Bankruptcy Cramdown And Its Impact On Private-Label RMBS

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Several bills have been recently introduced in Congress (collectively, the “Bankruptcy Legislation”) that would amend the U.S. Bankruptcy Code to, among other things, give bankruptcy judges in Chapter 13 cases the power to modify terms of certain mortgages secured by principal residences, including forcing principal reductions. This practice is known as “cram down” because it forces the mortgage holder to accept terms as modified by the bankruptcy judge. Under current bankruptcy rules, a judge has cram down power with respect to a debtor’s loans secured by second homes and certain other assets, but not principal residences. Although other attempts in Congress to pass similar legislation in the past year have failed, it appears that momentum is gaining in Washington for some form of cram down legislation to be passed in the near-term.

Considerable impetus to the passage of legislation was given by Citigroup’s announcement of its considerable impetus to the passage of legislation, including those involving principal forgiveness, rather than risk a more severe principal writedown in a bankruptcy proceeding.

This article examines the impact that enactment of the Bankruptcy Legislation would have on private label (non-GNMA and non-agency) securitizations of residential mortgage loans and investors in securities (“RMBS”) issued in such securitizations.

Proposed Changes to the Bankruptcy Code

The proposed legislation would allow individuals with higher debts to have access to Chapter 13 proceedings. To be eligible for filing under Chapter 13, an individual must have a regular income and unsecured debts of less than $336,900 and secured debts of less than $1,010,650. The Bankruptcy Legislation would exclude from computation of unsecured debts of less than $1,010,650. The Bankruptcy Legislation’s supporters hope that it will spur modification efforts by making securitization investors more amenable to the servicer implementing systematic pre-bankruptcy modifications, including those involving principal forgiveness, rather than risk a more severe principal writedown in a bankruptcy proceeding.

For adjustable-rate mortgages, prohibit, reduce or delay the interest rate adjustment. This could be used to prevent a very low introductory “teaser” rate from adjusting, in effect fixing such teaser rate for the life of the loan.

Reduce the interest rate to a fixed rate equal to the recent annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, plus a reasonable premium for risk.

The proposed legislation would provide bankruptcy judges in Chapter 13 proceedings with power to modify terms of mortgages originated before the enactment of the Bankruptcy Legislation and secured by principal residences (including mortgage loans secured by subordinate interests in such residences) as follows:

Reduce the principal amount of the mortgage loan secured by the principal residence to the value of such residence. The principal reduction would become an unsecured claim that would be paid consistent with the provisions of the debtor’s confirmed Chapter 13 plan.

For adjustable-rate mortgages, prohibit, reduce or delay the interest rate adjustment. This could be used to prevent a very low introductory “teaser” rate from adjusting, in effect fixing such teaser rate for the life of the loan.

Extend the mortgage loan term up to the longer of (i) 40 years (less period loan has been outstanding) and (ii) the remaining loan term.

A bankruptcy judge may not effect any such modifications unless:

1. the debtor has received prior to the bankruptcy filing, notice that a foreclosure proceeding may be commenced (thereby preventing a borrower who is current on his mortgage loan from taking advantage of these modification provisions);
2. the debtor makes certain certifications regarding
its attempt to request a modification from the servicer within a specified period prior to the bankruptcy filing; and
3. the court finds that:
such modification is in good faith, and the
debtor did not obtain the mortgage loan by
misrepresentation, false pretenses or actual
fraud. The proposed legislation would also allow
for the waiver of any prepayment penalty on a
mortgage loan secured by the debtor’s principal
residence regardless of whether the first two
conditions are met.

In addition, the bill recently approved by the
House Judiciary Committee provides that if the
principal balance was reduced by the bankruptcy
court, the mortgage holder, under certain
circumstances, will share in any appreciation of
the residence that is sold by the debtor during the
period prior to receiving a discharge under
Chapter 13. If the residence is sold in the first
year following the effective date of the plan, debtor
can pay the mortgage holder from the net sale
proceeds 80% of the difference between the sales
price and the amount of the mortgage holder’s
claim (plus costs of sale and improvements), not to
exceed the allowed secured claim calculated had
the bankruptcy court not reduced the principal
balance. The applicable percentages are 60%, 40%,
and 20% if the residence is sold in the second year,
third year and fourth year, respectively, following
the effective date of the plan.

The claim of a mortgage holder will be
disallowed if such claim is subject to a rescission
remedy due to violations of the Truth in Lending
Act, regardless of whether a foreclosure judgment
has been previously entered.

Impact of Bankruptcy Legislation on Private-Label RMBS

The effect of a reduction of the principal balance
or interest rate of a mortgage loan by a bankruptcy
court on an investor in a RMBS transaction will be
determined by the specific terms of the related
securitization documents and whether the
transaction utilizes the “shifting interest” structure

(used by virtually all of the prime and much of the
Alt-A market) or the overcollateralization structure
(used by virtually all of the subprime and a portion of the Alt-A market). In general, principal
losses resulting from a bankruptcy cram
down will be allocated to the most subordinated
class of securities in “shifting interest” transactions
or first to the overcollateralization and then the
subordinated certificates, if any, followed by a
monoline insurance policy, if any, in
overcollateralized transactions. However, in certain
“shifting interest” transactions, bankruptcy losses
in excess of a specified “excess bankruptcy loss
amount” will generally be allocated pro rata among
class of senior certificates and subordinated
certificates. The excess bankruptcy loss amounts,
which were established by the rating agencies, vary
from transaction to transaction based on the
volume of second, vacation and non-owner
occupied homes in the pool, which have always
been subject to cram down risk, but did not take into
account the possibility of cram down on
mortgage loans secured by principal residences.
These excess bankruptcy loss amounts can be as
low as $100,000.

The potential surge in Chapter 13 bankruptcy
filings that may result from passage of the
Bankruptcy Legislation raises the previously
unanticipated consequence that principal losses,
which may be significant, will be realized by
many more highly rated subordinated classes
in shifting interest transactions that incorporate an
“excess bankruptcy loss” feature. This may in turn
result in ratings downgrades and further erosion of
security prices. Further, the downgrade or
allocation of principal losses to those classes may
cause them to be considered “other than
temporarily impaired” for accounting purposes,
resulting in writedowns of securities classified as
“held to maturity” or “available for sale” and capital
charges to financial institution holders.

Regardless of how principal losses are allocated
to the related certificates, a question of timing arises.
Does the loss arise at the time that the secured
amount of the mortgage loan is reduced to the value
of the property or only when the unsecured excess,
to which the lender is entitled ratably with other
creditors, is discharged upon performance by the
debtor of his payment plan? This may depend on
how the related securitization agreements address
this matter and the extent to which it is clearly
specified in final Bankruptcy Legislation whether a
cram down is permanent or subject to reinstatement
if the debtor defaults on the payment plan. In the
event that the loss is not allocated in full at the time
of the cram down, additional interest shortfalls or
losses could be created as interest accrues on the
cramped-down principal amount, which interest,
even if advanced, would ultimately not be collected
from the borrower.

With respect to interest reductions resulting
from a modification of the mortgage terms by a
bankruptcy court, most commonly these
reductions would result in (i) shortfalls to the
most subordinate classes in a transaction where all
or most of the classes of certificates have fixed rates
or (ii) a lower interest rate payable to certificates
that have interest rates payable based on the
weighted average net mortgage rate of the loans in
the transaction. However, many variations exist
and reference must be made to the terms of the
specific securitization documents.

First lien mortgage loans secured by principal
residences with loan-to-value ratios in excess of
80% at origination generally have the benefit of
private mortgage insurance (“PMI”), covering a
portion of the loss incurred upon foreclosure.
However, the existence of private mortgage
insurance will not necessarily protect RMBS
investors against principal cram downs
effected by bankruptcy judges. The typical PMI policy
does not require the insurer to pay for losses
resulting from a principal reduction by a
bankruptcy judge at the time such cram down
occurs. The insurer will only be obligated to cover
the principal reduction if the borrower
subsequently defaults on his modified mortgage
loan. Accordingly, if the borrower pays off the
modified mortgage loan (including by way of sale
of the property), the insurer will not be obligated
to cover the losses resulting from the principal
cram down. ■

Notes
1. 11 U.S.C. 1129(a)(11) to be added by the Bankruptcy
Legislation.
2. A debtor filing under Chapter 13 of the Bankruptcy Code would
have the ability to adjust her debts pursuant to a plan without having
her assets liquidated. A debtor under Chapter 7 of the Bankruptcy
Code would have her assets liquidated and debts discharged.
3. On January 27, 2009, the House Judiciary Committee approved
(H.R. 200) Helping Families Save Their Homes in Bankruptcy Act of
2009, which limits the legislation’s applicability to mortgages in
existence at the time the legislation is enacted.
4. New Section 1322(b)(11) to be added by the Bankruptcy
Legislation.
5. As currently drafted, if a debtor were to fail to make payments in
accordance with the terms of the Chapter 13 plan the case is
dismissed, the terms of the mortgage could revert back to the original
modified terms. The National Conference of Bankruptcy Judges
submitted a letter to the sponsors of the legislation detailing certain
ambiguities with the text of the legislation. One such ambiguity
concerned whether it was the intent of Congress to have the cram
down modification be permanent, regardless of the debtor's
performance under the payment plan. Language was suggested that
could make the modification permanent (notwithstanding the
debtor's failure to make payments in accordance with the plan) if
Congress so intends.
6. The substitute version of (H.R. 200) Helping Families Save Their
Homes in Bankruptcy Act of 2009, approved by the House Judiciary
Committee on January 27, 2009, amends this fixed rate to equal the
currently applicable average prime offer rate corresponding to the
applicable repayment term, as published by the Federal Financial
Institutions Examination Council, plus a reasonable premium for
risk.
7. The proposed legislation does not define “reasonable premium for
risk.”
8. New Section 1325(a)(11) to be added by Bankruptcy Legislation.
9. New Section 1325(a)(11) to be added by revised House bill
recently approved by the House Judiciary Committee.
10. New Section 1322(c)(5) to be added by the Bankruptcy Legislation.
11. New Section 1322(g) to be added by the House bill.
12. New Section 522(b)(10) to be added by the bill approved by the
House Judiciary Committee on January 27, 2009. In the original
version of the Bankruptcy Legislation, claims would also be
disallowed for violations that resulted in a remedy of damages (in
addition to rescission) and would be triggered by violations of other
State or Federal consumer protection laws.