227] Nevertheless, the opinion contains some useful guidance on whether abusive loan terms could ever result in subordination of a lender's claim. First, the court explained that federal law could govern unconscionability in determining whether a claim could be allowed because a bankruptcy claimant "ask[s] a favor" of the bankruptcy court.[228] The court also noted that while it was reluctant to deny enforcement of a loan contract between two businesses like the one before it, it might not be as reluctant to deny enforcement of a consumer loan contract.[229] Last, the court cautioned that regulation of oppressive loan products was the job of the legislature, not the judiciary,[230] but suggested that it might be inclined to disallow a lender's claim if the loan terms bore no reasonable relationship to business risks.[231]

The U.S. Bankruptcy Court for the District of Montana recently equitably subordinated a non-insider claim in an opinion that seems to require that creditors be "honest but unfortunate" in order to obtain the relief given to creditors in bankruptcy. Tim Blixseth, the principal of the borrower in *Credit Suisse v. Official Committee of Unsecured Creditors* (*In re Yellowstone Mountain Club, LLC*)[232] does not elicit much sympathy. One can assume that he is a sophisticated businessperson; he developed "the world's only private ski and golf community."[233] Credit Suisse contacted Blixseth to offer him a new loan product, a syndicated term loan, which Credit Suisse analogized to a home-equity loan.[234] This new loan product enabled Credit Suisse to offer larger loans to borrowers than it had been previously able to offer.[235]

Although it seems that Blixseth's conduct, not Credit Suisse's conduct, precipitated the Yellowstone Mountain Club's bankruptcy filing,[236] the opinion contains some reasoning that could be useful to courts in refashioning equitable subordination to punish creative lending practices. In subordinating Credit Suisse's claim, the court described Credit Suisse's "naked greed" combined with its "complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position" as conduct that shocked the conscience of the court.[237]

227. *In re Elkins-Dell*, 253 F. Supp. at 875.
228. *Id.* at 869.
229. *Id.* at 871.
230. *Id.* at 872.
231. *Id.* at 873.
232. No. 08-61570-11, Adv. No. 09-00014, 2009 Bankr. LEXIS 2047 (Bankr. D. Mont. May 12, 2009).
233. *Id.* at *7. The *New York Times* described the Yellowstone Club's bankruptcy filing as "one of the signature, *fin de siècle* moments of our passing Gilded Age." Amy Wallace, *Checkmate at the Yellowstone Club*, N.Y. TIMES, June 14, 2009, at BU1.
234. *In re Yellowstone Mountain Club*, 2009 Bankr. LEXIS 2047, at *8–9.
235. *Id.* at *9.
236. The Credit Agreement provided that most of the loan proceeds could be used for purposes other than development of the Yellowstone Club, and Blixseth in fact used the funds for other purposes. *Id.* at *15–16
237. *Id.* at *31.

In deciding to subordinate the claim, the court relied on both the debtor's questionable financial condition at the time the loan was made and the failure of Credit Suisse to perform adequate due diligence. For example, Credit Suisse never requested audited financial statements from the debtors, relying instead on the debtors' own historical and future projections.[238] Additionally, the court found that Credit Suisse was offering a new loan product and was driven by the fees it received for these loans.[239]

The opinion is couched in predatory lending language, a point made by many members of the legal community in criticizing the result.[240] While such language is almost unheard of in cases involving commercial loans, it could be useful in attacking some consumer lending practices. The *In re Yellowstone Mountain Club* opinion was vacated after the parties reached a settlement,[241] but it is particularly useful in that it defined inequitable conduct in terms of what it is rather than what it is not.

## IV. WHY EQUITABLE SUBORDINATION IS A GOOD REMEDY FOR CREATIVE LENDING PRACTICES, DESPITE POSSIBLE OBJECTIONS

Equitable subordination can be a useful tool in attacking abusive lending practices because it must be applied only on a case-by-case basis and not against all mortgage creditors who find that their collateral is worth less than the amount outstanding on their loans. While granting special priority to home mortgage creditors seems like a bad policy in the wake of the mortgage crisis, it is up to Congress, not the courts, to remove that special priority. Yet courts have the power to make exceptions to this special priority when justified by the facts of a particular home mortgage claim.[242] The subordination approach would be an appropriate way of dealing with a home mortgage lender who engaged in abusive lending practices because, although such a lender is a creditor who is owed a legally enforceable

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238. *Id.* at *11.

239. *Id.* at *31.

240. *See, e.g.*, Jo Ann J. Brighton & Felton E. Parrish, Yellowstone*: New Standards for Lender Liability in Today's Economic Climate*, AM. BANKR. INST. J., Sept. 2009, at 28; *Hedge Funds and Bankruptcy: Credit Suisse and Yellowstone are Big Boys*, BULLIVANT, HOUSER, BAILEY P.C. (May 19, 2009), http://www.bullivant.com/Hedge-Funds-and-Bankruptcy; *Weathering the Storm: Look Out Lenders—Collecting Fees for Loaning Money May Be Considered Evil*, HAYNES AND BOONE'S NEWSROOM (June 12, 2009), http://www.haynesboone.com/weathering_the_storm_look_out_lenders/; *In re Yellowstone Mountain Club, LLC—The Pitfalls of "Equitable Subordination" for the Unwary Lender*, WHITE & CASE CLIENT ALERT (June 4, 2009), http://www.whitecase.com/files/Publication/0e4b30ee-17f3-411b-bfff9b4df82f5a44/Presentation/PublicationAttachment/843ae7fa-ae7b-4c75-a666-a94df156335e/alert_In_re_Yellowstone_MountainClubLLC.pdf.

241. Jessica Katz, *Secured Creditor's Claim Equitably Subordinated by Bankruptcy Court*, ABI COMMITTEE NEWS, SECURED CREDIT COMMITTEE, VOL. 6, NO. 1 (July 2009), *available at* http://www.abiworld.org/committees/newsletters/financebank/vol6num1/secured.html.

242. *See* Merrimac Paper Co. v. Harrison (*In re* Merrimac Paper Co.), 420 F.3d 53, 61 (1st Cir. 2005) (explaining that "[s]uch case-by-case adjudication is at the core of judicial competence").

obligation, equity might require that a portion of that lender's claim be treated as unsecured and that its loan terms be modified.[243]

A court should be able to both cram down the home mortgagee's claim and modify its interest rate using equitable subordination. Bifurcation of the undersecured mortgagee's claim into a secured and an unsecured claim would recognize the true nature of many abusive loans. Most subprime mortgage loans were used to refinance existing mortgage loans. Borrowers were encouraged to use their homes like credit cards.[244] By treating the portion of a home mortgage loan that exceeds the value of the home as unsecured, a court using equitable subordination would recognize that to the extent a home mortgage lender is in fact an unsecured creditor like a credit card issuer, it is also an unsecured creditor for priority purposes.

Yet the home mortgagee enjoys a special priority not only because it is treated as a fully-secured creditor regardless of the value of its collateral but also because it is entitled to enforce its original loan terms. These loan terms often include a higher interest rate than that which a court would permit to be paid to other holders of secured claims in Chapter 13.[245] A court exercising equitable subordination should thus also lower the interest rate payable on the home mortgage loan because only by doing so will the court deny the mortgagee its special priority and allow all creditors to be treated fairly in bankruptcy.

### *A. Abusive Lending and the* Mobile Steel *Test*

In order for a court to equitably subordinate a claim, the claimant must have engaged in some inequitable conduct. Congress intended that courts develop the concept of equitable subordination over time, and while it is said to be a rare and limited remedy,[246] the recent subprime mortgage crisis precipitated by abusive lending practices gives courts a unique opportunity to remedy the harm that was done by these practices and discourage the

243. *See* 4 COLLIER ON BANKRUPTCY, *supra* note 22, ¶ 510.01 (stating that § 510(c) "provides for the subordination of allowed claims, when principles of equity would be offended by the treatment of such claims as senior or on a parity with those of other creditors"); Herzog & Zweibel, *supra* note 161, at 86 (arguing that subordination "should be ordered when the claimant is undeniably a creditor, but for reasons of equity should be relegated to a rank inferior to that of general creditors").

244. *See* Adams, *supra* note 49, at 604 (explaining that changes to the Internal Revenue Code made by the Tax Reform Act of 1986 made the use of home equity for purposes other than home improvement more appealing); Dickerson, *supra* note 80, at 24–25 (explaining that most subprime loans were refinance loans and that most home equity lines of credit were used for purposes other than home improvement and suggesting a rebuttable presumption under which home equity and refinance loans would be treated as general unsecured loans unless they were used for housing purposes or to reduce overall debt); White, *supra* note 49, at 630 (explaining that one of the "principal marketing themes of subprime lenders was to encourage consumers with multiple credit card accounts to refinance the credit card debt with a mortgage refinance loan").

245. *See supra* notes 22–24 and accompanying text.

246. Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1464 (5th Cir. 1991).

lenders, brokers, and investors responsible for these practices from engaging in them in the future.

Bankruptcy courts should develop a federal standard for inequitable conduct because of the special favors that creditors receive under bankruptcy law.[247] State laws vary greatly in their treatment of abusive mortgage lending practices,[248] but full payment on the original loan terms is a special benefit granted by bankruptcy law. Because of this special bankruptcy benefit, it is appropriate to hold mortgage lenders to a bankruptcy standard of good behavior.

Lender behavior that departs from standard lending practices should be considered inequitable conduct.[249] Many subprime loans were made to individuals who could not afford them. The U.S. Department of Housing and Urban Development promulgates affordable housing standards that compare a household's income to its monthly housing costs. A household that is paying over 30% of its income toward housing costs is deemed to be living in unaffordable housing.[250] Making an affordable loan is a normal and prudent lending practice, therefore a lender who makes a loan to a homebuyer knowing that the loan will make the home unaffordable is a lender whose behavior merits punishment. Many subprime mortgage loans resulted in payments that far exceeded the housing cost to income ratio that would make a home affordable.[251] Lenders who make such loans are not relying on the debtor's ability to repay out of income; they are relying on either another bank's willingness to refinance when the interest rate resets or on repayment when the property is sold at a higher price. This is not a normal lending practice, in fact, it looks more like an equity investment in a business.[252]

Loan terms that bear no reasonable relationship to the risk of non-payment are often also the result of inequitable lender conduct.[253] There is evidence that borrowers who could qualify for "prime" loans were steered to "subprime" loan products. Many of the borrowers inappropriately

247. *See supra* notes 224–31 and accompanying text.

248. A list of state laws governing subprime and predatory mortgage lending can be found on the National Conference of State Legislatures' web site. *Mortgage Lending Practices, Subprime and Predatory Mortgage Lending*, NATIONAL CONFERENCE OF STATE LEGISLATURES, http://www.ncsl.org/default.aspx?tabid=12511 (last visited Feb. 23, 2011). Vern Countryman, in arguing for equitable subordination or disallowance of the claims of improvident lenders, suggested that bankruptcy courts should develop standards for unconscionability because the development of the concept of unconscionability in state courts was "extremely spotty." Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U. L. REV. 407, 430 (1972).

249. *See supra* notes 234–41 and accompanying text.

250. For a detailed discussion of these standards, see Eggum, Porter & Twomey, *supra* note 13, at 1135–40.

251. *See* Adams, *supra* note 49, at 606 (reporting that more than one-half of the subprime adjustable rate mortgage loans originated in 2006 had a monthly debt service to income ratio of over 40%).

252. Mechele Dickerson calls this "asset-based" lending, and classifies it as a type of predatory lending because the lenders have the goal of receiving the borrower's house, not receiving timely repayments. Dickerson, *supra* note 80, at 33.

253. *See supra* notes 224–31 and accompanying text.

steered towards higher cost loans were elderly and minority borrowers.[254] In addition, because subprime loans were more profitable for lenders than Federal Housing Administration (FHA) loans designed for first-time buyers, many lenders steered FHA-eligible buyers to subprime loans.[255] Such steering is an example of behavior that may be legal,[256] but certainly is objectionable. Steering to reap greater fees is a type of self-dealing. Although lenders have no fiduciary duties to their borrowers, loan terms that are motivated not by non-payment risk but by the desire to earn higher fees should certainly be viewed as inequitable, especially when the borrower is a consumer.

Under the second prong of the *Mobile Steel* test, the claimant's misconduct must have resulted in injury to the debtor's creditors or conferred an unfair advantage on the claimant.[257] Abusive lenders engaged in several lending practices that showed little regard for their borrowers' ability to repay their loans. One was the practice of making low and no documentation loans.[258] Another was the practice of ignoring affordable housing standards in making mortgage loans.[259] A third was making loans with initially high loan to value ratios.[260] These lending practices all led to loans with a high risk of default. When a mortgage lender makes a loan to a borrower with little regard for the borrower's ability to repay, that lender injures other creditors because funds that would otherwise go to those creditors outside of bankruptcy are diverted to pay an unusually large and expensive mortgage loan. Even prudent creditors may end up with borrowers who cannot repay their loans because of job losses and other

254. *See, e.g.*, Brescia, *supra* note 48, at 284 (noting that more than half of the mortgage loans obtained by African-Americans and 40% of those obtained by Latinos were subprime); Dickerson, *supra* note 80, at 35 (reporting that "homeowners in high-income black neighborhoods are twice as likely as homeowners in low-income white neighborhoods to have subprime loans" (emphasis omitted)); Painter, *supra* note 64, at 89 (arguing that the lack of competitive pressure on subprime lenders is "evidenced by the number of borrowers with good or excellent credit scores" who purchase their homes using subprime loans); Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing*, 60 S.C. L. REV. 678, 701–02 (2009) (discussing the New York Attorney General's investigation of Countrywide Home Loans, Inc., which found that "black and Hispanic customers with high credit scores were much more likely to receive subprime products").

255. *See* White, *supra* note 49, at 624–25 (explaining the credit scores of FHA and subprime homebuyers).

256. The Fair Housing Act and the Equal Credit Opportunity Act prohibit racial discrimination in mortgage terms, but direct proof of racial discrimination in loan approval is rare. *See* White, *supra* note 254, at 705 (arguing that the enforcement of fair lending laws "must respond to the more subtle but invidious mechanisms of the new price discrimination"). The Dodd-Frank Wall Street Reform and Consumer Protection Act passed in 2010 prohibits some of the abusive practices discussed in this article. For example, it gives a borrower a defense to foreclosure when there is a violation of the act's provisions that prohibit steering borrowers to particular mortgage products and making loans without regard to the borrower's ability to repay. Pub. L. No. 111-203, §§ 1403–14, 124 Stat. 1376 (2010). The new legislation will not affect the abusive mortgage loans that are currently outstanding.

257. Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977).

258. *See supra* notes 71–72 and accompanying text.

259. *See supra* notes 60–63 and accompanying text.

260. *See supra* notes 56–58 and accompanying text.

upheavals, but those creditors did nothing to contribute to the risk of nonpayment and should not be punished by the exercise of equitable subordination.

After a borrower becomes unable to pay, the mortgagee should be able to rely on the value of the mortgaged home for repayment. Yet many subprime lenders lent money based on inflated appraisals.[261] Negligently prepared appraisals might cause borrowers to pay too much for property and can leave junior lenders seriously undersecured or completely unsecured at the time of foreclosure.[262] Overappraisal causes similar harms in bankruptcy: junior mortgagees end up with no collateral, and the holders of unsecured claims suffer even greater harm when the home mortgage lender is entitled to full payment of not the amount that the property would bring at a foreclosure sale, but instead the amount that it is owed on the loan. Overappraisal is exactly the type of creditor behavior that should lead to equitable subordination of the creditor's claim, as it is more likely that an overappraised house will be subject to a mortgage in excess of the home's value.[263]

A lender who makes an abusive mortgage loan without regard to a homeowner's ability to pay and without serious attention to the value of the mortgaged property clearly improves its bankruptcy position against other secured and unsecured creditors of the debtor. A Chapter 13 debtor cures all arrearages and maintains payment on long-term debt during the term of the plan.[264] Therefore, she will make her original payments, which may include a high interest rate on a secured claim in excess of the value of her house, plus all overdue amounts, which may include exorbitant fees. A debtor must commit her "disposable income" to the payment of unsecured claims under a Chapter 13 plan, and the payments on secured debts are deducted from the debtor's income in calculating disposable income.[265] As a result, a loan that carries the hallmarks of an abusive loan—high fees, a high interest rate, and a high loan-to-value ratio—depletes the amount of money available to the debtor's other creditors. All mortgage loans do so, but abusive lending practices result in higher payments, and they are more likely to result in mortgage liens that exceed the value of the home.

By making loans that depleted borrower wealth rather than enabling borrowers to increase their wealth, subprime home mortgage lenders harmed other lenders. First, debtors were required to commit large

261. *See supra* note 78 and accompanying text. There is evidence that lenders pressured appraisers to inflate home values. Eggert, *supra* note 49, at 1287.

262. Robin Paul Malloy, *Lender Liability for Negligent Real Estate Appraisals*, 1984 U. ILL. L. REV. 53, 59–60.

263. *See* Miles, *supra* note 35, at 265–66 (discussing testimony from the early 1990s suggesting that most underwater mortgages were the result of overappraisals or were held by second mortgagees who lent against property in which the debtor had little equity).

264. 11 U.S.C. § 1322(b)(5) (2006).

265. *Id.* §§ 707(b)(2), 1325(b)(3). These Code sections specify that payments on secured debt are subtracted from current monthly income for above-median debtors. For other debtors, "disposable income" means current monthly income minus "amounts reasonably necessary to be expended for the maintenance or support of the debtor." *Id.* § 1325(b)(2).

percentages of their income to mortgage payments, reducing their ability to pay other creditors. Second, high fees and interest rates led to defaults, and these back payments were added to the loans, depleting the homeowners' already scant equity.[266] In those cases, the lender can be seen as another investor in the property, just as a corporate insider who makes a questionable loan to a corporation is viewed as an equity investor. By making a loan without regard to the borrower's ability to repay, the lender is draining the future bankruptcy estate of assets that could be used to pay other creditors because all appreciation in the value of the home will be paid to the mortgage creditor, not the other creditors.

The third *Mobile Steel* prong requires that the exercise of equitable subordination must not be inconsistent with the provisions of the Code.[267] Initially, reducing the claim of a home mortgage creditor might seem to fly in the face of the clear language of the Code. The result of equitable subordination is often to reorder the priorities set forth in the Code, however. If we view the enhanced property right of a mortgage creditor as a priority classification, then subordinating the unsecured portion of such claim so that it enjoys the same priority as unsecured claims is consistent with other exercises of the equitable subordination power.

Congress granted home mortgage lenders special priority and has resisted removing that special treatment.[268] That fact might lead some to argue that a court cannot equitably subordinate the claims of home mortgage creditors. But I do not suggest reducing the claims of all home mortgage creditors, only those who engaged in inequitable conduct. Therefore, such an exercise would comply with the Supreme Court's holding in *Noland*, which prohibits the equitable subordination of entire classes of claims on a general categorical level.[269] Subordinating the claims of abusive home mortgage lenders would further the purpose of equitable subordination: to ensure that injustice is not done in the administration of the bankruptcy estate.[270]

### *B. Possible Objections to Using Equitable Subordination To Cram Down Home Mortgages*

There are several possible objections to using equitable subordination to modify home mortgages. One objection is that no long-term debt can be modified and paid outside of a Chapter 13 plan. Another is that the claimants who will be punished are often not the entities who originated the abusive loans. A third objection is that the questionable practices were widespread; all lenders in the subprime sector were making questionable loans, and therefore, the practices should not be considered inequitable. A final objection is that debtors who borrowed responsibly will get no relief, and debtors who were most likely over their heads will. These arguments are discussed below.

266. Painter, *supra* note 64, at 94.
267. Benjamin v. Diamond (*In re* Mobile Steel), 563 F.2d 692, 700 (5th Cir. 1977).
268. *See supra* notes 42–46 and accompanying text.
269. *See supra* notes 171–73 and accompanying text.
270. *See supra* notes 153–59 and accompanying text.

When Congress first proposed allowing mortgage modification, proponents of the legislation argued that home mortgages had been unfairly singled out for better treatment than other secured debts by Congress in 1978. According to that argument, if a debtor can cram down and otherwise modify a mortgage on a vacation home or investor property in Chapter 13, a debtor should be able to cram down a home mortgage as well.[271] Others have explained that the ability of a debtor to cram down a mortgage on a second home in Chapter 13 is not as broad as it might seem because of the Code's mandate that a Chapter 13 debtor pay the value of an allowed secured claim (the stripped down mortgage claim) over the course of the three-to-five-year plan.[272] While the scant case law favors the latter position,[273] the reasoning in those cases does not prevent a court from modifying a mortgage using equitable subordination. Whether other long-term debt can be stripped down or not should be irrelevant to a court's decision to equitably subordinate an abusive mortgage creditor's claim. The point of equitable subordination is to remedy inequities caused by the bad behavior of a creditor, not to change the priority of an entire class of claims.

A major force behind abusive lending was securitization.[274] As a result, the entities asserting mortgage claims in a bankruptcy case are often not the entities who engaged in the questionable lending practices. This issue was raised by some of the critics of *In re Yellowstone Mountain Club*.[275] The subordinated loan in *In re Yellowstone Mountain Club* was made by a lending syndicate led by Credit Suisse, the party whose behavior the court found egregious. During the litigation, however, no one raised the issue of whether only the portion of the loan retained by Credit Suisse should be subordinated.[276]

The question of whether a court can equitably subordinate a claim held by someone other than the original wrongdoer is one on which there is little case law. When it was raised in one of the Enron proceedings in the Southern District of New York, it was a question of first impression in the Second Circuit.[277] The *Enron* court held that § 510(c) could not be applied

271. *Credit Cards and Bankruptcy: Opportunities for Reform: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 32 (2008) (written testimony of Robert M. Lawless), *available at* http://judiciary.senate.gov/pdf/08-12-04LawlessTestimony.pdf; Adam J. Levitin, *Back to the Future with Chapter 13: A Response to Professor Scarberry*, 37 PEPP. L. REV. 1261, 1267 (2010); Levitin, *supra* note 13, at 581.

272. 11 U.S.C. § 1325 (a)(5) (2006); Mark S. Scarberry, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13 Bankruptcy*, 37 PEPP. L. REV. 635, 717–21 (2010).

273. *See, e.g.*, Enewally v. Wash. Mut. Bank (*In re* Enewally), 368 F.3d 1165, 1171 (9th Cir. 2004) (holding that a debtor could not both strip down a mortgage lien and invoke the right to cure and maintain under Chapter 13); *In re* Bulson, 327 B.R. 830, 847 (Bankr. W.D. Mich. 2005) (holding that a stripped-down mortgage claim must be paid in full during the plan period).

274. *See generally* Eggert, *supra* note 49.

275. *See, e.g.*, Brighton & Parrish, *supra* note 240.

276. *Id.*

277. Enron Corp. v. Springfield Assoc. (*In re* Enron Corp.), 379 B.R. 425, 428 (S.D.N.Y. 2007).

to a transferee of a claim who himself had not acted inequitably "merely because that claim was transferred, directly or indirectly, by a bad actor."[278]

The court in *Enron* relied in part on the lack of case law allowing equitable subordination against transferees because of transferor conduct.[279] Congress, however, intended that courts continually develop standards for equitable subordination.[280] Abusive mortgage practices give the courts a perfect opportunity to stop these practices by subordinating claims held by investors. In the case of securitized subprime mortgages, there is considerable evidence that investors in subprime securities knew that these securities were risky.[281] Their very risk is what drew investors to securities made up of subprime loans—in exchange for that risk, they carried greater returns.[282] If a subprime mortgage goes into foreclosure, the investors will take the loss. A bankruptcy cramdown will only reflect that loss.

A third objection is that abusive lending practices were so widespread that the terms might not be seen as unusual. Given the universal scorn of these practices, and the evidence that subprime loan terms were often driven by concerns other than the borrower's default risk, their ubiquity should not prevent equitable subordination. Tort law provides a useful analogy in this regard. In a 1906 negligence case, Justice Oliver Wendell Holmes famously stated that "[w]hat usually is done may be evidence of what ought to be done, but what ought to be done is fixed by a standard of reasonable prudence, whether it usually is complied with or not."[283] Justice Learned Hand complemented this rule in 1932, stating, "in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices."[284] While in tort law it is said to be rare that an entire industry engages in unsafe practices,[285] we know that in the past decade, an entire sub-industry of lenders followed unsafe practices in making loans to home mortgage borrowers. As a result, the fact that all subprime lenders engaged in these practices should not prevent a court from finding that the practices were inequitable.

A final possible objection is that borrowers who borrowed within their means and whose mortgages became undersecured because of a market decline would get no relief under this proposal, while borrowers who borrowed more than they could pay would. In essence, an honest but unfortunate debtor saddled with an underwater mortgage would be denied

278. *Id.* at 440.
279. *Id.*
280. *See supra* note 145 and accompanying text.
281. Eggert, *supra* note 49, at 1303.
282. *Id.*
283. Tex. & Pac. Ry. Co. v. Behymer, 189 U.S. 468, 470 (1903) (citing Wabash Ry. Co. v. McDaniels, 107 U.S. 454 (1883)).
284. New Eng. Coal & Coke Co. v. N. Barge Corp. (*The T.J. Hooper*), 60 F.2d 737, 740 (2d Cir. 1932).
285. *See* Gideon Parchomovsky & Alex Stein, *Torts and Innovation*, 107 MICH. L. REV. 285, 294 (2008) (observing that "self-incriminating industry practices" like those followed in *The T.J. Hooper* rarely take place today).

relief because his lender was honest in the initiation of the loan and unfortunate when the market dropped. That is true because only abusive lenders would find their claims stripped down under this proposal. Abusive lenders acted imprudently in extending credit by ignoring affordable housing guidelines and making loans with high loan-to-value ratios and thus increased the chances that their borrowers would default on their loans. Congress chose to give home mortgage lenders favorable treatment, and in the absence of lender bad behavior, they should receive that treatment until Congress changes the rule.

On the other hand, not all irresponsible borrowers will get relief. A borrower who obtained a true "liar's loan" in that he misrepresented his income on his loan application would not be able to discharge the unsecured portion of his home mortgage debt.[286] Therefore, a court that equitably subordinates the unsecured portion of a home mortgage would be inquiring into the "honest but unfortunate" nature of both the debtor and his creditors.

## CONCLUSION

In one of the few law review articles that comprehensively addressed equitable subordination in bankruptcy, Asa Herzog and Joel Zweibel concluded that "where man's ingenuity creates new situations without precise factual precedent, equity has the capacity to adapt itself . . . . [e]quity will be found equal to the task, extending old principles, if necessary, to accomplish its purpose."[287] Human ingenuity created abusive home lending practices, and equity should intervene to ensure that those who engaged in such practices are not rewarded.

Equitable subordination is an excellent tool for combating abusive lending practices for several reasons. First, it can be used in the absence of legislative action. Unlike the various legislative proposals of the past few years, equitable subordination is flexible and durable. Several of the failed bills sought to provide relief only to homeowners whose mortgage loans were in existence at the time the legislation went into effect.[288] Such measures may have been effective to alleviate the current mortgage crisis, but would have done nothing for creative lending practices that may arise in the future.[289] The Dodd-Frank Wall Street Reform and Consumer

286. 11 U.S.C. § 523(a)(2) (2006) (providing that an individual cannot discharge a debt obtained by "false pretenses, a false representation, or actual fraud" or by a materially false written statement respecting the individual's financial condition on which the creditor reasonably relied).

287. Herzog & Zweibel, *supra* note 161, at 113. It is important to note that in 1972 Vern Countryman made a similar suggestion with respect to lenders who made "improvident" loans to consumers. He made this suggestion because such lenders extended credit "on volume rather than on diligent credit investigation." Countryman, *supra* note 248, at 431.

288. *See* Zinman & Petrovski, *supra* note 17, at 141–43 (describing the Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 1106, 111th Cong. (2009), and the Senate bill of the same name, S. 61, 111th Cong. (2009)).

289. A similar criticism is being aimed at proposals to submit systemically significant financial institutions to FDIC resolution authority. *See Too Big to Fail: The Role for*

Protection Act, passed in the summer of 2010, aims to curb the practices that led to the current crisis,[290] but it does nothing to give relief to the homeowners already harmed by these practices. Dodd-Frank is a step in the right direction because, in the absence of regulation, it is likely that dangerous loan products will reappear on the market,[291] but equitable subordination allows judges to deal with any abusive practices not anticipated by Congress in 2010. Judges, with their power to equitably readjust the bankruptcy distribution to ensure that "injustice or unfairness is not done in the administration of [a] bankrupt[cy] estate,"[292] should send a message to those involved in abusive lending practices that the claims arising from those practices will not get favorable treatment in bankruptcy because they did not come to court as honest but unfortunate creditors.

*Bankruptcy and Antitrust Law in Financial Regulation Reform: Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 13–16 (2009) (testimony of Harvey R. Miller, Weil, Gotshal & Manges LLP, New York, NY), *available at* http://judiciary.house.gov/hearings/pdf/Miller091022.pdf.

290. *See supra* note 256.

291. White, *supra* note 49, at 635. ("There is little reason to believe that another cycle of credit expansion, lax underwriting and hunger for yield will not produce a similar set of dangerous products . . . .").

292. Pepper v. Litton, 308 U.S. 295, 308 (1939).