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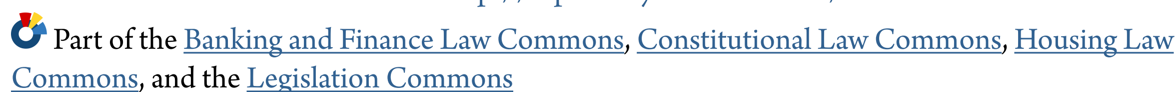
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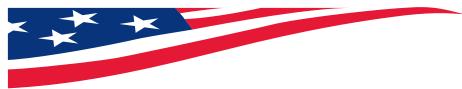

Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages

By Michael S. Barr and James A. Feldman

Summary

Legislation introduced last week by House Financial Services Committee Chairman Barney Frank (D-MA) would direct the Federal Reserve Board to conduct a study of the need for an auction or bulk refinancing mechanism and the efficacy of such an auction. The Federal Reserve would have to submit a report to Congress within 60 days of enactment. This legislative language refers to the study of proposals such as the one that we and colleagues at the Center for American Progress have made (see recent CAP testimony before Congress and CAP's Saving America's Family Equity, or SAFE loan program) to require the Treasury and/or Federal Reserve to conduct auctions to facilitate the sale of pools of mortgages from the trustees who hold them on behalf of investors to new owners.

Currently many mortgages are serviced on behalf of a group of investors in complex securitization trusts whose interests are not identical. The trustees' unclear obligations to the investors, along with certain provisions of the Pooling and Servicing Agreements, make it difficult for many mortgage servicers to make more beneficial modifications to at-risk mortgages and therefore to prevent more unnecessary foreclosures. A policy that encourages the current trustee to sell the loan or a pool of loans to a new owner without the complex duties to various investors would make it far more likely that beneficial modifications occurred at a rapid pace—especially if accompanied by policies providing federal credit enhancement for appropriate modified loans.

Unfortunately, provisions of the Pooling and Servicing Agreements and other documents that govern these securitization trusts also may preclude the servicer from selling individual mortgages or pools of mortgages to new holders in many circumstances when such a sale would be beneficial. Thus, one of the key questions about the feasibility of these auctions is whether any servicers would be able to participate. This problem can be addressed, however, through modification of the tax code rules governing Real Estate Mortgage Investment Conduits, or REMICs.

This memorandum argues that the sale of loans and loan pools to new owners would help to stabilize housing prices, and that such a modification to the REMIC rules would be desirable and well within Congress' constitutional authority. Furthermore, it would not lead to successful legal claims by investors in securitized loan pools under the Just Compensation or Due Process clauses, which provide the primary constitutional protections for property interests.

The Objective

For almost a year, financial institutions and the complex legal entities that hold the bulk of troubled subprime mortgages and almost prime Alt-A mortgages have failed to slow the pace of foreclosures—despite exhortation by the Bush administration for mortgage servicers, lenders, and investors to provide voluntary relief. Foreclosure action was taken on almost one million properties in the second half of 2007, with more in the fourth quarter of last year than in the previous quarter. This escalating pace of foreclosures continued into 2008—notwithstanding the voluntary efforts by the administration's HOPE NOW alliance to curtail foreclosures.

Investors' divided ownership of mortgage pools, conflicts of interest among different investor classes and among investors and mortgage servicers, and the tax consequences of mortgage restructuring for investors further complicate the process of providing mortgage relief. Yet escalating foreclosures contribute directly to the continuing crisis of confidence and lack of liquidity in global financial markets—twin problems that are likely to drive over-corrective declines in home and asset prices and a continued credit crunch. Only by restructuring impaired assets in mortgage loan pools can the effects be contained.

To facilitate this process, CAP has proposed a plan that builds upon components now embodied in Chairman Frank's mark in the House Financial Services Committee. The plan is designed to solve two problems. *First, it would facilitate the refinancing of millions of mortgage loans in a timely manner to avoid unnecessary defaults, foreclosure, and more severe home price declines.* Credit enhancements from the Federal Housing Administration and others would be available for the newly restructured loans to encourage private lenders to act.

At the same time, *the plan would help to restore liquidity and stability to the capital markets by creating a mechanism to spark price discovery in the marketplace for mortgage-backed securities.* An auction would quickly reprice existing mortgage pools and restore financial stability. Current investors in mortgage-backed securities of uncertain value would exchange them for new assets that boast the liquidity and reduced market risk of Treasury securities or cash.

How to Facilitate Loan Refinancing in Bulk

Under this proposal, the Treasury and the Federal Reserve would organize auctions, through which existing loans could be efficiently sold in bulk to FHA lenders and the Government-Sponsored Enterprises such as Fannie Mae and Freddie Mac, as well as their seller-servicers. The auction would determine the price the new lenders would pay (with assurance that loans meeting certain criteria would be eligible for credit enhancement), and the price at which the current holders would sell, establishing a market price.

Auction and Transfer Process

Mortgage servicers would receive cash or Treasury bonds for the loans tendered at auction, allowing them to mimic, at a market-determined discount, the income stream anticipated by investors in a loan pool. This "haircut" will ensure there is no bailout of the financial institutions and existing investors, many of whom uncritically and irresponsibly helped to create the bubble. When the auction-determined price for loan pools gets within a predetermined margin to the face value of the loan, the auction program will automatically shut off because the close-to-par pricing will indicate that it is no longer needed.

Investors would take a hit, trading a reduction in asset value and yield. But the widespread swap of now-illiquid pools of mortgage-backed securities for liquid Treasuries or cash would alleviate the credit crisis that has spread beyond housing-related securities in to a far wider array of credit market.

Portfolio Triage

Under this plan, purchasers of the pools of mortgages would refinance eligible loans for owner-occupants into new loans. Loans that are currently performing and are not at imminent risk would remain intact. Loans that would be unsustainable even if restructured would be foreclosed, or otherwise terminated, under program rules designed to prevent unnecessary adverse effects on neighborhoods and communities where there are higher percentages of foreclosures.

Loan Restructuring

Responsible mortgage originators working with the FHA, Fannie Mae, and Freddie Mac would restructure loans when restructuring would reduce the likelihood of default, foreclosure, and liquidation. Only loans on owner-occupied homes would be eligible for refinancing. Speculators would be excluded. Most of the refinanced loans would take the form of new, fixed-rate 30-year mortgages underwritten to 80 percent of current home value. New loans would be originated with sound underwriting, based on the current value of the property.

Legal Barriers to Bulk Sale and Restructuring

Existing loan pools at the center of the crisis are generally set up as REMICs. Maintaining REMIC status is crucial to the loan pool and to the holders of interests in the pool. The Pooling and Servicing Agreement and other related documents that define the loan pools therefore often provide that loan servicers are permitted to alter their terms in order to maintain REMIC status and to avoid or minimize the risk of a tax being imposed on the pool. Making use of that authority, the REMIC rules could be changed to exclude certain mortgage pools—those whose PSAs currently contain barriers to effective functioning of a federal auction-and-restructuring program—from the benefits of REMIC treatment under the tax code.

If the REMIC rules were altered in this way, then loan servicers would have the legal authority under their own agreements to alter the terms of their pools to participate in the federal program. They could be expected to exercise

that authority, in order to preserve the crucial REMIC tax treatment. REMIC pass-through tax treatment requires a (relatively) static pool, which some servicers fear would limit their ability to modify or refinance the loans at scale. Under 26 U.S.C. 860D, generally speaking, if there is a "significant modification" under section 1001, then there is a deemed exchange of the old loan for a new loan for federal income tax purposes, which is a "prohibited transaction" subjecting any gain/interest to 100 percent penalty tax.

Moreover, if more than 2 percent of the REMIC's assets are non-qualified (for example, because they have been significantly modified), then pass-through status is lost. Finally, the REMIC may cease to be a trust if the trust manifests a power to vary the investment of the certificate holders.

REMIC regulations *already* provide (1.860G-2(b)(3)) for modifications of loans occasioned by a default or reasonably foreseeable default; loans modified under such circumstances are not "prohibited transactions." Moreover, the REMIC regulations already provide that disposition of a loan is not a "prohibited transaction" if it is "incident to the foreclosure, default, or imminent default of the mortgage" (860F(a)(2)(A)).

In addition, in the context of the mortgage relief plan proposed last month by Treasury Secretary Henry Paulson, Treasury issued Rev. Proc 2007-72 (Dec. 26, 2007), which states that, for purposes of REMICs participating in the Paulson plan, the IRS would not challenge any vehicle's REMIC status on the grounds that the modification or disposition of loans did not fall within the exceptions of 860G or F, or that the modifications manifest a power to vary the investment of the certificate holders or resulted in a deemed reissuance of the REMIC regular interests. In short, Rev. Proc. 2007-72 provides a further safe harbor based on existing law for participants in the Paulson plan.

To ensure that large-scale loan modifications do not trigger disqualification of the trust as a REMIC, legislation could clarify that participation in a government-sponsored bulk refinancing mechanism would qualify for similar safe harbor status. A REMIC amendment could further provide for the possibility not simply of loan modifications and refinancings but also of sales of troubled loans. The legislation would permit sales of pools under the government program in exchange for Treasury securities as if the Treasuries had been qualifying assets from the date of the trust's creation.

We suggest that Congress go further by providing that continued REMIC status (and future tax benefits) is contingent on Pooling and Servicing Agreements and other documents that govern the pools are modified to permit (but not require) participation in the auction/loan process. Servicers are required under their PSAs to take steps necessary or helpful to maintain REMIC status. Many PSAs permit or require modification of the PSA in order to comply with REMIC requirements. Investors would likely unite behind servicer/trust PSA modifications required to maintain REMIC status. Thus, the REMIC amendment could significantly increase servicer incentives to participate in broad-scale restructuring, and also reduce potential liability to servicers for participating in the SAFE program.

Consequences of Making REMIC Changes Recommended

A variety of changes to the REMIC rules could usefully assist in encouraging necessary restructuring of existing mortgages. The legal analysis of each for potential constitutional issues raised by each of these changes would be similar. It is useful, then, to focus (for purposes of analysis) on a change to the REMIC rules that would deprive loan pools of REMIC status if their governing PSAs and other documents precluded the large-scale sale of loans.

If such new REMIC rules were adopted, the provisions precluding large-scale sales of mortgages were relaxed, and large-scale sales of mortgages occurred, then some holders of interests in those mortgage pools may end up ahead, and some behind. The government program would create a market for mortgage pools that today has little or no liquidity. Under standard economic assumptions, the provision of liquidity where none existed would *increase* the value of the mortgage pools as a whole, and would permit investors who want to exit the pools to do so.

In these ways, it would benefit the pool and the investors. But there may be holders of interests in the pools that would not benefit—holders of junior or other complex interests in the pool who would receive little or no return when the pool is sold. To be sure, those individuals knowingly undertook greater risks when they made their investments, and many of their investments would in any event be worth little or nothing under current market conditions. Nonetheless, holders of those interests may seek to find a legal basis to challenge the change in REMIC rules. For the reasons given below, however, such individuals would not have valid constitutional claims arising from the change in the REMIC rules.

Congressional Authority

First, there would be no valid argument that a law making such a change in the REMIC rules was beyond Congress's authority and therefore invalid. "Legislatures have especially broad latitude in creating classifications and distinctions in tax statutes" (*Regan v. Taxation with Representation*, 461 U.S. 540, 547 (1983). See also, *e.g.*, *Madden v. Kentucky*, 309 U.S. 83, 88 (1940) ("in taxation, even more than in other fields, legislatures possess the greatest freedom in classification"); *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359 (1973) (rejecting claim in challenge to state tax that "a State may not draw lines that treat one class of individuals or entities differently from the others"); *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 528 (1959) (stating, in challenge to state tax law, that the fact "[t]hat a statute may discriminate in favor of a certain class does not render it arbitrary if the discrimination is founded upon a reasonable distinction, or difference in state policy").

Under this well-settled body of law, there could be no question that Congress has the constitutional authority to grant REMIC-based tax benefits to mortgage pools only if the pools are structured to authorize the servicers to engage in large-scale sales of mortgages in connection with a specified government program.

Taking without Just Compensation

Second, Congress would not be opening up the government itself to liability under the Just Compensation Clause of the Fifth Amendment by altering the REMIC rules in this fashion. There are two general categories of takings: direct government appropriations of property and regulatory takings.

a. *Direct Appropriation*. "The paradigmatic taking requiring just compensation is a direct government appropriation or physical invasion of private property" (*Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528, 537 (2005). Ordinarily, a physical taking claim requires (a) compulsion or force, (b) a transfer of property, usually to the government, and (c) a failure to pay just compensation, which ordinarily means a failure to pay fair market value. See *United States v. 564.54 Acres of Land*, 441 U.S. 506, 511 (1979); *United States v. 50 Acres of Land*, 469 U.S. 24, 29 (1969). Legislation altering the REMIC rules as suggested above would not have any of those features. It would not *require* anyone to turn over any property to the government or to anyone else, and it would involve the creation of a market for mortgages in which servicers sell them for a fair market value—indeed, a value that the government program itself has likely enhanced by providing liquidity where little or none existed before. Accordingly, it would not be a direct taking of property without just compensation.

b. *Regulatory Takings*. The Supreme Court has "recognized that government regulation of private property may, in some instances, be so onerous that its effect is tantamount to a direct appropriation or ouster, and that such 'regulatory takings' may be compensable under the Fifth Amendment" (*Lingle*, 544 U.S. at 537-538). Of course, not all regulation that burdens property is a taking. The Court has long recognized that "government regulation—by definition—involves the adjustment of rights for the public good" (*Andrus v. Allard*, 444 U.S. 51, 65 (1979), and that "[g]overnment could hardly go on if to some extent values incident to property could not be diminished without paying for every such change in the general law" (*Pennsylvania Coal Co. v. Mahon*, 260 U. S. 393, 413 (1922) (Homes, J.). Accordingly, the question in a regulatory takings case is whether the government regulation has gone "too far" in diminishing or extinguishing a distinct private property interest, and has "forc[ed] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole" (*Armstrong v. United States*, 364 U.S. 40, 49 (1960). In considering that question, the mere fact that the government has taken action that has affected contract rights is not dispositive. See *Eastern Enterprises v. Apfel*, 524 U.S. 498, 528 (1998) (plurality opinion) ("Congress has considerable leeway to fashion economic legislation, including the power to affect contractual commitments between private parties."). In determining whether a regulatory taking has occurred, three factors are analyzed: (1) "the economic impact of the regulation on the claimant," (2) the extent to which it "interfere[s] with distinct investment-backed expectations," and (3) "the character of the governmental action," *i.e.*, whether it more resembles a physical occupation or a "public program adjusting the benefits and burdens of economic life to promote the common good" (*Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

A change in the REMIC rules to facilitate large-scale sales of mortgages could be argued to have a substantial "economic impact" on some holders of interests in mortgage pools—those whose interests lost substantial value as a result of the large-scale sale. But any such argument would have to contend with the facts that the mortgage

pool as a whole could well benefit from the creation of liquidity where little or none had previously existed, and that the holders of junior interests and others who might claim to suffer a loss as a result of the large-scale sale had themselves knowingly taken on substantial risks when they made their original investments. Moreover, the "character of the government action"—a change in the tax laws to deny favorable tax treatment to entities that, under current conditions, are toxic to the national economy—would be well within the adjustment of the benefits and burdens of economic life that legislature routinely undertake, and that bear little resemblance to a physical occupation or seizure of private property.

But, regardless of the analysis under those two factors, it is clear that those who invest in mortgage pools do not have "distinct investment-backed expectations" that the REMIC rules would alter. To the contrary, the documents creating mortgage pools generally recognize that the REMIC rules could change, and they accordingly grant the servicer authority to change the terms of the investment to comply with new REMIC rules (and thereby maintain the pool's favorable tax status). Investors thus entered into agreements that specifically recognized the risk of a change in the REMIC rules, and they made their investment on the premise that the governing documents could be changed to comply with such a change in the REMIC rules. For these reasons, even though investors may have hoped that REMIC rules would not change substantially, their "investment-backed expectation" was that the REMIC rules could change in a way unfavorable to them, and they undertook the risk of such changes in their contractual arrangements. That fact alone would be sufficient to defeat a suit against the government claiming that new REMIC rules amounted to a regulatory taking.

Substantive Due Process

Third, a change in the REMIC rules would not violate the Due Process Clause. There are rare occasions when retroactive legislation—legislation that alters a private party's legal rights and responsibilities based on actions that the private party has already taken—could be argued to violate the Due Process Clause. In *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998), for example, the Supreme Court addressed a statute that imposed liability on employers for health benefits due to their former employees under collectively bargained health plans that were entered into *after* the employers had withdrawn from the coal business entirely. A plurality of the Supreme Court found that the imposition of such liability was a taking of the employer's property (the payments for the health plan) without just compensation (See 524 U.S. at 528). Four Justices would have held that the legislation was not unconstitutional. Justice Kennedy broke the tie by stating that the legislation, though not violative of the Just Compensation Clause, did violate the Due Process Clause. In his view, the retroactivity of the statute, which imposed substantial present consequences on the employer based on conduct (participation in the coal industry) that occurred decades in the past, and that in no sense was wrongful, was so extreme that it violated the Constitution (524 U.S. at 547-550. Justice Kennedy noted that, although the Court "ha[s] been hesitant to subject economic legislation to due process scrutiny as a general matter," *id*. at 454, and legislation is judged under a "permissive standard" when challenged as a violation of due process, *id.* at 550, "the remedy created by the [statute] bears no legitimate relationship to the interest which the Government asserts in support of the statute," *id*. at 549. Apparently, Justice Kennedy reached that conclusion because there was in his view no relationship at all between the company and "the promises and agreements made long after [the company] left the coal business," which the legislation was trying to correct, *id*. at 550.

Initially, it is significant that no Justice agreed with Justice Kennedy that the statute violated the Due Process Clause. Indeed, repudiating the now-discredited doctrine of *Lochner v. New York*, 198 U.S. 45 (1905), the Court has "long eschewed . . . heightened scrutiny [under the Due Process Clause] when addressing substantive due process challenges to government regulation" (*Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528, 544 (2005); see *Ferguson v. Skrupa*, 372 U.S. 726 (1963). Justices Scalia and Thomas have questioned whether there is *any* substantive component to the Due Process Clause. See *Troxel v. Granville*, 530 U.S. 57, 80 (2000) (Thomas, J., concurring in judgment); *United States v. Carlton*, 512 U.S. 26, 39 (1994) (Scalia, J., concurring in the judgment). Thus, it may be doubted whether a majority of the Supreme Court would subject changes in REMIC rules or other economic regulatory legislation to *any* significant scrutiny under the Due Process Clause.

In any event, *Eastern Enterprises* involved rather extreme circumstances that would not be present in a constitutional challenge to changes in the REMIC rules. *Eastern Enterprises* involved imposition of a completely unexpected substantial direct monetary liability on an entity, based on economic conduct (mere participation in the coal industry) that occurred decades in the past and that in no sense was wrongful and caused no one any harm. Unlike in *Eastern*

Enterprises, changes in the REMIC rules would not, directly or indirectly, exact any money from anyone (other than the legitimate taxes paid by mortgage pools that chose not to comply with the new rules). Unlike in *Eastern Enterprises*, changes in the REMIC rules would not impose retroactive liability by attaching new legal consequences to past conduct on anyone; changes to the REMIC rules would simply alter the *future* taxes that would be owed by certain entities. And even tax legislation that is retroactive would be very likely to survive scrutiny under the Due Process Clause. See *United States v. Carlton*, 512 U.S. 26 (1994). Finally, unlike in Justice Kennedy's view of *Eastern Enterprises*, there would be a very direct relationship between the goals of a change in the REMIC laws (to discourage entities structured in a way that exacerbates the current mortgage crisis) and the means used to achieve that goal (changing the tax laws to deprive such entities of a tax benefit).

Conclusion

New legislation providing for an auction of troubled mortgage assets and altering REMIC provisions to facilitate participation could provide the key to broad scale restructuring of troubled home mortgages and the restoration of stability to home mortgage markets. Such legislation provides the best alternative for achieving changes in the current structure of the complex instruments impeding broad and necessary restructuring in the subprime mortgage market. Moreover, these provisions would pass constitutional muster.

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