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Features

Battle on the Home Front

A proposal to modify mortgages in bankruptcy fails in Congress, but proponents say it's the missing weapon in fighting foreclosures

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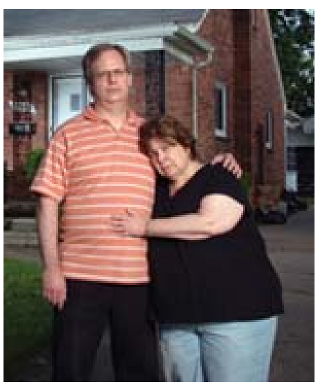
By Steven Seidenberg



Paul and Sheryl Vachon
Photo by Rachel Holland

Note: Register for this month's CLE "The Bankruptcy Bailout," from 1-2 p.m. ET on Wednesday, Aug. 19.

For 12 years, Paul Vachon lived with his wife and son in a four-bedroom bungalow in one of the nicer suburbs of Detroit. And he had a good job, selling higher-end furniture.

Then, in mid-2007, the U.S. economy collapsed. Detroit was hit particularly hard, as was Vachon's business. "People in the area, if they are worried about the future of the auto industry," he says, "are much less likely to spend $700 to $800 for a bedroom set."

Soon Vachon, 50, had trouble paying his bills. "I was falling behind each month," he says. "My wife and I were cutting back on our expenses, but I had to keep going into my savings to pay my mortgage. Then my savings ran out." He says the bank started sending threatening letters after he missed his mortgage payment in February 2008.

Vachon says he couldn't get the bank to seriously consider a modification of his mortgage loan, and he couldn't ask any other lenders to refinance his mortgage because the market value of his house had plummeted to less than the value of his home loan.

In the face of their mounting financial burdens, Vachon and his wife, Sheryl, filed for bankruptcy in February. It was a bitter pill.

"Our feelings on the matter were complex," says Vachon. "I could best describe them as a combination of shame, embarrassment and relief. I've always tried to be an honest, honorable person. I've always believed strongly in paying my debts. But I had no choice.

"My income has declined so much —in my opinion, through no fault of my own—that debts I incurred I simply could not satisfy, at least according to the schedule my creditors demanded.

"In the end, I feel cheated. I went to college, worked hard and played by the rules. I don't think I should have had to have done this."

Going through bankruptcy helped—some. In March, Vachon and his wife were granted a discharge under Chapter 7 of the U.S. Bankruptcy Code, which wiped out some $10,000 in unsecured debt, much of it on credit cards. "It helped me get a fresh start," Vachon says.

There was just one problem: The bankruptcy court was not empowered to do anything about the mortgage on Vachon's house, and even after the discharge of some of his other debts, there wasn't enough money to keep up with the mortgage payments. The house went into foreclosure, and in mid-April the bank took possession and the Vachons had to leave.

The family moved in with Vachon's widowed mother-in-law, sharing her three-bedroom home. "It's not so bad for my wife; she grew up in this house," he says. "It is a little difficult for me and my son, but it is an adjustment we are making."

If the bankruptcy court could have done something about the mortgage, Vachon thinks he probably could have kept his house. "It would have required a reduction in the loan principal and the interest rate," he says, but "it was a very, very strong possibility I could have stayed in my home."

Vachon still is numb from the experience. "My No. 1 emotion is disbelief," he says. "I never, ever thought something like this could happen to me. ... It was a great house."

LIKE A BROKEN RECORD

Carey Ebert
Photo by Charles Ford

As the U.S. economy continues to stumble through the recessionary doldrums, Vachon's story is hardly unique. Policymakers have focused on mortgage loan modification as a key to breaking the cycle of foreclosures that continue to be a major drag on the economy.

May was the third straight month in which foreclosure filings (default notices, auction sale notices and bank repossessions) topped 300,000 nationwide, according to RealtyTrac, an online real estate site that covers the foreclosure market. The 321,480 foreclosure filings in May—an increase of nearly 18 percent over May 2008—represent one out of every 398 housing units in the country.

May also was the third consecutive month in which consumer bankruptcies nationwide topped 120,000, according to the American Bankruptcy Institute, a nonpartisan organization in Alexandria, Va., that analyzes issues relating to insolvency. The 124,838 consumer bankruptcies filed in May represent a 37 percent jump from May 2008. Bankruptcy filings reached record lows immediately after the Bankruptcy Abuse Prevention and Consumer Protection Act went into effect in October 2005, but they have been climbing gradually ever since.

While foreclosure and bankruptcy don't necessarily go hand in hand, there appears to be some correlation. A report issued in December by Credit Suisse, an international financial services firm, estimates that there will be 8.1 million mortgages in foreclosure between now and 2012—which amounts to 16.1 percent of all home mortgages. But the report also projects that if those mortgages are modified in significant numbers, the number of foreclosures could drop by as much as half.

The federal government has been pushing lenders to engage in more loan modification since the economic climate worsened in 2007, and on March 4 the Obama administration unveiled its Making Home Affordable plan, which provides guidelines for modifying loans. Fannie Mae and Freddie Mac, the mortgage finance companies created by Congress and now controlled directly by the government, are required to participate, along with mortgage companies that receive funds under the Troubled Asset Relief Program. The administration hopes to lure others into participating by offering them financial incentives to modify loans. The administration also introduced a program that requires Fannie Mae and Freddie Mac to refinance some of the mortgages they own or have securitized at current low interest rates.

The administration claims that the two programs could help as many as 9 million homeowners, although some experts are dubious whether those targets are realistic. (See "Salvage Plan," May.)

CHANGING FORECAST

Francis Creighton
Photo by Ron Aira

Even before he announced those programs, president barack Obama called on Congress in February to give federal bankruptcy judges more power to modify the terms of mortgages for at least some homeowners in bankruptcy proceedings.

At first, prospects looked good for legislation that would enable bankruptcy courts to modify mortgage loans on principal residences for people in Chapter 13 bankruptcies. The House of Representatives quickly passed its version of the legislation (H.R. 1106) in early March with support from consumer organizations and other groups, including the National Association of Home Builders, consumer bankruptcy attorneys and many bankruptcy judges.

At a recent meeting of the National Conference of Bankruptcy Judges, "the unanimous conclusion of, I think, everyone there was to allow Chapter 13 to modify interest rates and mortgage principal," says Marc S. Stern, a Seattle attorney who serves as co-chair on the bankruptcy committee of the ABA's General Practice, Solo and Small Firm Division. He speaks for himself, and not for the division or the ABA.

The legislation also has powerful foes. In particular, it is strongly opposed by the banking industry. (One significant exception is Citibank, which supported the measure after receiving $45 billion in TARP funding.) On April 30, the Senate voted 51-45 to reject its version of the legislation (S. 61).

A report issued in January by Credit Suisse provided ammunition for both camps. The report, *Bankruptcy Law Reform—A New Tool for Foreclosure Avoidance*, estimates that permitting mortgages to be restructured in Chapter 13 bankruptcies could reduce foreclosures nationwide by 20 percent. But changing the law would have a negative impact on providers of consumer credit cards and auto loans because a revised law would encourage more people to file for bankruptcy, which would reduce their credit card and auto debt, the report states.

The Senate vote may not be the end of the line for the legislation. Sen. Richard J. Durbin, D-Ill., one of the bill's main supporters, vows to keep on fighting. “I’ll continue to bring this issue to the floor until the Senate decides to put the interests of homeowners above the interests of bankers,” Durbin said in a press statement after S. 61 was defeated.

Supporters of the legislation say it would provide another possible alternative for homeowners who can’t refinance or modify their mortgages because their homes are “underwater”—worth less than the amount of their current mortgages. At the same time, the possibility that a mortgage would be restructured in bankruptcy court might goad more lenders into voluntarily modifying them.

“Homeowners won’t get any great benefit unless they can hold the sword of Damocles over lenders’ heads,” says Carey D. Ebert, an attorney in Hurst, Texas, near Dallas, who is president of the National Association of Consumer Bankruptcy Attorneys. “Consumers need some sort of bargaining chip. They need to be able to say, ‘If you don’t like this proposal, I can present it to a bankruptcy judge.’ ”

Proponents insist that, as a matter of policy, allowing bankruptcy judges to modify the terms of mortgages on principal residences is a crucial step toward reviving the nation’s economy.

“If you don’t do something like this, all the government’s efforts to stimulate the economy are a waste of money,” Stern says. “You need to do this to stabilize the real estate market. Without it, you can’t have economic recovery.”

The Congressional Oversight Panel that monitors distribution of TARP funds reached a similar conclusion in a March 6 report analyzing the impact of foreclosure mitigation efforts. Without changes in bankruptcy law, the federal government’s current plan “does not deal with mortgages that substantially exceed the value of the home, which could limit the relief it provides in parts of the country that have experienced the greatest price declines,” the panel concludes in its report.

Supporters of the legislation also say it would bring greater fairness to bankruptcy law, which currently allows judges to modify loans on cars, boats and even second homes but not loans for primary residences.

Opponents of the legislation see things very differently. They warn that changing the law actually would undermine the economy further, not help it.

“If bankruptcy judges are allowed to independently change the terms of a signed mortgage contract, lenders will face new uncertainty as to the value of the collateral—the home,” said Mortgage Bankers Association Chairman David G. Kittle in testimony on Jan. 29 to a House Judiciary subcommittee.

“To account for the new risk, lenders will be forced to require higher down payments, higher costs at closing and higher interest rates, pushing the dream of home ownership beyond the reach of millions of families.”

HELP WANTED

In its current form, federal bankruptcy law doesn’t offer much help to debtors struggling to keep their homes. A homeowner who files under Chapter 7 of the Bankruptcy Code, for instance, gets to keep only some specified assets up to a certain value, known as exemptions, while all other assets are liquidated for the benefit of creditors. Secured creditors get first claim on pledged assets, which means that a mortgaged house goes to the lender.

“Chapter 7 is not helpful if someone is having trouble paying a home loan,” says Jason J. Kilborn, an associate professor at John Marshall Law School in Chicago. “It doesn’t help if there is a secured debt problem. That’s what Chapter 13 is designed to do.”

Chapter 13, which allows individuals to reorganize their debts and pay off creditors within a three-year to five-year time frame, offers most debtors their best shot at fighting off secured creditors. In general, Chapter 13 allows bankruptcy courts to modify the terms of secured loans—reducing the principal, cutting the interest rate and/or increasing the repayment term.

But there is one crucial exception: A bankruptcy judge may not modify the terms of the first mortgage on a debtor's primary residence. Generally, the most a judge may do is give the debtor 16 months in which to pay off any past-due amounts on the mortgage.

A second mortgage on the property, however, may be wiped out completely under Chapter 13—if the home's current value is equal to or less than the amount of the first mortgage. But if the home is worth even a little more than the first mortgage, the second mortgage remains intact.

In some cases, Chapter 13 also allows mortgages on second homes and investment properties to be modified, but with some strict limitations.

Section 1322(b)(2) of the Bankruptcy Code says a Chapter 13 plan may modify any secured obligation other than one secured by a debtor's principal residence, notes Kilborn. "So most people think if there's a loan on an investment property or a second residence, you can modify it. But practically, you can't because of section 1322(b)(5)." Under that section, any debts covered by a Chapter 13 bankruptcy must be paid off within the term of the bankruptcy plan, which cannot exceed five years. "So unless the entire amount of the obligation can be paid off within the five-year term of the plan," he says, "you can't modify it."

The bankruptcy bills recently considered by Congress contained an exemption to the five-year repayment limit under section 1322(b)(5) that would allow modified residential home loans to be repaid over a much longer period of time.

THE CHAPTER 11 ALTERNATIVE

Another problem with chapter 13 is that it is available only if the debtor's unsecured debt is less than $336,900 and secured debt is less than $1,010,650. Chapter 13 thus is unavailable to people who took out large loans to purchase homes in particularly expensive areas.

"Here in LA, home prices were so high, many buyers can't file for Chapter 13," notes Peter A. Davidson, a partner at Ervin Cohen & Jessup in Beverly Hills.

Those people might instead file under Chapter 11, which also allows debtors to repay creditors over time. But filing under Chapter 11 can be prohibitively expensive for most people. "The debtor needs to do a lot of reporting, negotiate with creditors—sometimes a creditors' committee—and must pay for all the professionals employed by the creditors, including accountants and legal counsel," Davidson says.

Yet even Chapter 11 does not allow modifications on the first mortgage for a primary residence. Many experts assert there is a good reason why loans on primary residences—unlike other secured loans—may not be modified in bankruptcy.

"Homes are unique," says Alan Schwartz, a professor at Yale Law School and the School of Management in New Haven, Conn. "Congress deliberately created this ex- ception to boost home ownership. Congress found that if a bankruptcy court couldn't 'strip down' home loans, the interest rates for those loans would be lower."

But there is heated debate about what would happen to interest rates if Congress did allow mortgages to be stripped down in bankruptcy proceedings.

The Mortgage Bankers Association estimates that mortgage interest rates would jump at least 1.5 percent and predicts that lenders also would require larger down payments and impose higher closing fees to counterbalance the risk that bankruptcy courts would reduce the amounts that borrowers must pay on mortgages. The MBA—echoing chairman Kittle's testimony before the House Judiciary subcommittee—warns that those higher costs would push home ownership beyond the financial reach of millions of families.

Others disagree—in some cases, vehemently. “The MBA’s number is pure and demonstrable hokum,” says Adam J. Levitin, a professor at the Georgetown University Law Center in Washington, D.C. Levitin asserts that the MBA arrived at its 1.5 percent number by “cherry-picking” the data—comparing the interest rate for single-family principal residences, which may not be modified in bankruptcy, with the rate for investment properties, which technically may be modified in bankruptcy, even if it doesn’t often happen in practice.

But the MBA’s analysis does not consider loans on second homes, which also may be modified in bankruptcy, according to Levitin. The interest rates on these loans are the same as mortgage rates for residences. “This means,” Levitin says, “that the mortgage rate variation between single-family principal residences and investor properties is due to factors other than bankruptcy modification risk.”

Contentions by both sides of the issue should be taken with caution because the reference points for their analyses may not provide much evidence one way or the other. Both sides are comparing home loans, which can’t be modified in bankruptcy, to other mortgages that supposedly can be modified. In practice, however, these other loans hardly ever are modified.

“There is no serious current risk of strip-down on substantial mortgages on vacation homes or investment properties,” says Mark S. Scarberry, a professor who teaches bankruptcy law at Pepperdine University School of Law in Malibu, Calif. “I wouldn’t expect to see any risk premium for these homes, because there is no real risk.”

DEBATE OVER ECONOMICS 101

There was a time, not so long ago, when many bankruptcy courts did modify home loans. “When the 1978 Bankruptcy Code passed, it was not 100 percent clear if you could strip down home loans in bankruptcy,” says Alan M. White, an assistant professor at Valparaiso University School of Law in Indiana. “Some courts said you could, others said you couldn’t.”

The U.S. Supreme Court resolved the split in 1993, ruling in *Nobelman v. American Savings Bank* that bankruptcy law does not permit strip-downs of mortgages by bankruptcy courts.

Research by Levitin and others found that mortgage strip-downs prior to the Supreme Court’s *Nobelman* ruling did not have a significant impact on interest rates or loan costs. The study goes on to suggest there would be similarly little impact if Congress now permits bankruptcy courts to modify mortgage terms on principal residences.

Scarberry disagrees with that prediction, noting that pre-*Nobelman* strip-downs reduced a loan’s principal to the house’s current market value but did not decrease monthly mortgage payments. This enabled a homeowner to pay off the mortgage sooner or refinance the loan on better terms. That’s very different from the proposals recently before Congress, which would allow bankruptcy courts to modify the interest rate, term and principal on loan in order to reduce the monthly mortgage payment.

“Those who got strip-downs in the ’80s and ’90s were people who could afford to pay their mortgages,” says Scarberry. “Today’s proposal would be for people who can’t afford to pay their mortgages. So how can you draw conclusions about losses that will be suffered?”

Even without strong empirical evidence to bolster their arguments, experts on both sides of the issue are willing to debate on the basis of economic theory.

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Proponents of keeping the status quo in bankruptcy law maintain that there clearly will be a harmful effect if courts are allowed to modify mortgages on principal residences. “It seems to me that if you increase the risk on these loans,” Scarberry says, “it is Economics 101 that you will increase interest rates and tighten mortgage requirements for borrowers who cannot make large down payments.”

Proponents of changing bankruptcy law argue that economic theory cuts the other way. They claim that allowing home loans to be modified in bankruptcy would reduce lenders’ downside risk and help their bottom lines.

“Lenders lose 45 to 55 cents on the dollar in foreclosure,” Levitin says. “If a home loan can be modified and the lender gets 60 cents on the dollar, the lender will be doing better. So long as a lender’s losses in bankruptcy will be better than in foreclosure, the market won’t price against it.”

The ultimate arbiter, of course, will be Congress, where, at least for now, the issue may have moved to the back burner.

“All signs are this [proposal] is dead for at least the near future,” says Francis Creighton, vice president and chief lobbyist for the Mortgage Bankers Association. “Ultimately, this will go away only when the foreclosure rate goes back to a normal level.”

That may not be for a while. “The foreclosure crisis isn’t going away,” Ebert says. “We have a whole other wave of subprime and Alt-A loans [somewhat less risky than subprime loans] whose interest rates are going to be reset in the next two years.”

But even if continuing waves of foreclosures eventually push Congress to act, it will be too late to help Paul Vachon.

Perhaps he shouldn’t, but Vachon frequently drives past the house he used to own. “It feels tough when I do that,” he says. “It doesn’t seem like the bank is taking care of the house. The grass is growing all over. If I were there, my son and I would be taking good care of it.”

Multiple participants may listen via speakerphone, but each individual who wants CLE credit must register separately.

Coming in September: Don't Eat That! Legal Issues in Food Safety.

Steve Seidenberg is a lawyer and freelance journalist in Fanwood, N.J., who contributes regularly to the ABA Journal.

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