



Real Home Mortgage Relief

Overcoming Legal Barriers to Helping Homeowners and Stabilizing the Financial System

By Michael S. Barr and James Feldman

There is bipartisan agreement today that stemming foreclosures and restructuring troubled mortgages would slow the downward spiral harming financial institutions and the real American economy.

Treasury has unprecedented powers. The Hope for Homeowners bill enacted last summer allows the Federal Housing Administration to refinance troubled mortgage loans. The Emergency Economic Stabilization Act allows Treasury to buy up troubled mortgages and refinance them with a federal guarantee. Fannie Mae and Freddie Mac are under conservatorship, and the Federal Deposit Insurance Corporation is serving as receiver of failed banks with broad authority to address risk to the system. If Treasury Secretary Henry Paulson can nationalize much of the housing finance system and even large swathes of banking in America, why can Treasury not slow the tide of foreclosures?

What has been missing is a way to get servicers, who control these loans on behalf of mortgage-backed securities investors, to restructure the loans themselves or sell the loans to the Treasury at a discount, so the loans can be refinanced.

To date, Treasury's efforts have failed. Owing a duty to countless investors with conflicting interests, servicers are paralyzed by fear of liability, restrictive tax and accounting rules, and the wrong financial incentives. What's more, the contracts typically bar servicers from selling underlying mortgage loans out of loan pools. Instead, servicers are foreclosing at alarming rates, dragging down our economy with them.

Since September of last year, the Center for American Progress has been arguing for a modern-day Home Owners Loan Corporation, which helped American homeowners out of the Great Depression. To work today, servicers need to sell the mortgage loans out of the securitized pool, so the loans can be restructured. Here is how our plan would work:

Servicers managing pools of loans for investors are generally barred by contract from selling the underlying mortgage loans, but the trust agreements also provide that servicers must amend the agreements if doing so would be helpful or necessary to stay in compliance with tax rules under the Real Estate Mortgage Investment Conduit, or REMIC, statute. We propose modifying the REMIC rules to ensure that servicers have the authority and incentive to sell the mortgages to Treasury.

Specifically, we would provide that contract provisions that have the effect of barring servicers from selling or restructuring loans under Treasury’s programs are not consistent with REMIC. Servicers would then have a legal obligation to their investors to modify the agreements to stay in compliance. We also would urge the accounting standards board to make necessary changes to accounting rules for this limited public purpose. Servicers could then sell loans to Treasury for restructuring. Participation in the Treasury program would remain voluntary, but the key legal impediments to participation would be removed. Servicers could also be indemnified in certain circumstances.

Further details on legal barriers to loan modifications and sales

The problem underlying the current financial crisis is troubled mortgages. To date, efforts have failed to encourage servicers, who administer large pools of mortgages held in trusts, to restructure troubled mortgages at sustainable levels. Such restructuring or modification would keep current owners in their homes and avoid the costs that unnecessary foreclosure causes for everyone—homeowners, holders of mortgages, and the community at large. To “unlock” these trusts and permit restructuring of sustainable mortgages, a way must be found to encourage the servicers to sell mortgages out of the trusts under the aegis of a government program, which would provide credit enhancements and resell the restructured, now-sustainable mortgages into the market. Currently, the contracts governing mortgage pools frequently restrict the servicer’s ability to sell mortgages, and, beyond that, servicers fear legal liability to unhappy investors if they sell mortgages out of the pool—even where the sale is at a price that would maximize the value of the mortgage for the pool as a whole. The Center for American Progress’ SAFE plan provides a legal mechanism through which servicers would be authorized to sell home mortgage loans out of pools—without abrogating existing contracts and without imposing major new costs on taxpayers.

1. The Emergency Economic Stabilization Act of 2008 includes provisions encouraging modification of troubled mortgages to increase their net present value and avoid foreclosure, and such modifications have benefits for the homeowner, the holder of the mortgage, and the community.

Modifications of troubled mortgages—i.e., reduction in interest rate, write down of principal, term extension, or other changes in a mortgage that make it easier to pay—are frequently in the interest of both of the homeowner and the holder of the mortgage. There

are many cases in which a reduction of interest or principal on a mortgage, for example, could enable a homeowner to pay the newly modified mortgage on time, thus avoiding foreclosure. Such a modification could maximize the net present value of the mortgage and make that value higher than if the mortgage went into default. The result is a benefit to the homeowner (who avoids foreclosure), to the mortgage holder (who gets a greater payback than if the loan went to foreclosure), and the community (which avoids the costs of foreclosure, including lower property values).

The Emergency Economic Stabilization Act of 2008 encourages such economically beneficial modification of mortgage loans. Section 109(a) requires the secretary to use his authority to encourage servicers of mortgages to take advantage of the HOPE for Homeowners Program and similar programs to minimize foreclosures. Section 109(a) also permits the secretary to “use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.” Section 109(b) similarly requires the secretary to coordinate with other federal actors “to identify opportunities for the acquisition of classes of troubled assets that will improve the ability of the Secretary to improve the loan modification and restructuring process.” Section 109(c) requires the secretary to consent, where appropriate, to “loss mitigation measures, including term extensions, rate reductions, principal writedowns, increases in the proportion of loans within a trust or other structure allowed to be modified, or removal of other limitation on modifications.” Section 110 similarly contains provisions that require federal property managers to encourage servicers to modify mortgages.

2. While EESA provides authority to the secretary, it does nothing to address the legal and other impediments to servicers selling or modifying mortgages that are part of a pool or trust.

When a federal agency or a servicer itself holds the complete interest in a mortgage, the federal agency can act under the EESA provisions to encourage modifications of troubled mortgages that would increase their value and avoid foreclosure. But when the mortgage is part of a pool of mortgages held in a trust, such modifications of troubled mortgages may be impossible. Initially, the servicer of the trust may have a fee structure that gives the servicer little financial incentive to agree to a modification. Some servicers may make a *higher* return when loans are delinquent, because the servicers may benefit from late fees, and because prepayments on delinquent mortgages (which tend to lower the servicer’s total fees) are rare.

In addition, there can be legal impediments that keep servicers from modifying mortgages. The trust documents themselves may forbid the servicer of the trust from making modifications, except for mortgages that are on the verge of foreclosure. And the servicers may have a fear of suits by some investors if they modify mortgages. Investors in the various tranches in a mortgage pool ordinarily have differing bases for receiving their return on

their investment. They may receive their return based on the pool's interest-and-principal payments, on principal payment only, on interest payments only, on prepayment fees only, etc. The tranches also vary in terms of priority—i.e., which tranches get paid first when less than full payments on the mortgages are received. Given this wide variety of types of interests in the pool, modifying a mortgage could alter the relation of principal and interest and have other uneven effects on the various interests. It could therefore benefit some investors and harm others. Servicers may fear that, if they permit modifications, investors who claimed that the modifications harmed their particular interests would sue the servicers—even if it were clear that the trust as a whole benefited from avoiding foreclosure.

One way out of the problem would be to institute a plan for purchasing troubled mortgages from a pool (or even the entire pool), modifying the purchased mortgages if such modification would enhance their net present value (as compared to foreclosure), and reselling them. That would allow the homeowners with the modified mortgages to stay in their homes. It would maximize the net present value of the mortgages. And servicers would have an incentive to participate in such sales. Ordinarily, servicers must make advances to the investors in certain circumstances and incur other expenses, to be reimbursed when there is sufficient cash in the pool. Because sales of mortgages bring extra cash into the pool, servicers, who seek reimbursement for their advances and other expenses, can be expected to want such sales, even under circumstances when they would otherwise lack sufficient incentives to modify loans held in trusts.

Selling troubled mortgages that can be sustainably modified should thus be attractive to investors as a group, homeowners, and servicers. But, just as the contracts governing the pool may limit the extent to which servicers may modify mortgages in a pool, those contracts may also limit the extent to which servicers may sell mortgages in a pool. That is because, as above, if mortgages are sold out of the pool, there would be winners and losers among the investors.

For example, selling mortgages—even troubled mortgages—may benefit some investors. An investor in a senior interest-and-principal tranche would likely welcome such a sale, because the investor would get much of his investment back immediately—a valuable return of cash in the current environment. But others, such as an investor with an interest-only investment in the pool, would lose out. Once the mortgages are sold, the interest-only investor would get nothing further from those mortgages. By comparison, if the mortgages remained in the pool (or, in a large-scale sale, if the pool continued to exist), even with high rates of default and foreclosure, the interest-only investor would get some return from the mortgages over a period of time. Because investors would be affected differently by a sale of mortgages, the contracts governing the mortgage pools frequently severely restrict the servicer's ability to sell mortgages from the pool—even where such sales would both maximize the net present value of the mortgages and help the homeowner stay in his home.

3. Legislation that directly eliminated the legal impediments could face serious constitutional challenges and subject the government to liability.

While the EESA attempts to encourage sound modifications of mortgages, it offers no solution to the problem caused by these legal and practical impediments preventing mortgage modifications. One potential solution would be to enact legislation that simply invalidates provisions in mortgage pool documents that preclude the sale of mortgages. The difficulty with such a solution is that the contractual restrictions on sale or modification are lawful private contractual rights possessed by classes of investors (such as the interest-only investor in the above example) who would be disadvantaged. The interest-only investor would have a substantial claim that a law that simply invalidated that protection would be an unconstitutional taking of property without just compensation—whether conceptualized as a taking of the investor’s entire interest-only interest in the pool, or a taking of the investor’s contractual right not to have the loans in the pool modified or sold absent specified circumstances. The interest-only investor (as well as other “losers” among the owners of interests in the pool) could sue the government for a regulatory taking, and, depending on the circumstances, could have a substantial claim. To put this another way, the investors who lost out when the mortgages were sold—especially the investors in relatively junior tranches—may have taken many risks. But they did not take the risk that their investment would be wiped out by a sale or modification of the mortgages outside the conditions for such sale and modification in the pool documents. If legislation simply eliminated the restriction on sales of mortgages, the disadvantaged investors could well have substantial claims under the Takings Clause of the Fifth Amendment.

Other potential legislative solutions would face the same difficulties. Congress could simply preclude investors from bringing Takings claims of this sort, or it could immunize the secretary or the relevant government agency from suit. But such legislation would itself face serious constitutional challenge, since it would in effect abrogate the Fifth Amendment’s Takings Clause for this category of claims. The government could also purchase the servicing rights to pools of loans and become the servicer itself. But the government would then be bound by the same contractual limitations that bound the original servicer. If, in violation of the contractual documents, the government modified or sold the mortgages, the investors that lost out would be able to sue the government for a breach of contract. Finally, the government could offer to indemnify servicers who sell mortgages in connection with a government program from suits by unhappy investors. But such an indemnification provision (without other changes to the tax laws we discuss below) would have few advantages, because it would just transfer the liability from the servicer to the government.

The core of the problem here is that it does not make any difference whether the pool as whole is benefited by the sale of the mortgages—whether the net present value of selling or modifying the loans would be greater or lesser than leaving them alone and permitting them to go into serious default or foreclosure. As long as there are some investors who have interests in the pool that would suffer substantially if the mortgages in the pool were

sold, and as long as those investors have contractual provisions in their PSAs forbidding sales of mortgages from the pool, they may well have legal claims if the government by legislation overrode their contractual protections.

4. Altering the REMIC rules would remove the major legal impediments, without abrogating existing contracts and with little likely legal risk to the government.

There is an effective solution to the problem, however, that would permit the sale and modification of troubled mortgages so as to increase their net present value, to the general benefit of both homeowners (who would avoid foreclosure and retain their homes) and investors as a whole (who would get the maximum return for their investment by avoiding foreclosure). Such a solution would rely on changing the rules for Real Estate Mortgage Investment Conduits, or REMICs.

It is generally essential that mortgage pools be structured as REMICs, so that taxes are paid only by the investor, rather than by the investor and the pool itself. Because REMIC status is so important, the contracts governing mortgage pools frequently include a rule providing that the servicer may amend the contract as necessary in order to retain REMIC status. If the REMIC rules change, the servicers can be expected to amend the contracts to retain REMIC status.

The problem of legal impediments to economically beneficial sales or modifications of mortgages can thus be solved in part by changing the rules governing REMICs. In particular, Congress could amend the REMIC rules to deprive any pool that has undue restrictions on the sale or modification of mortgages of its ability to retain REMIC status. If such legislation were enacted, servicers could be expected to amend their pool documents promptly to remove the restrictions on sale or modification of mortgages. And once the restrictions were removed, modification and/or sale of the mortgages would be permitted—not forbidden—by the contractual documents.

Such a REMIC-based solution would not be likely to lead to successful suits against the government. The REMIC rules give a tax benefit to entities that are organized in a certain way. Congress is certainly entitled to change provisions in the tax code, including the REMIC rules, to encourage (or discourage) economic activities that it views as beneficial (or harmful). Here, a change to the REMIC rules would simply adjust the availability of the REMIC tax benefit to encourage conduct that Congress desires, i.e., to encourage mortgage pools to eliminate provisions that restrict loan modifications or sales and thereby to “unlock” the pools. Indeed, given the provisions in the agreements permitting the agreements to be amended to retain REMIC status, it is clear that the investors knowingly undertook the risk of a change in the REMIC rules when they made their investments. Having undertaken that risk, they would have no basis to bring a Takings or other suit against the government.

Finally, although a different kind of change than the one proposed here—a retroactive change in the tax code—could raise some constitutional questions, this kind of change in the REMIC rules would be entirely prospective, not retroactive. Mortgage pools would retain their REMIC status for past periods, but they would be unable to continue to claim REMIC status on future tax filings unless they amended their contracts to comply with the new REMIC rules.

5. Other additional steps could also help remove the legal impediments and give servicers a positive incentive to participate in a program involving loan modifications and/or sales to limit foreclosure and maximize the net present value of troubled loans.

Even if the REMIC-based solution eliminates the problem of contractual restrictions on modifications or sales of mortgages, servicers may still fear suit from investors. For example, a servicer is generally required to act to maximize value for investors in the pool. But it may not be clear whether that obligation is owed to the investors as a group or to each investor individually. If the obligation is owed to each investor individually, any investor that is disadvantaged by a modification or sale of a loan could sue the servicer—even if the modification or sale would maximize the net present value of the loan.

Section 119(b)(2) of the EESA includes a provision intended to address servicers' fear of liability based on ambiguity in whether their duty is owed to the investors as a group or to each individual investor. It provides that, "[e]xcept as established in any contract," a servicer owes the duty reasonably to maximize net present value of the mortgages "to all investors and holders of beneficial interests ... , but not to any individual or groups of investors or beneficial interest holders." It also provides that a servicer "shall be deemed to act in the best interests of all such investors if the servicer agrees to or implements a modification or workout plan when the servicer takes reasonable loss mitigation actions, including partial payments."

Section 119(b)(2) of the EESA can be useful in resolving the ambiguity in some contracts. But, because of the "[e]xcept as established in any contract" proviso, it gives very limited reassurance to servicers. If an unhappy investor sues the servicer that has agreed to modify some mortgages, and if the court in that suit ultimately determines that the servicer's contract "establishes" that the duty is owed to each individual investor, the EESA provision would not have any effect. That could occur even if the contract is not entirely clear on the matter. A servicer who wants to be cautious therefore frequently could not know in advance just how the particular contract would be construed; the servicer's only way to ensure against lawsuits from unhappy investors would be to refuse to permit modifications.

This problem could be ameliorated by legislation similar to the EESA provision but omitting the “[e]xcept as established in any contract” proviso. Such legislation could instead provide that “standard industry practice” (the background rules for contractual interpretation in this context) directs the servicer’s duty to the investors as a group, rather than to individual investors. Such a provision would not completely eliminate the problem for every mortgage pool and every servicer, since there may remain some contracts that make it entirely clear that the duty is owed to each individual investor. But such a provision would provide the basis for a court, in any suit, to lean very heavily toward resolving ambiguities in contracts in favor of finding the duty owed to the group, rather than to the individual investor. In addition, the legislation could further make the precise contours of the duty clear, by stating how the duty is satisfied. The legislation could provide that the servicer satisfies any duty to maximize net present value so long as the servicer reasonably determines that the net present value of the payments on a troubled mortgage loan as modified or sold would be likely to be greater than the anticipated net recovery that would result from default or foreclosure.

With those provisions clarified, servicers’ fears of legal liability would be substantially reduced, thus eliminating one of the greatest obstacles to servicer participation in a program to modify or sell mortgage loans before they go into foreclosure. At that point, after the most serious bases for potential servicer liability would have been removed, the legislation could then offer a final reassurance to servicers by offering to indemnify them for any remaining legal liability for participating in the government program. So long as the indemnification provision is carefully drafted to provide protection only for conduct by servicers that is required for participation in the government program, and so long as the primary grounds for lawsuits against servicers have been addressed as described above, such an indemnification provision by the government would likely not result in a serious cost to the taxpayers.

Insofar as fear of legal liability deters servicers from participating in a program to modify or sell appropriate mortgages, there are thus three steps that could eliminate that fear and encourage servicers to make economically sound modifications or sales.

First, there is the REMIC-based solution to the problem of contractual restrictions on modifications or sale of mortgages held in a pool; that solution would likely have no cost to the taxpayer and would remove the key legal impediment to modification or sales of mortgages under a government program.

Second, legislation could further reassure servicers by making clear that any duty to maximize value flows to the pool as a whole, not to each individual investor, and by clarifying that the servicer can satisfy the duty by modifying troubled loans where the modification results in an increase in expected net present value of the loan, as compared with the value if the loan reached foreclosure. Such legislation would likely also have little or no cost to the taxpayer.

Finally, an appropriate indemnification provision could further encourage participation by servicers. Though such a provision could potentially have some cost to the taxpayer, a carefully drafted indemnification provision should not carry a great cost; once the legal impediments to sale or modification of mortgages are eliminated through changes in the governing agreements to stay in compliance with REMIC rules, and clarification of the servicer's duty to the trust as a whole, the primary bases for suits against servicers—and thus the potential for servicers to seek indemnification from the government—would be eliminated as well.

If these steps were taken, the effect would be to give servicers a positive incentive to participate in a program involving modification or sale of troubled mortgages to increase their net present value. Indeed, rather than fearing suit if the modification or sale *were* made, the servicer would likely fear suit if it were *not* made. That is because, if the modification or sale were not made, investors who would *gain* from the modifications or sales would claim that the servicer failed to fulfill the duty to maximize value to the investors as a whole. Whereas servicers under current law frequently have a variety of incentives not to modify mortgages and have lagged in doing so, this reversal of incentives would go a long way toward increasing the prospects for economically beneficial modifications of mortgages and reduction of foreclosures.

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