Trying to Help Financially Troubled Homeowners

Gregg Matthews for The New York Times
By VIKAS BAJAJ and TARA SIEGEL BERNARD
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People seem to pass certain milestones on the road of financial desperation. First the unpaid bills pile up. Then the bank forecloses. Finally, they reach the end of the line: bankruptcy court.

It has been done before, on a relatively small scale and with some success. In the midst of the farm crisis during the 1980s, Congress gave bankruptcy judges the power to reduce onerous farm loans to reflect a steep drop in land prices.

The Obama administration and Congressional Democrats are pushing a similar idea to stem the swelling tide of home foreclosure. Yet a close look at the farm experience raises questions about how widespread any relief would be.

While the creation of a special bankruptcy workout for farmers, known as Chapter 12, helped resolve that earlier crisis, many farmers still lost their farms or had to scale them back, according to judges and lawyers who studied the effects.

If a similar allowance is provided today for Chapter 13 filings, which let homeowners keep their property while working out their debts, bankruptcy courts could help a few million homeowners. But millions more would still face foreclosure, especially if unemployment continued to rise. Credit Suisse, for example, estimates that about 20 percent of an expected eight million foreclosures could be avoided by letting judges alter the terms of home loans.

“We are making the best of a lousy situation,” said Joseph A. Peiffer, a bankruptcy lawyer in Cedar Rapids, Iowa, who has represented both farmers and lenders and favors giving bankruptcy courts power to modify home loans. But, he added, “there will still be people losing their homes.”

One of his clients, a farm family in eastern Iowa, sought Chapter 12 bankruptcy in late 1986. The family had borrowed when times were good to pay medical bills, but struggled to keep up with payments when interest rates jumped and crop prices fell. The day before the family filed its case, a lender seized half of its 350 cows. “It was sort of like a perfect storm of bad things,” Mr. Peiffer said.

The bankruptcy court eventually wrote down about 40 percent of the family’s $1.5 million debt, and today, they are still farming, according to Mr. Peiffer.

That type of resolution may help troubled homeowners avoid foreclosure, advocates say. Having a bankruptcy judge change loan terms can solve disputes that bankers and borrowers might be unable to tackle on their own, they say. And some loans could become more profitable for banks in bankruptcy than in foreclosure, where losses can be 50 percent or higher after legal and home repair costs, according to Rod Dubitsky, a Credit Suisse analyst.

Perhaps more important, a bankruptcy judge can also cut through a thicket of legal complications for mortgages packaged into securities and sold to investors, which some banks say they have no authority to modify. Some investors have threatened to sue banks if those mortgages are altered.

But the banking industry fiercely opposes the proposal to amend bankruptcy law. Officials warn that they would have to raise the price of credit to offset the cost of having to wait years to see whether borrowers successfully pay off modified loans — or slide back into default. Only a third to 40 percent of Chapter 13 personal bankruptcy filings are successful, experts say, often because people lose jobs again, become sick or get divorced.

Foreclosure might bring them less, but banks and investors would get some money right away if they seized homes.

In Chapter 12, judges could change interest rates and reduce, or “cram down,” debts secured by farmland, which suffered a boom-bust cycle in the 1970s and 1980s. The amount written down was added to other unsecured debts, like credit card balances, which are repaid cents on the dollar from money left over after living expenses and secured debt payments. Congress made Chapter 12 a permanent part of the Bankruptcy Code in 2005.

Neil E. Harl, an agriculture and economics professor at Iowa State University, found that 85 percent of the first 150 farmers in Iowa who filed bankruptcy under Chapter 12 were still farming in 1995.

But many farmers who encountered distress did not seek bankruptcy protection: from 1986 to 1997, farmers filed 19,216 Chapter 12 cases, according to the Agriculture Department — less than 1 percent of the two million family farms that existed in 1995. “As soon as everybody knew it was there,” Mr. Harl said about cram-downs, “they did the next best thing, which is to sit down and negotiate.”

Nonetheless, bankers say that Chapter 12 resulted in higher interest rates, as lenders passed on the costs of bankruptcy. The Agriculture Department estimated in 1997 that rates on farm loans increased by 0.25 of a percentage point to 1 percentage point as a result of the law.

The Financial Services Roundtable, an industry lobbying group, calculates that cram-downs may increase the cost of mortgages by up to 2 percentage points either through higher rates or bigger down payments. The restrictions on cram-downs “keeps the cost of homes low, and this bill will unravel that,” said Scott E. Talbott, its chief lobbyist.

But other experts say such estimates are inflated. Adam J. Levitin, an associate professor of law at Georgetown University who favors changing the law, said rates may only rise by 0.15 of a percentage point.

Lawmakers and lobbyists in Washington are deeply divided on cram-downs. The opposition includes Senator Charles E. Grassley, Republican of Iowa, who helped create Chapter 12. Banks, with the exception of Citigroup, have vowed to fight cram-downs, though some lobbyists have been pushing for amendments that would limit them to certain loans and would let lenders recoup losses if home prices rebound.

The Obama administration and Democrats, including Senator Richard J. Durbin of Illinois, hope to pass the measure either on its own or as part of another bill.

The measure is eagerly awaited by households like the Benitez family in Palm Coast, Fla., which hopes bankruptcy will help them keep their three-bedroom house.

Rosa Benitez, a real estate agent, and her husband, Carlos, who works in construction, have been unable to pay their mortgage since payments on their adjustable rate loan shot up in early 2008. At the same time, given the housing crash, they are making a lot less money.

“Everything started going down when the mortgage payments went up,” Ms. Benitez said. The couple owes $227,000 on their mortgage and $31,000 on a home equity line of credit, but their home is worth only $175,000. Ms. Benitez said the couple could catch up if their debt was reduced to the current value of the home.

Still, the couple, like many others, is vulnerable to falling behind again as home prices decline further. But Robert M. Lawless, a law professor at the University of Illinois who favors cram-downs, said success should not be viewed simply “in terms of dollars and cents.”

“We forget the human side of the bankruptcy case,” he said. “Sometimes bankruptcy is about the soft landing.”