

Lenders Should be Wary of Proposed Changes in the Bankruptcy Law that are Designed to Cure the Home Loan Crisis



Recently, we have seen a dangerous turn in America's financial condition. Today's problems have roots in the early 2000s, when historically low interest rates and a government effort to increase opportunities to less-qualified borrowers created significant alternatives in the sub-prime home finance and equity loan markets. But the 2007-08 failure of the sub-prime industry and set off an economic chain reaction, which led to the "crash" of equity holdings and the severe tightening of commercial credit worldwide.

In October, Congress passed a \$700 billion bailout bill providing the Federal Reserve system with the authority to stimulate the credit crisis and bolster the equity markets. Simultaneously, the Senate Committee on the Judiciary published a report on *Helping Families Save Their Homes in The Bankruptcy Act of 2008* (Senate Bill 2136). Bill 2136 included provisions amending Chapter 13 Bankruptcy cases to allow individuals with regular income to modify the mortgages on their principal residences. Although the amendment to the Bankruptcy Code appeared in the early versions of the bailout bill, these revisions did not survive Congress' final version. Many believe that the bill will be reintroduced in the next Congress and spearheaded by the President-elect.

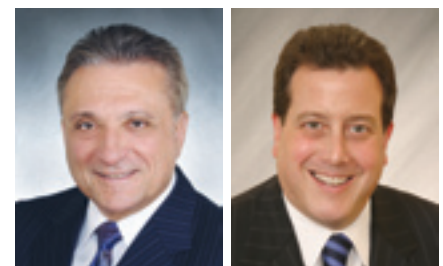
In 1978, Congress revised the Bankruptcy Code, offering reorganization as an alternative to individual debtors with regular income. Chapter 13 of the Bankruptcy Code allowed individual debtors to pledge a portion of their post-petition earnings to pay off their pre-petition liabilities rather than walk away from their obligations in a Chapter 7 liquidation, which provided creditors with no recovery. This provision allowed individual debtors, behind on mortgage payments, and facing foreclosure, to be able to "decelerate" a mortgage default, and pay the arrearage amount over the life of the Chapter 13 plan, presuming the debtor could continue to make the current mortgage payment post-petition in an attempt to keep the home.

The bill would have allowed individual debtors to modify the first mortgage securing the debtor's principal residence, if the debtor could verify that he had insufficient income to meet his customary expenses and that such insufficiency resulted in the inability of the debtor to cure pre-petition arrearages and maintain current payments under the first mortgage. The modification of the first mortgage includes the ability of the debtors to "strip down" the first mortgage on the principal residence to the residence's value at the time of the bankruptcy filing. If, for example, the first mortgage on a debtor's primary residence had a principal balance of \$300,000 and the value of the property on the date of the petition had fallen to

\$200,000, the Chapter 13 debtors would only be required to pay an amortized payment on a \$200,000 principal balance to the first mortgagee. The bill also required that the first mortgagee payment be extended up to 30 years from the petition date at an interest rate equal to the most recent annual yield on conventional mortgages plus some undefined "reasonable premium for risk."

If this bill is reintroduced, the crippled real estate finance industry will strenuously oppose such an amendment to Chapter 13 because it would raise interest rates on home mortgage loans. Additionally, the proposed changes to the Bankruptcy Code will have no provisions for first mortgagees who have been stripped of their lien interests in their primary residences from reestablishing their lien interests when the real estate market begins to rise again.

While there has been a dramatic downturn in the real estate market, the market will return. The real estate finance industry will be damaged by allowing modification of first mortgages on primary residences stripping down the first mortgagee's lien interests and allowing an eventual appreciation of the real property to revert to the debtors and not to the mortgagees. ↴



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