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BUSINESS VIEW

Soaring foreclosures tied to bankruptcy reform

Mortgage foreclosures soared in 2006. Massachusetts was up 299 percent, second only to Alabama, where foreclosures leapt 466 percent in the same 12 months. These events have been widely reported and explained. Wages are stagnant or declining. Savings are inadequate. Risky mortgages are common. Prominently absent from this "usual suspect" lists is last year's revision of federal bankruptcy law. These changes are affecting the real estate markets, and their impact may prove profound.

Last year saw the most complete revision of bankruptcy law since the Bankruptcy Code in 1978. The amendments were largely pressed by one interest group and were drafted by its lobbyists. The altered statute requires more forms to be filled out and filed according to varying deadlines, it strips judges of much discretion and requires entry and exit counseling — without which the consumer is back out into the cold. The case is dismissed and foreclosure is back on track.

FREDERIC DELANO GRANT JR.

The modern era of "easy" bankruptcy, if it ever existed, is over. A new era of "easy" foreclosure has begun. With access to bankruptcy restricted, homeowners in financial trouble are left to the old ways of state law. That process was described by a Boston writer in 1837. Property "stuck to its holders, till the sheriff obligingly negotiated for them." The seeds sewn as "reform" in 2005 are sprouting as foreclosure signs in 2007.

Modern bankruptcy was created to avoid the foreclosure of entire railroad systems, a catastrophic loss for communities, labor, creditors, and debtors. It operated to conserve value. In recent years, it has helped head off the foreclosure of vast numbers of residential and commercial properties by giving debtors a chance to stabilize financially or prepare for orderly sale. The rules helped maintain the markets themselves by avoiding distress sales. Modern bankruptcy may be compared to the circuit breaker and market volatility rules of the stock markets, which control or arrest liquidation during periods of market decline. It has protected value by avoiding foreclosure. It is not by pure coincidence that the great postwar increase in American real estate value took place under the sheltered regime of the Bankruptcy Code of 1978.

We are in a period of real estate market decline and abundant foreclosure. It is hard enough to get a good price in a declining market, and harder still when nearby property is in foreclosure. This coincidence is testing the effect of the bankruptcy revisions on the real estate markets. The foreclosure surge is affecting and may weaken those markets. It remains to be seen whether its impact will be confined to market categories, or whether soaring foreclosure comes to affect the markets generally, as happened in 1837.

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SOARING FORECLOSURES AND "BANKRUPTCY REFORM"

Mortgage foreclosures soared in 2006. Massachusetts was up 299%, second only to the State of Alabama, where foreclosures leapt 466% in the same twelve months.[1] California foreclosures are running 68% ahead of 2005 numbers.[2] In Georgia, foreclosures are up 99%.[3] Residential foreclosures in Denver, Colorado are said to be the worst on record.[4] These are striking increases, even by the standard of the real estate market plunge of the late 1980's.

These events have been widely reported. Familiar explanations are generally offered. Real wages are stagnant or declining. Household savings are inadequate for financial emergency. Risky "creative" mortgage devices are common (interest only, adjustable rate, no documentation, etc.). We are experiencing a historically normal down cycle in the real estate markets. Notably absent from these lists of "usual suspects" is last year's revision of the federal bankruptcy laws. These changes are affecting and will continue to affect the real estate markets. Their impact may prove profound.

Last year saw the most complete revision of bankruptcy law since the Bankruptcy Code in 1978. The amendments were largely pressed by one interest group, consumer creditors, and were drafted by its lobbyists. The altered statute requires many more forms to be filled out, and many more papers to be filed, all according to a host of varying deadlines, it strips bankruptcy judges of much discretion, and requires entry and exit counseling -- without which the consumer is shot back out into the cold. The case is dismissed and the foreclosure is back on track, sometimes quickly indeed. The 2005 "reform" was intended to reduce the number and duration of bankruptcy cases. That has happened.

The modern era of "easy" bankruptcy, if it ever existed, is over. In its place, a new era of "easy" or less impeded foreclosure is dawning. With access to bankruptcy restricted, homeowners in financial trouble are left to the old ways of state law. That process was described by a Boston writer in 1837 (when there was no federal bankruptcy law). Property "stuck to its holders, till the sheriff obligingly negotiated for them."[5] The seeds sewn as "reform" in 2005 are sprouting on front lawns as foreclosure signs in 2006.

Modern federal bankruptcy was born to avoid the foreclosure sale of entire railroad systems, a catastrophic loss for communities, labor, creditors, and debtors. It has operated to conserve value. In recent years, it has helped avoid

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[1] ForeclosuresMass.com statistics, as reported in the Boston Globe, December 13, 2006. http://www.boston.com/business/articles/2006/12/13/foreclosure_activity_surges_in_mass/

[2] Foreclosures.com statistics, as reported in the Central Valley Business Times, December 11, 2006. http://www.centralvalleybusinesstimes.com/stories/001/?ID=3787

[3] RealtyTrac statistics, as reported in the Atlanta Journal-Constitution, December 6, 2006. http://www.ajc.com/business/content/business/stories/2006/12/05/1206bizforeclose.html

[4] Public records, as reported by TheDenverChannel.com (ABC Channel 7 News), December 5, 2006. http://www.thedenverchannel.com/news/10465322/detail.html

[5] Anonymous, The Pressure and its Causes: Being the Old Fashioned Notions of an Old Fashioned Man, page 29 (2d ed., Boston: Otis, Broaders & Co., 1837 (at the Massachusetts Historical Society, Boston).

the foreclosure of vast numbers of residential and commercial properties, by giving debtors a chance to stabilize financially or catch up on payments or providing for an orderly sale of the property. These federal rules, by slowing or avoiding distress sales, have helped to maintain the markets themselves. Modern bankruptcy may be compared to the circuit breaker and market volatility rules of the stock markets, which control or arrest liquidation during periods of market decline. The modern bankruptcy system protected value by avoiding foreclosures. It is not entirely coincidental that the great postwar increase in American real estate value took place under the sheltered regime of the federal Bankruptcy Code of 1978.

We are in a period of real estate market decline and abundant foreclosure. The coincidence is a matter of concern. It is a challenge to get a good price for a house in a declining market. It is far harder to do so when nearby property is in foreclosure. This coincidence is testing the effect of the 2005 bankruptcy changes on the real estate markets. The current surge of foreclosure is affecting and may weaken those markets. It remains to be seen whether the material impacts will be confined to local markets or price categories, or whether soaring foreclosure comes to affect the markets generally, as happened in 1837.

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