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Clients&FriendsMemo

New Bankruptcy Cram Down and Foreclosure Prevention Legislation Introduced

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Introduction

This week, Representative John Conyers introduced the "Helping Families Save Their Homes Act of 2009" (H.R. 1106) (the "**Act**"), which has been circulated in advance of a vote by the House of Representatives anticipated as early as today. Additional amendments have been offered to the bill, but it is unclear which, if any, will be incorporated into the final text. It is not expected that the Senate will consider its version of the bill until mid-March.

The Act expands upon the "Helping Families Save Their Homes in Bankruptcy Act of 2009", which was introduced by Representative Conyers earlier this year. Both bills would amend the Bankruptcy Code to enable bankruptcy judges in Chapter 13 proceedings to modify the terms of (i.e. "cram down") mortgages secured by principal residences. Current bankruptcy law prohibits modification of mortgages secured by principal residences. For a discussion of the proposed cram down legislation set forth in the prior bill and its potential impact on private-label residential mortgage-backed securities, see *Bankruptcy Cramdown and its Impact on Private-Label RMBS*.[1]

The Act replaces the prior bill and new provisions have been added in furtherance of the goal of preventing and mitigating foreclosures as well as ensuring credit availability. This memorandum summarizes certain of the new provisions added by the Act.

Changes Related to Proposed Bankruptcy Cram Down Legislation

- Unenforceability of Certain Bankruptcy Loss Allocation Provisions in Securitization Agreements. The Act would render unenforceable, as contrary to public policy, provisions in contracts governing securitizations that require bankruptcy losses exceeding a certain dollar

[1] *Total ASF 2009*, February 10, 2009, Lisa J. Pauquette, Frank Polverino and Jordan M. Schwartz. See http://www.cwt.com/assets/article/021009PauquettePolverinoSchwartzTotalASF.pdf.

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amount on residential mortgages, often referred to as "excess losses," to be borne by classes of certificates on a *pro rata* basis if such losses could not have been incurred under the bankruptcy law in effect at the time the securitization contract was entered into. However, the *pro rata* allocation of "excess" bankruptcy losses that could have been incurred under the bankruptcy law in effect at the time the securitization contract was entered into (i.e., bankruptcy-related losses on non-owner occupied mortgage loans), will continue to be enforceable.

Enactment of this provision would appear to provide protection to investors in AAA-rated residential mortgage-backed securities backed by jumbo prime or Alt-A mortgage loans where the securitization included the excess loss feature. While the Act does not expressly state how excess bankruptcy losses should be allocated among security holders where *pro rata* loss share provisions are rendered unenforceable, the result will likely be that all bankruptcy losses would be allocated in the same manner that other non-"excess" type losses would be allocated, which is typically to the most subordinate securities first.

- **Determination of Value of Allowed Secured Claim is Clarified.** Under the Act, bankruptcy courts would be given the power, with respect to mortgage loans secured by principal residences, to bifurcate a lender's claim with respect to its mortgage loan into two claims: (i) an allowed secured claim equal to the "value" of the collateral and (ii) an unsecured claim in the amount of the difference between the outstanding loan balance and the "value" of the collateral. It was not clear from the language of the prior bill how or as of what date "value" would be determined. The Act provides some clarification on this point. It specifies that, for purposes of determining the lender's allowed secured claim, the value of the borrower's principal residence will be the fair market value of the mortgaged property on the date such value is determined. However, the Act does not clarify as of what date the value should be determined (e.g., the date of filing, or the date of confirmation of the plan).

- **FHA, VA and RHS Authorized to Guarantee and/or Insure Mortgage Loans Modified in Bankruptcy.** To ameliorate the concern that cram down losses with respect to loans securitized in the Ginnie Mae program would be borne by the related issuer/servicer, the Act authorizes the Federal Housing Administration ("**FHA**"), Department of Veterans Affairs ("**VA**") and Rural Housing Service ("**RHS**") to pay insured or guaranteed losses resulting from modifications of mortgage loans on primary residences in bankruptcy proceedings (including where the borrower does not re-default), based on the original unmodified claim amount.

Servicer Safe Harbor for Mortgage Loan Modifications

Supporters of the bankruptcy legislation do not necessarily want to encourage every troubled borrower to file for bankruptcy, which would overwhelm the bankruptcy courts with a significant increase in new filings. Instead, supporters hope the legislation will encourage modification efforts by making owners of troubled mortgage loans (including 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.

While the threat of cram down under the bankruptcy legislation could be helpful in increasing pre-bankruptcy modifications, some securitization governing documents prohibit all or certain types of modifications or place quantitative limits on the number of modifications. Further, even where the servicer has clear authority to modify loans, the servicer may generally do so only if the modification is in the best interest of investors. Given the limited history of large scale modifications, there is not, as yet, a clearly evolved consensus by market participants about what type of modifications are in the best interests of investors. This lack of consensus may inhibit the willingness of a servicer to pursue modifications resulting in significant payment and/or principal reductions for fear of certain classes of investors suing the servicer. To address such concerns, the Act includes a safe harbor for servicers, a form of which was previously introduced by Representative Barney Frank earlier in this year in H.R. 384.

The Act provides that notwithstanding any servicing contract (including a securitization contract), if a mortgage to be modified (which modification must be initiated prior to January 1, 2012) meets the servicer safe harbor criteria (set forth below), a servicer will not be:

- limited (i) in its ability to modify mortgages, (ii) the number of mortgages that can be modified, (iii) the frequency of loan modifications or (iv) the range of permissible modifications; or
- obligated to repurchase loans from, or make payments to, securitization vehicles on account of a modification, workout or other loss mitigation plan meeting the servicer safe harbor criteria.

A loan meets the servicer safe harbor criteria if:

- the loan is in default or default is reasonably foreseeable;
- the mortgaged property is occupied by the borrower; and
- the servicer reasonably and in good faith believes that recovery of principal under the loss mitigation plan, modification or workout will exceed, on a net present value basis, recoveries of principal through foreclosure.

Servicers that modify loans meeting the servicer safe harbor criteria will not be liable to:

- owners of (i) whole residential mortgage loans or (ii) interests in a pool of residential mortgage loans (including securities backed by such loans);
- persons obligated by derivatives contracts to make payments in reference to those loans or interests therein; or
- insurers of those loans or interests therein.

Changes to Hope For Homeowners

The Act includes modifications to the Hope for Homeowners Program that are intended to encourage (i) borrowers to participate by reducing fees and (ii) servicers to engage in modifications by providing incentives. Among other changes, the Act:

- reduces the initial up-front insurance premium payable by the borrower from 3% to 2% or less;
- reduces the annual insurance premium payment payable by the borrower from 1.5% to 1% or less;
- allows FHA to pay $1,000 per loan to servicers of loans that are successfully refinanced into the FHA program;
- allows FHA to share, upon sale of the mortgaged property, up to 50% of any price appreciation with the borrower, up to the appraised value of the mortgaged property at the time the mortgage being refinanced was made (previously FHA was entitled to such amounts);
- allows FHA to share its 50% of price appreciation with the mortgage holder to induce loan writedowns;
- imposes a "ban on millionaires", which prohibits borrowers with a net worth exceeding $1 million from participating in the program; and
- eliminates and softens certain of the certifications required to be provided by borrowers.

Permanent Increase in FDIC and NCU Insurance

The Act provides for Federal Deposit Insurance Corporation ("**FDIC**") and National Credit Union ("**NCU**") insurance to be permanently increased from $100,000 to $250,000 per depositor or member, as applicable, per financial institution. The FDIC's credit line with the Treasury would be increased to $100 billion and the NCU's credit line with the Treasury would be increased to $6 billion.

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