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Treatment of Unsecured Claims in Bankruptcy: An Emerging Disaster for Housing Finance

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Treatement of Undersecured Claims in Bankruptcy: An Emerging Disaster for Housing Finance

By Alvin C. Harrell

Bankruptcy and other federal courts around the country are moving to embrace a new interpretation of the Bankruptcy Code that dramatically alters the legal environment for home mortgage lending. The best known case, In re Houghland, is typical: It allows a mortgagor to file a Chapter 13 plan which effectively discharges home mortgage debt in excess of the current appraised valuation of the home, while retaining the home and reaffirming the mortgage terms as to the remaining loan balance. This results from a creative use of Bankruptcy Code section 506(a) to modify the apparent purpose of subsection 1322(b)(2) so as to deprive the home mortgagee of the protection seemingly provided by the latter provision. Courts seem to be embracing this view without full consideration of the obvious purpose of subsection 1322(b)(2) or the probable impact of these holdings on the availability of home mortgage financing. A similar case from the Third Circuit, Gagliad v. First Federal Savings & Loan Association, enabled a Chapter 7 debtor to utilize section 506 for the same purpose in a liquidation case. The basis of both Houghland and Gagliad is an application of section 506 that permits a trustee in bankruptcy to bifurcate the claim of a mortgage lender into secured and unsecured portions (clearly a correct and long-recognized proposition, standing alone), and then allows the debtor to reaffirm the secured portion in order to keep the collateral while discharging liability for the unsecured portion. In Houghland this required the court to alter the apparent purpose of a specific protective provision at Bankruptcy Code subsection 1322(b)(2).

Effectively this new interpretation changes home finance into a speculative gamble at the expense of mortgage lenders. If property values rise, the borrower can resell the property at a profit, pay off the loan, and pocket the difference. If property values decline, the mortgagor can unilaterally restructure the debt, keep the property, and impose the loss on the lender by discharging liability for the amount of the debt in excess of the depressed appraisal value. Then when real estate markets recover, the borrower can sell the property and keep the profit produced by any subsequent appreciation in value. Because there is no six year bar to successive Chapter 13 cases, this process can be repeated as often as desired during a downward market cycle, in order to assure that the debtor restructures the lender's claim at the lowest possible level.

With real estate values down as much as 75% in some areas, this is a compelling business strategy for almost any debtor. On a $100,000 – $200,000 home the nominal cost of a bankruptcy filing is small potatoes compared to the immediate and certain gain to be derived from use of the Houghland or Gagliad doctrines.

Of course, lenders always have assumed some of the downside risk, but for lenders in the past there was consolation in knowing that a debtor who wanted to discharge home mortgage debt in bankruptcy would have to give up his or her home in the process. This has been an important constraint on abuse of the system, as most borrowers traditionally have been hesitant to "walk away" from this important asset. Even if the borrower decided to "walk," the lender was assured of obtaining the collateral and had some hope of recovering at least part of the loss from an ultimate appreciation in property values.

The enactment of the new Chapter 13 in 1978 represented a major change in the relationship between consumer debtors and secured parties, permitting consumer debtors to restructure debts as businesses do in Chapter 11, but without the creditor safeguards built into a Chapter 11 case. Subsection 1322(b)(2) apparently was intended to protect home mortgage finance from the dangers presented by this change, as now illustrated by Houghland. The revisionist use of section 506 to override subsection 1322(b)(2) now deprives home mortgage lenders of any last ray of hope for recovery in a declining real estate market. Their claims will now be "forced out" at the bottom of each new market cycle, by law, with no hope of any subsequent recovery. The borrower, in turn, can have his cake and eat it too, often at virtually no cost and completely risk-free.

It is no answer to explain, as some courts have, that it is all the lender's fault anyway for lending so much money. For years home mortgage lenders have been pressured to offer liberal loan-to-value ratios, in order
to better serve their communities and to help deal with perceived affordability problems in real estate. A prudent lender can no longer do so after Houghland and its progeny, but even a 20% or 30% down payment requirement (which would price most buyers out of the market) would not be enough to protect lenders in some current real estate markets.

The adverse impact of this for mortgage lenders is compounded by another line of cases that has strictly construed the requirement in subsection 1322(b)(2) that the protected claim be "secured only by a security interest in real property that is the debtor's principal residence . . . ." Some courts have excluded from the protection of subsection 1322(b)(2) any mortgage with standard language encompassing fixtures or other items of personal property or even insurance proceeds, thereby depriving the home mortgage lender of any special protection whatsoever in Chapter 13.10

Perhaps the most egregious example in this line of cases is In re Klein,11 where Judge Scholl held that a standard provision in the mortgage covering plumbing and heating fixtures disqualified the mortgage from protection under subsection 1322(b)(2). This decision also held that the standard language covering "rents, issues, and profits" precludes protection under subsection 1322(b)(2). Most startling of all, the court held that a clause allowing the mortgagee to claim hazard insurance proceeds in the event of damage or destruction to the collateral "alone is enough to take the mortgage out of the realm of subsection 1322(b)(2)."12 Surely these cases frustrate the purpose of subsection 1322(b)(2). Several courts have moderated the impact of this trend by holding that a mortgagee's protection under subsection 1322(b)(2) is not lost unless the creditor's additional collateral actually exists and has value.13

With this new system of "heads the borrower wins, tails the lender loses," and with much of what remains of the thrift industry decimated after FIRREA, it is not clear who is going to want to fund home mortgage lending in this country. Surely lenders will recognize that the razor-thin interest rate margins and low down payment requirements that have been common since World War II15 (and have been viewed as essential to promote housing affordability) are not sufficient to compensate for these new risks. The result, perhaps, will be that only those with a very high net worth or surplus "disposable income"16 or a huge downpayment will be deemed creditworthy for purposes of mortgage lending, since the collateral alone may no longer serve as a primary basis for justifying the loan. If so, those who view Houghland as a panacea for mortgagees may have badly misjudged its consequences in terms of creating a new legal environment for home mortgage lending.

10. See, e.g., Wilson, 895 F.2d 112 (mortgage covering appliances, machinery, furniture, and equipment in addition to the debtor's residence was not protected by § 1322(b)(2)); In re Lewis, 875 F.2d 53 (11th Cir. 1989); In re Stiles, 74 B.R. 708 (Bankr. N.D. Ala. 1987) (mortgage not protected by § 1322(b)(2) because it was not a security interest in real property but instead in personal property).
12. See, e.g., 106 Bankr. at 400.
13. Id.

15. While some commercial lenders have faced the Houghland problem for many years in Chapter 11 cases, creditor's claims in Chapter 11 play a much greater role in formulating and approving the plan than do creditors in Chapter 13, and commercial loan interest rates are much higher than first mortgage home loan rates, is part due to this very risk. See, e.g., 11 U.S.C. § 1129(a). 16. Which can be secured by creditors in Chapter 13 pursuant to 11 U.S.C. § 1322(b) (1986).