Bankruptcy and Loan Modifications: Hype or Help?

You may have heard commercials from attorneys and loan modification gurus offering loan modification services through bankruptcy. They are probably referring to proposed legislation called the Helping Families Save Their Homes in Bankruptcy Act. Beware of the hype, because this has not become law and may change significantly before it becomes law, assuming it becomes law at all.

How Current Bankruptcy Laws Impact Mortgages

Under current bankruptcy laws, debtors who qualify can file a Chapter 13 repayment plan bankruptcy proposing to strip unsecured liens, other than a first mortgage, from their home. Lien stripping is available if a second mortgage is completely unsecured (i.e. the fair market value of the home is less than the balance on the first mortgage). The following example may illustrate the point better:

Example: In 2000, husband and wife purchase a home for $500,000 with 100% financing, including a $400,000 balance on their first mortgage (30-year fixed rate at 6%) and $100,000 on a second mortgage (adjustable rate mortgage). in 2008, the home value has dropped to $350,000 and the formerly happy homeowners now have $50,000 in credit card debt because their mortgage payments are now beyond their ability to pay. In a Chapter 13 bankruptcy, the debtors have the capability of completely removing the second mortgage and treating it as unsecured. However, current bankruptcy laws do not allow any type of modification to the first mortgage.

What Will The Proposed Legislation Do?

A common frustration that I hear from potential clients is that they cannot get their lender to modify their mortgages to a more reasonable payment or interest rate. With falling home values and spiraling mortgage payments, adjustable rate mortgages are a common cause of home foreclosures. The Helping Families Save Their Homes in Bankruptcy Act makes the following proposals:

- Eliminating a provision of the bankruptcy law that prohibits modifications of first mortgages;
- Changing the Chapter 13 debt limitations to allow more debtors to qualify for a Chapter 13 repayment and lien stripping plan;
- Permitting bankruptcy judges to modify variable interest rates with a new interest rate that will keep the mortgage affordable while allowing creditors to get a fair return on their investment;
- Make filing bankruptcy easier by waiving the pre-bankruptcy credit counseling requirement for families facing imminent foreclosure; and
- Requiring lenders to give proper notice when assessing fees and allowing judges to waive prepayment penalties.

When Will These Proposals Become Law?

It is too early to tell if the proposals will even become law, let alone what the final law may look like. Supporters and lobbyists are lining up on both sides to have their say and there are 2 different versions pending, one before the Senate and one before House of Representatives. For now, the best advice is to ignore the hype and remain watchful. In the meant time, contact a qualified bankruptcy attorney if you are facing foreclosure or need other debt relief assistance.

About the Author: *Carl H. Starrett II has been a licensed attorney since 1993 and is a member in good standing with the California State Bar and the San Diego County Bar Association. Mr. Starrett practices in the areas of bankruptcy, business litigation, construction, corporate planning and debt collection.*