

***A Farewell to ARMs:***  
**Bankruptcy Lessons from the Subprime Origination Meltdown**

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*Synopsis: The contraction of the American housing market in late 2006 set off a chain reaction that plunged a succession of housing, investment and retail industries into economic distress. The first commercial casualties to enter the chapter 11 process were the mortgage originators, and their experience may provide useful insight to industries that go through the restructuring and bankruptcy process during the next three years.*

CREDITORS WILL BE SORTING OUT the financial and legal fallout from the current mortgage market contraction for years to come. But even before the smoke clears, the wave of mortgage origination bankruptcies that began in the fall of 2006 and continued into 2008 has left its legal and economic footprint on the chapter 11 process. By looking backwards, at the causes and immediate effects of the mortgage origination bankruptcies, the contours of future bankruptcies of financial services providers may become clearer.

**Prelude to a Meltdown**

The base of the residential mortgage-backed securities (RMBS) pyramid was the humble subprime mortgage, underwritten through an originator, with or without the help of a mortgage broker. Subprime loans, which command higher-than-prime interest rates because they are extended to high-risk borrowers, accounted for 8.6 percent of all residential mortgages in 2001, a share that ballooned to 20 percent by 2006.<sup>1</sup> Given the overall size of the U.S. mortgage market, the resulting numbers were huge; by mid-2007, the outstanding principal balance of subprime loans totaled approximately \$1.6 trillion.<sup>2</sup>

Of particular interest to many subprime borrowers was the adjustable rate mortgage (ARM), a product that took advantage of low interest rates facilitated by the Federal Reserve Board in the early 2000's and offered low initial interest rates for a certain period of time, say, two or three years. After the introductory period, the loan would reset to a market rate of interest, often prime plus two to eight percentage points.<sup>3</sup> Because the initial payments under these mortgages were low, many buyers purchased homes they could not otherwise afford because they either did not understand the impact of the reset feature, or because they believed that housing values would continue to climb, allowing them to refinance their way into a conventional fixed-rate mortgage before the introductory period expired. By 2006, ARM loans accounted for 91 percent of all subprime mortgages.<sup>4</sup>

Another distinguishing feature of the subprime boom was the high incidence of 100 percent loan-to-value mortgages, in which have buyers could obtain a loan with no money down. In cases of refinanced mortgages, professional appraisers allegedly were pressured by lenders to inflate property values to support larger loan balances, and some lenders offered higher-interest

lines of credit that were nominally unsecured.<sup>5</sup> Some borrowers therefore were able to “cash out” home equity they did not have to fund consumer purchases or pay off large credit card balances.

One distinct feature of the 2002-2007 subprime boom was the high incidence of “low document/no document” loans, in which little or no evidence of income or assets was required for loan approval. In 2006, one half of all subprime loans were of this minimal documentation type, up from 28 percent just five years earlier.<sup>6</sup> In making these loans without the usual due diligence, the ultimate investors—hedge funds, commercial banks, investment banks, insurance companies, pension funds, and others—bet on the same gamble the borrowers did: that housing prices would continue to rise, ensuring that those with money at risk could look to a relatively safe collateral package.

The intermediate level of the subprime pyramid was the mortgage originator/seller. Large originators such as Aegis and New Century underwrote billions of dollars of loans on a beautifully simple model: they did not lend their own money. They immediately sold their loans (either directly or packaged as RMBS) to a network of securitization arrangers—principally investment banks or specialized financing arms of commercial banks, and sometimes to financing arms of the originator, as in the cases of Countrywide and American Business Financial Services. Approximately 80 percent of all subprime loans originated in 2005 and 2006 were securitized, up from 50 percent in 2001,<sup>7</sup> and mortgage loans sold to securitizers were subject to repurchase agreements providing for their mandatory repurchase if the loans remained delinquent for a set period of time. Many origination companies also had loan servicing departments, which would service the loans for purchasers through contractual arrangement. Originators obtained working capital through warehouse lenders who held liens on mortgages that were awaiting securitization or were in the process of closing (sometimes referred to as “pipeline loans”).

The securitization sale formed the apex of the pyramid and provided the capital that drove the market’s explosive growth. Securitizations could be structured in a wide variety of ways, but the general structure was as follows: an arranger, such as a division of Bear Stearns, would fund a bankruptcy-remote trust or other special purpose vehicle (SPV) whose only role was to hold the loans and issue securities backed by these mortgages, called collateralized debt obligations (CDOs).<sup>8</sup> The SPV would divide the CDOs into tranches to accommodate varying risk tolerances. Senior tranches would be paid first and were therefore the safest tranche; they were awarded the highest ratings and carried the lowest interest rates. To ensure that senior tranches obtained investment-grade ratings from Standard & Poor’s, Moody’s or one of the other recognized ratings agencies, these tranches were generally insured by AAA-rated credit insurers. Mezzanine (BBB-rated) and equity (junk-grade) tranches carried successively higher risk and interest rates.

After the CDOs were segregated into tranches, the SPV would sell investment-grade CDOs on the open market, while mezzanine and equity tranches would be sold to risk-friendly hedge funds, parked with cash-flush institutions such as foreign banks, or become repackaged into synthetic CDOs through the creative use of credit default swaps or further slicing and leveraging.

Thus, a discreet set of mortgages would be parceled out to potentially thousands of individuals and institutions with varying rights and remedies and a complex set of interlocking documents that governed the relationships. In this way, the creditworthiness of the subprime borrower—traditionally the market’s least credit-worthy prospect—supported a pervasive, trillion-dollar sector of the credit market.

### **Oily Rags, Paper and Matches**

The securitization wave of 2001-2007 represented a departure from previous real estate booms in several respects. First, the ready supply of securitization products altered the traditional relationship between homeowner and immediate lender because the focus shifted from long-term investment to short-term monetization. New home buyers began purchasing more expensive homes than they could afford on a two- or three-year refinance timetable, and existing homeowners began looking at their homes as cash machines that could be tapped to pay short-term debts. Mortgage lenders, whose income derived from origination fees rather than loan interest, lacked an incentive to safeguard the integrity of the loan process because they did not intend to hold the loan or ensure that it would remain current beyond the time frame set out in the repurchase agreement’s representations and warranties. Critically, neither of the two parties best able to police the transaction—the borrower and the mortgage originator—put any money at risk, and both had an economic incentive to close a deal. As a result of this systemic moral hazard, underwriting standards for many loans deteriorated, and a foundation was laid for unrealistic expectations further down securitization stream.<sup>9</sup>

A second factor that made the 2001-2007 subprime securitization process different was the huge size of the market and the rapid rate at which it ballooned during that six year period. From 2001 to 2005, annual subprime loan originations leaped from roughly \$190 billion to \$625 billion; 2006 originations declined only slightly, to \$600 billion.<sup>10</sup> The result of this mortgage boom was a fourth quarter 2004-2007 home ownership rate that exceeded the 1981-1999 historical average of 64.5 percent, peaking at 69.2 percent in 2004 and tapering off at 67.8 percent for the first quarter of 2008.<sup>11</sup> The subprime CDO boom thus drove home ownership to artificially high levels.

A final distinguishing factor was the lack of transparency up and down the securitization chain. As the origination bankruptcies were to show, many parties to complex CDO transactions did not know precisely which mortgages they owned, much less have the documentation necessary to support claims of legal or beneficial title. Moreover, the process of blending, slicing and repackaging a blizzard of subprime paper—much of which was carried off-balance sheet in SPVs and in synthetic CDOs—robbed the system of the sort of transparency that allows market players to estimate their exposure when the market takes a sudden fall. As one Lehman Brothers economist put it, high-dollar products spawned by the subprime boom included “parts of the capital markets that most of us had never heard of.”<sup>12</sup>

The sole backstop to this financial tinderbox was an article of faith supported by a trend dating back to 1995: that housing prices would continue to rise at healthy if not steep levels.

Since 1981, housing prices almost invariably rose on an annual basis, and from 1997 to 2006, home prices rose 85 percent, an appreciation level not reached since the housing boom immediately following World War II.<sup>13</sup> As long as home prices went up, cornered borrowers could refinance their way out of high interest rates when their ARMs adjusted, originators would not have to weather repurchase demands, and CDOs would remain solidly collateralized because the houses that backed them were worth the face amount of the securities. Everyone was happy.

## First Blood

Of course, the housing market could not sustain such exponential (and artificial) growth. Beginning in the second quarter of 2006 most major U.S. markets began to flatten and decline.<sup>14</sup> Consumers whose incomes could only support mortgages at the low introductory rates found themselves unable to afford large increases in their monthly payments when their ARMs reset. By the end of 2007, one in five ARMs was seriously delinquent, meaning either 90 days past due or in the foreclosure process,<sup>15</sup> and subprime borrowers began defaulting on mortgage loans at an estimated rate of 18 to 20 percent.<sup>16</sup> The Mortgage Bankers Association recently concluded that delinquency rates have reached a peak not witnessed since 1985.<sup>17</sup>

As a result, foreclosures in January 2008 were up sixty percent over the same period for 2007, and one tracking organization estimated that the percentage of U.S. households in some state of the foreclosure process rose from .58 percent in 2006 to 1 percent in early 2007.<sup>18</sup> In many cases borrowers, having no equity in their homes, simply walked away from their mortgages, leaving entire subdivisions of vacant houses and burdening a housing market that already had 79,000 more vacant homes for sale in 2007 than in 2006.<sup>19</sup> The last quarter of 2007 witnessed a national median house price drop of 5.8 percent, the steepest drop since the National Association of Realtors began keeping records in 1979—until the first quarter of 2008, which racked up another 7.7 percent, enough to push the median price of a U.S. home below \$200,000.<sup>20</sup>

The first institutions to feel the pinch were the mortgage loan originators, which were besieged with repurchase demands from loan purchasing clients, cease-and-desist orders from state authorities, tighter warehouse lending criteria and less money for their mortgages and RMBS. While a few of these institutions, such as Countrywide Financial Corporation, were able to win a reprieve through massive equity infusions, most had no choice but to shut their doors or, in the case of companies with substantial assets, to file for bankruptcy protection.<sup>21</sup> December 2006 therefore commenced a year-long roster of mortgage originator bankruptcies that reads like a “Who’s Who” of mid-sized and large mortgage industry players:

<u>Debtor</u>	<u>Date Filed</u>	<u>Venue</u>	<u>Case No./Chapter</u>
Ownit Mortgage Solutions, Inc.	12/28/2006	C.D. Cal.	06-12579 (11)
Mortgage Lenders Network USA, Inc.	02/05/2007	D. Del.	07-10146 (11)
ResMAE Mortgage Corporation	02/12/2007	D. Del.	07-10177 (11)
LoriMac Inc.	02/13/2007	N.D. Cal.	07-30165 (7)

<u>Debtor</u>	<u>Date Filed</u>	<u>Venue</u>	<u>Case No./Chapter</u>
People's Choice Home Loan, Inc.	03/20/2007	C.D. Cal.	07-10765 (11)
New Century TRS Holdings, Inc.	04/02/2007	D. Del.	07-10416 (11)
SouthStar Mortgage Funding, LLC	04/11/2007	N.D. Ga.	07-65842 (7)
Oak Street Mortgage LLC	06/08/2007	S.D. Ind.	07-05279 (11)
Alliance Mortgage Investments, Inc.	07/13/2007	D. Del.	07-10941 (7)
American Home Mortgage Holdings, Inc.	08/06/2007	D. Del.	07-11047 (11)
HomeBanc Mortgage Corp.	08/09/2007	D. Del.	07-11079 (11)
Aegis Mortgage Corp.	08/13/2007	D. Del.	07-11119 (11)
First Magnus Financial Corp.	08/21/2007	D. Ariz.	07-01578 (11)
Quality Home Loans	08/21/2007	C.D. Cal.	07-13006 (11)
Fieldstone Mortgage Co.	11/23/2007	D. Md.	07-21814 (11)
Delta Financial Corp.	12/17/2007	D. Del.	07-11880 (11)
First NLC Financial Services, LLC	01/18/2008	S.D. Fla.	08-10632 (11)
NovaStar Home Mortgage, Inc.	01/23/2008	W.D. Mo.	08-40245 (7)

### **Mortgage Originator Issues**

The mortgage originator cases of 2006-2008 yielded a wide variety of nonstandard bankruptcy disputes between the originators, warehouse lenders, loan purchasers, SPV trustees, credit insurers and buyers, in addition to more conventional bankruptcy disputes over items such as utilities motions, lease rejections and key employee retention plans. While a detailed review of the most contentious issues in each case would fill a large tome, a sampling of the issues raised in these cases gives a fair idea of the twists and turns this generation of chapter 11 cases took:

***Stay Relief.*** Warehouse lenders moved quickly to request stay relief on their collateral, which naturally impacted each debtor's ability to generate cash from operations. For example, in the case of *American Home Mortgage Holdings*—a debtor whose loans were predominantly prime and Alt-A loans rather than subprime—its lender, Bank of America, moved for stay relief to foreclose on some \$584 million in mortgage loans, arguing that cause for stay relief existed under Bankruptcy Code section 362(d)(1) because the market value for the loans was declining rapidly in the contracting housing market.<sup>22</sup> Similarly, in *HomeBanc Mortgage Corp.*, lender JPMorgan Chase moved on the first day of the case for adequate protection for its \$69 million pre-petition loan secured by the debtor's servicing rights, intangibles and deposit accounts.<sup>23</sup> In many cases, commingling of funds and dispersed documentation complicated the adequate protection analysis.

Another type of stay relief litigation arose in cases where the originator holds a junior mortgage under a foreclosing senior mortgagee. In these cases, the delay imposed upon the senior, non-debtor mortgagee by the automatic stay can impose costs on the debtor (a) by delaying foreclosure in a declining housing market, and (b) by forcing the senior mortgagee to incur fees and expenses in obtaining stay relief, which costs may be added to the indebtedness secured by the senior lien. To avoid the costs of stay relief rebounding against the debtor, some debtors moved proactively to modify the stay in those instances.<sup>24</sup>

A third variation of stay relief litigation turns on whether the stay applies at all. In *American Home Mortgage*, a counterparty to a “servicing retained” master repurchase agreement moved for a declaratory judgment that the agreement was not subject to the automatic stay by virtue of Bankruptcy Code sections 362(b)(7) and 559, which exempt repurchase agreements from stay and executory contract termination prohibitions in Bankruptcy Code sections 362(a) and 365(e). (Section 546(f) also exempts repurchase agreement counterparties from certain avoiding powers of a bankruptcy trustee.) American Home Mortgage contended that the repurchase agreement was actually a disguised financing agreement that fell outside the definition of repurchase agreement set forth in Bankruptcy Code section 101(47). In the alternative, the debtor argued that, at a minimum, the servicing provisions did not constitute a repurchase agreement, and were severable from the rest of the agreement. The court ultimately found that the agreement was both a repurchase agreement under section 101(47), and a securities contract under section 741(7) (which provides similar safe harbor provisions for mortgage purchases and other types of derivative transactions), but it also held that the servicing provisions of the agreement were severable and remained property of the estate. The repurchase agreement counterparty was therefore entitled to enforce any setoff and liquidation rights available due to the debtor’s bankruptcy filing—a trigger normally prohibited in executory contracts by Bankruptcy Code section 365(e)(1). Because the order in this case did not adjudicate the dispute over the servicing rights, it was not a final order, and the repurchase agreement party could not immediately appeal the bankruptcy court’s order residual holding that the servicing rights remained property of the debtor’s estate.<sup>25</sup>

**Section 363 Asset Sales.** Consistent with broader trends in large chapter 11 cases, the goal of most of mortgage lender cases was the liquidation of non-securitized or “whole” loans, interests in securitization trusts, servicing agreement rights, and other loan platform assets. Accordingly, section 363 sales played a large role in these cases. Of the fourteen chapter 11 cases noted here, all but two of them resulted in sales of substantially all business assets within ten months of the petition date. In cases where the assets have not yet been approved for sale, the debtors are marketing them. In many cases, the debtor moved for the sale or consummation of pre-petition sales on or near the first day of the case, or had sold most of their assets immediately prior to filing.

**Litigation.** Litigation against warehouse lenders, parties to repurchase agreements, insurers, directors/officers and professionals has also become a standard feature of subprime originator bankruptcy cases.

**Claims Against Mortgage Purchasers.** In the *Ownit Mortgage Solutions* case, for instance, the debtor investigated or brought claims against JPMorgan Chase (for turnover of

account funds, conversion, wrongful participation in the collapse of the debtor's restructuring efforts, and improper use of confidential information), Merrill Lynch (for conversion and/or turnover of purchased loans, recharacterization of true sales as disguised financing transactions, avoidance of allegedly unperfected security interests, equitable subordination, turnover of funds paid by the debtor's pre-petition servicing agent, participation in the collapsed restructuring efforts, and preferential transfers), and the debtors' loan servicer, Litton Loan Servicing (for wrongful payment to Merrill Lynch). In addition, JPMorgan Chase sued the debtor and certain Merrill Lynch affiliates alleging senior rights in certain operating accounts of the debtor.<sup>26</sup>

*Fiduciary Duty Claims.* Reflecting the wave of nonbankruptcy lawsuits directed at officers, directors, arrangers and other parties to securitization transactions, bankruptcy trustees and liquidation agents have begun looking at possible claims against securitization players. In a hefty 581-page report, the examiner appointed in the *New Century TRS Holdings* case found that the debtor's estate holds colorable claims against New Century's auditor, as well as former directors and officers of the debtor for departing from proper accounting practices, such as in the valuation of loss reserves, which aided and abetted material misstatements of New Century's financial status. The *New Century* examiner's report may provide a blueprint for other liquidating agents and bankruptcy trustees to follow in future cases.<sup>27</sup>

*Claims by Mortgage Purchasers.* In some cases, parties to master repurchasing agreements have sued debtors to obtain access to records of purchased mortgage loans, control over the loans as required by their repurchasing agreements, and accounting of custodial funds collected by the debtors prior to their repurchase. In the *New Century* case, the largest chapter 11 case filed in 2007, repurchase agreement counterparty UBS Real Estate Securities and other purchasers commenced adversary proceedings to obtain accountings of custodial funds collected by New Century for purchased loans.<sup>28</sup> In the second-largest case of 2007, *American Home Mortgage*, Credit Suisse First Boston Mortgage Capital, Bear Stearns Mortgage Capital Corporation and Morgan Stanley Mortgage Capital Holdings similarly filed adversary proceedings to obtain control over certain purchased loans, recover loan files and terminate the debtor's servicing rights.<sup>29</sup>

*Investor Claims.* Where bonds are sold directly from the mortgage company to investors, a bankruptcy trustee may have standing to pursue claims on behalf of the investors. This situation arose from the chapter 7 case of American Business Financial Services, Inc., a subprime lender that securitized its loans through Bear Stearns, JPMorgan Chase, Morgan Stanley and Credit Suisse Group. The cause of ABFS's collapse in 2005 was different from the current wave of subprime originator cases—ABFS had, among other things, miscalculated prepayment rates—but the investment bank group faced similar exposure under fraudulent conveyance and other theories. The trustee's lawsuit against the investment banks, filed in 2006, has since been removed from Pennsylvania state court to federal court, and as it plays out, it may provide some guidance as to the path other bankruptcy trustees may follow in those cases where investors are direct creditors of the originator.<sup>30</sup>

*Insurance Litigation.* Because bond insurers are a critical part of the subprime securitization structure, debtors and insurers have engaged in litigation when the insurer desires to cancel insurance policies or otherwise refuses to accede to debtor demands. In the *American*

*Home Mortgage* case, for example, a well-known credit insurer for complex financial products, sued the debtor to require the turnover of servicing rights to the insurer's designated servicing successor.<sup>31</sup> In an analogous adversary proceeding in the same case (although one not involving insurance per se), one of the debtors' SPVs sued Bank of America to enforce a credit default swap that backstopped certain losses on the sale of mortgage loans.<sup>32</sup>

Since director and officer (D&O) claims have predictably risen with the collapse of the subprime securitization market, D&O liability insurers have become minor though important players in chapter 11 cases. In the *Delta Financial* case, the debtor filed an adversary proceeding to force its D&O liability carriers to fund the defense of the debtors' officers and directors who were defendants in suits related to their work for the defunct originator.<sup>33</sup>

### ***People's Choice: A Case Study***

Fairly typical in this population is the case of People's Choice Home Loans, Inc., an Irvine, California-based mortgage company that owned bankruptcy-remote SPVs to facilitate the securitization of its mortgage loans.<sup>34</sup> People's Choice and its affiliates originated, funded, sold and serviced loans through wholesale and retail channels. Financing for its lending operations was provided through warehouse facilities with Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Lehman Brothers, Wachovia, Washington Mutual, Wells Fargo and other well-known financial institutions. On the petition date, these lenders asserted claims totaling \$84 million and held some \$26.5 million on deposit in margin call accounts. People's Choice also sold loans not for purposes of securitization (called "whole loan" sales) with repurchase obligations to third parties such as Citigroup Global Markets, DB Structured Products, Credit-Based Asset Servicing, UBS, Nomura, Merrill Lynch, and other institutions, while retaining servicing rights on these loans to itself. The debtor's exposure under repurchase obligations for whole loan sales was around \$79 million. Finally, the debtor securitized about \$3 billion in RMBS in 2004, and another \$4 billion in RMBS in 2005.<sup>35</sup>

As the housing market began to slide in late 2006, the debtors began receiving margin calls from warehouse lenders, repurchase demands from loan purchasers, and reduced pricing offers from secondary buyers of RMBS. Unable to finance their way out of this convergence of threats, People's Choice and its affiliates filed their chapter 11 petitions on March 20, 2007.<sup>36</sup>

*Cash Collateral Use.* In addition to fairly standard chapter 11 disputes, People's Choice confronted a variety of issues specific to its mortgage business. First, several different warehouse loan participants claimed an interest in the debtors' commingled cash, which thwarted easy tracing of funds claims by particular parties. This created problems for the provision of adequate protection to the lenders for the debtor's use of cash collateral under Bankruptcy Code section 363, a mess that had to be resolved through consensual adequate protection carve-outs.<sup>37</sup>

*Section 363 Sales.* The debtor's chapter 11 strategy was to execute section 363 sales of its major assets, including (a) residual interests in securitization trusts (sold to PC Asset Acquisition for \$21 million), (b) servicing interests (sold to Equity One, Inc. for \$24 million), (c) loan servicing and origination platforms (sold to UBS for \$2.5 million), and (d) certain loans that it had been required to repurchase (referred to as "scratch and dent loans"), which sold in small

parcels for a total of \$1.7 million. The servicing agreement sale to Equity One proved the most contentious, as the counterparty to the servicing agreement, EMC Mortgage Corporation, objected to the sale, and the debtors and creditors committee had to enter into settlement and transition services agreements with EMC to pave the way for the sale.<sup>38</sup> These sales were consummated prior to the confirmation of a chapter 11 plan and drove the estimated 10 to 14 percent return for most general unsecured creditors.<sup>39</sup>

*Tax Issues.* People's Choice also had to address maintenance of its subsidiary's status as a real estate investment trust (REIT) under sections 856 through 860 of the Internal Revenue Code, to avoid significant tax consequences for tax year 2007, and to ensure that the four mortgage securitization trusts it set up for 2007 would continue to be treated as separate legal entities. These tax considerations affected both the debtor's corporate tax liability and the IRS's proof of claim.<sup>40</sup>

*D&O Litigation.* In its disclosure statement, the debtor has raised claims against certain former directors, officers and shareholders on a variety of theories, including: (i) excessive compensation, (ii) fraudulent conveyance, (iii) illegal dividends, (iv) approving improper intercompany transfers, (v) approving unsafe lending practices for subprime borrowers, (vi) approving stock repurchases, and (vii) generally causing the company to fail.<sup>41</sup> These claims have not yet been filed, and absent settlement, litigation involving the debtors (or their successor), the directors and officers, and the D&O insurance policy carrier will likely last well into 2009.

*Lender Litigation.* As one of the debtor's principle pre-petition lenders, Washington Mutual Bank claimed a security interest in certain prepetition tax refund proceeds; when a dispute over this interest could not be worked out, the debtor filed an adversary proceeding alleging (a) preferential transfers (b) breach of contract, (c) conversion, and (d) objection to Washington Mutual's claims. The complaint, which has not yet been resolved, also attempts to avoid Washington Mutual's security interest in the refund proceeds. Absent settlement, litigation will continue well into 2008.<sup>42</sup>

The debtor also investigated avoidance claims against one of its warehouse lenders, Residential Funding Company, LLC, which claimed an interest in certain commingled funds in the debtors' bank accounts, as well as a security interest in the proceeds of certain scratch and dent loans. Ultimately the two parties settled RFC's claims for approximately seventy-two cents on the dollar.<sup>43</sup>

*Substantive Consolidation.* Because of the interconnected nature of the debtors' securitization businesses, the debtors and their financial advisors conducted an extensive review of various intercompany transactions to determine whether substantive consolidation was appropriate under the Second Circuit's *Augie/Restivo* test, as adopted by the Ninth Circuit.<sup>44</sup> While the assets and liabilities of the debtors were not hopelessly entangled, there were enough factors favoring substantive consolidation—the creation of subsidiaries for tax rather than business reasons, below-market sales to subsidiaries, consolidated liquidity management, and commonality of management, for instance—that protracted litigation was a real threat. Ultimately, the debtors and the creditors committee ultimately agreed not to press for substantive

consolidation, subject to a number of allocation and administrative conditions set forth in the debtor's proposed plan.<sup>45</sup>

### **Lessons for the Future, Economic and Legal**

The impact of the subprime contraction is likely to continue well into 2009 as 2005- and 2006-vintage ARMs reset themselves to higher interest rates over the next twelve months. Federal Reserve Chairman Ben Bernanke cited estimates of 1.5 million ARM resets in 2008,<sup>46</sup> and one study estimated that ARM resets in 2008 will raise mortgage payments by an average of 32 percent.<sup>47</sup> This will undoubtedly spawn a new wave of defaults and foreclosures; a Congressional Joint Economic Committee report predicted that by the end of 2009 home foreclosures will reach the two million mark.<sup>48</sup>

As market players slowly become aware of the magnitude of 2007's biggest "black swan," loss estimates continue to be revised. In July 2007 Chairman Bernanke estimated of \$100 billion of subprime-related write-downs. That total grew to \$120 billion in write-downs by major banks as of February 2008, and lurking out there are another \$123 billion in additional write-downs that UBS analysts warn may be necessary before all losses are accounted for.<sup>49</sup> The OECD revised its "all-in" total for the subprime crisis at \$350-420 billion, disputing an IMF worldwide estimate of \$1 trillion.<sup>50</sup>

The effects of the subprime debacle will not be limited to the residential mortgage industry; the home-building and building materials industries have been directly hurt by the housing glut (resulting in several large home builder filings in 2007 and 2008).<sup>51</sup> The relative collapse of the subprime capital market has also spilled into other credit sub-industries, affecting bond insurance, credit default swaps, auction rate securities, synthetic CDOs, and other complex financial products, and the contraction in the availability of commercial paper has limited the ability of businesses outside the housing industry, such as specialty retail chains and airline companies, to refinance their way out of cash flow problems. A few investment funds, such as First NLC Financial Services and Bear Stearns High-Grade Structured Credit Strategies, have filed for bankruptcy protection, and as many besieged hedge funds close their doors, others are likely to consider their options in chapter 11.

While the full impact of the subprime contraction is still murky, there are some legal and economic conclusions that can be drawn from the recent bankruptcy experiences of mortgage originators:

- **The post-BAPCPA trend is reversing, temporarily.** Business bankruptcy filings have been on a steep and steady decline since the implementation of the 2005 amendments to the Bankruptcy Code, which limited exclusivity, key employee retention plans, and debtor leverage in areas such as reclamation rights and preference claims.<sup>52</sup> As the subprime meltdown reaches into the lower tiers of corporate credit, however, both consumer and business bankruptcy filings are beginning to buck this trend, at least for 2008. Consumer filings were up 40 percent from 2006 to 2007,<sup>53</sup> and public company filings during the last two years rose from 66 in 2006 to 78 in 2007, on total chapter 11 filings of 5,010 for 2006 and 6,236 in 2007.<sup>54</sup> Anecdotal and initial statistical evidence

indicates that 2008 business filings will substantially exceed those of 2007 in both quantity and claim amounts, and one source estimates that chapter 11 filings increased 16 percent during the first quarter of 2008 over the preceding year.<sup>55</sup>

- **The claims are huge, but the cases are not.** In terms of assets, mortgage lenders filed the five biggest public company bankruptcy cases of 2007.<sup>56</sup> But in these cases asset size does not correlate with case duration or complexity. Most of the mortgage bankruptcies of 2007 resulted in section 363 sales of most business assets or converted to chapter 7 within four to ten months of filing. This result is explained by the fact that (1) most mortgage lenders had few business assets other than servicing agreements, which were sold off to distressed investors or strategic buyers, (2) the major repurchase agreements will fall within the safe harbor protections of Bankruptcy Code sections 362(b)(7), 546(f) and 559, reducing bankruptcy entanglements for those counterparties, and (3) because none of the creditors—hedge funds and investment banks, for the most part—had any real interest in preserving a debtor’s going-concern value. It is not unrealistic to believe that future chapter 11s in other financial services sectors will follow the blueprint of “carve up and sell off.” Those rare companies that survive chapter 11 will likely be ones that have prearranged or prepackaged plans set on a fast judicial track.
- **The biggest legacy of these bankruptcy cases may be litigation.** While in many chapter 11 cases litigation revolves around basic avoidance actions and low-probability “kitchen sink” complaints filed by committees against pre-petition lenders, subprime-related lawsuits against directors and officers, underwriters, insurers, lenders and audit professionals are likely to comprise a large part of creditor recovery. This litigation, whether commenced inside or outside bankruptcy court, is likely to trail the effective end of the bankruptcy cases for many years.
- **DIP and exit financing will become more expensive.** As the economic effects of the subprime contraction ripple through capital markets, financing for distressed entities will become more expensive. In a seller’s market, DIP lenders can be expected to demand shorter termination periods, more due diligence, wider rate spreads and higher fees. Although a strict comparison of initial proposed DIP facilities is not easily accomplished, a comparison of the ten largest chapter 11 cases for 2007 and 2008 generally indicates that rate spreads in DIP loans are widening, meaning that financing—inside or outside the mortgage industry—is becoming more expensive.<sup>57</sup> Exit lenders, for their part, will be more reluctant to wait until after closing to syndicate loan commitments and will likely impose (and enforce) more restrictive covenants than in previous deals.<sup>58</sup>

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<sup>1</sup> U.S. Congress, Joint Economic Committee, “The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here,” October 2007, at 10, accessed April 2, 2008 at <http://jec.senate.gov/Documents/Reports/10.25.07OctoberSubprimeReport.pdf> (hereinafter “Subprime Report”).

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- <sup>2</sup> Steve Schifferes, “Carnage on Wall Street as Loans Go Bad,” *BBC News*, November 13, 2007, accessed April 2, 2008 at <http://news.bbc.co.uk/1/hi/business/7086909.stm>.
- <sup>3</sup> Christopher L. Cagan, “Mortgage Payment Reset: The Issue and the Impact,” March 19, 2007, at 28, accessed April 2, 2008 at <http://www.facorelogic.com/newsroom/marketstudies/mortgage-payment-reset-issue-and-the-impact.jsp>.
- <sup>4</sup> Subprime Report, at 10.
- <sup>5</sup> “NY Attorney General Files Appraiser Fraud Suit Against First American,” *Mortgage News Daily*, November 2, 2007, accessed April 10, 2008 at [http://www.mortgagenewsdaily.com/1122007\\_Appraiser\\_Fraud\\_Suit.asp](http://www.mortgagenewsdaily.com/1122007_Appraiser_Fraud_Suit.asp).
- <sup>6</sup> Jennifer E. Bethel, Allen Ferrell and Gang Hu, “Law and Economic Issues in Subprime Litigation,” Discussion Paper dated March 2008, accessed April 2, 2008 at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/Ferrell\\_et\\_al\\_612.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf); Subprime Report, at 10.
- <sup>7</sup> Subprime Report, at 18.
- <sup>8</sup> Bethel, et al., at 6-7. Because the structure of the various financial products often makes for loose terminology, for the limited purpose of this article “straight pass-through” residential mortgage-backed obligations as “RMBS” and mortgage pools that have been packaged then segregated into various priority tranches as “CDOs.”
- <sup>9</sup> Ben S. Bernanke, speech to the National Community Reinvestment Coalition, March 14, 2008, transcript accessed April 2, 2008 at <http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm>; Subprime Report, at 10.
- <sup>10</sup> Adam B. Ashcraft and Til Schuermann, “Understanding the Securitization of Subprime Mortgage Credit,” Federal Reserve Bank of New York Staff Reports, March 2008, at 8, accessed April 2, 2008 at [http://www.newyorkfed.org/research/staff\\_reports/sr318.pdf](http://www.newyorkfed.org/research/staff_reports/sr318.pdf); Subprime Report, at 10.
- <sup>11</sup> Robert R. Callis and Linda C. Cavanaugh, “Census Bureau Reports on Residential Vacancies and Homeownership,” *U.S. Census Bureau News*, release dated January 29, 2008, p.4; U.S. Census Bureau, “Census Bureau Reports on Residential Vacancies and Homeownership,” April 28, 2008, at 4, accessed May 16, 2008 at <http://www.census.gov/hhes/www/housing/hvs/qtr108/q108press.pdf>.
- <sup>12</sup> David Leonhardt, “Can’t Grasp the Credit Crisis? Join the Club,” *New York Times*, March 19, 2008, accessed April 2, 2008 at <http://www.nytimes.com/2008/03/19/business/19leonhardt.html> (quoting Ethan Harris of Lehman Brothers).
- <sup>13</sup> Subprime Report, at 2.
- <sup>14</sup> National Association of Realtors, “Median Sales Price of Existing Single-Family Homes for Metropolitan Areas, 2005-2007,” accessed April 2, 2008 at [http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/\\$FILE/MSAPRICESF.pdf](http://www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf); Subprime Report, at 4.
- <sup>15</sup> Bernanke, supra.
- <sup>16</sup> Subprime Report, at 7, 26 (citing estimates of 18 to 20 percent default rates).
- <sup>17</sup> Mortgage Bankers Association, press release, March 6, 2008, accessed April 21, 2008 at <http://mbaa.org/NewsandMedia/PressCenter/60619.htm>.
- <sup>18</sup> RealtyTrac, “Foreclosure Activity Increases 8 Percent in January 2008,” March 11, 2008, accessed April 2, 2008 at <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4295&acct=64847>; RealtyTrac, “Foreclosure Activity Decreases by 4 Percent in February,” March 13, 2008, accessed April 2, 2008 at <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4284&acct=64847>; *Mortgage News Daily*, “RealtyTrac Report Confirms Foreclosures Skyrocketing,” January 29, 2008, accessed April 2, 2008 at [http://www.mortgagenewsdaily.com/1292008\\_Foreclosures\\_2007.asp](http://www.mortgagenewsdaily.com/1292008_Foreclosures_2007.asp); Mortgage Bankers Association, press release, March 6, 2008, accessed April 21, 2008 at <http://mbaa.org/NewsandMedia/PressCenter/60619.htm>.
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- <sup>20</sup> Les Christie, “Home Prices in Steepest Quarterly Drop,” *CNNMoney.com*, February 14, 2008, at [http://money.cnn.com/2008/02/14/real\\_estate/home\\_prices\\_fall\\_for\\_year/index.htm?postversion=2008021414](http://money.cnn.com/2008/02/14/real_estate/home_prices_fall_for_year/index.htm?postversion=2008021414), accessed May 16, 2008 (citing data by National Association of Realtors); “NAR: Prices Up in 1 of 3 Metro Areas,” *Realtor Magazine*, May 13, 2008, at <http://www.realtor.org/RMODaily.nsf/pages/News2008051301>, accessed May 16, 2008.
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- <sup>23</sup> Emergency Motion of JPMorgan Chase Bank, N.A. in *In re HomeBanc Mortgage Corp.*, Case No. 07-11079 (Bankr. D. Del.), docket no. 5, at 1-3.
- <sup>24</sup> Debtors' Motion for Modification of the Automatic Stay, in *In re American Home Mortgage Holdings, Inc.*, Case No. 07-11047 (Bankr. D. Del.), docket no. 3344, at 1-3
- <sup>25</sup> Order on Phase 1 Trial, *Calyon New York Branch v. American Home Mortgage Corp.* Adv. Pro. 07-51704, in *In re American Home Mortgage, Inc.*, Case No. 07-11047, docket no. 77, at 1.
- <sup>26</sup> Second Amended Disclosure Statement Describing Debtor's Second Amended Liquidating Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, in *In re Ownit Mortgage Solutions, Inc.*, Case No. 06-12579 (Bankr. C.D. Cal.), docket no. 845, at 35-38.
- <sup>27</sup> Final Report of Michael J. Missal, Bankruptcy Court Examiner, in *In re New Century TRS Holdings, Inc.*, Case No. 07-10416 (Bankr. D. Del.), docket no. 5132 (filed under seal, unsealed March 26, 2008), accessed April 10, 2008 at [http://graphics8.nytimes.com/packages/pdf/business/Final\\_Report\\_New\\_Century.pdf](http://graphics8.nytimes.com/packages/pdf/business/Final_Report_New_Century.pdf).
- <sup>28</sup> Complaint, *UBS Real Estate Securities, Inc. v. New Century Mortgage Corp., et al.*, Adv. Pro. No. 07-50875, in *In re New Century TRS Holdings, Inc.*, Case No. 07-10416 (Bankr. D. Del.), docket no. 1.
- <sup>29</sup> Complaint for a Temporary Restraining Order and for Declaratory and Injunctive Relief, *Credit Suisse First Boston Mortgage Capital LLC v. American Home Mortgage Corp.*, Adv. Pro. 07-51684, in *In re American Home Mortgage Corp.*, Case No. 07-1119 (Bankr. D. Del.), docket no. 1, at 1-3; Complaint for Declaratory and Injunctive Relief, *Morgan Stanley Mortgage Capital Holdings LLC v. American Home Mortgage Corp.*, Adv. Pro. 07-51690, in *In re American Home Mortgage Corp.*, Case No. 07-1119 (Bankr. D. Del.), docket no. 1, at 1-2; Complaint for Declaratory and Injunctive Relief, *Bear Stearns Mortgage Capital Corp. v. American Home Mortgage Corp.*, Adv. Pro. 07-51701, in *In re American Home Mortgage Corp.*, Case No. 07-1119 (Bankr. D. Del.), docket no. 1, at 1-3.
- <sup>30</sup> *Miller v. Santilli, et al.*, Case No. 07-04506 (E.D. Pa. Oct. 25, 2007).
- <sup>31</sup> *Federal Guaranty Insurance Company v. American Home Mortgage*, Adv. Pro. No. 07-51725, in *In re American Home Mortgage Corp.*, Case No. 07-1119 (Bankr. D. Del.), docket no. 1, at 1-5.
- <sup>32</sup> *Broadhollow Funding LLC et al. v. Bank of America*, Adv. Pro. No. 07-51738, in *In re American Home Mortgage Corp.*, Case No. 07-1119 (Bankr. D. Del.), docket no. 1, at 1-5.
- <sup>33</sup> *Delta Financial Corp. v. Westchester Surplus Lines Insurance Co.*, Adv. Pro. No. 08-50287, in *In re Delta Financial Corp.*, Case No. 07-11880 (Bankr. D. Del.), docket no. 1, at 1-2.
- <sup>34</sup> Debtor's Proposed First Amended Disclosure Statement for Debtors' First Amended Joint Liquidating Plan of Reorganization Under Chapter 11 of the Bankruptcy Code Dated March 28, 2008, in *In re People's Choice Home Loan, Inc.*, Case No. 07-10765 (Bankr. C.D. Cal.), docket no. 1004 (hereinafter, "PCDS"), at 22.
- <sup>35</sup> *Id.* at 23-26.
- <sup>36</sup> *Id.* at 27-28.
- <sup>37</sup> *Id.* at 29-30.
- <sup>38</sup> *Id.* at 30-32.
- <sup>39</sup> *Id.* at 20-21.
- <sup>40</sup> *Id.* at 36-38.
- <sup>41</sup> *Id.* at 45-47, Exhibit C.
- <sup>42</sup> *Id.* at 52-53.
- <sup>43</sup> Notice of Motion and Motion for Order Approving Debtors' Settlement with Residential Funding Company, LLC and Homecomings Financial, LLC, in *In re People's Choice Home Loan, Inc.*, Case No. 07-10765 (Bankr. C.D. Cal.), docket no. 886 (approved by order dated March 24, 2008).
- <sup>44</sup> *In re Bonham*, 229 F.3d 750, 766 (9<sup>th</sup> Cir. 2000).
- <sup>45</sup> PCDS, at 53-63.
- <sup>46</sup> Bernanke, *supra*.
- <sup>47</sup> Cagan, at 30.
- <sup>48</sup> Subprime Report, at 4, 6.
- <sup>49</sup> Jenny Anderson, "Wall St. Banks Confront a String of Write-Downs," *New York Times*, February 19, 2008, accessed April 2, 2008 at [http://www.nytimes.com/2008/02/19/business/19banks.html?\\_r=2&ref=business&oref=slogin&oref=slogin](http://www.nytimes.com/2008/02/19/business/19banks.html?_r=2&ref=business&oref=slogin&oref=slogin).
- <sup>50</sup> Brian Love, "OECD Raises Subprime Loss Tally to \$350-420 bn," Reuters report, April 15, 2008, accessed April 17, 2008 at <http://www.reuters.com/article/telecomm/idUSL1579684220080415?sp=true>.

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<sup>52</sup> Administrative Office, U.S. Courts, “Bankruptcy Statistics,” accessed April 2, 2008 at <http://www.uscourts.gov/bnkrpctystats/statistics.htm#june>.

<sup>53</sup> American Bankruptcy Institute, “January Consumer Bankruptcy Filings Increase 30 Percent Over Previous Year,” press release dated February 4, 2008, accessed April 2, 2008 at <http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=50714>.

<sup>54</sup> Mark Douglas, “United States: The Year in Bankruptcy 2007 – Part I,” accessed April 9, 2008 at <http://www.mondaq.com/article.asp?articleid=58228>.

<sup>55</sup> Tiffany Kary and Caroline Salas, “Bankruptcies Rise for ‘Firms that Should Have Failed (Update 1),”” *Bloomberg News Service*, accessed April 15, 2008 at <http://www.bloomberg.com/apps/news?pid=20601109&sid=ar84gQGhY7Ic&refer=news> (citing Jupiter eSources LLC).

<sup>56</sup> *Id.* (New Century, American Home Mortgage, Homebank, Delta and NetBank).

<sup>57</sup> LIBOR spreads for large 2008 cases have tended to run in the “LIBOR plus 4-7 percent” range, while DIPs for large 2007 cases tended to offer LIBOR plus 2-3 percent.

<sup>58</sup> An example of a “worst-case” scenario for debtors may be found in the adversary proceeding *Solutia, Inc. v. Citigroup Global Markets, Inc., et al.*, Adv. Pro. No. 08-01057, in *In re Solutia, Inc.*, Case No. 03-17949 (Bankr. S.D.N.Y.), a \$3.2 billion dollar lawsuit brought by a debtor after its prospective exit lender refused to close, citing problems syndicating the loan. In another case, Appaloosa Management, a \$2.55 billion exit lender, announced that it was pulling out of a \$6.1 billion exit financing package for ailing automotive components manufacturer Delphi Corporation. *In re Delphi Corporation*, Case No. 05-44481 (Bankr. S.D.N.Y.); “Appaloosa hedge fund terminates \$2.55 billion investment agreement with Delphi International,” *International Herald Tribune*, April 4, 2008, accessed on April 15, 2008 at <http://www.iht.com/articles/2008/04/04/business/delphi.php>.