2011

The Trillion Dollar Problem of Underwater Homeowners: Avoiding a New Surge of Foreclosures by Encouraging Principal-Reducing Loan Modifications

Gregory S. Crespi
Southern Methodist University, Dedman School of Law

THE TRILLION DOLLAR PROBLEM OF UNDERWATER HOMEOWNERS: AVOIDING A NEW SURGE OF FORECLOSURES BY ENCOURAGING PRINCIPAL-REDUCING LOAN MODIFICATIONS

Gregory Scott Crespi*

I. INTRODUCTION

How many U.S. homeowners with outstanding mortgage obligations have been put into a negative equity position by the recent decline in housing prices, and to what extent? Unfortunately, no comprehensive private or governmental database accurately tracks all real estate price trends, mortgage loan data, and loan modification information in a way that would allow one to definitively answer these questions.[1] However, it has been credibly estimated that there are at least 11.3 million U.S. homeowners, and probably as many as 15.2 million or more, who are "underwater" in that the outstanding balances on their mortgages exceed the market value of their homes (these persons are hereinafter

* Professor of Law, Dedman School of Law, Southern Methodist University. J.D., Yale Law School, 1985, Ph.D., University of Iowa, 1978. I would like to thank Jean Braucher, Eric Posner, Alan White, and Brent White for their insightful and helpful comments on earlier drafts of this article. I would also like to thank the Dedman School of Law and the Marla and Michael Boone Faculty Research Fund for their generous support of my research efforts.

1. *See* CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 14 (Comm. Print 2009).

> The existing [mortgage and loan delinquency] data are plagued by inconsistencies in data collection methodologies and reporting, and are often simply unverifiable. Worse still, the data being collected are often not what is needed for answering key questions, namely what are causing mortgage defaults and why loan modifications have not been working.

Id.

referred to as "underwater homeowners").[2] These two estimates constitute 23% and 32.2%, respectively, of all mortgaged residential properties,[3] and some informed observers expect this percentage to sharply increase to as high as 48% by 2011 if property values continue to decline in

---

2. First American CoreLogic, a leading assembler of mortgage-related information, estimated that 11.3 million homeowners had negative equity as of the end of 2009, a total of 24% of all residential properties with mortgages. Press Release, First American CoreLogic, Underwater Mortgages on the Rise According to First American CoreLogic Q4 2009 Negative Equity Data (Feb. 23, 2010) [hereinafter First American CoreLogic (Feb. 23, 2010)]. This was a substantial increase from their comparable earlier estimate of 10.7 million homeowners with negative equity as of September 30, 2009, a total of 23% of all residential properties with mortgages. *Id.* These estimates did *not* include those homeowners who had negative equity positions as a result of negative amortization mortgages, or as a result of including the balances of any home equity lines of credit as well as their primary mortgage obligations. These recent estimates reflect a significant change in the firm's measurement methodology. First American CoreLogic had earlier estimated that, as of June 30, 2009, there was a much larger number of 15.2 million homeowners with negative equity, a total of 32.2% of all residential properties with mortgages. Press Release, First American CoreLogic, Summary of Second Quarter 2009 Negative Equity Data: New Data Shows Nearly One-Third of All Mortgages Underwater (Aug. 13, 2009) [hereinafter First American CoreLogic (Aug. 13, 2009)]. The difference here from the later estimates stems from the fact that this earlier estimate also included those homeowners whose negative equity stemmed from either negative amortization mortgages or home equity lines of credit. *Id.*

Some informed observers are of the view that the earlier and more inclusive First American CoreLogic measurement methodology presents a more accurate picture of the scope of the negative equity problem. *See, e.g.*, Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis* 1 n.1 (Arizona Legal Studies Discussion, Paper No. 09-35, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494467 (using for his analysis the 15.2 million underwater homeowners estimate that was presented in First American CoreLogic (Aug. 13, 2009), *supra*).

The Congressional Oversight Panel offered a much more conservative estimate of 7.5 million for the number of homeowners with negative equity, a number totaling only 18% of all outstanding residential mortgages. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 24 N.55 (Comm. Print 2009) (citing to a September 2008 First American CoreLogic report). However, that lower estimate is likely a significant understatement because it was based on a September 30, 2008 First American CoreLogic report that used data that the firm had compiled nine months before the more current data that was included in its later and comparable report that was cited by Brent T. White. *See* White, *supra*, at 1. Further, the Panel relied on data that had been compiled fifteen months before the even more current end-of-2009 data utilized by First American CoreLogic for its February 23, 2010 report.

3. First American CoreLogic (Feb. 23, 2010), *supra* note 2; First American CoreLogic (Aug. 13, 2009), *supra* note 2.

some areas of the country.[4]

These individual negative equity positions are often quite substantial in size. The same study that conservatively estimated that 11.3 million homeowners are now underwater also estimated that the aggregate negative equity for this large group totaled over $800 billion, an average of $70,700 per homeowner.[5] Moreover, many of these homeowners are underwater by significantly greater amounts than this average, sometimes by as much as hundreds of thousands of dollars.[6] Homeowners this far underwater have relatively little chance of recouping the equity they once had in their house, when housing prices were at their 2006–2007 peaks, through future price appreciation taking place over any reasonable period of time.[7]

While the disturbing magnitude of this negative equity problem is becoming more widely understood, what is not nearly so widely publicized is that the interests of those underwater homeowners who have significant negative equity

---

4. White, *supra* note 2, at 3 n.7 (presenting an August 2009 Deutsche Bank estimate). In March 2009, the Congressional Oversight Panel much more conservatively estimated that "over the next few years" a projected 20% of homeowners would owe more on their mortgages than the value of the homes, CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 1 (Comm. Print 2009), but that estimate, as noted above, was based on earlier September 30, 2008 data, while the much higher Deutsche Bank estimate was offered later in August 2009. *See supra* note 2.

5. First American CoreLogic (Feb. 23, 2010), *supra* note 2. If the larger and perhaps more meaningful earlier estimate of 15.3 million underwater borrowers is used, First American CoreLogic (Aug. 13, 2009), *supra* note 2, the aggregate amount of negative equity may well exceed $1 trillion. Although, it is possible that the negative amortization mortgage borrowers and home equity loan borrowers also included in that earlier estimate may on average have smaller negative equity positions than do the 11.3 million underwater homeowners counted under the more restrictive methodology, so that the aggregate negative equity total for this overall group may fall slightly below $1 trillion in size.

6. White, *supra* note 2, at 4.

> By the second quarter of 2009, for example, over 16% of homeowners had negative equity exceeding 20% of their home's value, and over 22% of homeowners had negative equity exceeding 10% of their home's value . . . . [A] large percentage of these homeowners were underwater by hundreds of thousands of dollars.

Id. "[Forty-seven percent] of homeowners in Nevada had negative equity exceeding 25% of their home's value, as did 30% of homeowners in Florida, 29% in Arizona, and 25% in California." *Id.* at 13 n.48 (citing First American CoreLogic (Aug. 13, 2009), *supra* note 2).

7. White, *supra* note 2, at 1.

positions, but still continue to make their mortgage payments, would often be better served by their defaulting on those mortgages and going through a foreclosure proceeding.[8] This is often true even given the necessity after default for then making another housing arrangement, and for enduring the other adverse consequences that foreclosure may have on their credit ratings and upon their lives more generally.[9] Such homeowners would be even better off if they could successfully invoke the threat of default as leverage to pressure their loan servicers to negotiate a loan modification that would reduce their outstanding principal balance sufficiently to eliminate most, or even all, of their negative equity position and their incentive to default.[10]

The overwhelming majority of underwater homeowners who can afford to do so currently continue to make their mortgage payments.[11] However, since doing so is often not in their economic interest if they are significantly underwater, as many homeowners are, this is a fragile and unstable situation that could easily reach a "tipping point"[12] and

---

8. *See generally id.* at 7–13.

9. *See generally* White, *supra* note 2, at 7–13.

10. After a default by an underwater homeowner and after the subsequent foreclosure sale, the mortgage holders would bear the negative equity losses as well as the substantial costs of a foreclosure proceeding and any additional associated loss of property value. The mortgage holders would generally have little if any hope of obtaining reimbursement of their losses through collecting on a deficiency judgment after a foreclosure, even in states that allow such deficiency judgments. The unfavorable prospects presented by this default situation would encourage the mortgage holders to instruct their loan servicers to attempt to negotiate sufficient principal reductions to forestall such a strategic default.

11. *Id.* at 6 (calculating that the strategic default rate among underwater homeowners was only about 3% as of the end of the second quarter of 2009, less than one-tenth of the 32% of homeowners that had underwater mortgages at that time). However, over 20% of loans to underwater homeowners are currently sixty to eighty-nine days delinquent, CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 26 (Comm. Print 2009), indicating that a number of those underwater borrowers had also experienced job losses, divorces, or other financial difficulties that compromised their ability to make their mortgage payments. *See* White, *supra* note 2, at 5. It has been estimated that about 26% of current mortgage defaults are strategic defaults by persons who have the financial capability to continue making their payments. Eric A. Posner & Luigi Zingales, *A Loan Modification Approach to the Housing Crisis*, 11 AM. LAW & ECON. REV. 575, 580 (2009) (citing to several studies).

12. *See* CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 29 (Comm. Print

change dramatically in short order. In particular, if housing prices should continue to broadly decline over the next few years, at even a modest rate, a sudden and rapid cascade of millions of additional mortgage defaults and subsequent foreclosures could erupt. These new defaults, unlike most mortgage defaults in recent years, would not stem primarily from the resetting of the low initial interest rates on variable rate subprime and Alt-A mortgages in a falling home price environment that makes loan refinancing difficult or impossible for many such borrowers. Nor would they stem from the unemployment consequences of the recent recession and its aftermath. These defaults would instead be voluntary, strategic defaults by those underwater homeowners who are still financially capable of meeting their current mortgage obligations, but now recognize that it is not in their best interest to do so, and whose loan servicers are unwilling to make substantial reductions in their loan balances so as to avoid the need for those persons to default and go through foreclosure. Such a cascade of new defaults and foreclosures would obviously have the potential to put additional strong downward pressure on housing prices,[13] and to further burden local government budgets.[14] This could lead to a spiral of even more strategic defaults as yet more

---

2009) (footnote omitted).

> Given the slim prospects of the housing market recovering to 2005–2007 price levels in the near future, some [currently underwater] homeowners might begin to question whether they will ever have positive equity in their homes.
>
> . . . [T]here may be a point at which they begin to consider abandoning the house and finding an equivalent (but cheaper) rental property, resulting in a foreclosure on the house. . . . If even a small percentage of those with negative equity . . . abandon their homes, foreclosure rates will remain greatly elevated.

Id. *See generally* MALCOLM GLADWELL, THE TIPPING POINT: HOW LITTLE THINGS CAN MAKE A BIG DIFFERENCE (Bay Back Books 2002) (discussing the general concept that in certain situations a seemingly small change in an important factor can lead to unforeseen, large, and geometrically cascading behavioral changes).

13. "A single foreclosure can depress [each of] the eighty closest neighbors' property values by nearly $5,000. When multiple foreclosures happen on a block or in a neighborhood, the effect is exponential." CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 9 (Comm. Print 2009) (footnote omitted).

14. "Foreclosed properties also impose significant direct costs on local governments and foster crime. A single foreclosure can cost a city over $34,000." *Id.* at 10 (footnotes omitted).

homeowners face substantial and growing underwater positions, with obvious adverse consequences for the many financial institutions, for other investors who hold interests in those mortgages, and also for broader macroeconomic recovery efforts.

The current unstable situation where the large majority of underwater homeowners continue to make their mortgage payments, despite this often not being in their best interests, is the result of three contributing factors that I will discuss in some detail below. First, for various reasons that I will discuss in Part II of this article, it is difficult for even those underwater homeowners with significant negative equity positions to recognize that their financial interests would be better served by defaulting on their mortgages, or by at least threatening to default unless their principal balances are modified downward by their mortgage loan servicer much closer to the home's current value.[15] Having failed to conduct the required financial calculations showing the relative advantages of default, or having done so but then being emotionally unable to accept and act upon their implications, most of those homeowners continue for now to dutifully make their mortgage payments even though it is often not economically rational for them to do so.

Second, in Part III, I will discuss the reasons why mortgage loan servicers are quite reluctant to significantly modify mortgages so as to substantially reduce outstanding principal balances for those underwater homeowners who do have the means to continue making their payments, even if those persons credibly threaten to default if such loan modifications are not forthcoming.[16] This reluctance is in contrast to servicers' far greater willingness to engage in more modest loan modifications that do not reduce the loan principal balance—and may even increase it by rolling in any accumulated arrearages. These loan modifications usually only lower the interest rate or extend the time period of the loan, and are only usually made for those homeowners, underwater or otherwise, who are in some financial distress and are having trouble meeting their monthly payment obligations (hereinafter referred to as "troubled borrowers").

15. *See infra* Part II.
16. *See infra* Part III.

As I will discuss in Part IV, the federal government has placed its bets almost exclusively on the hope of being able to help foster a sustained recovery of housing prices back towards their 2006–2007 peaks, and has largely limited the scope of its mortgage assistance programs to assisting troubled borrowers who cannot meet their current mortgage payments.[17] The government has not made any serious efforts to assist those many underwater homeowners who are capable of continuing to meet their payment obligations in understanding and weighing the potential economic benefits and the risks of default, or to advise them how to most effectively pressure their loan servicers to agree to principal-reducing loan modifications. If anything, the federal government's moral exhortations encouraging debt repayment have contributed to the psychological difficulties that underwater homeowners face in rationally determining where their interests lie and then taking suitable action. Nor has the government made available the many billions of dollars of financial support that would be necessary to significantly ameliorate the financial consequences of the widespread and substantial reductions of the principal balances of the mortgages of underwater homeowners for the financial institutions and other investors who directly or indirectly hold those mortgages, so as to encourage such modifications and thus reduce the possibility of a sudden and substantial increase in foreclosure rates resulting from a wave of strategic defaults.

In Part V of this article, I will set forth my thoughts on how this dangerous economic situation might be better addressed through measures designed to lead to loan principal modifications taking place on a very large scale before the current foreclosure crisis suddenly takes a turn for the worse.[18] I will offer a relatively inexpensive plan of public information and education that is intended to assist underwater homeowners in accurately assessing their financial circumstances, and then to encourage them, when appropriate, to effectively demand principal-reducing modifications from their loan servicers. I will also recommend that this public education program be

17. *See infra* Part IV.
18. *See infra* Part V.

accompanied by a few federal statutory enactments that are each intended to limit the adverse consequences of foreclosure for borrowers, and by federal legislation that would protect loan servicers who engaged in principal-reducing loan modifications from litigation initiated by mortgage investors who are unhappy with those loan modifications, and by more aggressive federal enforcement efforts designed to assure that loan servicers properly discharge their fiduciary duties to their mortgage investors to maximize their returns. I believe that this combination of efforts would lead to principal-reducing modifications of the loans of millions of underwater homeowners, and thus avoid the possibility of our having to endure another cascade of defaults and foreclosures and the resulting macroeconomic dislocations. My proposal also has the advantages of not requiring any large-scale, multi-billion dollar taxpayer bailouts of underwater homeowners or mortgage investors, nor would it require any amendments to the Bankruptcy Code that would expand judicial authority to discharge residential mortgage obligations. It thus finesses two major areas of political controversy that would each probably doom at the outset any attempt to address this problem.

Part VI describes and then compares my recommendations to another recent and interesting proposal for addressing the problem of underwater homeowners that has been developed by Professors Eric Posner and Luigi Zingales of the University of Chicago, two prominent commentators in this area.[19] Their approach calls for amending Chapter 13 of the Bankruptcy Code to allow for a streamlined mortgage principal reduction and shared appreciation procedure that would be made available to those underwater homeowners living in postal ZIP Code areas that have recently experienced at least a 20% decline in median house prices.[20]

The Posner and Zingales proposal differs substantially from my recommendations in a number of ways, as discussed below. Their proposal is similar to mine in one key regard, in that it also does not require a taxpayer-financed, multi-billion dollar bailout of underwater homeowners and mortgage

19. *See infra* Part IV. *See generally* Posner & Zingales, *supra* note 11.
20. Posner & Zingales, *supra* note 11.

investors. I believe that my approach would prove somewhat easier to implement politically than would the Posner and Zingales proposal, although both proposals would certainly encounter significant opposition from creditor interests. I also believe that my approach would be more likely to succeed in resolving the negative equity problem. Additionally, my proposal would also result in loan modifications that would arguably provide for a fairer allocation between mortgage creditors and underwater homeowners of the very large losses stemming from recent housing price declines than would their approach, which in my opinion unduly and unnecessarily favors creditors over borrowers. I do, however, recognize that reasonable persons could disagree here regarding the relative distributive justice merits of the two proposals.

The Posner and Zingales proposal would clearly be an improvement over the existing status quo. Yet their approach has some inherent limitations that I believe would make it much less effective than my recommendations in fundamentally resolving the negative equity problem. The central problem is that their approach is hamstrung by their explicit underlying premise that it would somehow be immoral for those underwater homeowners who are financially capable of continuing to make their payments to act on the recognition that, in many instances, their interests would be best served by strategically defaulting on their loans, and thus forcing their loan servicers to choose between offering them very substantial loan modifications or pursuing foreclosure. According to their argument, it would therefore be bad public policy for the government and others to attempt to encourage and assist underwater homeowners to strategically default when this is their most effective course of action. I disagree with this premise, and my approach instead embraces the idea that public policy should encourage and assist underwater homeowners to rationally assess where their best interests lie, and to act accordingly, even if this leads to large numbers of threatened strategic defaults. As discussed below, such a situation is more likely to result in large numbers of principal-reducing loan modifications than in a wave of foreclosures.

II. WHY UNDERWATER HOMEOWNERS DO NOT DEFAULT MORE OFTEN

The relatively low rates of strategic default by even significantly underwater homeowners are somewhat puzzling and merit a closer analysis. In a recent and insightful article, Professor Brent White of the University of Arizona analyzed in some detail why such a large proportion of those underwater homeowners who have the financial capability to make their mortgage payments, but who have significant negative equity positions and whose interests would often be better served by defaulting, continue to make those payments.[21] Let me summarize below and comment upon the thrust of his arguments.

White recognizes that part of the reason for this behavior is that the financial calculations that are required for one to accurately assess the relative merits of defaulting on a mortgage versus continuing to make the payments are relatively complex. These calculations involve not only a number of cash flow variables but also include many hard-to-value factors such as deficiency judgment risk, tax liability exposure, and the disruption and inconvenience associated with changing residences.[22] The inherently difficult process of conducting such a multi-variable mathematical calculation is made even harder by various cognitive biases that people

21. *See generally* White, *supra* note 2. This article is likely to be both influential and insightful, as is demonstrated by the 38,896 abstract views and the 12,131 downloads that its SSRN posting has received as of June 29, 2010. In his more recent work, White attempts to shed further light on the various social problems and moral questions presented by strategic defaults by underwater homeowners. *See generally* Brent T. White, *Take this House and Shove It: The Emotional Drivers of Strategic Default* (Arizona Legal Studies, Discussion Paper No. 10-17, 2010); Brent T. White, *The Morality of Strategic Default* (Arizona Legal Studies, Discussion Paper No. 10-15, 2010).

22. White, *supra* note 2, at 7–13. These financial calculations involve the many costs of continued homeowning, including the loan payments, property taxes and maintenance and insurance, minus any expected appreciation above the final mortgage balance due at sale and any tax savings over the planned period of ownership. The financial calculations then compare these costs to the transitional costs of moving to a rental property and the costs of renting. *Id.* They also involve quantifying the financial risk, if any, of being held liable for a deficiency judgment pursuant to a foreclosure proceeding, the risk of any adverse tax consequences that may result from an unpaid mortgage balance, the burden of any adverse impacts of a foreclosure for a period of time upon one's credit rating, and any disruptions inherent in moving to a different residence. *Id.*

are prone to in this context,[23] such as the status quo bias, myopia, selective perception, and overconfidence. Each bias impedes an objective weighing of these various considerations.[24] However, White convincingly demonstrates that these calculations, even if done in a rather crude and approximate fashion, clearly reveal the relatively large net benefits of default for most significantly underwater homeowners.[25] The primary impediment to rational assessment by underwater homeowners of their circumstances is, in White's view, more emotional than cognitive; it is the feelings of fear and shame and guilt that are often triggered by the prospect of mortgage default and foreclosure.[26]

White's article provides considerable support for his claim that most underwater homeowners view the prospect of default with such strong negative feelings that they would not even consider a strategic default if they are at all capable of continuing their payments.[27] He also describes in some detail how these negative emotions are strongly and effectively reinforced by many if not all of our social institutions,[28] which

---

23. *Id.* at 14–15.

24. *Id.* at 13–16. The "status quo bias" would tend to bias underwater homeowners to favor continuing to make their mortgage payments rather than to default and start a process of major change in their lives. *Id.* at 15. The "myopia" bias would tend to bias homeowners to overvalue up-front costs and undervalue long-term gains. *Id.* The "selective perception" bias would bias underwater homeowners against recognizing that the prices of comparable homes sold in their neighborhood suggest a steep fall in their home's value. *Id.* The "overoptimism" bias would incline underwater homeowners to embrace unrealistic expectations of the prospects of a strong recovery in home prices. *Id.*

25. *Id.* at 12–13.

26. *Id.* at 16–18. "As a large body of work in the neurosciences has revealed, much of what passes for cognitive bias is actually emotional bias, reached with no cognitive process whatsoever." *Id.* at 16–17 (footnote omitted).

27. *See id.* at 22–23 (footnotes omitted).

> [T]he term commonly used to describe foreclosure by those who face it is "terrifying." As one commentator on foreclosure has noted, "foreclosure is the terrifying word no homeowner wants to hear, let alone experience." People not only fear losing their homes, but fear having ruined credit for life, not be able to find a decent place to live, to buy a car, to get a credit card, to get insurance, to ever buy a house, or even get a job. Foreclosure is seen as the end of life as one knows it: financial suicide to be avoided at all costs. In short, fear—like shame and guilt—is a powerful motivator in homeowner decisions not to default.

Id. See also generally id. at 16–23.

28. "[T]he predominant message of political, social and economic

together broadcast the general message that one has a moral responsibility to pay one's mortgage.[29] However, this moral exhortation delivered by the federal government, the media, credit counseling agencies, and our other major economic and political actors routinely ignores the fact that there is a huge financial upside to strategic default for those underwater homeowners with significant negative equity positions. The true risks and burdens associated with possible deficiency judgments, potential tax liability on the unpaid portions of mortgage balances, and subsequent credit score impairment are all far less severe than are commonly represented.[30] Underwater homeowners are systematically discouraged from regarding mortgage default as simply the exercise of the in-the-money "put option" rights that they are effectively entitled to under the terms of their loan agreement,[31] a

---

institutions in the United States has functioned to cultivate fear, shame, and guilt in those who might contemplate foreclosure." White, *supra* note 2, at 25.

> Typical of such criticism [of defaulting mortgagors] is that of [former] Secretary of the Treasury Henry Paulson, who declared . . . "any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator—and one who is not honoring his obligations."
>
> . . . Such individuals are portrayed [by the media] as obscene, offensive, and unethical, and likened to deadbeat dads who walk out on their children, or those who would have "given up" and just handed over Europe to the Nazis.

Id. at 26 (footnotes omitted).

29. *Id.* at 25.

30. *Id.* at 32–35. Some states are "non-recourse" jurisdictions that do not allow mortgage lenders to pursue defaulting mortgagors for deficiency judgments. Even where this is permitted, lenders usually do not attempt to do so. *Id.* at 12–13, 33, 33 n.144–45. In addition, the federal tax laws have recently changed to waive tax liability on the unpaid portion of a mortgage upon foreclosure, *id.* at 13, although it should be recognized that under some circumstances, homeowners may have some tax liability after a foreclosure. This liability arises primarily (although not exclusively) when they have engaged in a cash-out refinancing of the property, or have taken out a home equity loan, and then have spent the loan proceeds in a manner other than improving the property. In addition, in some states, including California, homeowners are legally liable for paying state income taxes on forgiven mortgage debt. *See generally* Les Christie, *Foreclosed? Here Comes the Tax Man*, CNNMONEY, Apr. 14, 2010, http://money.cnn.com/2010/04/08/pf/taxes_mortgage_debt/index.htm (discussing these potential sources of tax liability). Finally, while going through foreclosure has an immediate and significant negative impact on one's credit rating, most people can expect to fully recover from the negative impact of a foreclosure on their credit score within a two-year period. White, *supra* note 2, at 11-12.

31. An example of such an anti-default orientation with regard to underwater borrowers is the views expressed by the Congressional Oversight

course of action that in White's opinion should be evaluated in those dispassionate terms.[32]

White is highly critical of this social moralizing effort that reinforces the emotional aversions of underwater homeowners to rationally calculating where their true interests lie,[33] given that mortgage lenders and loan servicers are generally under no such cognitive or emotional impediments that impede their clear-eyed pursuit of their own financial interests.[34] He calls forcefully for "leveling the playing field"[35] between homeowners and their mortgage lenders with regard to loan renegotiations by reducing the effect of these "norm asymmetries"[36] upon those negotiations.[37] However, he then stops short of endorsing a sweeping public education and assistance campaign designed to educate underwater homeowners as to the true nature of their options and to encourage them to pressure their mortgage servicers for meaningful principal reductions,[38] a stance that while perhaps prudent in terms of avoiding controversy is somewhat surprising in light of the powerful critique he has developed. He does call for the federally

---

Panel in 2009. *See, e.g.*, CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 29 (Comm. Print 2009) ("Incentives may be needed to encourage borrowers with negative equity to adopt a long-term view and to remain in their homes whenever possible.").

32. White, *supra* note 2, at 40.

33. White does not, however, go so far as to claim that there is a consciously coordinated effort to so manipulate the emotions of homeowners. "This is not to say that there is a grand scheme to manipulate the emotions of homeowners, or even that the government and other institutions consciously cultivate these emotional constraints on default." *Id.* at 25 (footnote omitted). But he does claim that the cultivation of fear, shame, and guilt in those who might contemplate foreclosure is the "predominate message" sent by our leading social institutions, *id.*, and that this needs to be changed. "Regardless of the precise policy prescription, it is time to put to rest the assumption that a borrower who exercises the option to default is somehow immoral or irresponsible." *Id.* at 53.

34. "[N]orms governing homeowner behavior stand in sharp contrast to norms governing lenders, who seek to maximize profits or minimize losses irrespective of concerns of morality or social responsibility." *Id.* (quoting the abstract). *See also generally id.* at 35–40.

35. *Id.* at 41.

36. *Id.* at 40. "Such 'norm asymmetry' . . . has led to distributional inequalities in which individual homeowners shoulder a disproportionate burden from the housing collapse." *Id.* (quoting the abstract).

37. *Id.* at 47 n.217.

38. Such an approach "would likely be so distasteful to most policy makers, and many readers of this article, that this idea will not be pursued further here." White, *supra* note 2, at 44.

approved and financially supported housing and credit counseling agencies to at least cease sending the message to homeowners that foreclosure should be avoided at all costs. Further, those agencies should begin to provide homeowners with more accurate information regarding their very limited deficiency judgment exposure risk, the rather narrow contours of their tax liability risk, and the usually rather modest and relatively short-term credit score implications of a foreclosure.[39] White briefly notes, and in a couple of instances critiques, some other recent proposals that have been made with regard to the problem of underwater homeowners,[40] and then sets forth in some detail a proposed amendment to the federal Fair Credit Reporting Act that would prevent lenders from reporting mortgage defaults and foreclosures to the credit rating agencies.[41] He also calls for adoption of what he labels a "national anti-deficiency statute" that would bar lenders from pursuing homeowners for the unsatisfied portion of a mortgage obligation after foreclosure in those states that now permit this.[42]

---

39. *Id.* at 45.

40. White specifically, but only briefly, critically discusses a recent proposal made by Adam Levitin regarding expanded powers for bankruptcy judges to write down the principal of mortgage debts on primary residences. White also discusses a recent proposal offered by Eric Posner and Luigi Zingales, which I will extensively discuss in Part VI, that would allow prepackaged mortgage writedowns under Chapter 13 of the Bankruptcy Code for homeowners who live in postal ZIP code areas that have experienced at least a 20% decline in median home prices. *Id.* at 42–44; *see infra* Part VI; *see generally* Adam Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565 (2009), *available at* http://ssrn.com/abstract=1071931; Posner & Zingales, *supra* note 11. White also briefly notes, without discussion, proposals made by Rebel A. Cole and Christopher L. Foote that each call for the use of federal government stimulus funds to cover homeowner negative equity positions. White, *supra* note 2, at 43 n.198, 52 n.231. *See generally* Rebel A. Cole, *The Housing-Asset Relief Program: A Plan for Stabilizing the Housing and Securities Markets* (Apr. 22, 2009) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1338883; Christopher L. Foote et. al., *A Proposal to Help Distressed Homeowners: A Government Payment-Sharing Plan* (FRB of Boston Public Policy Brief No. 09-1, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1432514.

41. White, *supra* note 2, at 45–52.

42. *Id.* at 46 n.212, 53 n.232. White unfortunately does not elaborate upon this novel and interesting proposal. In particular, he does not discuss how one might address potential constitutional challenges to the retroactive application of such a statute to existing mortgages that would obviously be necessary for a statute to meaningfully contribute to any resolution of the current underwater homeowner problem.

Professor White is very convincing in his argument that the current behavior of underwater homeowners with significant negative equity positions who continue to make their payments is based more upon the cognitive and emotional limitations they are subject to than upon a rational calculation of their self-interest, although he gives insufficient weight to the complexity of the required calculations and to the cognitive impediments influencing these calculations, as relative to the great weight he accords the emotional aspects of the default decision. One may or may not agree with his position that we should reduce the widespread public moralizing that serves to reinforce the negative emotions that homeowners feel about the prospects of foreclosure. Instead, White argues that we should attempt to provide those homeowners with accurate information and other support for making rational calculations as to where their true interests lie so that they are able to negotiate on a more even playing field with their bottom line-driven lenders for meaningful modifications of their obligations.[43] I personally agree with White on this matter. But apart from this point of agreement, the main purpose of this article is to demonstrate that the current situation is indeed unstable and dangerous if Professor White is correct that the low strategic default rates for underwater homeowners do rest primarily upon cognitive limitations and the emotional factors of fear, guilt, and shame, rather than upon rational calculations of self-interest.

If in the next few years there is a significant increase in the number of underwater homeowners who strategically default, and if the substantial financial gains for those persons choosing this course of action are then well-publicized, as would be likely, this publicity would serve to reduce the social stigma of foreclosure and the intensity of negative emotions associated with its prospect. The behavior of the millions of underwater homeowners with significant negative equity positions could then change on a large scale in a very sudden, geometrically cascading fashion.[44] This

43. White, *supra* note 2, at 44.

44. "[P]eople who know someone who has strategically defaulted are 82% more likely to declare their intention to do so." *Id.* at 19 (citing as support for this claim Luigi Guiso, Paola Sapienza & Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages* 6 (Nat'l Bureau of Econ.

change would probably occur before any effective governmental policy could be put into place that would forestall this new wave of defaults, or at least channel it into principal-reducing loan modifications rather than foreclosures. Given this very real tipping point possibility, it would be prudent for policymakers to attempt to resolve the problem posed by the many millions of underwater homeowners through some more fundamental measures that address the underlying negative equity situation. We need to encourage the making of substantial loan modifications on a large scale, so as to entirely eliminate the looming risk of a new wave of foreclosures, rather than simply trying to hold back that wave by continuing to reinforce the current fearful and guilt-ridden emotional attitudes of homeowners towards the prospect of default and foreclosure.

III. WHY LOAN SERVICERS DO NOT RENEGOTIATE THE MORTGAGE LOANS OF UNDERWATER HOMEOWNERS MORE OFTEN AND MORE SUBSTANTIALLY

It is well documented that mortgage loan servicers have been very reluctant to renegotiate mortgages in any fashion since the current foreclosure crisis started in 2007.[45] A recent

Research, Working Paper No. 15145, 2009).

45. Manuel Adelino, Kristopher Gerardi & Paul Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization*, 1 (FRB of Boston Pub. Policy Discussion Paper No. 09-4, 2009). "[M]any banks appear to have a policy of either not renegotiating loans or doing so only in unusual circumstances." Posner & Zingales, *supra* note 11, at 577.

On March 24, 2010, the Bank of America announced a new loan modification program that allowed for substantial loan principal reductions over a period of time, and thus appeared at first glance to address to a greater extent the problems posed by underwater homeowners than any prior efforts by large loan servicers. However, that program was only made available to the approximately 45,000 homeowners serviced by Bank of America whose loans had been originated by Countrywide Financial prior to that firm's 2008 acquisition by Bank of America, representing less than 5% of the persons in default whose mortgages Bank of America was servicing. For eligibility, the program also required that the homeowner demonstrated that he had suffered some financial loss of income. David Streitfeld & Louise Story, *Bank of America to Help Distressed Homeowners*, N.Y. TIMES Mar. 25, 2010, at B1. It therefore appeared that this concession, made in the face of significant legal pressure from the State of Massachusetts, *id.*, did not address the core problem addressed in this paper of solvent underwater homeowners who have the ability to continue making their mortgage payments, but who may at some point strategically default.

study reveals that as of July 2009, loan servicers had entered into "concessionary" loan modifications on only about 3% of a large random sample of seriously delinquent mortgage loans within the first year following an initial serious delinquency.[46] This reluctance presents somewhat of a puzzle, since it is obvious that a principal-reducing loan modification, keeping the borrower in the house and making payments under the modified mortgage, will generally be an economically preferable outcome for both the borrower and the lender as compared to a default and a subsequent foreclosure sale.[47] This puzzle is made more disturbing by the fact that foreclosures are an economically inefficient outcome relative to loan modifications, not only for the affected borrowers and lenders, but also for society at large once the significant negative external impacts upon other persons and various governmental bodies are also considered.[48]

There is a plethora of competing (and to some extent also complementary) explanations that have been offered for this servicer reluctance to modify loans. First, I will briefly summarize these numerous general explanations, and then I will discuss the extent to which each of those explanations shed specific light on servicer reluctance to agree to principal-reducing loan modifications for underwater homeowners with significant negative equity positions that would substantially reduce or even eliminate that negative equity.

The leading and probably the most commonly articulated explanation for the low rates of renegotiation of delinquent mortgages is that the subsequent securitization and re-securitization of many mortgage loans in recent years has created many indirect claimants to the payments made on a given mortgage.[49] This has made it much more difficult to

46. Adelino, Gerardi & Willen, *supra* note 45, at 3. "Concessionary" modifications were defined in this study to include only those modifications that reduced a borrower's monthly payment, such as reductions in the principal balance or interest rate, or an extension of the loan term, *id.* at 2–3. The definition did not include those loan modifications that simply capitalized arrearages into the balance of the outstanding loan and thus led to increased payments. *Id.*

47. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 6 (Comm. Print 2009).

48. *Id.* at 10.

49. Adelino, Gerardi & Willen, *supra* note 45, at 4.

consummate loan renegotiations that satisfy all of the numerous parties involved. The rights of these indirect claimants are derived from their ownership of an interest in one or another prioritized tranche of a mortgage-backed security that includes that mortgage in its mortgage pool that generates the security's cash flow stream. Consequently, these claimants often have different priority rights among themselves to those mortgage payments. In some instances these rights may be even more indirectly derived from the ownership of one or another prioritized tranche of a collateralized debt obligation, which is in turn secured partially by an interest in a tranche of that mortgage-backed security, again with different priority rights among themselves to the payments received by the collateralized debt obligation from the securities that secure that obligation.[50]

Given this often very complex structure of indirect claims with different priorities to the payments on a given mortgage, it is said by some to be difficult or impossible for loan servicers to arrange for loan modifications that will satisfy all of these different claimants and avoid the risk of subsequent litigation calling into question the prudence of the modifications.[51] The servicers are claimed to be legally unable to engage in collectively wealth-preserving modifications because of this "tranche warfare,"[52] particularly

50. There exist even more indirect interests based upon ownership interests in a tranche of a collateralized debt obligation that is itself based upon a pool of interests in tranches of other collateralized debt obligations, interests that are sometimes referred to as "collateralized debt obligations squared." I have even seen references to interests in "collateralized debt obligations cubed," involving yet another level of pooling and tranching existing "collateralized debt obligations squared"-type securities to back newly issued securities. *See* CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 43 (Comm. Print 2009).

51. *See* Phillip Swagel, *The Financial Crisis: An Inside View* (Brookings Papers on Economic Activity 24–25, 2009) ("Servicers were unclear as to their legal ability to modify loans within securitization trusts. . . . "); Posner & Zingales, *supra* note 11, at 578 ("[W]hen loan servicers do renegotiate loans, they face the risk of lawsuits from MBS holders who claim that the loan servicer was too generous to the homeowner . . . . [S]eriously delinquent mortgages controlled by servicers of securitizations enter foreclosure much more quickly than portfolio loans."); *id.* at 600 (stating that servicers of securitized loans are claimed to face a "huge liability risk" if they renegotiate them); Christopher Mayer, Edward Morrison & Thomasz Piskorski, *A New Proposal for Loan Modifications*, 26 YALE J. ON REG. 417, 417–20 (2009).

52. Adelino, Gerardi & Willen, *supra* note 45, at 4 (citing Kurt Eggert,

given that a high proportion of recent mortgages are also accompanied by junior second mortgages on the property.[53] These second mortgages must also be dealt with in any renegotiation effort, and problems can arise where the interests of junior mortgage holders often conflict to some extent with those of the holders of the senior mortgage with regard to the terms of a renegotiation.[54]

While this oft-repeated explanation of mortgage servicer reluctance to renegotiate loans as being grounded in the difficulties presented by the conflicting interests of the persons they directly or indirectly represent is facially plausible, not everyone accepts it as *the*—or even *a*—central cause of the problem. For example, some observers who have conducted empirical studies comparing the renegotiation rates between securitized mortgages and those mortgages that continue to be held and serviced by their originators have expressed doubts about whether securitization has actually had an adverse impact on loan renegotiation rates.[55]

Comment, *What Prevents Loan Modifications*, 18 Housing Policy Debate No. 2 (2007) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1081479). Many holders of mortgage-backed securities would have no incentive to support a modification; the holders of the out-of-the-money junior tranches would generally not benefit from a modification, nor would the most senior tranches that have a substantial enough cushion of more junior tranches to guarantee their payments. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 43 (Comm. Print 2009).

53. Some of these mortgages were originated simultaneously with the senior mortgage, often without the knowledge of the senior mortgagee, and others were later taken out as home equity lines of credit. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 40 (Comm. Print 2009).

54. *Id.* at 40, 43; *see* Swagel, *supra* note 51, at 24

> [T]he presence of a second lien . . . could present a challenge to a modification on the primary mortgage, since owners of second liens had an incentive to hold up the process unless they received a payoff—this even though a second lien on a troubled borrower was worth only pennies on the dollar . . . .

Id. Mayer, Morrison & Piskorski, *supra* note 51, at 419.

55. Adelino, Gerardi & Willen, *supra* note 45, at 4–5

> Our empirical analysis provides strong evidence against the role of securitization in preventing renegotiation. . . . [T]he differences in the likelihood of renegotiation . . . between [securitized mortgage loans and mortgage loans owned by the loan servicers] is neither economically nor statistically significant.
>
> . . . Our results are highly robust.

Id. *See also* J. P. Hunt, *What do Subprime Securitization Contracts Actually Say about Loan Modification?* (Berkeley Center for Law, Business and the

This doubt persists despite sometimes seeming impediments to renegotiations incorporated in the securities' governing documents.[56] The truth here may well be that mortgage securitization and the presence of junior mortgages have not so far been the major obstacle that is impeding renegotiations, but they may prove to be more of a problem if efforts to engage in larger numbers of modifications that significantly reduce principal balances for underwater homeowners are attempted.[57]

Another common explanation for the low renegotiation rates is that the contract terms under which mortgage servicers are reimbursed for their expenses often provide perverse financial incentives for them to foreclose on a loan rather than to modify it,[58] even though, in most instances, less value will ultimately be realized for the direct or indirect holders of the mortgage by foreclosure than by renegotiation of even quite substantial loan principal reductions.[59]

Economy, Working Paper, 2009) (concluding after an "exhaustive review" of a sample of pooling and servicing agreements governing the conduct of servicers of securitized home loans that "it appears that large-scale modification programs may be undertaken without violating the plain terms of PSA's in most cases.") (cited in Adelino, Gerardi & Willen, *supra* note 45, at 4).

56. "[S]ome PSA's contain additional restrictions that can hamper servicers' ability to modify mortgages. Sometimes the modification is forbidden outright, sometimes only interest rates can be adjusted, not principal, and sometimes there are limitations on the amount by which interest rates can be adjusted. [Other limitations also exist]." CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 42 (Comm. Print 2009). However, the Congressional Oversight Panel also noted that "it is important not to overstate" the significance of PSA limitations on renegotiation efforts, and that it "knows of no litigation against mortgage servicers for engaging in modifications that violate the terms of PSAs." *Id.* at 44; *see id.* at 46–47; *cf.* Mayer, Morrison & Piskorski, *supra* note 51, at 418.

57. "Restrictive PSA's do not appear to be the main immediate obstacle to loan modifications, but they present a significant limitation on expanded modification efforts." CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 44 (Comm. Print 2009).

58. "[M]ortgage servicer compensation structures can create a situation in which foreclosure is more profitable to servicers than loan modification, even if it imposes bigger losses on both the homeowners and the investors." *Id.* at 44–45; see *id.* at 45–47 for a more detailed discussion of these compensation structures.

59. Adelino, Gerardi & Willen, *supra* note 45, at 4. When both the costs of a foreclosure proceeding and the sub-market prices that foreclosure sales usually bring are considered, mortgage lenders lose, on average, $60,000 in a foreclosure sale relative to the market value of the property. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 9 (Comm. Print 2009). "[F]oreclosed properties lose a substantial

Mortgage servicer compensation for managing performing loans is typically determined on a fixed-price basis, with the fixed payments reduced if a loan's principal balance or interest rate is modified downward. But their foreclosure efforts are typically compensated on a more generous cost-plus basis, "with no oversight of either the costs or plus components."[60] It is also often noted that mortgage servicers never envisioned having to modify a large proportion of their loans, a much more complex and judgmental process than is simply collecting and forwarding mortgage payments. Servicers as a result now face a severe shortage of the qualified staff needed to carry out such modifications.[61]

Yet another explanation often given relates to the accounting implications of loan modifications for the financial institutions and others that hold an interest in those loans. If mortgages or mortgage-backed securities are being valued internally by their holders at par or close to par, they may then be reluctant to renegotiate those mortgage loans because such renegotiations would require that the assets supported by those loans would then have to be written down to reflect the renegotiated value of the loans, possibly revealing serious financial difficulties for their holders.[62] Another accounting treatment related basis claimed for the reluctance of those mortgage lenders who continue to hold and service the loans that they have originated to enter into loan modifications is that, historically, the Securities and Exchange Commission ("SEC") rules have stated that contacting a borrower who is fewer than sixty days delinquent in their payments may constitute an "ongoing relationship" with that borrower that may jeopardize the right to preferentially treat that loan as an off-balance sheet asset.[63] However, the SEC later ruled in 2008 that if default was "reasonably foreseeable," then contact with a borrower prior to the sixty-day delinquency would not affect the accounting status of the loan.[64] In the

fraction of their value, about 30%." Posner & Zingales, *supra* note 11, at 576.

60. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 46 (Comm. Print 2009).

61. *Id.* at 6, 40, 47–48; *see also* Swagel, *supra* note 51, at 16.

62. *Id.* at 30.

63. Adelino, Gerardi & Willen, supra note 45, at 4.

64. *Id. See also* Swagel, *supra* note 51, at 24–25

> Servicers . . . worried that undertaking too many modifications would lead to an adverse change in the accounting treatment of the MBSs

same vein, accounting rules that require banks acting as such lenders to identify loan modifications as "troubled debt restructurings," thereby reducing their amount of crucial regulatory Tier II capital, may also serve as an impediment to some renegotiations.[65]

Some observers have argued that the primary factors underlying mortgage servicer reluctance to modify delinquent mortgages are more what one might call the "self-cure" risk and the "redefault" risk that are each associated with loan modifications.[66] The self-cure risk is based upon the fact that historically a substantial fraction of seriously delinquent borrowers will eventually fully cure their deficiency without receiving a loan modification.[67] For those borrowers, any concessions made in a loan modification would be money wasted from the point of view of the lender. In addition, large proportions of the borrowers who receive loan modifications quickly redefault, and within six months or less are again in arrears on their new, modified obligations.[68] For those borrowers, the loan modification has simply postponed default and eventual foreclosure, and if house prices have fallen further during the period of modification the lender will now recover even less from the foreclosure. In addition, a borrower who redefaults may do little or nothing to maintain the home during the period of modification before the ultimate foreclosure sale takes place, again reducing the lender's eventual recovery.

Some commentators have argued that mortgage servicers are concerned about the possibility that, if they show too much willingness to make concessions to troubled borrowers and renegotiate loan terms that are more favorable to those borrowers, this may lead to a dreaded "contagion effect" that will encourage yet more homeowners who live in the same geographical area to seek loan modifications themselves

---

> containing the loans. . . . The concern was that if too many loans were modified, this would make the trust no longer a passive structure and therefore ineligible for off-balance sheet treatment.

Id.

65. Adelino, Gerardi & Willen, *supra* note 45, at 6.

66. *Id.* at 7.

67. "[M]ore than 30% of seriously delinquent borrowers 'cure' without receiving a modification." *Id.*

68. *Id.*

rather than continue to make their payments.[69]

A contagion effect occurs when homeowners learn from their neighbors or from media sources of loan concessions being made to others, and thereby see more clearly the advantages of renegotiation and become less troubled by the social stigma attached to defaulting or at least threatening to default. The aggregate costs of the subsequent concessions made to satisfy those additional homeowners who then come forward seeking loan modifications will perhaps more than outweigh the losses that would have resulted from refusing the original requests for modifications and proceeding through foreclosures instead, thus rendering the original modifications uneconomic in light of those contagion consequences. The servicers may thus believe that they will do better by "holding the line" against all attempts by homeowners who have the financial capacity to make their payments rather than to renegotiate their loan obligations.

One knowledgeable commentator, Professor Phillip Swagel of Georgetown University, who served as Assistant Secretary for Economic Policy at the Department of the Treasury from December 2006 to the end of the Bush Administration in January 2009, has emphasized the importance of servicer concerns regarding such a potential contagion effect if they engage in concessionary modifications for underwater but solvent homeowners.[70] Swagel claims that (unnamed) mortgage servicers have told him that because of "reputational considerations" they would "never" write down the principal on a loan when the borrower had the financial resources to make their mortgage payments.[71] Swagel states candidly that

> [t]hey would rather take the loss in foreclosure when an underwater borrower walked away than set a precedent for writing down principal, and then have to take multiple losses when entire neighborhoods of homeowners asked for similar writedowns. We [at the Treasury] also realized that the prospect of assistance could lead borrowers who were not in difficulty to stop making payments in order to

69. "[W]idespread defaults reduce the social stigma of defaulting . . . ." Posner & Zingales, *supra* note 11, at 576.
70. Swagel, *supra* note 51, at 1.
71. *Id.* at 19.

qualify for easier terms.[72]

This contagion effect argument, explaining servicer reluctance to modify the loans of borrowers who have the financial capability to continue making their payments, has some facial plausibility. But it is undermined to some extent by the recognition that even if a substantial number of such contagion-induced requests for loan modifications occur as a result of a particular mortgage servicer entering into significantly principal-reducing loan modifications, for most servicers—those that are not the dominant servicers of home mortgages in the various geographic communities in which they operate—many if not most of any contagion-induced requests for loan modification will probably be made of other mortgage servicers by persons living in the same general geographical area as the persons whose loans were modified. Any adverse contagion effects stemming from loan modifications will thus, for many servicers, be primarily "external" costs that are imposed on other mortgage servicers and the mortgage holders they represent, rather than being borne directly by the servicer agreeing to the original modifications and the mortgage holders they represent.[73] The quote above from Swagel, however, suggests that mortgage servicers, rightly or wrongly, often regarded those contagion costs as internal costs that they themselves would bear.

Finally, any concessionary loan modifications will entail some "bailout eligibility risk." So long as the holders of mortgages or mortgage-backed securities believe that there may eventually be some form of a taxpayer-financed bailout of borrowers who default, either through direct governmental payments made to mortgage servicers on those borrowers' behalf or otherwise, they will be reluctant to reduce even the interest on those loans, let alone the principal balance. Instead, loan servicers would rather await receipt of those potential bailout payments than risk eligibility for any such

72. *Id.*

73. This "externality" observation must be qualified to the extent that mortgage servicers feel and act upon a sort of "industry solidarity" with other mortgage servicers that operate in the same geographical markets and the mortgage holders they represent. This solidarity serves to somehow psychologically internalize the adverse financial impacts that contagion-induced modifications arising from their loan modifications might impose upon other servicers and their mortgage holders.

bailout by engaging in concessionary loan modifications.[74]

The above-noted reasons why mortgage servicers may be reluctant to renegotiate mortgages all presumably apply to the renegotiation of mortgages of underwater (but solvent) homeowners, as well as to the renegotiation of the mortgages of troubled borrowers. However, some of those concerns are perhaps less pressing in the underwater homeowner context, while others likely take on particular importance in that context.

The legal concerns presented by the modification of securitized mortgages, and by the modification of mortgages that are accompanied by junior mortgages, appear to be no different in nature in the underwater homeowner context than in other contexts. Nevertheless, the far larger sums involved in principal-reducing modifications may well serve to energize these concerns.[75] Similarly, while the basic nature of the problems presented by perverse servicer financial incentives, inadequate staffing to handle modifications, and disadvantageous accounting treatment of modifications are much the same in all contexts, the relatively large principal reductions that would have to be made when modifying the loans of many underwater homeowners with significant negative equity positions, so as to largely or completely eliminate their negative equity,[76] would have particularly burdensome consequences. The large principal reductions would, first, lead to consequently large reductions in servicer compensation under their typical fixed-price contracts with the mortgage holders. In addition, such modifications would obviously necessitate extra staff attention and expertise to properly negotiate. Relatively large amounts of money would be involved, and these modifications would, of course, have far more significant accounting ramifications for the financial positions of the mortgage and mortgage-backed securities holders than would typical loan modifications for troubled borrowers that only alter the interest rates or the length of

---

74. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 36–37 (Comm. Print 2009).

75. The aggregate amount of homeowner net equity has been estimated to exceed $800 billion and perhaps may even exceed $1 trillion. *See supra* note 5 and accompanying text.

76. Many underwater borrowers have negative equity positions that may be as large as several hundred thousand dollars or more. *See* White, *supra* note 2. *See also supra* note 6 and accompanying text.

the repayment period.

One factor that may contribute to servicer reluctance to modify loans that will likely actually *lessen* in importance in the context of principal-reducing modifications of the loans of underwater homeowners that largely or completely eliminate their negative equity position, perhaps dramatically, is the risk that the borrowers will quickly redefault after the modification. Such principal-reducing modifications will sharply reduce the amount of the monthly payments owed, and will also give the homeowners some reasonable expectations of building an equity position in the home that will be put at risk upon redefault. The redefault risk on such modifications is therefore likely to be negligible, in sharp contrast to the current rather high redefault risk for troubled borrower modifications that do not reduce the principal balances and often also do not reduce monthly payments.

On the other hand, the large reductions in principal balances that such modifications of the obligations of underwater homeowners would entail would correspondingly increase the amount of money lost, should such a borrower who is considering (or even threatening) default elect to self-cure any deficiencies. The self-cure risk associated with such principal-reducing modifications is thus likely much more of a relevant factor to be considered than for other types of loan modifications because of the much larger sums of money involved. The risk of contagion effects would also appear to loom far larger here than for other types of loan modifications, since the losses that would result if such a modification has contagion effects leading to further principal-reducing modifications are also correspondingly increased. Finally, such modifications would also result in the formal recognition of correspondingly larger losses that would now likely no longer qualify as a basis that could be asserted for obtaining any payments from any potential subsequent taxpayer-finance bailout of defaulting homeowners. Thus, this type of modification would also increase the bailout eligibility risk associated with such modifications, as compared to other types of modifications.

IV. WHY THE FEDERAL GOVERNMENT HAS NOT HELPED TO RESOLVE THE PROBLEM

The federal government, through the combination of its

recent general economic stimulus programs,[77] its tax credit programs for homebuyers,[78] and its massive interventions in the markets for mortgage-backed securities through guarantees and purchases by government-sponsored entities and by the Federal Reserve System,[79] has attempted to broadly support housing prices through increasing the demand for housing and reducing mortgage interest rates. A broad and sustained increase in housing prices back towards the former peak levels of 2006–2007 would of course largely eliminate the homeowner negative equity situation, rendering unnecessary any specific measures targeted at facilitating principal-reducing loan modifications for underwater homeowners. However, those combined intervention efforts have not yet been successful in increasing housing prices, although they may well have had some positive effects in reducing the rate of price decline, and now in stabilizing those prices. No sharp and sustained increases in housing prices appear to be on the immediate horizon, and the problem of massive negative equity,[80] and the consequent potential for a sudden spiraling cascade of millions of additional strategic defaults and foreclosures, therefore remains.

The federal government's efforts to specifically address the unique problems posed by the many millions of underwater homeowners have, unfortunately, been minimal at best. They have consisted primarily of moral exhortations and appeals to the negative emotions of guilt, shame, and fear commonly associated with the prospect of foreclosure, made in an attempt to discourage strategic defaults, rather than attempts to subsidize or otherwise encourage principal-reducing loan modifications.[81] None of the initiatives implemented during the later years of the Bush Administration were at all effective in encouraging such

77. I refer here to the $700 billion Emergency Economic Stabilization Act of 2008, 12 U.S.C. §§ 5201–5261. (2008), and the $787 billion American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (codified in scattered sections of U.S.C.).

78. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1006.

79. OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, 111TH CONG., QUARTERLY REPORT TO CONGRESS 109–26 (Comm. Print 2010).

80. *See supra* note 75.

81. *See generally* White, *supra* note 2, at 23–35.

modifications.[82]

The Obama Administration's Homeowner Affordability and Stability Plan (hereinafter "HASP"), announced on February 18, 2010, also does not deal effectively with the problems impeding such modifications. HASP provides $75 billion in government funds to support government-sponsored entity-guaranteed loan refinancings, loan modification efforts, and additional reductions in mortgage interest rates.[83] However, the HASP provisions allowing for the refinancing of those loans, while very attractive to eligible borrowers and their servicers,[84] only apply if the mortgage loan does not exceed 105% of the property's current appraised value. This requirement disqualifies almost all underwater homeowners from participating, particularly those with significant negative equity positions.[85] In addition, the very modest financial incentives HASP provides, in order to encourage loan modifications,[86] are unlikely to be sufficient. They will

82. *See generally* Swagel, *supra* note 51, at 13–30.

83. OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, 111TH CONG., QUARTERLY REPORT TO CONGRESS 96 (Comm. Print 2010). *See also* CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 63–70 (Comm. Print 2009). The Obama Administration later provided more details about HASP, labeling its efforts to achieve loan modifications under that program the "Home Affordable Modification Program" ("HAMP"). This loan modification effort is now more commonly referred to in the literature as the HAMP program rather than as the HASP program. For a recent and critical assessment of the operation of the HAMP program in its first year, *see generally* Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons from the Lackluster First Year of the Home Affordable Modification Program* (Arizona Legal Studies, Discussion Paper No. 09-37, 2010).

84. The loan interest rates to borrowers could be lowered to as low as a 2% annual rate through government subsidies to the lenders. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 64 (Comm. Print 2009).

85. *See* CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 66 (Comm. Print 2009).

> The [Homeowner Affordability and Stability] Plan does not deal with mortgages that substantially exceed the value of the home. It allows homeowners with [government guaranteed] mortgages . . . to refinance . . . only if the value of the mortgage does not exceed 105 percent of the current appraisal value. . . .[T]he homeowners most at risk for foreclosure because of negative equity will be shut out of the program.

Id.

86. These incentives include an up-front loan servicer participation payment of $1,000, and $1,000 annual "pay for success fees" to be paid to

not induce mortgage servicers to modify loans and make the far larger reductions in principal balances of the likely hundreds of billions of dollars in total needed to effectively address the problem of underwater homeowners with significant negative equity positions.[87] HASP also does not deal with the potential legal issues presented by the modification of securitized mortgages,[88] nor does it provide sufficient financial incentives for holders of second mortgages to assent to modification plans.[89]

On March 26, 2010, the federal government announced a new loan modification proposal under HASP that focused more on the problems of underwater homeowners than had earlier efforts.[90] In particular, it announced the commencement of a voluntary loan modification program for underwater homeowners. If the investors were willing to write the loan principal amount down to 97.75% of the current appraised value of the property, the Federal Housing Administration would then repay those loans, refinancing them through new lending to the homeowners, and insuring the new loans through the Federal Housing Administration.[91] Importantly, the program does not require some level of financial distress for underwater homeowner participation,[92] although it is not open to those persons who currently have Federal Housing Administration mortgages. In addition, where the homeowners also had a second mortgage on the property, as many underwater homeowners do, the loan could be refinanced for as much as 115% of the current appraised value.[93] The Federal Housing Administration was authorized to spend up to $14 billion from the HASP funds to provide incentives to investors and loan servicers, and to provide

---

servicers over the following three years if the modified loan payments continue to be made. Incentives also include a $1,500 incentive payment for the mortgage holder and $500 payment for the mortgage servicer if the loan is modified while the loan payments are still current, as well as a $1,000 per year reduction in the payments of borrowers if they remain current on their modified loan payments, for up to five years. *Id.* at 64.

87. *See supra* note 75

88. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 67 (Comm. Print 2009).

89. *Id.* at 66–67.

90. David Streitfeld, *A Salvage Operation*, N.Y. Times, Mar. 27, 2010, at B1.

91. *Id.*

92. *Id.*

93. *Id.*

insurance on the refinanced loans, so as to encourage such modifications.[94] No new funds were committed for this initiative beyond the original HASP $75 billion authorization, however,[95] and while the new program will obviously be very attractive to underwater homeowners, it appears unlikely that it will provide sufficient incentive for lenders to voluntarily agree to make very many substantial loan principal reductions.[96]

In recent years Congress has repeatedly rejected proposed amendments to the Bankruptcy Code that would confer on judges the "cramdown" authority to discharge some of the principal of residential first mortgage loans, and thus give underwater homeowners more leverage with their loan servicers to have their loans renegotiated to reduce or eliminate their negative equity.[97] HASP did include a very narrow amendment to the bankruptcy laws that would grant bankruptcy judges the authority to modify, to a limited extent, recently-issued mortgages where the loan is within certain size limits, and to then treat the homeowner's negative equity as an unsecured debt.[98] However, the Obama Administration did not try to encourage another legislative attempt to authorize broader judicial cramdown authority.

Why has the federal government not taken more narrowly targeted and effective actions to encourage and facilitate principal-reducing modifications of the mortgages of solvent underwater homeowners? Given the substantial benefits to borrowers, lenders, and other parties negatively impacted by foreclosures of modifications as an alternative to foreclosures, one would expect more governmental action.

94. *Id.*

95. *Id.*

96. "Early reaction to the refinance program among lending groups was less than enthusiastic. 'The magnitude of this program will likely be measured in the tens of thousands rather than the hundreds of thousands of borrowers.'" David Streitfeld, *A Salvage Operation*, N.Y. Times, Mar. 27, 2010, at B1. (quoting Tom Deutsch, Executive Director of the American Securitization Forum).

97. American Bankruptcy Institute, *U.S. Senate Rejects Mortgage Modification in Chapter 13 Cases: Sens. Durbin, Kyl Debate the Response to America's Foreclosure Crisis*, 28–5 AM. BANKR. INST. J. 10, 10 (2009) (referring to the April 30, 2009 Senate rejection of S. 896, proposed by Senator Dick Durbin, and to a prior 2007 rejection of a similar proposal by Senator Durbin).

98. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 64–65 (Comm. Print 2009).

Additionally, the dangers involved in allowing the persistence of such a huge and fragile overhang of potential strategic loan defaults that could cascade at any time, with possibly dramatic adverse macroeconomic consequences, create further incentive for the government to act. There appear to be several complementary reasons for this seemingly irresponsible inaction.

Consider for a moment the possible option of a large-scale bailout. The federal government could likely overcome all of the obstacles to principal-reducing modifications that I have discussed in Parts II and III above, and effectively facilitate renegotiation of many, or even most, of the mortgage loans of underwater homeowners to substantially reduce or even eliminate their negative equity positions. This could be accomplished if the government provided the powerful incentive of a subsidy of a significant portion of the losses that would have to be formally recognized by the affected direct or indirect mortgage holders as a result of a substantial number of such modifications. One rather obvious reason for the government's reluctance to take this tact is that the problem is truly massive in scope and would be hugely expensive to address in such a bailout-type fashion. The significant and widespread fall in housing prices over the last few years has caused literally trillions of dollars of losses to homeowners, financial institutions, and investors,[99] a substantial fraction of which are now embodied by the underwater component of residential mortgages. While no comprehensive and accurate statistics are available as to the precise size of the residential negative equity problem, there are credible estimates of there being at least 10.7 million and perhaps over 15.2 million underwater homeowners,[100] many of whom are underwater by substantial amounts that are sometimes as large as several hundred thousand dollars or more.[101] In light of these estimates, the aggregate amount of homeowner negative equity has been conservatively estimated as likely to be at least $800 billion,[102] and may even be more than $1 trillion.[103]

99. *Id.* at 52.
100. *See* White, *supra* note 2, at 3 n.6.
101. *Id.* at 4.
102. *See supra* note 5 and accompanying text.
103. *See supra* note 6.

Any attempt to provide a taxpayer subsidy on the order of hundreds of billions of dollars to cover losses that are widely perceived to often stem from irresponsible borrower or lender behavior would almost certainly encounter overwhelming—and probably fatal—political resistance in the current highly partisan Washington climate of opinion, particularly given the large and growing federal budget deficits of recent years that are envisioned to persist and even worsen indefinitely.

Professor Phillip Swagel, as the Treasury Department's Assistant Secretary for Economic Policy from 2006 until 2009, was a key player in many aspects of the various governmental measures taken in response to the financial crisis.[104] He has made it abundantly clear that such an expensive taxpayer bailout-type targeted approach to the underwater homeowner problem never received serious consideration by senior government policymakers during that period. The Bush Administration's Hope Now Alliance program of foreclosure prevention, launched in October 2007,[105] focused upon encouraging modifications of the loans of troubled borrowers with some equity in their homes who were struggling to make their mortgage payments, and did not provide incentives to encourage significant principal-reducing modifications for solvent underwater homeowners.[106] Treasury Department officials well understood that underwater homeowners "(rationally) did not want to keep paying the monthly bill once the value of the home had declined below their mortgage balance,"[107] but they saw "little prospect of getting legislative approval for . . . a massive program to avoid foreclosure."[108] Moreover, as noted earlier, the general stance taken by Treasury Secretary Henry Paulson,[109] and reflected by other senior Treasury

104. *See generally* Swagel, *supra* note 51.

105. *Id.* at 15.

106. *Id.* at 2.

107. *Id.* at 10. "[I]t was quite rational for a person who got into a home with little or no equity and then suffered a 40 or 50 percent price decline to walk away." *Id.* at 19.

108. *Id.* at 4.

109. "And let me emphasize, any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator—and one who is not honoring his obligations." Henry M. Paulson, Jr., U.S. Treasury Secretary, Remarks before the National Association of Business Economists on the U.S. Housing and Mortgage Market (Mar. 3, 2008)

Department officials, was one of scorn and hostility towards underwater homeowners who were financially capable of making their payments, but who nevertheless defaulted or threatened to default. The Treasury Department consequently did not encourage nor did it pressure lenders to modify such loans.[110]

Swagel does note that in October, 2007, Treasury Department economists were asked to formulate for further discussion various plans to put public resources into foreclosure prevention, and that one of these plans that was prepared did focus primarily on underwater borrowers.[111] Under this plan, after a lender had agreed to a principal-reducing modification, the federal government would partially subsidize the cost of a guarantee of the modified loan, with the borrower also obligated to pay part of the annual premium for the guarantee.[112] However, there was strong resistance to this plan both within the Treasury Department and among White House staff because such a program "would inevitably involve a bailout of some 'irresponsible' homeowners."[113] There was also the perception that both Congress and the public would be intensely opposed to such a bailout,[114] so this plan was never pursued further.

In 2008, Congress did pass legislation sponsored by Congressman Barney Frank and Senator Christopher Dodd

---

(transcript available at http://www.ustreas.gov/press/releases/hp856.htm).

110. "The Treasury did not expect banks to modify loans when borrowers could afford the payments but were balking at paying because they were underwater—quite the opposite. Secretary Paulson's view was that a homeowner who could afford the mortgage but chose to walk away was a speculator." Swagel, *supra* note 51, at 19.

111. *Id.* This plan was known internally at the Treasury as the "GHA." *Id.* at 20.

112. *Id.* at 20.

113. *Id.* at 21.

114. Swagel summarizes the prevailing attitude of policymakers well:

> [S]pending public money on foreclosure avoidance would be asking responsible taxpayers to subsidize people living in McMansions they could not afford, with flat-screen televisions paid for out of their home equity line of credit. The policy rationale to spend public money is clear in that there is a negative externality from foreclosures to home inventories and thus prices. But the public opposition to such bailouts appeared to be intense. . . . .
>
> Congress appeared to heed this opposition as well. . . . Until the FDIC came out with a proposal late in 2008, there was no legislative support to spend public money to actually prevent foreclosures . . . .

Id. at 15.

that provided for Federal Housing Administration-guaranteed refinancing of mortgages for which lenders were willing to write down the loan principal to 87% of the home's current value.[115] This program was obviously very attractive to underwater homeowners, and if it had been widely embraced the negative equity problem would have been largely resolved. However, such drastic modifications would often involve a large loss for the lender, and no government subsidy of those losses was provided beyond the guarantee of the renegotiated loan, which after such a large reduction in principal would likely present very little if any default risk necessitating a guarantee.[116] Accordingly, the program was rather unattractive to lenders. While the Congressional Budget Office originally optimistically estimated that 400,000 loan modifications would result, not surprisingly very few loans were actually refinanced through this program.[117] The same fate may well result for the very similar March, 2010 HASP initiative discussed above.[118]

The federal government has also not been very supportive of other approaches to addressing the negative equity problem that do not involve substantial government expenditures or potentially expensive loan guarantees. For example, the Treasury Department has opposed various legislative proposals to amend the Bankruptcy Code to confer upon bankruptcy courts the cramdown authority to retroactively reduce the principal of mortgage loans. This judicial authority would have given underwater homeowners more negotiating leverage to obtain principal-reducing loan modifications. However, opposition to this authority stemmed from concern that this "would have undesirable consequences for the future availability of [mortgage financing, particularly for] low-income borrowers."[119] The Treasury Department also considered a variety of external policy proposals submitted by academics that generally recommended that it promote shared-appreciation mortgages in which homeowners would receive a loan modification in

115. *Id.* at 22; Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2850 (codified in scattered sections of U.S.C.).

116. Swagel, *supra* note 51, at 22.

117. *Id.*

118. *See supra* notes 84–90 and accompanying text.

119. Swagel, *supra* note 51, at 22.

exchange for giving up part of the home's future price appreciation to the lender.[120] But the Treasury Department ultimately did not support such proposals because it concluded that there was little demand for such shared-appreciation modification arrangements.[121] It also chose not to support a 2008 Federal Deposit Insurance Corporation proposal for a loss-sharing insurance plan under which the federal government would guarantee half of the loss suffered by a lender upon a redefault of a suitably modified loan, concluding that the proposal had both adverse selection and moral hazard problems that made it more of a bailout for the direct or indirect holders of mortgages than a benefit for homeowners.[122]

In summary, the federal government has essentially placed its bets on the hope that its general economic stimulus efforts—when coupled with modest homebuyer tax credits, with herculean Federal Reserve System and government-sponsored enterprise loan guarantees and asset purchase efforts intended to keep mortgage financing available at relatively low interest rates, and hopefully also accompanied by a general worldwide economic recovery—will solve the homeowner negative equity problem and will obviate the need for more targeted but politically highly controversial measures to avoid the possibility of a sudden and massive wave of strategic defaults. There has apparently been wide recognition among senior federal government policymakers, from at least 2007 onwards, that there are millions of underwater homeowners with significant negative equity positions who, in the absence of substantial housing price appreciation, might at some point eventually begin to strategically default en masse, greatly exacerbating the foreclosure crisis and leading to broader macroeconomic

---

120. Swagel does not specifically identify the particular shared appreciation proposals that he was referring to here, but it is virtually certain that one of those proposals was an earlier version of the proposal recently offered by Eric Posner and Luigi Zingales. *See generally* Posner & Zingales, *supra* note 11.

121. Swagel, *supra* note 51, at 26. Swagel's brief comment that the Treasury chose not to pursue this option because it concluded that there was "little demand for it" did not clarify whether he was referring to a perception of limited demand from underwater homeowners, or from mortgage servicers, or both. *Id.*

122. *Id.* at 27–28. "At the Treasury, we viewed the [FDIC's] loss-sharing insurance proposal as a nontransparent way to funnel money to institutions that had made bad lending decisions and to investors who had bought the loans–a hidden bailout." *Id.* at 28.

dislocations. Further, it has been recognized that any substantial home price appreciation in the near future is far from assured and probably unlikely. However, there simply has not been the political will to go beyond moral exhortations aimed at discouraging strategic defaults and to attempt to seriously address in some fashion the fundamental negative equity problem. Attempts to initiate such efforts have been badly undercut, as Professor White has extensively discussed,[123] and as Professor Swagel has confirmed,[124] by a general unreflective attitude of moral condemnation of those underwater homeowners who are financially capable of continuing to make their mortgage payments but who choose not to do so.

In addition, there is also, as Professor Swagel has noted,[125] a widely-shared perception among policymakers that any federal program authorizing the very large government expenditures that would be necessary to successfully encourage lenders to formally recognize hundreds of billions of dollars of losses on their mortgage loans to underwater homeowners would be widely regarded as a bailout of irresponsible borrowers and lenders, and would arouse such fierce public resistance that it would surely be "dead on arrival" in Congress. Thus, under current policies, and in the absence of substantial and sustained home price appreciation, the negative equity problem will persist, and take a turn for the worse if underwater homeowners ever soberly reassess their circumstances en masse, causing strategic default rates to sharply increase.

V. A PROPOSAL FOR RESOLVING THE PROBLEM

A. General Features of the Proposal.

I have described above the various reasons why even those underwater homeowners with significant negative equity positions have been reluctant to threaten to default in order to pressure their loan servicers to modify their loans by substantially reducing their outstanding principal

123. White, *supra* note 2, at 23–35.
124. Swagel, *supra* note 51, at 19.
125. *Id.* at 21.

balances.[126] I have also described the numerous reasons why loan servicers are reluctant to engage in those kinds of principal-reducing loan modifications,[127] and why the federal government has not taken effective measures to encourage such modifications.[128] As a result of these various factors, there remain more than ten million solvent underwater homeowners who continue to make their mortgage payments, many of whom have large negative equity positions and whose interests would be better served by defaulting rather than by making those payments. This rather fragile and unstable situation could at any time quickly turn into a cascade of millions of new mortgage defaults and foreclosures, with potentially severe macroeconomic consequences. Below, I outline my thoughts about how this negative equity problem could be effectively addressed through a program designed to bring about large-scale loan modifications before the problem leads to a new wave of foreclosures of crisis proportions.

I wish to offer politically realistic suggestions. My proposal will therefore be premised upon the realistic assumption that there is no reasonable possibility that the federal government will anytime in the foreseeable future choose to provide large financial incentives to encourage underwater homeowners and their loan servicers and mortgage investors to engage in substantial principal-reducing modifications. Even if new incentives are provided, it is unlikely that they would be significantly more generous than the modest $11,000 per modification total that is now provided for the various participants in a qualifying loan modification by the current HASP program.[129] A large-scale and well-financed taxpayer bailout program might actually be the ideal way to quickly resolve the problem. However, any multi-billion dollar program, designed to significantly insulate solvent underwater homeowners and their direct and indirect mortgage holders from bearing the losses associated

126. *See supra* Part II.

127. *See supra* Part III.

128. *See supra* Part IV.

129. The maximum combined amount of payments that could be made to the homeowner, servicer, and investors involved in a particular loan modification under HASP therefore appears to be calculated as: $1,000 + ($1000 x 3) + $1,500 + $500 + ($1,000 x 5) = $11,000. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 67 (Comm. Print 2009).

with the sharp fall in residential real estate prices that has created these negative equity positions, would likely provoke such vehement political resistance as to render any such program infeasible.

In addition, I will also assume conservatively that there is no reasonable possibility that Congress will reverse its existing stance and confer upon bankruptcy judges the broad cramdown authority to discharge the negative equity portion of residential mortgage debts so as to dramatically increase the leverage that underwater homeowners would have in any loan renegotiations.

Given these two practical political constraints, what is both necessary and sufficient to break the logjam now impeding widespread principal-reducing modifications of the loans of underwater homeowners would be if a large number of them came forward en masse, stopped making their mortgage payments, and credibly threatened to go through foreclosure unless their obligations were renegotiated downwards to substantially reduce or even eliminate their negative equity positions, in which case they would cure their deficiencies. If this broad and uncompromising demand for loan modifications did arise, then the mortgage servicers would no longer be concerned about the self-cure risks usually associated with modifications. These homeowners, by defaulting and demanding substantial loan modifications as the price of cure, would have now crossed the psychological Rubicon of accepting the possibility of foreclosure, and would be prepared to go through that process if those modifications were not forthcoming. There would therefore be few if any self-cures if the modifications were refused. Rather, there would only be foreclosures, so that the possibility of foregoing essentially costless self-cures by engaging in expensive loan modifications would no longer be a risk for servicers to worry about.

Under these circumstances of broad demand for modifications, loan servicers would also no longer be concerned about the possible contagion effects of modifying loans. If virtually all of the solvent underwater homeowners whom they feared might be inclined to threaten default, if they learned that other borrowers were obtaining meaningful loan modifications, have already come forward to demand modifications, then the contagion would have already reached

epidemic proportions and could get no worse. In addition, as previously discussed, there will also be very little redefault risk associated with such principal-reducing modifications now that the homeowners with modified loans will have at least a reasonable prospect of having some equity to protect.

Some of the other impediments that I have discussed that arguably influence loan servicers to be reluctant to modify loans would still exist, and the federal government could play a very helpful role here in encouraging renegotiations without having to commit itself to large expenditures. Federal legislation could be adopted that would more clearly shelter loan servicers from litigation that might be initiated by disappointed direct mortgage lenders or indirect mortgage-backed security investors, or initiated by holders of second mortgages on the subject properties, with regard to particular loan modifications. This legislation should apply only to those servicers that are able to show that those modifications were done in a good faith attempt to maximize the aggregate return to investors.[130] The government could also aggressively investigate any instances of mortgage servicers allegedly refusing to modify mortgage loans, despite this generally being in their investors' ultimate interests as a superior alternative to foreclosure, so as to maintain the servicer's right to be paid the largest possible commissions under their fixed-price contracts for loan servicing and eventually also be paid large and effectively unreviewed foreclosure-related fees. The government could then initiate or support private parties in pressing breach of fiduciary duty litigation where appropriate to discourage such action.

Unfortunately, there appears to be relatively little that the federal government could do directly to soften the

130. In their article, Mayer, Morrison, and Piskorski discuss in some detail a similarly-oriented "litigation safe harbor" that they propose could be federally legislated to encourage loan modifications. Mayer, Morrison & Piskorski, *supra* note 51, at 422–23. Their proposal would provide a temporary three-year protection from litigation for loan servicers who modify loans or surrender second liens in a good faith attempt to advance the interests of their investors as a group. Their proposal would also abrogate certain provisions in the securitization agreements that explicitly impeded such modifications, and would require public disclosure of the details of any modifications. *Id.* at 423. A comprehensive analysis of the appropriate standards for the conduct of fiduciaries with conflicting obligations has been recently provided by Steven Schwarez. *See generally* Steven L. Schwarez, *Fiduciaries with Conflicting Obligations*, 94 MINN. L. REV. 1867 (2010).

unavoidable accounting consequences of the writing-off of hundreds of billions of dollars of mortgage obligations of underwater borrowers through these renegotiations. But these homeowner and investor losses have already occurred and are reflected in the heavily discounted prices offered in the secondary markets for many mortgage-backed securities and collateralized debt obligations.[131] These loan renegotiations would now force their formal recognition on balance sheets. The formal recognition of these losses could well threaten the regulatory capital adequacy, and even the solvency, of some financial institutions and other entities that have invested heavily in mortgage-backed securities. But this large loss recognition appears to be an unavoidable aspect of any fundamental resolution of the negative equity problem. The federal government does, however, already have in place various programs to provide financial support for, or liquidate in orderly fashion, distressed financial institutions, and to otherwise deal with these collateral consequences of loss recognition.

Finally, with regard to servicer reluctance to engage in substantial loan modifications stemming from the fear that doing so will threaten their eligibility for a share of those billions of dollars that they hope may be later made available for a large-scale bailout of those persons suffering losses as a result of real estate price declines, the government should try to put those fears to rest by making it as clear as possible that no such taxpayer-financed bailout is at all likely to be forthcoming.

In brief summary, what I am suggesting here is a kind of "carrot and stick" approach to forcing a loan modification resolution of the homeowner negative equity problem. The approach would focus on the incentive structure facing mortgage loan servicers. The modest carrot that would be held out to loan servicers would be federal legislation eliminating the legal risks faced by those servicers who negotiate substantial loan principal reductions in a good faith attempt to maximize investor returns. The very large stick that would be wielded would be demands from millions of currently underwater homeowners for principal-reducing

131. "Prices of AAA mortgage backed securities oscillated around 35 cents on the dollar in February 2009." Posner & Zingales, *supra* note 11, at 576.

modifications, upon threat of default, accompanied by federal investigations of and legal actions against any servicers who improperly resisted those demands solely to maximize their servicing and foreclosure fees. This approach would be accompanied by a clear announcement that no bailout of those persons suffering losses from real estate price declines will be forthcoming.

So what form should these efforts to encourage broad public demand for substantial loan modifications take? What actions should be taken by the federal government and others to help individual underwater borrowers with significant negative equity positions better understand their current situation? What steps can be taken to help homeowners overcome their current unwillingness to threaten default, if such a threat is necessary for them to be able to obtain principal-reducing loan modifications from their reluctant loan servicers? How can homeowners overcome the cognitive and emotional factors—so well described by Professor White—that now impede these persons from recognizing that defaulting and going through a foreclosure process is often their best course of action, should they be unable to obtain major loan concessions, and that also impede them from taking decisive action on the basis of this recognition?

From the point of view of those homeowners with significant underwater positions, there fortunately would not be posed a collective action problem. This is because each of these individuals who would rationally strategically default—while they, of course, would much prefer to obtain a loan modification that would painlessly eliminate their negative equity position rather than go through a foreclosure proceeding—still have the incentive to go through foreclosure if their servicer refuses to modify their loan regardless of whether other borrowers are demanding or receiving comparable concessions.

In designing a program, it should be kept in mind that not only from the point of view of individual borrowers, but also from the broader social point of view, it would be much preferable for the loan servicers to significantly modify these loans on a large scale rather than to impose these foreclosure costs. For these modifications to occur, however, it will probably require such a large proportion of the underwater homeowners to come forward and strategically default that

the servicers' fears that principal-reducing modifications will then lead to a contagion effect of yet more demands for loan modification are essentially rendered moot. This broad servicer acquiescence to demands for modifications will therefore be more likely to occur if the group of homeowners that comes forward and demands significant loan modifications is not only those homeowners that are significantly underwater, but also includes other not-quite-so-far-underwater homeowners for whom foreclosure is perhaps only marginally, if at all, better than their continuing to make payments. Since the goal of the overall program would be widespread loan modifications rather than foreclosures, it should not only provide public education and assistance resources that will help significantly underwater homeowners better understand the financial advantages of default, and then act accordingly, but it should also include efforts to help other, not-quite-so-far-underwater homeowners to collectively overcome their reluctance to risk foreclosure and also come forward with demands for modifications.

One realistic and relatively inexpensive step would be to begin a large-scale public education and assistance campaign designed to provide underwater homeowners with the information and professional assistance necessary for them to accurately calculate and understand where their true interests lie. The campaign should also be designed to encourage them to default if this is their optimal course of action and if their loan servicer is unwilling to otherwise negotiate substantial principal reductions. These homeowners could be given assistance in carrying out the relatively complex financial calculations regarding the trade-offs they would face if they defaulted on their loans, and could also be advised as to the limited range of circumstances under which they may have any federal tax liability for discharged debt.[132] Homeowners could also be advised as to the applicable state anti-deficiency laws that would protect many of them altogether from deficiency judgment liability, and as to the actually quite limited risk of deficiency judgment liability they would face in those states that do not have such

132. *See supra* note 30 (referring to the potential tax liability for homeowners after foreclosure if they have engaged in cash-out refinancings or have taken out home equity loans, and then used the loan proceeds for purposes other than improving the property).

anti-deficiency laws. Finally, homeowners could be advised as to the actual length and modest severity of the consequences of default for one's credit rating.

Professor White has described such a public education approach as a "solution that naturally follows" from the "norm asymmetry" between mortgage borrowers and lenders,[133] but he then somewhat surprisingly backed away from endorsing this approach. He described it as being "distasteful to most policy makers,"[134] and chose not to pursue it further. I respectfully disagree with his reluctance to advocate such public education and assistance efforts. Loan servicers and mortgage investors certainly calculate in a clear-eyed fashion where their financial interests lie and then act on those calculations, as White makes abundantly clear.[135] In fairness, underwater homeowners should be encouraged and assisted to do the same. The message that should henceforth be sent to these homeowners by professional counselors and others concerned with their best interests is that there is nothing shameful or immoral about going through foreclosure as a matter of choice, rather than of necessity. Furthermore, homeowners should be advised as to the low (often zero) probability of their being held responsible for a deficiency judgment after foreclosure, their exemption from tax liability for most discharged mortgage debt, and the relatively minor and fairly short-term impact of the adverse credit rating consequences of foreclosure, as compared to its benefits. The rational move for an underwater homeowner may well be to default and threaten to go through foreclosure if his loan servicer refuses to substantially reduce his loan principal balance. Underwater homeowners need help to realize that this course of action should be thought of as simply the exercise of an in-the-money put option right, and that the decision should be evaluated in those dispassionate terms.

At relatively little cost, the federal government could provide some valuable support guidance for this public

133. White, *supra* note 2, at 44.

134. "Whether or not such [a public education campaign to encourage defaults] would be effective, it would likely be so distasteful to most policy makers, and many readers of this article, that this idea will not be pursued further here." *Id.*

135. *Id.* at 38, 52.

education and assistance effort by requiring all federally approved and supported housing and credit counseling agencies to make significant efforts to send such a message. State governments could also do the same within their scope of operations. Non-governmental, public interest-oriented actors that are now involved in some way with the problems facing underwater homeowners—such as churches and other local community organizations, legal defense organizations, and academics generally—could also help contribute to changing the climate of opinion regarding foreclosure. Specifically, they could help ensure that it is no longer thought of as a shameful and dangerous prospect, or as a form of financial suicide to be avoided at almost all costs, but simply as just another financial decision of no particular moral import. Private attorneys might also come to see the need for informed counsel for underwater homeowners as offering an opportunity for them to provide these services for modest compensation.[136] This effort would also help motivate those not-quite-so-far-underwater homeowners, who in some instances would probably be better served by continuing to make their payments rather than by defaulting and going through foreclosure, to also make demands for modifications in the hope that these demands would be granted without undue resistance. Such additional demands for modifications, even if the homeowners involved were not in all instances prepared to actually follow up with their threatened defaults, would further increase the likelihood that what would result from all of these borrower demands would be significant loan modifications done on a very large scale, rather than a new wave of additional foreclosures.

Another measure that would encourage some additional underwater homeowners to demand loan modifications would be to amend the Mortgage Forgiveness Debt Act of 2007 to

136. As an example of how private attorneys might seek to benefit from the need for informed counsel for underwater homeowners, and in so doing provide a useful service, there is currently a San Diego-based firm named You Walk Away, LLC, which for $995, will provide underwater homeowners considering defaulting on their mortgages with legal information and other services. *See* Kelly Bennet, *Is Foreclosure Right for You?*, VOICE OF SAN DIEGO, Feb. 6, 2008, http://youwalkaway.com/press/voiceofsandiego.org_%20Housing...%20%27Is%20 Foreclosure%20Right%20for%20You.pdf. If the overall climate of opinion became more supportive of strategic defaults, doubtless more attorneys would seek to provide the needed legal counsel and assistance for homeowners.

broaden the federal tax liability exemption given to discharged mortgage debt to now also include the debt incurred through a cash-out refinancing or through a home equity loan when those loan proceeds were spent for purposes other than improvement of the property.[137] In addition, federal legislation amending the Fair Credit Reporting Act could be adopted along the lines recommended by Professor White, so as to prevent lenders from reporting mortgage defaults and foreclosures to credit rating agencies.[138] This amendment to the Fair Credit Reporting Act would reduce the fear factor associated with the contemplation of foreclosure, as well as reduce foreclosure's adverse consequences for borrowers. On the other hand, such a measure could perhaps be legitimately criticized as inefficiently distorting the information available for subsequent lenders to use in making their judgments as to borrower creditworthiness.

Another measure that might also be very helpful in encouraging underwater homeowners to demand substantial modifications would be the adoption of a "national anti-deficiency law," covering both senior and junior residential real estate mortgage obligations, as is recommended briefly in passing by White.[139] Such a statute would provide some assurance to underwater homeowners that they would not be held liable for potentially large deficiency judgments after foreclosure proceedings, and if well-publicized the statute would help to overcome homeowner reluctance to threaten mortgage servicers with default. However, for such a statute to provide effective legal protection for currently underwater homeowners considering default, it would have to apply retroactively to the mortgage loans that had been entered into before the statute was adopted, rather than apply only prospectively to future obligations as does most legislation. While such retroactive abrogation of pre-existing lender rights to seek deficiency judgments (which exist in some but not all states) might at first glance appear to be impermissible for a state government to carry out under the

137. *See generally* Les Christie, *Foreclosed? Here Comes the Tax Man*, CNNMONEY, Apr. 14, 2010, http://money.cnn.com/2010/04/08/pf/taxes_mortgage_debt/index.htm.

138. White, *supra* note 2, at 45–52.

139. *Id.* at 46 n.212, 53 n.232.

literal text of the "Contracts Clause"—Article I, Section 10 of the U.S. Constitution[140]—it has been convincingly argued that since the 1934 Supreme Court case of *Home Building & Loan Ass'n v. Blaisdell*,[141] this formerly significant constitutional provision is no longer regarded as providing a meaningful restraint on state action.[142] Therefore, such protection from deficiency judgments could be constitutionally provided by state law revisions with retroactive effect.[143] Further, it is even less likely that a federal anti-deficiency statute with retroactive effect, but not expressly subject to that same constitutional restriction, would be found to have any constitutional defects.[144]

B. Loan Modification Negotiations under the Proposal.

Assume for the sake of argument that my proposal was implemented, and that it proved to be sufficient to result in a large number of underwater homeowners with significant negative equity positions strategically defaulting and demanding loan modifications with substantial principal reductions as the price of cure. What kind of modified loan terms would likely result from such negotiations? Below, I will present a general analysis of the various constraints imposed on such negotiations, and of the nature of the resulting outcomes.

Each of the many individual negotiations between underwater homeowners and their loan servicers can be

140. "No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ." U.S. CONST. art. I, § 10, cl. 1.

141. Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).

142. James W. Ely, *Whatever Happened to the Contract Clause?* 13–15 (Vanderbilt Univ. Law School, Pub. Law & Legal Theory, Working Paper No. 09-21, 2009).

143. The various states could, for example, adopt either variations of section 511(b) of the Uniform Land Security Interest Act, or variations of the relevant provisions of the Uniform Nonjudicial Foreclosure Act, so as to provide defaulting homeowners with such protection against deficiency judgment liability. John Mixon, *Fannie Mae/Freddie Mac Home Mortgage Documents Interpreted as Nonrecourse Debt*, 45 CAL. W. L. REV. 35, 82 (2008).

144. Such a federal anti-deficiency statute with retroactive effects could conceivably be challenged as a regulatory "taking" of some of the wealth of mortgage creditors to such a degree as to violate the Takings Clause of the U.S. Constitution, or as to constitute a violation of the Due Process rights of mortgage creditors. These challenges appear to be unlikely to succeed, but a comprehensive analysis of the constitutionality of such a federal statute is a question that goes beyond the scope of this paper.

modeled as a bilateral monopoly situation in which each party has only the two options of either dealing with the other party on terms acceptable to that other party, or breaking off negotiations and going through the foreclosure process. First, I will discuss in general terms the position of each of these two parties in such negotiations, and then I will present an illustrative numerical example of the range of possible mutually-advantageous outcomes for a typical such negotiation.

From the point of view of the lender, its default option is to put the property through foreclosure, receiving the property's market value minus the lender's foreclosure-related costs.[145] Consequently, if a lender can convince the homeowner to accept a modified loan principal balance at the market interest rate that exceeds that lower bound by enough to cover all of the additional lender costs associated with modifying a loan,[146] it would be better off making that loan modification rather than pursuing a foreclosure. From the point of view of the underwater homeowner, his default option is also to go through foreclosure, eliminating his negative equity position but bearing all of his foreclosure-related costs. These costs would include the cost of any risk he bears of being found liable for a deficiency judgment or for tax obligations, the cost of any adverse impacts upon his credit rating, and any other personal costs associated with going through foreclosure and moving to a different residence. If a homeowner can convince the lender to accept a modified loan principal balance at the market interest rate that exceeds the market value of the property by no more than these foreclosure-related costs, he would be better off accepting that modification than going through foreclosure and bearing those foreclosure-related costs.

There is therefore, in most instances, a range of possible loan modifications with a new loan principal balance in the general vicinity of the property's current market value that are mutually advantageous to both the lender and the

145. These foreclosure-related costs have been estimated to average as much as $60,000 per foreclosure. CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 1, 9 (Comm. Print 2009).

146. These costs would include the costs of negotiating a modification, as well as any costs associated with any legal risks or regulatory difficulties that might be associated with modifying a loan to reduce its outstanding principal balance.

underwater homeowner relative to how they each would fare in a foreclosure proceeding. Rational parties should agree to a modified loan principal, at the market interest rate, that is set in amount somewhere between the lender's lower bound of the market value of the home minus the lender's foreclosure-related costs plus the lender's loan modification-related costs, and the borrower's upper bound of the market value of the home plus his foreclosure-related costs. There is probably considerable room here for a deal in most cases, and exactly where within that range of mutually advantageous outcomes the parties will agree depends generally upon their relative bargaining power and abilities.

Let me illustrate the above reasoning with a simple and typical numerical example. Assume that a homeowner, who had the funds for a $30,000 down payment, borrowed an additional $570,000 from a lender in 2006 on interest-only initial mortgage payment terms to buy a $600,000 California house with a 5% down payment. Also assume (quite realistically) that the market value of that house has now declined by 50% to $300,000. The homeowner now has an approximately $270,000 negative equity position on the house. If the homeowner defaults and the house goes through foreclosure, and if we assume for this example that the lender's foreclosure-related costs would total $60,000,[147] then the lender will only realize $240,000 from the foreclosure. The lender will therefore be in a better position if he is able to convince the homeowner to accept a modified loan balance, at the market interest rate, totaling enough more than $240,000 so as to cover its additional costs of modifying the loan. Also assume for this example that those loan modification costs would total $10,000. The lender should thus agree to modify the loan if he can get the borrower to accept at least a $250,000 modified principal balance at the market interest rate.

From the borrower's perspective, as a result of a foreclosure he would then have a zero negative equity position, plus he would need to bear his foreclosure-related costs. Assume for this example that those foreclosure-related costs would total $25,000. The borrower will therefore agree to modify the loan if he can convince the lender to reduce the

147. *See supra* note 59.

outstanding principal balance to no more than the $300,000 market value of the house, plus his $25,000 foreclosure-related costs, or a total of $325,000, loaned at the market rate of interest. Therefore, based on these numerical upper and lower bounds, a modified loan at the market interest rate with a principal balance somewhere between $250,000 and $325,000 will be preferable to both parties over a foreclosure proceeding. Where exactly within this broad range any two given rational parties will reach agreement depends on their relative bargaining power and abilities.

To the extent that either a lender's foreclosure-related costs are lower or its loan modification-related costs are higher than are assumed in the example above, or to the extent that a borrower's foreclosure-related costs are lower than assumed in the example above, this would shrink the range of mutually advantageous outcomes, i.e., reduce the room for a deal. If the cost factors change in this way, and this range is sufficiently compressed, then unfortunately no deal could be reached and a foreclosure would result. But to the extent that a lender's foreclosure-related costs are higher, or its loan modification-related costs are lower, or the borrower's foreclosure-related costs are higher than assumed in the example above, this will increase the range of mutually advantageous outcomes, making it presumably even easier for the parties to reach agreement than in the example presented.[148]

C. Advantages of the Proposal.

My proposal has a number of obvious advantages over the current status quo. First of all, it appears to have some promise for encouraging and facilitating the widespread modification of the mortgage debt of underwater borrowers so as to sharply reduce or eliminate the negative equity overhang and the associated risk of a sudden future cascade

148. The current situation, in which many underwater homeowners are unwilling to utilize the threat of default to induce their loan servicers to modify their loans, could be similarly conceptualized as a bilateral monopoly bargaining situation. Under this situation, the "borrower's foreclosure-related costs" are so high due to borrower fear of the consequences of foreclosure that the upper end of the range of mutually acceptable modifications includes the current outstanding loan balance, and the "loan modification" consequently generally agreed to is for the borrower to simply keep making his payments on his existing loan.

of strategic defaults and foreclosures, although it is possible that either homeowner or loan servicer attitudes would prove to be more resistant than hoped for to the suggested measures, and any mutually acceptable modifications would be more difficult to reach. Moreover, my proposal would accomplish this end without requiring a large-scale commitment of government funds, as a bailout-type approach would necessitate, and it would not pressure loan servicers into making loan modifications in the shadow of the threat of coerced principal reductions made possible by changes in the cramdown provisions of the Bankruptcy Code.[149] The rather modest and relatively inexpensive combination of expanded public information and assistance for underwater homeowners, statutory protections for loan servicers entering into good faith modifications, greater scrutiny of servicer compliance with their fiduciary duty obligations to their investors, and a few statutory limitations imposed upon mortgage creditor remedies and borrower tax liability may be all that is needed to begin the orderly unwinding of the large and dangerous negative equity overhang through loan modifications. These changes would render unnecessary any highly disruptive and inefficient foreclosures.

While an approach along the lines of my proposal would avoid the major controversies that would accompany a large taxpayer bailout or major changes in the Bankruptcy Code, it would still almost certainly encounter substantial opposition. Such public education and assistance efforts, and mortgage debtor-protective statutes that would together serve to encourage mortgage defaults by solvent underwater homeowners, would likely be resisted quite strenuously by financial creditors and their associated trade associations and political allies. Those critics would doubtless choose to emphasize the moral condemnation of encouraging persons who are capable of paying their debts to not do so, rather

149. I must concede, however, that there is an element of implicit coercion in my proposal. If loan servicers are faced with determined demands by borrowers for principal-reducing modifications, upon pain of default if their demands are denied, and if loan servicers conduct, as to whether their decisions to agree to such modifications or to instead pursue foreclosures were consistent with their fiduciary duty obligations to their investors, was subject to review, they may well feel effectively coerced, as a practical if not a legal matter, to enter into such modifications. In some sense, that feeling of coercion imposed on loan servicers may be viewed as one hope of my proposal.

than the threat to creditor economic interests of such conduct. However, apart from the obvious rejoinder that can be made to this rather dubious moral critique,[150] a powerful counter-argument can also be made that the social and economic benefits of winding down the negative equity problem would redound, not only to the benefit of those borrowers, but would also benefit creditors of all kinds to a very major extent. This is because a resolution to the negative equity problem would significantly lower the risk of the eruption sometime in the near future of a sudden wave of strategic defaults by underwater homeowners and subsequent foreclosures that could trigger another downward economic spiral that would be hurtful to all, debtors and creditors alike.

Internal discussions of approaches to the negative equity problem following the same general lines as my proposal have doubtless taken place within the White House, within many governmental agencies, and among members of Congress in recent years, even though those internal discussions apparently did not reach the stage where they were externally vetted. One reason for this may have been that strong creditor resistance to such proposals for strengthening mortgage debtor resolve to seek modifications and for weakening mortgage creditor rights was exercised covertly behind closed doors. If so, this would not be at all surprising. Mortgage creditors of course benefit from having the legal right in some states to pursue mortgage debtors for deficiency judgments, even if that right is primarily only useful as an *in terrorum* deterrent and is generally not practical to exercise.[151] Creditors further benefit from having the right to

---

150. White, *supra* note 2, at 53.

> [I]t is time to put to rest the assumption that a borrower who exercises the option to default is somehow immoral or irresponsible. To the contrary, walking away may be the most financially responsible choice if it allows one to meet one's unsecured credit obligations or provide for the future economic stability of one's family. Individuals should not be artificially discouraged on the basis of "morality" from making financially prudent decisions, particularly when the party on the other side is amorally operating according to market norms and could have acted to protect itself by following prudent underwriting practices.

Id.

151. *See, e.g.*, Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2009) (finding that even in recourse states, deficiency judgment actions are often not cost-effective for the lender, thus turning recourse loans into de facto non-recourse loans).

publicly disseminate foreclosure information that will damage the credit ratings of defaulting borrowers. Creditors of all types, mortgage and otherwise, also obviously benefit from the reinforcement of the widespread, if somewhat problematic,[152] social attitude that the non-payment of one's debts by one who can afford to do so is morally blameworthy, even if one can legally avoid those obligations, and even if as a practical matter the commonly feared potential consequences of default are often actually rather remote possibilities or not really that severe in nature.

Representatives of debtors and creditors will doubtless tend to align on different sides of these issues of whether and how to encourage underwater homeowners to default on their mortgages so as to motivate loan servicers to significantly modify their loans to reduce or even eliminate their negative equity positions. This trend has often been the case throughout history when policy questions have involved the restructuring of debtor-creditor relationships in some fundamental fashion. The creditor lobbying pressure to block such a program would no doubt be fierce indeed, but in my opinion it would not necessarily prevail. It remains to be seen whether these creditor interests would be powerful enough to prevent the adoption of a plan for resolving the underwater homeowner problem along the lines of my proposal, were such a plan to be seriously debated in policy-making circles and its overall macroeconomic advantages consequently better appreciated.[153]

V. THE MERITS OF THE POSNER AND ZINGALES PROPOSAL

Professors Posner and Zingales, in their recent and interesting paper, agree with my view that what is most needed to fundamentally resolve the homeowner negative equity problem is for a large proportion of these underwater

---

152. *See* White, *supra* note 2.

153. Not only would the widespread modification of the mortgages of underwater homeowners greatly reduce the chance of a sudden surge in strategic defaults, with likely severe and adverse macroeconomic consequences, but it would also reduce the other economic costs of millions of homeowners being burdened with negative equity. These other costs include both depressed consumer spending and drastically reduced household mobility, which in turn contributes to increased structural unemployment, and reduced labor productivity. White, *supra* note 2, at 50–52.

homeowners to have their mortgages modified so that the outstanding mortgage balance would be much closer to the house's current value.[154] However, they set forth a very different framework than my proposal for overcoming the obstacles that are now impeding such modifications.

A brief summary of the main lines of their proposal reveals that it is mathematically somewhat complex, but conceptually relatively straightforward. Under the Posner and Zingales proposal, every underwater homeowner who lives in a postal ZIP code area where the median house price has dropped 20% or more from its recent peak would have a new "current value" calculated for their house by applying their ZIP code area median price decline percentage to the initial purchase price of their house.[155] These homeowners would then be eligible to have their outstanding mortgage balance reduced to that so calculated "current value," regardless of how much (if any) their particular house has actually declined in value.[156] Underwater homeowners who live in ZIP code areas that have not suffered at least a 20% median price decline from their peak prices would be ineligible for this program, no matter how much their particular houses may have declined in value. In exchange for having the principal of the loan so reduced, a qualifying homeowner would have to agree to pay over to his mortgage lender, upon the subsequent sale of his house, 50% of any price appreciation that has taken place since the loan modification. That price appreciation would be similarly calculated by multiplying the percentage appreciation in the value of the median house in that ZIP code area since the date that the loan modification took place by the "current value" of the house at the time of the modification.[157]

---

154. "The goal is to force a renegotiation between the homeowner with negative equity and the owner or owners of the mortgage." Posner & Zingales, *supra* note 11, at 578.

155. "People with positive equity do not qualify [for the Posner and Zingales plan.]" *Id.* at 593.

156. *Id.* at 589.

157. *Id.* at 589–90. The use of changes in the median home price for a ZIP code area, rather than the use of the subject house's actual price appreciation, is intended to counter the "moral hazards" that would be created by using the actual sale price data. These hazards include the possibility of homeowners falsely documenting the sales taking place as doing so at low prices, while they also obtain unrecorded side payments, and also undercutting homeowners' incentives to maintain the house in good condition since they would then have

For example, if an underwater homeowner had initially purchased a house for $600,000, and currently has a $550,000 outstanding mortgage balance on the house, and the percentage decline in the median house price in his ZIP code area since its recent peak price was 24%, then he would now have a "current value" calculated for his house of $600,000 - (0.24 x $600,000) = $456,000, and he would be eligible to have his loan balance reduced to that same $456,000 "current value." If he then sold his house five years later, and if the median home price in his ZIP code area had increased over that time period by 20% from the level it was at when his loan was modified, he would then be credited with price appreciation, measured in this particular way, of $456,000 x .20 = $91,200. He would then be obligated to pay 50% of this appreciation—$45,600—to his mortgage lender.[158] The lender would therefore, upon the later sale of the property, recover some portion of the loan principal reduction and thus reduce (and perhaps even eliminate) its overall losses on the loan modification.[159] This shared appreciation loan modification procedure would be enabled by amending Chapter 13 of the Bankruptcy Code to allow for the homeowner to initiate a

---

to share those gains with their lenders. *Id.* at 596.

158. Neither the market value of the house at the time of the loan modification, nor its actual sale price at the later time of sale would be relevant for determining the amount of house price appreciation to be divided upon a sale. The relevant prices here would be based on ZIP code area median numbers. The actual price appreciation that took place for a property thus might not be divided on a 50-50 basis between the homeowner and the lender. If the particular house sold had appreciated more in percentage terms than did the median house in that ZIP code area, then the homeowner would be able to retain more than 50% of this actual appreciation. *Id.* at 590. On the other hand, if the house appreciated less than the median house for that ZIP code area then the lender would receive obtain more than 50% of this actual appreciation. *Id.* This approach of applying a standard formula to public information would reduce the opportunities for persons to manipulate the process with phony appraisals or sale price information. *Id.* at 590–91.

159. This procedure would appear to allow the homeowner to avoid having to share the future appreciation of the property with the lender by the ploy of immediately selling the property, paying off the modified mortgage without having to share any appreciation, since none has yet occurred, and then buying an identical property with similar mortgage financing and no shared appreciation obligations. Posner and Zingales recognize this possibility, but argue that because of the transaction costs involved in selling a property and buying another, relatively few recipients of modified mortgages would be inclined to pursue this option. If such behavior did prove to be a problem, the plan could be modified to allow the lender to reassert their claim to the stripped down portion of the prior mortgage. *Id.* at 599–600.

streamlined "prepackaged bankruptcy" proceeding that would have these effects.[160] Once this amendment was adopted, however, probably many, if not most, such modifications would be negotiated outside of bankruptcy. The availability of this option would provide homeowners who were willing to sacrifice half of their price appreciation potential in order to eliminate their negative equity position with the needed leverage to get their loan servicers to agree to such terms without their having to file for bankruptcy.

The advantages of the Posner and Zingales approach as compared to the current status quo, or as compared to a taxpayer-financed bailout-type approach, are obvious and substantial. First, this plan does not require significant taxpayer funding since there is no bailout of the homeowner or mortgage investor losses that have occurred due to price declines. Second, the Bankruptcy Code amendments advocated by Posner and Zingales would empower underwater borrowers to unilaterally commence (or threaten to commence) the loan modification process, thus addressing to some extent the critical problem I have discussed earlier of loan servicer reluctance to engage in principal-reducing modifications. In addition, their use of median price changes to determine for which ZIP code areas homeowners would qualify for such modifications, and to determine the amount of the specific principal reductions to be allowed and the amount of price appreciation that will later be divided between borrowers and lenders upon the eventual sale of the house, makes the plan much easier to apply administratively than if house-specific price data had to be used in each instance and verified for its accuracy to prevent abuses.

The Posner and Zingales proposal does, however, have some significant drawbacks as compared to my proposal. Their proposed amendments to the Bankruptcy Code would make mortgage servicer participation in such principal-reducing loan modifications legally compulsory at the option of the homeowner, rather than being wholly consensual as it is under my approach.[161] Therefore, their approach would

160. Posner & Zingales, *supra* note 11, at 579.

161. I concede that the combination of broad and insistent demands for loan modifications by underwater homeowners, upon pain of default, (hopefully) generated by my proposal, accompanied by close regulatory scrutiny as to whether loan servicers were making decisions that realized the maximum

likely trigger the same strong political resistance as other attempts to expand in various ways the cramdown authority of bankruptcy judges in the residential mortgage area. My proposal avoids the need for any such controversial changes in bankruptcy law. In addition, with regard to accurately targeting underwater homeowners, the Posner and Zingales proposal with its ZIP code area-based eligibility threshold is underinclusive, perhaps significantly so.[162] It denies eligibility to all underwater homeowners who happen to live in ZIP code areas that have had less than a 20% decline in median home prices.[163] A ZIP code area with an 18% decline in the median home price in recent years, for example, likely has a large number of underwater homeowners who initially purchased their homes during the last few years with small or even zero down payments, but would not be allowed to participate in this plan. My proposal, in contrast, allows every underwater homeowner to demand a loan modification, although it does not arm them with the threat of coercively obtaining principal reductions, subject to shared appreciation obligations, through a streamlined mandatory Chapter 13 bankruptcy proceeding as does the Posner and Zingales proposal.

Another drawback of the Posner and Zingales proposal is

---

possible value for their investors, would make such loan modifications virtually compulsory as a practical matter. However, the fact remains that under my proposal, loan servicers would retain the legal right to refuse to engage in any particular principal-reducing loan modification, while under the Posner and Zingales approach, they could be compelled to do so through the Chapter 13 bankruptcy proceeding.

162. I am not aware of any statistics regarding the proportion of underwater borrowers who live in those ZIP code areas that have had less than 20% median home price declines in recent years, nor any statistics regarding the average and aggregate negative equity of those borrowers. But these borrowers obviously could comprise a significant proportion of all underwater borrowers, and of all negative equity. Posner and Zingales recognize this underinclusiveness, describing it as a "Type I error" of their proposal, although they do not attempt to quantify its magnitude, and they defend it as the inevitable effect of having a "bright-line rule for administrative convenience" that is "justified" because of "the vast cost of administering millions of mortgage write-downs." They apparently believe that this cost would be unacceptably increased were their proposal to be made more complex and discerning so as to eliminate this underinclusiveness. Posner & Zingales, *supra* note 11, at 594.

163. If an underwater homeowner was located in a ZIP code area where median house prices have not fallen the requisite 20%, he would not be eligible to participate under the Posner and Zingales proposal, regardless of how large his individual underwater position happened to be.

that the use of the median price decline in a particular qualifying ZIP code area to determine the percentage reduction in the loan principal for a given homeowner, rather than the actual price decline for that property, is a rather crude and approximate measure that may easily reduce that homeowner's mortgage balance either not enough or more than necessary to eliminate his negative equity position. In contrast, under my proposal, the amount of principal reduction in a particular loan modification would be individually negotiated, with borrowers being unlikely to settle for much less than total elimination of their negative equity,[164] and lenders unlikely to make much greater concessions than this,[165] likely leading to modified mortgages roughly equal in size to the current value of the house, obviously a socially desirable result.

Similarly, the ZIP code area median measure of the percentage amount of price appreciation that would be divided equally between the borrower and the lender upon sale is another crude measure that may not accurately reflect the true appreciation for a particular house. This could lead to windfalls by one party at the expense of the other in terms of sharing the actual property's appreciation on a rather random, haphazard basis in those qualifying ZIP code areas that proved to be heterogeneous with regard to the rates of price appreciation of particular houses.[166] In particular, a homeowner, whose property experienced only a relatively

164. A rational borrower would not accept a loan modification that left him with negative equity greater than his expected foreclosure costs. *See supra* note 132 and accompanying text.

165. A rational lender would not accept a loan modification that specified a loan principal balance less than what the lender could recover in a foreclosure proceeding, plus the lender's loan modification costs. *See supra* note 135 and accompanying text.

166. If, for example, a house had appreciated 100% from $200,000 up to $400,000 after a loan modification down to a $200,000 mortgage balance had taken place, but the median rate of price appreciation for that district was only 20%, then only $240,000 - $200,000 = $40,000 of that appreciation would be split evenly between the borrower and the lender. This would give the borrower 90% of the actual $200,000 price appreciation, and the lender only 10%. But if that same house had only appreciated by only 5% from $200,000 to $210,000 over that time period, again $240,000 - $200,000 = $40,000 would be split evenly between the borrower and the lender. This would give the lender $20,000, a full 200% of the actual price appreciation, and leaving the borrower with only $190,000 after the sale, not even enough to pay off his $200,000 mortgage obligation.

small appreciation in value of less than 50% of that appreciation experienced by the median house in that ZIP code area, would actually owe to the lender—upon the sale of the property and under the shared appreciation feature—more than 100% of that appreciation, and would thus be exposed in some instances to potential liability for the unpaid balance.[167] This unfortunate situation could arise for a significant number of homeowners in a qualifying ZIP code area that had substantial heterogeneity of price appreciation.

One important aspect of the Posner and Zingales plan is that the loan modifications that it would induce would be substantially more generous to mortgage investors and less generous to homeowners than those modifications that would likely take place under my proposal. Under their plan, the mortgage investors who have written off the negative homeowner equity portions of the mortgage loans through these loan modifications would eventually recapture a perhaps quite substantial portion of those losses through their rights to receive, upon sale, 50% of the (median for the ZIP code area) property appreciation since the modification. Under my proposal, in contrast, there would be no such shared appreciation feature for the modified loans unless the borrowers and lenders had agreed to such an arrangement, and there is no incentive created under my proposal for borrowers to offer such a concession. Nor would such a concession be necessary to induce servicers to engage in such modifications under the very limited "modify the loan substantially or you will have to foreclose" choice that they would be presented with by many of their underwater homeowner borrowers, if my approach were to prove successful in helping those borrowers understand where their best interests lie, and acting accordingly.

The difference between the Posner and Zingales approach and my proposal, with regard to the relative distribution of the burdens of principal-reducing loan modifications that we each seek to encourage, goes to the heart of the fundamental difference in our approaches as to how to address the core problem of loan servicer reluctance to agree to such

167. Posner and Zingales recognize this possibility, but "expect that the risk of such an outcome is relatively low," and that if this problem turned out to be significant, then their suggested 50-50 allocation of price appreciation could be adjusted. Posner & Zingales, *supra* note 11, at 597.

modifications. Their plan attempts primarily to make these modifications somewhat more attractive to loan servicers by incorporating a shared appreciation feature, and then to encourage those modifications to actually take place by also giving underwater homeowners the leverage through bankruptcy law to force loan servicers to enter into them. But their plan still does not make these shared appreciation modifications as attractive to loan servicers as simply having the underwater borrowers continue to make their payments on their existing mortgages, if this option is possible. Moreover, the shared appreciation feature has the counter-productive effect of making such modifications far less attractive for underwater homeowners to pursue. As a result, probably very few of those underwater borrowers would invoke or threaten to invoke the newly-available bankruptcy procedure to force their loan servicers to enter into those shared appreciation modifications,[168] and the loan servicers have no economic reason to do so without such pressure.

Under my proposal, in contrast, there is no attempt to try to make the desired principal-reducing modifications more attractive to loan servicers than their continuing to receive payments under existing mortgages. To do so, I believe, would be difficult or impossible to achieve through any feasible new incentives, and therefore my proposal instead focuses primarily upon assisting underwater homeowners to rationally assess their circumstances and then, if it is called for, encouraging them to default on their loans and forcefully demand substantial modifications as the price of cure. The choice that loan servicers would then be presented with is either to modify the loans substantially or proceeding with foreclosures. Given *this* choice, the loan modification option then becomes the far more attractive one for realizing maximum value for the investors. Once these borrowers have made clear to the loan servicers that the status quo of their continuing to make their payments is not an option, and that self-cure of their payment deficiencies simply will not occur, and once the loan servicers also realize that the dreaded contagion effect that they feared might result from their

168. Posner and Zingales themselves concede this point. "In fact, it is likely that only a fraction [of those homeowners who could avail themselves of the option presented to them by the Posner and Zingales plan] would do so." *Id.* at 592.

engaging in significant loan modifications for some solvent underwater borrowers has already pervasively occurred, then and only then will the desired loan modifications take place.

In his work extensively discussed earlier in this article Professor White has convincingly argued that it would be in the best interest of many underwater homeowners to default and endure foreclosure if they are not granted very significant loan modifications. White further argues that what is impeding homeowners in taking this action is a combination of calculation difficulties, various cognitive impairments, and especially the emotions of fear, shame, and guilt associated with foreclosure. In his view, this association is irrational and unfortunately reinforced by most of our important social institutions including the federal government.[169] While White recognized that a public education-oriented approach, accompanied by enactment of a few federal statutes protecting loan servicers from litigation and limiting mortgage creditor remedies, such as I recommend, "naturally follows" from his analysis and could well be "effective" in obtaining the desired loan modifications, he did not endorse this kind of approach to the problem because of his concern that it would be "distasteful to most policy makers."[170]

Professors Posner and Zingales appear to be exactly the kind of influential policy formulators and commentators that White was referring to and seeks not to offend. Their plan clearly does not try to encourage those underwater homeowners whose best interests would be served by default to realize this fact, and then to default so as to pressure their loan servicers to engage in principal-reducing loan modifications. Moreover, they go much further here than White's prudential concerns, by characterizing such strategic default behavior on the part of underwater homeowners as evidencing a kind of moral failing that their plan is specifically designed not to encourage.[171] In their view, what

169. White, *supra* note 2, at 29.

170. *Id.* at 44.

171. Posner and Zingales make it quite clear that in their view a strategic default by one who has the financial capability to continue making their payments is an immoral act. Posner & Zingales, *supra* note 11, at 597.

> One concern with this . . . plan is that it might . . . undermine the moral standards that prevent families from defaulting, exacerbating the very problem that it tries to resolve. . . . . While this is a possible

is wrong with recommendations like my proposal is not simply that it would be viewed as distasteful by policy makers, but that it would be rightfully so condemned because the strategic default behavior that I seek to encourage in order to force loan servicers to make modifications would be immoral.

Thus the contrast between our approaches is rather sharply drawn. Posner, Zingales, White, and I all seek the "elusive public policy holy grail" of having large numbers of underwater homeowners enter into principal-reducing loan modifications with their loan servicers.[172] However, Posner and Zingales believe that these modifications can be effectively encouraged by legal changes that make them somewhat more attractive to loan servicers, although these very legal changes simultaneously and correspondingly make the modifications somewhat less attractive to underwater homeowners. They see no need for any measures that might fundamentally change the thinking and behavior of those homeowners to better understand their true interests and then demand such modifications upon pain of default, something Posner and Zingales regard as immoral. I disagree with their moral stance, and I also do not feel that the necessary loan modifications will occur unless and until underwater homeowners threaten to default en masse if the appropriate loan modifications are not made, thus leaving their loan servicers with little choice but to accede to those demands. Unlike Posner and Zingales, I have no qualms about attempting to help these underwater homeowners better understand where their true interests lie and then encouraging them to act on that understanding.

VI. CONCLUSION

There are currently well over ten million underwater homeowners, with an aggregate negative equity position of at

---

> spillover effect, there are two factors that minimize this risk under our plan. . . .

Id. They also criticize any loan modification plan that "could weaken the moral stigma against defaulting on loans." *Id.* at 589. They defend their plan by claiming that they "doubt that [the] plan will erode the stigma on default." *Id.* at 595.

172. White, *supra* note 2, at 49–50.

least \$800 billion and possibly over \$1 trillion.[173] The overwhelming majority of these people who can afford to do so currently continue to make their mortgage payments, even though it can be shown that for many of them their interests would actually be better served by defaulting and going through foreclosure. This is, therefore, a rather fragile and unstable situation that could suddenly erupt with a rapid cascade of millions of strategic defaults, potentially triggering another large wave of foreclosures and potentially severe macroeconomic dislocations. It is a matter of some urgency that this situation be defused through the large-scale modification of the mortgages of a substantial number of these underwater homeowners, so as to sharply reduce or even eliminate their negative equity positions. This problem is all well understood, and the question is how best to overcome the numerous obstacles that are impeding such principal-reducing loan modifications from taking place. These impediments are, as I have discussed, numerous and complex.[174] They include various cognitive impairments and emotional factors that make it difficult for underwater homeowners to rationally determine where their best interests lie and to act accordingly by demanding such modifications. These impediments also include numerous reasons why loan servicers are reluctant to grant such modifications, and reasons why the federal government has so far been unable to effectively address this problem.

I have set forth recommendations as to how these impediments can be best overcome.[175] My proposal centers on the implementation of a public education and assistance program designed to assist underwater homeowners in rationally assessing where their interests lie, and then to encourage them to demand loan modifications, upon pain of default, when this proves to be their best course of action. I also have recommended the adoption of federal legislation that would shelter loan servicers from litigation by their mortgage investors, if those servicers had engaged in loan modifications in good faith attempts to maximize investor returns, and greater federal enforcement efforts to assure

173. *See supra* note 5 and accompanying text.
174. *See supra* Parts II–III.
175. *See supra* Parts V–VI.

that loan servicers are placing their investors' interests foremost in their decisions. Such legislation would encourage servicers to respond to these homeowner demands with principal-reducing loan modifications, rather than by initiating foreclosure proceedings. In addition, I recommend the adoption of federal legislation that would shelter defaulting homeowners from liability for deficiency judgments, and from tax liability, and that would prevent loan servicers from reporting mortgage foreclosures to credit rating agencies.

I have contrasted my proposal with a recent proposal made by Professors Eric Posner and Luigi Zingales that would amend Chapter 13 of the Bankruptcy Code so as to allow underwater homeowners to obtain loan modifications that would substantially reduce or eliminate their negative equity position, in exchange for granting their lenders a 50% interest in any subsequent appreciation of the property.[176] While their proposal would be a substantial improvement over the current status quo, it would not be nearly as effective in bringing about the needed loan modifications as would my proposal.

The Posner and Zingales proposal is hamstrung by its premise that it would be immoral for underwater homeowners who are capable of making their current mortgage payments to strategically default in order to obtain substantial modifications of their loans, and that it would therefore be bad public policy to encourage such behavior. I have no such qualms. I regard assisting underwater homeowners to recognize where their true interests lie, and encouraging them to strategically default when this is in their interest, as the sine qua non to bring about the principal-reducing loan modifications that we all seek and that are very much needed. The anomaly here, if it may be called that, is that the looming threat of millions of additional foreclosures can only be avoided if these underwater homeowners threaten en masse to bring this exact result about. Loan servicers will enter into principal-reducing loan modifications on a large scale only after many underwater homeowners show a willingness to default and go through foreclosure if significant loan modifications are not granted. Encouraging this

176. *See supra* Part VI.

willingness to default therefore (and somewhat paradoxically) needs to be the central focus of our efforts to resolve the problem.