



HOUSE BILL 3
OHIO HOUSE HOUSING & URBAN REVITALIZATION COMMITTEE
INTERESTED PARTY TESTIMONY
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Executive Summary

This testimony is offered on behalf of the Buckeye Institute's 1851 Center for Constitutional Law, a public interest law firm dedicated to defending Ohioans from regulations with widespread, deleterious effects. House Bill 3, as currently constituted, is such a regulation, and if signed into law in its current form, the 1851 Center is likely to initiate legal action challenging the constitutionality of its loan modification provisions.

House Bill 3 authorizes Ohio judges to rewrite existing mortgage agreements; and *appears* to even authorize the Ohio Department of Commerce to “implement a comprehensive loan modification program.”

Specifically, Section 2308.04 of the bill empowers Common Pleas judges to reduce the principal amount and/or interest rate of the loan. Meanwhile, Section 1223.34(B) empowers the Department of Commerce to (1) reduce the interest rate on a home loan; (2) extend the period over which a homeowner may repay a home loan; (3) defer the amount of principal due on a home loan; (4) reduce the principal due on a home loan; and (5) utilize “other factors that the director determines are appropriate.”ⁱ

Although the sponsors of this bill have expressed the intent to rescue homeowners who are currently in foreclosure or risk thereof,ⁱⁱ it is clearly unconstitutional to interfere with existing mortgage agreements in Ohio. As such, any provision authorizing Common Pleas judges or the Ohio Department of Commerce to modify existing mortgage contracts will be stricken from HB 3 upon legal challenge. This will not only negate assistance for current homeowners, but it will leave the statute applying only to prospective mortgage contracts.

As applied to these prospective mortgages, House Bill 3, as currently written, would clearly raise interest rates for prospective homeowners, thus harming more Ohioans than it would help, and enhancing the likelihood of increased delinquencies.

I. House Bill 3 contravenes traditional principles of contract law and policy.

Mortgages are written contracts containing binding obligations on both the lender and the homeowner. House Bill 3, as currently constituted, would welcome borrowers to nullify their obligations to lenders.

As the Ohio Supreme Court has explained, “[c]ontracts and compacts have been entered into between men, tribes, and nations during all time from the earliest dawn of history; and the right and liberty of contract is one of the inalienable rights of man, fully secured and protected by our constitution...”ⁱⁱⁱ Consequently, “one of the most valuable and sacred rights is the right to make *and enforce* contracts.”^{iv}

The freedom to contract means little if the obligations contracted for are not enforced. As one Ohio court recently observed “The right to contract freely with the expectation that the contract shall endure according to its terms is as fundamental to our society as the right to speak without restraint.”^v

Ohio judges have never possessed the awesome power to rewrite contracts. The Ohio Supreme Court recently acknowledged as much, stating that “[t]he law prohibits courts from rewriting contracts when the words of a contract are unambiguous,” and that “it is not the responsibility or function of this court to rewrite the parties’ contract in order to provide for a more equitable result.”^{vi}

Consequently, the modification provisions of HB 3 seek to (1) transgress traditional principles of contract law; and (2) supply Ohio’s judiciary with powers that it has never before had.

II. Ohio’s Contracts Clause prohibits application of House Bill 3 to current mortgages.

The Ohio Constitution. Whether the federal Constitution’s Contracts Clause prohibits judges and bureaucrats from modifying existing mortgage agreements is largely immaterial, since Ohio’s Contracts Clause is directly applicable, and *more* protective of contractual rights and obligations.

Section 28, Article II of the Ohio Constitution states, in pertinent part, as follows: “The general assembly shall have no power to pass retroactive laws, or laws impairing the obligation of contracts * * *.” The retroactivity clause “prohibits the legislature from passing new laws that

reach back and create new burdens, new duties, new obligations, or new liabilities not existing at the time [the contract was made].”^{vii}

Notably, courts and scholars concur that “[t]he prohibition against retroactive laws is broader than the prohibition in [the federal Contracts Clause].”^{viii} This is in part because the delegates to the 1851 Ohio Constitutional Convention expressly rejected an amendment that would have amended this section by substituting the phrase ‘ex post facto,’ the narrow term used in the federal constitution, for the broader term, ‘retroactive.’^{ix}

The prohibition against laws that “impair the obligations of contracts” is deeply rooted in Ohio history, extending all of the way back to the Northwest Ordinance.^x Since at least 1875, the Ohio Supreme Court has stressed that, pursuant to this clause, “any change in the law which impairs the rights of either party, or amounts to a denial or obstruction of the rights accruing by contract, is repugnant to the Constitution.”^{xi}

Thus, any reliance on the 1934 United States Supreme Court case of *Home Building & Loan Ass’n v. Blaisdell*, or other federal precedent, for the conclusion that the modification provisions in House Bill 3 are constitutionally permissible, is misplaced: while *Blaisdell* was decided under the federal Contracts Clause, the Ohio Contracts Clause is more protective of contractual rights.

Modification of existing mortgage agreements. Representatives Foley and Driehaus have explicitly stated that their intention behind this bill is to protect homeowners who are in danger of foreclosure due to their current mortgage agreements.^{xii} However, the loan modification provisions in House Bill 3 will not achieve this end because they are unconstitutional as applied to already-existing mortgage agreements.

Ohio Courts have always held that “Section 28, Article II, of the Ohio Constitution prohibits laws impairing *existing* contractual obligations.”^{xiii} In the 1998 case of *Ross v. Farmer’s Insurance Group*, the Ohio Supreme Court has outlined the strict limitations on the legislature’s capacity to pass legislation that alters existing contracts.^{xiv} The Court explained that “‘Section 28, Article II * * * prohibiting the passage of retroactive laws, has application to all laws affecting substantive rights.’”^{xv}

Applicable precedent demonstrates that House Bill 3 implicates “substantive rights.” In 1986, the Ohio Supreme Court specifically ruled that *the alteration of the terms of a contract related to real property impact “substantive rights.”*^{xvi} In that case, *Kiser v. Coleman*, the Court concluded that “*the retroactive application of R.C. 5313.07 and 5313.08 to land installment contracts which were in existence at the time of the enactment of these statutes is violative of Section 28, Article II of the Ohio Constitution which prohibits the enactment of retroactive laws or laws impairing the obligation of contracts.*”^{xvii}

Consequently, any retroactive application of House Bill 3 to existing mortgage agreements will violate Ohio’s Contract Clause.

Using the Judicial Branch to circumvent the Contracts Clause. There may be a belief that, since the Ohio Contracts Clause is only binding on the legislature, and since House Bill 3 seeks to lend the power to modify existing mortgage agreements to the judiciary, rather than modifying such mortgage agreements *per se*, the modification provisions are constitutional.^{xviii} Such a view would be mistaken.

In considering this distinction between judicial and legislative action, the United States Supreme Court concludes that, in cases where a contract-impairing statute has been passed subsequent to the making of the contract, “it is the statute as enforced by the state through its courts which impairs the contract, not the judgment of the court.”^{xix}

Consequently, the effects of the Ohio Contracts Clause are not cured, and House Bill 3 is not constitutional, merely because it uses judicial action, rather than legislative action, as the vehicle to modify existing mortgage agreements.

III. The specter of mortgage modification will harm Ohioans by raising interest rates on Ohio homeowners subject to future mortgage agreements.

Some may believe that House Bill 3 is, notwithstanding its transgression of Ohio’s Contracts Clause, a valid exercise of the Legislature’s police power. However, House Bill 3 does not survive the threshold criteria of bearing “a real and substantial relation” to “the general welfare” because it will raise the costs of housing for far more Ohioans than it will help.

House Bill 3, as currently constituted, will cause interest rates to increase on all future home loans in Ohio. Interest rates charged by mortgage lenders are a function of (1) the lender’s inflationary expectations; (2) the value of alternative investments available to the lender; (3) the “risk premium;” and (4) the “liquidity premium.”^{xx} The “risk premium” reflects the amount that a lender charges to compensate itself for the losses accompanying a default on the loan, and the “liquidity premium” reflects the perceived difficulty of converting an asset into money and thus into goods.^{xxi}

Given the above, higher liquidity premiums and risk premiums will result in higher interest rates on Ohio home loans. As the Mortgage Bankers Association has aptly explained:

If [judges] are allowed to independently change the terms of a signed mortgage contract, lenders will face new uncertainty as to the value of collateral – the home. To account for the new risk, lenders will be forced to require higher down payments, higher costs at closing, and higher interest rates, pushing the dream of homeownership beyond the reach of millions. * * * *Rates will certainly have to rise to offset the anticipated losses.* * * * The lender will have to absorb the increased risk, which it will ultimately pass on to the consumers in the form of higher prices or more restrictive lending terms.^{xxii}

Bankruptcy Scholar Todd Zywicki has also succinctly explained this concept, noting:

If judges can rewrite mortgage loans after they are made, it will increase the risk of mortgage lending at the time they are made. *Increased risk increases the*

overall cost of lending, which in turn will require future borrowers to pay higher interest rates and upfront costs, such as higher down payments and points.^{xxiii}

Through observing similar phenomena in the auto loan industry, Mr. Zywicki demonstrates that the risk of judges rewriting mortgage agreements clearly raises interest rates for borrowers. He cites to a Federal Reserve report which concludes that that in 2005 bankruptcy reforms that eliminated the power of bankruptcy judges to modify auto loans reduced the cost of such loans by an average of 265 basis-points.^{xxiv} Conversely, it can be expected that permitting judges to modify home loans will increase the cost of such loans.

The Mortgage Bankers Association concurs. It concluded that permitting judges to alter the terms of residential mortgages in bankruptcy would increase interest rates on Ohio home loans by approximately 1.5 percent. It has further concluded that, in Ohio, where the average loan amount is \$118,376, permitting judges to alter mortgage terms, and the attendant 1.5 percent increase in rates on home loans, will increase the average homeowner's mortgage payments by \$118, or \$1,416 per year.^{xxv}

If anything, this estimate is likely on the conservative side, because it contemplated that modification of mortgage agreements would occur only in bankruptcy proceedings. While many are deterred from petitioning for bankruptcy because it destroys the filer's credit rating, and may result in the loss of personal property, no similar deterrents exist, under House Bill 3, to prevent a homeowner from merely abstaining from paying his mortgage, to effectuate a foreclosure, and then renegotiating the terms of their mortgages.

Consequently, any legislation that permits the modification of mortgage agreements will drive up interest rates that must be paid by homeowners. As the costs of homeownership rise, so does the foreclosure rate. Thus House Bill 3 may ultimately cause more foreclosures than it prevents.

IV. House Bill 3, as currently constituted, encourages homeowners to “game the system.”

Proposed Sec. 2308.04(A)(1) lends judges the discretion to “reduce the principal amount of the loan being foreclosed * * * in consideration of *the appraised value of the property.*” This approach ignores the basic reality that housing prices fluctuate. As such, the aforesaid provision will encourage homeowners to use the law to lower their payments, even though they may later sell their house for an amount higher than today's appraised value.

Nothing in R.C. 2308.04(A)(1), as currently constituted, prevents a homeowner from deliberately refraining from making his mortgage payments, so as to cause the bank to file a foreclosure action. At that time, under the aforementioned Section, the homeowner may obtain an appraisal, and the judge may rely on that appraisal in reducing the principal or interest rate on the property. However, there is no account for the possibility that the homeowner will obtain a reduction in principal or interest based upon a current appraisal, only to then turn around and sell the property at a significantly higher value many years later, after the housing market has recovered.

As an example, House Bill 3, as currently written, would allow a homeowner who paid \$200,000 for a property that is now appraised at \$100,000, obtain a judicial order cutting his payments in half, only to later sell the property at \$200,000 when the housing market improves.

One who views such gamesmanship as unlikely would do well to observe the automobile loan markets prior to the 2005 bankruptcy reforms. A Federal Reserve of New York Staff Report explains: “[o]ne could buy a new car on credit then file bankruptcy immediately afterward and have his obligation crammed-down to the current ‘used’ car price. New cars depreciate rapidly, so strategic filers could buy a good new car for the price of a bad ‘used’ car.”^{xxvi} The Federal Reserve found that doing away with this opportunity for gamesmanship “made auto credit cheaper,” and also “increased auto credit supply.”^{xxvii} Presumably, permitting this type of gamesmanship with housing credit will make housing credit more expensive.

Consequently, it would be unwise to include loan modification provisions in any foreclosure legislation. If such provisions must be included, they should limit the opportunity for gamesmanship.

V. Any legislation should address the fundamental causes of the high rate of foreclosures in Ohio, rather than the symptoms of those foreclosures’ frequency.

Federal Reserve Chairman Ben Bernanke has observed that “mortgage delinquencies are tied to local economic conditions; notably, several Midwestern states struggling with job losses and slow economic growth have seen increased delinquencies.”^{xxviii} This statement is bolstered by Federal Reserve research identifying the four primary variables that are predictive of foreclosure as (1) median home price appreciation; (2) the unemployment rate; (3) real per capita income; and (4) real per capita income growth.^{xxix}

Thus economic growth is the quintessential mechanism for decreasing mortgage delinquencies. Contract enforcement, in turn, is crucially important for economic development.^{xxx} Indeed, in his review of the causes of economic growth, Nobel Prize winning economist Douglass North identifies the lack of means for enforcing contracts as the single most important source of economic stagnation and underdevelopment.^{xxxi}

Ohio recently ranked 38th in an index of economic freedom amongst the 50 states.^{xxxii} If House Bill 3 is written so as to eviscerate existing contractual rights, it will signal to businesses across the nation that their investments are not safe in Ohio, and will thereby result in an economic climate that only renders foreclosures, by Chairman Bernanke’s stated criteria, all the more likely. Consequently, the General Assembly would better prevent foreclosures by pursuing pro-growth policies that increase incomes and employment.

ⁱ Although not chronicled in greater detail, this last “other factors” power would appear to be both unconstitutionally vague as applied to the due process interests of lenders, and an unconstitutionally broad delegation of policy-making, legislative functions to an unaccountable administrative agency.

ⁱⁱ In his March 4, 2009 Sponsor Testimony, State Representative Mark Foley stated “[t]his comprehensive piece of legislation is aimed at providing much needed assistance to homeowners attempting to save their homes during this economic

crisis...” In her March 4, 2009 Sponsor Testimony, State Representative Denise Driehaus stated “[w]e have to make necessary changes...to ensure that we do everything within our power to give homeowners a chance to stay in their homes...”

iii *Palmer v. Tingle* (1896), 55 Ohio St. 423, 36 W.L.B. 315, 45 N.E. 313.

iv *Palmer v. Tingle* (1896), 55 Ohio St. 423, 36 W.L.B. 315, 45 N.E. 313.

v *Mark-It Place Foods, Inc. v. New Plan Excel Realty Trust*, 156 Ohio App. 3d 65, 2004 -Ohio- 411, 804 N.E.2d 979 (4th Dist. Scioto County 2004), citing *Blount v. Smith* (1967), 12 Ohio St.2d 41, 231 N.E.2d 301. See also *J.F. v. D.B.* (2007), 116 Ohio St.3d 363, 879 N.E.2d 740 (“If the parties understand their contract rights, requiring them to honor the contract they entered into is manifestly right and just.”).

vi *Foster Wheeler Enviresponse, Inc. v. Franklin Co. Convention Facilities Auth.* (1997), 78 Ohio St.3d 353, 361-362, 678 N.E.2d 519; See also *Mansfield* at 545, citing *Werner v. Cincinnati Ins. Co.* (1991), 77 Ohio App.3d 232, 235, 601 N.E.2d 573 (“[t]he court should not interpret the words beyond their plain meaning or rewrite the contract if there is no ambiguity in the language of the contract itself.”)

vii *Miller v. Hixson* (1901).

viii Steinglass and Scarselli, *The Ohio State Constitution, a Reference Guide*, p. 148.

ix Id.

x Id.

xi *Goodale v. Fennell* (1875), 27 Ohio St. 426.

xii In his March 4, 2009 Sponsor Testimony, State Representative Mark Foley stated “[t]his comprehensive piece of legislation is aimed at providing much needed assistance to homeowners attempting to save their homes during this economic crisis...” In her March 4, 2009 Sponsor Testimony, State Representative Denise Driehaus stated “[w]e have to make necessary changes...to ensure that we do everything within our power to give homeowners a chance to stay in their homes...”

xiii See, e.g., *State ex rel. Youngstown v. Jones* (1939), 136 Ohio St. 130, 136, 16 O.O. 73, 24 N.E.2d 442 (the General Assembly had power to enact an amended section and repeal the prior law, but in doing so could not interfere with vested rights or impair the obligations of existing contracts in violation of Section 28, Article II of the state constitution); *Goodale, supra* (“when the contract is once made, the law then in force defines the duties and rights of the parties under it. Any change that impairs the rights of either party, or amounts to a denial or obstruction of the rights accruing by a contract, is obnoxious to [Section 28, Article II of the Ohio Constitution]”).

xiv *Ross v. Farmer’s Insurance* (1998) 82 Ohio St.3d 281, 695 N.E.2d 732, 1998 -Ohio- 381. See also *Aetna Life Ins. Co. v. Schilling* (1993), 67 Ohio St.3d 164, 616 N.E.2d 893, syllabus, that a statutory provision applied to contracts that were entered into before the effective date of the statute would impair the obligation of contracts in violation of Section 28, Article II of the Ohio Constitution. See also *Burtner-Morgan-Stephens Co. v. Wilson* (1992), 63 Ohio St.3d 257, 586 N.E.2d 1062 (holding that, pursuant to Section 28, Article II of the Ohio Constitution, a statute could not be retroactively applied to determine the distribution of royalties that were provided for in an agreement entered into prior to the enactment of the statute); and *Kiser v. Coleman* (1986), 28 Ohio St.3d 259, 28 OBR 337, 503 N.E.2d 753 (holding that the retroactive application of statutory provisions to land installment contracts that were in existence at the time of the enactment of the statutes violated Section 28, Article II of the Ohio Constitution by impairing an obligation of contract).

xv *French v. Dwiggins* (1984), 9 Ohio St.3d 32, 33, 458 N.E.2d 827.

xvi See *Kiser v. Coleman* (1986), 28 Ohio St.3d 259, 503 N.E.2d 753, 28 O.B.R. 337 (holding that “ a state statute impacts substantive rights where “[u]pon payment of twenty percent of the purchase price or payments extending over five years, the defaulting vendee has been effectively granted an equity of redemption in the property,” and further where “the statutes would

destroy the vested rights of appellants to foreclosure according to the terms of their contract upon default and without judicial process.”).

xvii Id.

xxiii Such a belief would likely be founded in reliance on the declaration, in *Tidal Oil Co. v. Flanagan* (1924), 263 U.S. 444, 44 S. Ct. 197, that “the provision of * * * the federal Constitution, protecting the obligation of contracts against state action, is directed only against impairment by legislation and not by judgments of courts.”

xix *Tidal Oil Co. v. Flanagan* (1924), 263 U.S. 444, 44 S. Ct. 197, citing Other cases cited are *Louisiana v. Pilsbury*, 105 U. S. 278, 26 L. Ed. 1090, and *453 *Muhlker v. New York & Harlem R. R. Co.*, 197 U. S. 544, 25 Sup. Ct. 522, 49 L. Ed. 872,

xx Sidney Homer, Richard Eugene Sylla, Richard Sylla (1996). *A History of Interest Rates*. Rutgers University Press. pp. 509.

xxi Sidney Homer, Richard Eugene Sylla, Richard Sylla (1996). *A History of Interest Rates*. Rutgers University Press. pp. 509.

xxii January 29, 2008 testimony of David G. Kittle, Chairmen of the Mortgage Bankers Association, before the House Judiciary Committee’s Subcommittee on Commercial and Administrative Law.

xxiii Todd J. Zywicki, *Don’t Let Judges Tear up Mortgage Contracts*. Electron copy available at <http://online.wsj.com/article/SB123449016984380499.html>

xxiv Id.

xxv Mortgage Bankers Association, Bankruptcy Cram Down Resource Center.

xxvi Donald Morgan, Benjamin Iverson, and Matthew Botsch, Federal Reserve Bank of New York Staff Reports, Staff Report No. 358 (February, 2009) *Seismic Effects of the Bankruptcy Reform*.

xxvii Id.

xxviii Federal Reserve Chairman Ben S. Bernanke, at the National Community Reinvestment Coalition Annual Meeting, Washington, D.C. , March 14, 2008.

xxix *Seismic Effects of the Bankruptcy Reform*, supra.

xxx Richard E. Messick, Public Sector Group, World Bank, *What Governments Can Do to Facilitate the Enforcement of Contracts*. <http://siteresources.worldbank.org/INTLAWJUSTINST/Resources/ContractEnforcementCairo.pdf>

xxxi Id.

xxxii William P. Ruger, Jason Sorens, Freedom in the 50 States, an Index of Personal and Academic Freedom. Mercatus Center, George Mason University (February, 2009).