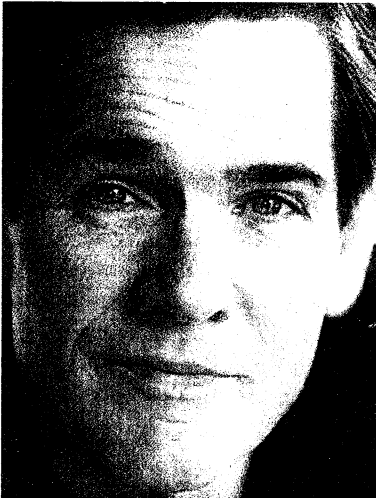


## Foreclosures, Bankruptcy, and the Subprime Crisis

By Lawrence A. Young, Heather Heath McIntyre, and Pascal Arteaga



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### I. Introduction

The credit crisis that began in 2007<sup>1</sup> has changed the environment in which both



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Before joining HWA, Pascal served as an intern with the law firm of Bustamante & Bustamante in Quito, Ecuador, and with the Office of the Attorney General of the State of Texas in the Consumer Protection Division. Prior to attending law school, Pascal worked for three years as a secondary market analyst for Aames Financial Corp. in Los Angeles, California, and as a senior financial analyst at e.spirit Communications, Inc. in Washington, D.C. Pascal is part of a team that counsels clients in banking and real estate matters. As a part of his practice, he represents clients in leasing, financing, collections, and foreclosures of consumer and commercial debts.

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1. See, e.g., Alvin C. Harrell, Commentary, *The Subprime Lending Crisis—the Perfect Credit Storm?*, 61 Consumer Fin. L.Q. Rep. 626 (2007).

mortgage-related lawsuits in bankruptcy and counterclaims to foreclosures are brought. A large number of homeowners are in or at risk of foreclosure, by reason of an inability or unwillingness to make their loan payments, *e.g.*, due to resets of interest rates on adjustable-rate mortgage loans, excessive borrowing, unemployment, inflated appraisals and mortgage fraud, the crash in housing prices, or just unwise borrowing and spending decisions during the 1993–2006 housing and credit bubble (a failing shared by many in the investment and financial communities). Many homeowners are simply “walking away” from their homes because the value has dropped so far below the balance owed on the mortgage loan. Persons in or facing foreclosure may resort to bankruptcy as a temporary solution.

## II. Hot Issues in Bankruptcy

### A. Restrictions and Limitations on Fees and Charges Incurred Pre- and Post-Petition in Bankruptcy

Attorney’s fees and costs and various post-petition fees, such as property inspection fees, are receiving greater judicial scrutiny across the country. Lenders expect their attorneys to recover the agreed-to flat fees for the handling of routine matters. However, many bankruptcy courts now insist upon greater detailed time records to justify the lender’s or servicer’s attorneys’ fees in a particular case.<sup>2</sup>

Because the borrower’s liability for attorneys’ fees is premised on the servicer having incurred those fees, courts are generally unwilling to consider evidence demonstrating the average cost for such motions, but instead require records of the actual time spent on that particular case. Furthermore, the allowed flat-rate method utilized in the industry often does not comport with the lodestar method utilized by the courts to deter-

mine attorneys’ fees. Under the lodestar method, the attorney must provide detailed records evidencing the amount of time the attorney worked on the matter.<sup>3</sup>

For example, *In re Ezzell*,<sup>4</sup> Bankruptcy Judge Marvin Isgur in the Southern District of Texas, reiterating his previous opinion in *In re Padilla*,<sup>5</sup> found that a court has a duty to evaluate an application for an award of fees.<sup>6</sup> In *In re Ezzell*, the court denied an application for \$200 in post-petition fees filed by the creditor’s attorneys.<sup>7</sup>

First, the *Ezzell* court noted that the attorneys did not qualify as direct applicants because they did not fall under the categories in Bankruptcy Code section 503(b)(4).<sup>8</sup> Section 503(b)(4) provides:

After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including —

(4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph (A), (B), (C), (D), or (E) of paragraph (3) of this subsection,<sup>9</sup> based on the time, the nature, the extent, and the value of such

services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant;<sup>10</sup>

Second, assuming the application was in substance an application from the creditor for fees, the application did not allege that the promissory note permitted the recovery of fees.<sup>11</sup> Third, the application did not allege that the fees were actually paid, which was a precondition to recovery in the note.<sup>12</sup> Finally, the *Ezzell* court noted that the application did not comply with the procedural requirements of Bankruptcy Rule 2016(a): service on the United States Trustee and “[a] statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case.”<sup>13</sup>

This decision, holding that fee applications and Rule 2016(b) disclosures are now required for fees the parties agree to pre-petition and that are described in loan documents, essentially requires servicers and lenders to forfeit their rights because the cost of complying exceeds the fees themselves in many, if not most, cases.

In *Padilla*, the bankruptcy court was asked whether lenders must seek court approval before charging or collecting post-petition reimbursable expenses, *e.g.*, legal fees, inspection costs, and other expenses to protect a security interest in the debtor’s property.<sup>14</sup> The *Padillas*’ Chapter 13 plan stated that the debtors would pay arrearage payments separately

2. Weslwy Kozeny & Garry McCubbin, *Be Ready for Greater Judicial Scrutiny of Fees and Costs*, *Servicing Mgmt.*, at 56-57 (Feb. 2006).

3. *Id.*

4. *In re Ezzell*, No. 07-34780 (Bankr. S.D. Tex. Jan. 14, 2008).

5. *Padilla v. Wells Fargo Home Mortgage, Inc.* (*In re Padilla*), 379 B.R. 643, 651 (Bankr. S.D. Tex. 2007).

6. *Ezzell*, No. 07-34780, slip op. at 3.

7. *Id.* at 6.

8. *Id.* at 3. Section numbers herein reference the U.S. Bankruptcy Code, 11 U.S.C. \_\_\_\_, unless otherwise noted.

9. 11 U.S.C. § 503(b)(3)(A)–(E) describes such compensation as:

(A) a creditor that files a petition under section 303 of this title;

(B) a creditor that recovers, after the court’s approval, for the benefit of the estate any property transferred or concealed by the debtor;

(C) a creditor in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor;

(D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee ap-  
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9. (Continued from previous column)

pointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title;

(E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian;

10. 11 U.S.C. § 503(b)(4).

11. *Ezzell*, No. 07-34780, at 3.

12. *Id.*

13. *Id.* at 5.

14. *Padilla*, 379 B.R. at 651.

