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The eNewsAlert for the Coalition for Mortgage Industry Solutions ("CMIS")

Coalition for Mortgage Industry Solutions

CMIS *focus*

Special eNews Alert Update *for Credit Unions, Regional and Community Banks*

1. HAMP: Is Compliance With HAMP/HAFA Causing Excessive Impairment Losses, Lower Capital Ratios, Or Threatening Safety and Soundness?

*** What is 'Materially Impact' or 'Material Change' Under HAMP/HAFA?**

*** Can Banks Opt-Out of HAMP or Fashion Variances?**

*** HAMP "Certifications" Are Coming Due: Can You Sign for 100% Compliance?**

2. Commercial Real Estate Workouts - New Law Updates!

Are Commercial Real Estate & Debt Workouts Finally Ready For Prime Time?
[9-7-10 Revenue Procedure 2010-30; The Dawn of New Creative Financing Empires]

Feature Articles:

"Zone of Insolvency" Meets the "Zone of Coverage" in the Mortgage Meltdown"
By Richard Ivar Rydstrom, Esq., Chairman, Coalition for Mortgage Industry Solutions (www.CMISMortgageCoalition.org)

Removing the Toxicity: The Detoxification Process under the Financial Stability Plan *A Primer on the Public Private Investment Partnership* By Andrew J. Sherman, Esq., Jones Day

Conference Corner: **Thank You for a Successful American Legal & Financial Network (ALFN) Conference on July 18-21, 2010 at the Grand Hyatt Washington**, Washington, D.C.

ALFN AMERICAN LEGAL & FINANCIAL NETWORK

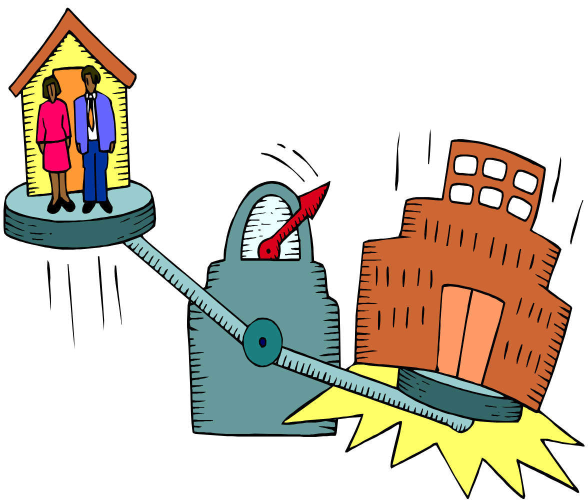
Coalition for Mortgage Industry Solutions

CREOBA Commercial REO Brokers Association

eNews Alerts

1. HAMP: Is Compliance With HAMP/HAFA Causing Excessive Impairment Losses, Lower Capital Ratios, Or Threatening Safety and Soundness?

The Net Present Value (NPV) calculation for HAMP requires the comparison between the *cost of foreclosure* and the *cost of modification*; but fails to take into account the ***cost of impairment loss* of principal and interest forgiveness or reductions and the affect on capital and covenant ratios.** Ever-changing supplemental directives may have a negative impact or alter the HAMP contractual expectations. This is a material issue, and under HAMP may be classified as a material change, allowing opt-out, or variance analysis. This is a critical issue for consideration for each institution.



Many regional or community banks and credit unions may incur substantial losses due to the *cost of impairment of principal and interest forgiveness or reductions* to the extent requiring special attentiveness to safety and soundness.

Solutions to this dilemma may include:

1. Fashioning opt-outs or variances from HAMP requirements or programs

2. Alternative solutions to principal and interest reductions or forgiveness, including *management safe harbor* principal or interest reduction devices or methods

Material loss write-offs and asset write-downs may cause substantial capital and covenant ratio impairments and lending restrictions. Alternative solutions which produce true borrower affordability on a monthly cash basis and at the same time lessen or eliminate loss write-offs at the outset on modifications, or on alternatives to foreclosure, such as short sales, are now of paramount concern to all banks, financial lending institutions, and portfolio holders, but especially, smaller regional or community banks, as well as credit unions.

'Material Changes' effectuated by new Supplemental Directives may allow participating servicers (as HAMP signatory lenders, banks and credit unions) to make a case to opt-out of HAMP or HAFA, or request a variance to changes contained in the program requirements necessary to avoid or avert excessive impairment losses or challenges to safety and soundness. Since the HAMP commitment is a contractual obligation, material changes must rise to the level of 'unforeseen negative impacts' changing the contractual bargain, causing a threat to safety and soundness of the institution.

The institution should consider the following questions:

> Is HAMP or HAFA economically feasible as originally thought? For example, did the Unemployment Supplemental Directive materially impact HAMP contractual or economic expectations?
>
> Does the institution have a duty to consider alternatives to HAMP, HAFA or select Supplemental Directives when implementation will have a negative financial impact, or place the institution within consideration of the legal duties concerned with the zone of insolvency?

Certifications: HAMP certifications are coming due this month. Can your institution certify 100% absolute compliance without condition or qualification?

The author has successfully achieved reprieve from HAMP obligations for a major banking institution wherein its capital ratios were impaired.

Small banks and Credit Unions must address variances for HAMP, and new opportunities for commercial workouts, to reverse or preserve its capital or lending ratios.

By Richard Ivar Rydstrom, Esq., Rydstrom Law Group (rich@rirlegal.com) (949-678-2218).

About Richard Ivar Rydstrom: Mr. Rydstrom started his career 30 years ago as a Wall Street accountant/auditor for the banking industry. He holds a J.D. in Law, LL.M. in Taxation and Bachelor of Science in Professional Accounting. He is an honorary member of the AFN, a national expert published by the industry numerous times, and a frequent panelist and national keynote speaker. He was a member of the Treasury/Industry HAMP policy and foreclosure working groups. He has successfully assisted a major California banking institution to avoid the negative impacts of HAMP and secured its safety and soundness. In August 2010 he received the honor of *OC Top Attorney*. He is the Chairman of CMIS (Coalition for Mortgage Industry Solutions of DC), a California attorney for over 20 years, and a mortgage banking solutions provider. He is published by *Congress (House Ways & Means Committee)*, published, or quoted in the national and regional media, and a keynote speaker and frequent panelist in the mortgage banking and foreclosures industries for the AFN, NBI, CMIS, CMBA, etc. Mr. Rydstrom has been quoted or published by: *110th Congress of the United States*, The Los Angeles Times, USA Today Magazine, AIR Commercial Real Estate Association, Constructor Magazine for the American General Contractors Association, MortgageOrb, Mortgage Daily News, The American Legal & Financial Network, Orange County Register, Tax.org, National Business Institute, CMISfocus Magazine, Pepperdine University (Law, Business Journal), Society of California Accountants, landlords and real estate owners associations nationwide, and others. Mr. Rydstrom in his predictive writings in 2006 warned of a cataclysmic mortgage and financial meltdown. In January 2007, in his *Statement to the 110th Congress, House Ways & Means Committee* for Chairman Charles Rangel, he identified the specific pressing mortgage industry problems in terms of the economy, retirement, housing, and the mortgage banking and finance industries. Mr. Rydstrom also enunciated several key solutions in categorical terms, two of which were later identified as revolutionary. In 2007 Mr. Rydstrom and CMIS created an all day Executive Leadership Summit in DC with William LeRoy and the AFN (and its member sponsors). Mr. Rydstrom and his special guest, *Wilbur Ross* (American Home Mortgage) explored and discussed remedies and new principal reduction techniques that would be necessary to incentivize all parties to the mortgage transaction. Congress implemented limited principal reduction devices with little success, and expanded the scope of same in 2010; as principal reduction has become a paramount concern. Mr. Rydstrom was a member of the HAMP working groups with the AFN (Treasury, MBA, etc.) Mr. Rydstrom created a special all day live CLE webcast and course book with CMIS and the National Business Institute (NBI), entitled: The Business, Law & Ethics of Mortgage Modifications. Mr. Rydstrom has created safe harbor management tools which lessen litigation and moral hazard risks. He created solutions to principal reduction, forgiveness and loss write-offs, loan loss reserves, write-downs and valuations, re-default rates, ratings, (embedded) enhancements, litigation risks, and investor tranche or tier conflicts. He has created multi-party incentives that allow for, among other things, the optimization of principal loan write-downs that lessen frequency and severity of loss write-offs at the outset, while at the same time (1) optimizing the return to the loan holders (trusts, REMICS, owners and investors) and (2) maximizing the borrower's truly affordable monthly payment. Some of Mr. Rydstrom solutions are: SHILO™ (Safe Harbor Intelligent Loan Options™), QBieSam™ (Quarantined Built In Equity Share Appreciation Modifications™ (Mortgages)), Short Sale Safe-Harbor™, REO Safe-Harbor™, and FMII™(Foreclosure Mortgage Insured Investment Funds™). Richard Ivar Rydstrom, Esq., LL.M. T: (949) 678-2218 E: rrydstrom@gmail.com

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2. Commercial Real Estate Workouts - New September 2010 Law Updates!

Are Commercial Real Estate & Debt Workouts Finally Ready For Prime Time?

[This is the Dawn of New Creative Financing Empires; New 2010 Tax Regulations Support the Ballooning Commercial Workout with Revenue Procedure 2010-30]

By Richard Ivar Rydstrom, Esq., LL.M.
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(Pre-Released to CREOBA Members)

September 7, 2010

If you have ever wondered how and why certain rules come to exist, take a look behind the new tax Revenue Procedure 2010-30 to understand the 'thinking' behind commercial modifications and debt restructurings. Just as commercial

real estate workouts are set to balloon, Revenue Procedure 2010-30 was issued to describe the circumstances under which the Internal Revenue Service will not challenge a mortgage loan held by a real estate mortgage investment conduit (a "REMIC") as other than a "qualified mortgage" on the grounds that the mortgage loan fails to be principally secured by an interest in real property for purposes of section 860G(a)(3)(A) of the Internal Revenue Code and § 1.860G-2(a)(8) of the Income Tax Regulations following a release of a lien on an interest in real property that secures the mortgage loan. Revenue Procedure 2010-30 will appear in IRB 2010-36 dated Sept. 7, 2010 and apply to release of liens on interests in real property held by REMICS on or after September 16, 2009.

If this movie sounds familiar, it should. On September 16, 2009, TD 9463 (26 CFR Parts 1 and 602) took effect. TD 9463 **expanded the list of permitted exceptions** under Section 1.860G-2(b)(3) to include (1) changes in **collateral, guarantees, and credit enhancement** and (2) clarified when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage. Although these final regulations (TD 9463) resolved and clarified many issues for Modifications of commercial mortgages held by Real Estate Mortgage Investment Conduits (REMICs), the IRS and Treasury continued to study commentators' recommendations and solicited input concerning comments on whether additional guidance may be appropriate on Modifications of Commercial Mortgage Loans Held by an Investment Trust (Notice 2009-79).

Last year, TD 9463, expanding on the work of Rev. Proc. 2009-45, paved the way for borrowers, special servicers, attorneys, and brokers to start the workout process **before default or upon a reasonably foreseeable default,** to afford the servicer more chances of fashioning a workout plan without invoking fear of violating REMIC, contract, or covenant restrictions, and without unnecessary costs, fees, or regulation restrictions (See **New Final Regulations Resolve Open Issues for Modifications of Commercial Mortgages Held by REMICs –But Modifications Held by Investment Trusts Remain Unanswered Pending Comments** [TD 9463, Rev. Proc. 2009-45, Notice 2009-79] By: Richard Ivar Rydstrom, Esq.; http://www.commercialworkoutgroup.com/COMMERCIAL_MODS_REGS_ARTICLE_9-16-09_A_1__1_.pdf). For illustration, TD 9463 concluded in part as follows:

1. The Lien Release Rule - The final regulations clarify that a release of a lien on real property that does not result in a significant modification under §1.1001-3 (***for example, a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan***) is not a release that disqualifies a mortgage loan, so long as the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. Similarly, the final regulations clarify that a lien release occasioned by a default or a reasonably foreseeable default is not a release that disqualifies the mortgage, so long as the principally-secured test continues to be satisfied.

To satisfy a lender (in a modification), the borrower may have to enhance the value and quality of the security for the loan (collateral) by adding, replacing or pledging other assets as collateral. Examples may include substitute collateral that consists of other real property, or Government Securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a1)); Stripped bonds and coupons. The term qualified mortgage includes stripped bonds (1286(e)(1) and stripped coupons (1286(e) (2) and (3)) if the bonds would have been qualified mortgages.

2. The Requirement to Retest the Collateral Value - The TD required a retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan). Here as well, the principally secured test is satisfied if either the 80–percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before. In addition, to provide a more flexible standard for changes that do not decrease the value of real property securing the mortgage loan, the final regulations provide an alternative method for satisfying the principally secured test. For these types of changes (***for example, a change from recourse to nonrecourse, or vice versa***), the final regulations provide that a modified mortgage loan continues to be principally secured by real property if the fair market value of the interest in real property that secures the loan immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the loan immediately before the modification. This alternative test is consistent with the general rule that a decline in the value of collateral does not cause a mortgage loan to cease to be principally secured by real property. The final regulations provide an example to illustrate the application of this alternative method for satisfying the principally secured test. The final regulations also require retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a ***release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan***). Here as well, the principally secured test is satisfied if either the 80–percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before.

If the loan docs allowed the release of certain property securing the loan, such as a ground lease, pad, or parking lot, when the borrower reached certain predefined lease-up goals, or valuations, as long as the fair market value continued to meet the 80% principally secured test immediately after the release, the loan would continue to be a qualified mortgage. In cases where the valuations were lower, and the post-release valuation was below the 80% principally secured test, it would not be permitted under the regulations.

3. The Appraisal Requirement - TD 9463 in pertinent part states: In response to these comments and to make the retesting requirement more consistent with the current rules for satisfying the 80-percent test at the startup day, the final regulations provide that the principally-secured test will be satisfied if the servicer reasonably believes that the modified mortgage loan satisfies the 80-percent test at the time of the modification. The final regulations provide that a servicer must base *a reasonable belief upon a commercially reasonable valuation method*. The final regulations set forth a nonexclusive list of commercially reasonable valuation methods that can be used by servicers for retesting purposes. These same commercially reasonable methods can be used under the alternative test to establish that the value of the real property collateral immediately after the modification is no less than the value of the real property collateral immediately before it.

4. Changes in the Nature of an Obligation from Nonrecourse to Recourse - TD 9463 states: The final regulations clarify that changes in the nature of an obligation from *nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) are permitted so long as the obligation continues to be principally secured by an interest in real property*.

In the event the borrower elects a pre-defined assumption right (contained in the loan documents), but the lender is not comfortable with the credit, it may require a recourse guaranty. This change from nonrecourse to recourse is *permitted so long as the obligation continues to be principally secured by an interest in real property*.

5. Investment Trusts: TD 9463 in pertinent part also deferred to further comment, that changes to the terms of commercial mortgage loans held by investment trusts may raise issues as to whether a "power to vary" is present.

BACKGROUND OF COMMERCIAL MORTGAGE LOANS

Negative Tax Consequences of Modifications (Release of Liens) That Violate Tax Rules/Regulations:

Generally, when a lien is released or a mortgage is modified in whole or part (as a prohibited transaction), a 100% tax may be assessed for violation of the REMIC requirements, or on the gain realized from the disposition of the prior obligation, or on the income from the prohibited transaction (from the modified obligation) (IRC 860 et seq.) Generally, Internal Revenue Code (IRC) section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from "prohibited transactions." The disposition of a qualified mortgage is a prohibited transaction unless the "disposition [is] pursuant to—(i) the substitution of a qualified replacement mortgage for a qualified mortgage . . . , (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation." Section 860F(a)(2)(A).

Revenue Procedure 2010-30 explains that a single commercial mortgage loan is secured by liens on multiple interests in real property. The terms of a commercial mortgage loan typically allow the borrower to obtain a release of a lien if certain conditions are satisfied. In a limited number of cases, the borrower may obtain the release of a lien at will. More often, a <u>lien release is conditioned on a requirement that the borrower pay down the principal</u> on the loan by a prescribed amount. If the mortgage loan is secured by multiple properties, the terms of the obligation may provide that certain properties may be sold and the sale proceeds applied to pay down the loan. In general, <u>the payment required must be no less than the net proceeds from a sale of the property</u> or no less than an amount that is calculated by a predetermined formula.

SCOPE OF NEW RULE:

Section 5 of Revenue Procedure 2010-30 defines the scope of this new rule as follows:

> .01 This revenue procedure applies to a release of a lien on an interest in real property that secures a mortgage loan held by a REMIC in circumstances in which §§ 1.860G-2(b)(7)(ii) and 1.860G-2(b)(7)(iii) are not satisfied. A release of a lien that is effected by either a grandfathered transaction described in section 5.02 of this revenue procedure or by a qualified pay-down transaction described in section 5.03 of this revenue procedure qualifies for the benefits of this revenue procedure.

.02 A grandfathered transaction is any release of a lien on an interest in real property that satisfies the following two criteria—

(1) The lien release is not a modification for purposes of § 1.1001–3(c) because it occurred by operation of the terms of the debt instrument (including a lien release pursuant to the exercise of a unilateral option of the borrower within the meaning of § 1.1001-3(c)(3)); and

(2) The terms providing for the lien release are contained in a contract that was executed no later than December 6, 2010**.**

.03 A "qualified pay-down transaction" is a transaction in which a lien is released on an interest in real property and which includes a payment by the borrower resulting in a reduction in the adjusted issue price of the loan by a "qualified amount" as described in section 5.04 of this revenue procedure.

.04 A "qualified amount" is an amount that is equal to or greater than at least one of the following:

(1) the sum of —

(a) the net proceeds available to the borrower from an arms-length sale of the property to an unrelated person;

(b) the net proceeds from the receipt of a condemnation award with respect to the property; and

(c) in a case to which (a) or (b) above applies, the net proceeds from the receipt of an insurance or tort settlement with respect to the property;

(2) an amount that is determined under the loan agreement and that equals or exceeds the product of —

(a) the adjusted issue price of the obligation at the time of the lien release; multiplied by

(b) a fraction equal to the fair market value at origination of the released interest, divided by the aggregate fair market value at origination of all of the interests in real property that secured the loan immediately before the lien release;

(3) the fair market value (at the time of the transaction) of the interest in real property the lien on which is released, plus the amount of any tort or insurance settlement that is expected to be, or has been, received with respect to the property and that is not reflected directly or indirectly in the

property's fair market value at the time of the transaction;

or

(4) an amount such that, immediately after the transaction, the ratio of the adjusted issue price of the loan to the fair market value of the interests in real property securing the loan is no greater than what that ratio was immediately before the transaction.

.05 The term "net proceeds" for purposes of section 5.04(1) of this revenue procedure means the amount realized for purposes of computing gain or loss under section 1001.

REMICS & SAFE HARBOR DISCUSSION:

Section 3 of Revenue Procedure 2010-30 explains REMICS in pertinent part only, as follows:

.01 Commercial mortgage loans are commonly pooled and held in REMICs, securitization vehicles governed by sections 860A through 860G.

.02 Section 860D(a)(4) provides, in pertinent part, that an entity qualifies as a REMIC only if, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of the entity's assets consist of qualified mortgages and permitted investments. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. See § 1.860D–1(b)(3)(i). As a safe harbor, the amount of assets other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity's assets. Section 1.860D–1(b)(3)(ii).

WHAT IS A MODIFICATION?

.05 Section 1.1001–3(c)(1)(i) defines a "modification" of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001–3(e) governs which modifications of debt instruments are "significant." Under § 1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.06 Under §1.860G–2(b), related rules apply to determine REMIC qualification. Except as specifically provided in §1.860G–2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. See § 1.860G-2(b)(1). For this purpose, the rules in § 1.1001–3(e) determine whether a modification is "significant." See § 1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate the entity's qualification if the modifications cause less than substantially all of the entity's assets to be qualified mortgages.

.07 Certain loan modifications are not significant modifications for purposes of § 1.860G–2(b)(1), even if the modifications are significant under § 1.1001–3. Section 1.860G–2(b)(3) contains a list of modifications that are expressly permitted without regard to the section 1001 modification rules.

WHAT IS A "MORTGAGE LOAN" "PRINCIPALLY SECURED BY AN INTEREST IN REAL PROPERTY"?

Section 4 of Revenue Procedure 2010-30 explains the principally secured by an interest in real property test in pertinent part only, as follows:

.01 A mortgage loan is a qualified mortgage only if it is principally secured by an interest in real property. Section 860G(a)(3)(A).

WHAT IS THE 80% TEST?

.02 In general, for purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property only if it satisfies the "80–percent test" set forth in § 1.860G–2(a)(i). (Section 1.860G–2(a)(ii) contains an alternative test.)

.03 Under the 80–percent test, an obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation—

(1) Was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated; or

(2) Is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC.

.04 In the absence of a lien release or certain other transactions that alter a legal right or obligation either of a REMIC or of the issuer of a mortgage loan that is held by the REMIC, the mortgage loan is not retested to determine whether the current value of its real estate collateral still satisfies the principally secured test.

.05 Under § 1.860G–2(a)(8), if a REMIC releases its lien on an interest in real property that secures a qualified mortgage, the mortgage ceases to be a qualified mortgage on the date the lien is released unless either—

(1) The mortgage is defeased in the manner described in § 1.860G–2(a)(8)(ii); or

(2) The lien is released in a modification that satisfies both of the following criteria:

(i) The modification either is not a significant modification as defined in § 1.860G–2(b)(2) or, under one of the exceptions in § 1.860G–2(b)(3), is not treated as a significant modification for purposes of § 1.860G–2(b)(1); and

(ii) Following the modification, the obligation continues to be principally secured by an interest in real property, as determined by § 1.860G–2(b)(7).

.06 Section 1.860G–2(b)(7) provides that, for purposes of §§ 1.860G–2(a)(8)(i), 1.860G–2(b)(3)(v), and 1.860G–2(b)(3)(vi), an obligation continues to be principally secured by an interest in real property following a transaction that alters the legal rights of the parties only if, as of the date of the transaction, the obligation satisfies either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of § 1.860G–2.

APPRAISALS AND VALUATIONS ARE KEY!

.07 An obligation satisfies § 1.860G–2(b)(7)(ii) if the fair market value of the interest in real property securing the obligation, determined as of the date of the modification, is at least 80 percent of the adjusted issue price of the modified obligation, determined as of the date of the modification. If, as of the date of the modification, the servicer reasonably believes that the obligation satisfies the criterion in the preceding sentence, then the obligation is deemed to do so. A reasonable belief does not exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied. For purposes of § 1.860G–2(b)(7)(ii), a servicer must base a reasonable belief on—

(1) A current appraisal performed by an independent appraiser;

(2) An appraisal that was obtained in connection with the origination of the obligation and, if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property;

(3) The sales price of the interest in real property in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage; or

(4) Some other commercially reasonable valuation method.

.08 An obligation satisfies § 1.860G–2(b)(7)(iii) if § 1.860G–2(b)(7)(ii) is not satisfied but the fair market value of the interest in real property that secures the obligation immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the obligation immediately before the modification. The criterion in the preceding sentence must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method; and the servicer must not actually know, or have reason to know, that the criterion in the preceding sentence is not satisfied.

.09 Under § 1.860G–2(a)(5), obligations secured by interests in real property include mortgage pass-through certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation) and other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, provided that the investment trust is classified as a trust under § 301.7701–4(c) of the Procedure and Administration Regulations.

.10 Under § 1.860G–2(b)(6), if a REMIC holds as a qualified mortgage a pass-through certificate or other investment trust interest of the type described in § 1.860G–2(a)(5), the modification of a mortgage loan that backs the pass-through certificate or other interest is not a modification of the pass-through certificate or other interest unless the investment trust structure was created to avoid the prohibited transaction rules of section 860F(a). Analogously, unless a substantial purpose of the trust structure was to avoid the restrictions imposed by § 1.860G–2(a)(8) and § 1.860G–2(b), the release of a lien on an interest in real property that secures an obligation held by the trust does not cause § 1.860G–2(a)(8) automatically to disqualify the obligation.

.11 When there are significant declines in commercial real estate property values, properties that secure commercial loans may fall in value to an amount below the 80 percent threshold. The borrower may be in default on its obligation or default may be reasonably foreseeable. In these instances, the servicer may work with the borrower to avoid default.

.12 In the preamble to final regulations published September 16, 2009 (the "Final Regulations"), the Service noted that, although a qualified mortgage must be principally secured by an interest in real property, a release pursuant to the terms of a mortgage obligation is not a release that disqualifies the mortgage if the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. In addition, the preamble explains that a lien release occasioned by a default or reasonably foreseeable default would not disqualify a mortgage if the principally secured test continues to be satisfied. See T.D. 9463, 74 FR 47436-01.

Conclusion:

The time is now to engage commercial workouts en-masse. Brokers should contact owners of commercial buildings and banks holding loans or portfolios, and provide valuable workout assistance. As commercial defaults continue to grow in this environment of declining valuations (or negative equity) with the current anemic credit markets, many commercial owner borrowers will not be able to refinance or satisfy the payment due at maturity (or the conditions of refinance). Lack of available funds for principal pay-down workouts is limiting owner borrowers from fashioning acceptable workouts. The accepted model of expecting to use the proceeds from refinancing to satisfy the principal balance due at maturity is facing great challenges and causing defaults, whether or not sufficient cash flow (ROI) can satisfy the existing debt service. Creative finance solutions are now paramount. Owner borrowers, who do negotiate discounted-payoffs, often cannot satisfy the cash needs of the workout, and need creative debt/equity financiers to close the transaction. With less liquidity and less sales, we need more creative take-out procedures and financing, such as short term bridge equity/debt lenders, transfers to *Valuation Implementation Vehicles™ (VIV™)* into unregulated joint venture vehicles (with borrowers, buyers, investors), (financing to) third party note purchasers with simultaneous forbearance agreements, otherwise liquidations will continue as the servicer's solution of choice. Solutions that allow owner borrowers or buyers to hold commercial property for 5-10 years (after discounted workout solutions or purchases) are likely to realize secure equity and profits. Creative financiers have sufficient market demand opportunities that can build new empires (resulting in new major lenders/banking institutions).

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The Prior June 2008 CMIS/AFN DC Executive Leadership Summit Webinar with Solutions from Wilbur Ross is Now Available for Viewing

The AFN filmed the Executive Leadership Summit on June 17, 2008 for the Coalition for Mortgage Industry Solutions ("CMIS"), hosted by Dickstein Shapiro in DC. The AFN developed a Webinar of the Summit which aired over three days on September 24-26, 2008. If you are interested in viewing this webinar, send an email to Matt Bartel, Chief Operating Officer, American Legal & Financial Network (AFN) located at 12400 Olive Blvd., STE 555 St. Louis, MO 63141 Phone: 314-878-2360 Fax: 314-878-2236 mbartel@e-afn.org.

The breakdown for CMIS Webcast was as follows:

1. Introduction/ Welcome - (30min) Overview of the Crisis and State of the Marketplace
   · Michael E. Nannes, Chairman, Dickstein Shapiro, LLP
   · Richard Rydstrom, Esq., CMIS
   · Andrew Sherman, General Counsel, CMIS

2. Keynote: w/Richard Rydstrom moderating (30min)
   · Wilbur L. Ross, Jr. , Chairman & CEO, WL Ross & Co. LLC

3. Panel One: Impact on Capital Markets, Financial Institutions, Consumer and Communities (1hr)
   · Moderator: David W. Dworkin, CEO and Founder, Affiniti Network Strategies, LLC
   · Douglas G. Duncan, Vice President and Chief Economist, Fannie Mae
   · Richard H Neiman, Superintendent of Banks, New York State Banking Department
   · Rick Sharga, Vice President Marketing, RealtyTrac, Inc.
4. Luncheon Keynote Speaker (45 min)
   · Marc H. Morial, President and CEO, National Urban League, former Mayor, City of New Orleans, Former President of the U.S. Conference of Mayors
5. Panel Two: Loss Mitigation- Workouts that Work (and Those that Don't) (1hr)
   · Moderator: Richard Rydstrom, Esq., CMIS
   · Bruce Dorpalen, Co-Founder, Director of Housing Counseling, ACORN Housing Corporation
   · Arnold Gulkowitz, Partner, Bankruptcy Practice, Dickstein Shapiro, LLP
   · Patricia A. Hasson, President, Consumer Credit Counseling Services of Delaware
   · Steve Horne, President, Wingspan Portfolio Advisors, LLC
   · Andrew Jakabovics, Associate Director for the Economic Mobility Program, Center for American Progress
   · Laurie Maggiano, Deputy Director, Office of Single family Asset management, U.S. Department of Housing and Urban Development
6. Panel Three: Charting a Future Course- The Case for Self-Regulation (1hr 15min)
   · Moderator: William LeRoy, CEO, American Legal and Financial Network (AFN)
   · R.K. Arnold, President and CEO MERSCORP, Inc.
   · Francis P. Creighton, Vice President of Legislative Affairs, Mortgage Bankers Association
   · Henry E. "Hank" Hildebrand, Chapter 13 Trustee
   · Robert Klein, Chief Executive Officer, Safeguard Properties
   · Hon. Raymond T. Lyons, U.S. Bankruptcy Court, District of New Jersey
   · Debra L. Miller, Chapter 13 Trustee
   · George W. Stevenson, Chapter 13 and 7 Trustee
   · Carolyn A. Taylor, Partner, Hughes, Watters & Askanase
7. Closing Keynote (15 min)
   · Congressman Thaddeus McCotter (MI-11)

We express our gratitude to the support of our Panelists, Guest Speakers, Keynote Speakers Wilbur Ross, Congressman McCotter, Marc H. Morial (CEO NUL), our summit quests, and participants, the CMIS Summit Executive Team, MortgageOrb and John Clapp, and contributing SPONSORS:

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Removing the Toxicity: The Detoxification Process under the Financial Stability Plan
A Primer on the Public Private Investment Partnership

By Andrew J. Sherman
Jones Day

For CMISfocus
Due: June 15, 2009

"Toxic assets" is a prominent term used to refer to complex set of derivatives and securities, for example mortgage-backed securities and collateralized debt obligations, whose value is tied, through complex mathematical models, to the value of mortgages, in major part sub prime mortgage loans, and other financial instruments. Our article in the previous edition of CMISefocus focused extensively on the composition of such securities.[1] The difficulty in valuation of such securities which is significantly lower than their face value is what has made such assets "toxic". As our article indicates, though the structure of such securities was devised so as to make them fairly safe under normal conditions, they proved to be extremely vulnerable to a significant fall in house prices in the second half of 2007 that burst the housing bubble seen in the five years preceding the commencement of the crisis. The public at large is not directly impacted by the toxicity attained by such assets, but its indirect impact with banks bearing huge losses due to holding a significant quantity of such assets exacerbated by uncertain valuations has created severe doubts about the solvency of such banks. This solvency concern in turn has made banks focus on increasing their capital ratios, by raising more capital or cutting back on new loans or investments. This decreased willingness to make loans is a major factor in the credit crunch that hit businesses and consumers and fueled the severe recession. Such troubled toxic assets have been at the center of the problems currently impacting the U.S. financial system. A vicious cycle in which declining asset prices triggered further de-leveraging and reductions in market liquidity, in turn, led to further price declines.

The Financial Stability Plan

The Financial Stability Plan, announced in February, has three broad goals – improving affordability for responsible homeowners, facilitating a consumer and business lending initiative to unlock frozen credit markets and assist troubled banks with capital injections – and different programs to attain each such goal. In a bid to unlock frozen credit markets so that lending resumes at affordable terms and conditions, the Obama Administration outlined a broad approach to address this issue through the formation of Public-Private Investment Funds ("PPIFs"). In March, the Treasury announced the Public-Private Investment Program under which it will make targeted investments in multiple PPIFs that will purchase such toxic assets that are eligible under the Program. The Public-Private Investment Program is designed to draw new private capital into the market for these assets by providing government equity co-investment and attractive public financing. It is hoped that this program shall facilitate price discovery and shall help, over time, to reduce the excessive liquidity discounts embedded in current toxic asset prices. This in turn should free up capital and allow U.S. financial institutions to engage in new credit formation. Furthermore, enhanced clarity about the value of legacy assets should increase investor confidence and enhance the ability of financial institutions to raise new capital from private investors. The primary areas of focus for the government's troubled legacy asset programs are the residential and commercial mortgage sectors, including both whole loans and securitizations backed by loan portfolios. These troubled assets are held by all types of financial institutions, including those that predominantly hold them in the form of loans, such as banks, and those that predominantly hold securities, such as insurers, pension funds, mutual funds and individual retirement accounts. While the program may initially target real estate-related assets, it can evolve, based on market demand, to include other asset classes.

What is the Public-Private Investment Program?

The Public-Private Investment Program has been formulated to generate $500 billion in purchasing power to buy "legacy assets" – primarily residential and commercial real estate loans held directly by banks ("legacy loans") even though, on market demand, the program may include other asset classes and securities backed by such loan portfolios ("legacy securities"). The generation of $500 billion will include $75 to $100 billion provided as capital by the Treasury under the Troubled Assets Relief Program (TARP) authorized by the Emergency Economic Stabilization Act of 2008, the guarantee provided by the Federal Deposit Insurance Corporation, the capital provision under the Term

[1] Sub-Prime Mortgage Crisis: The Legal Business Fallout, Pink Slips, Attrition & Redeployment, By Andrew J. Sherman, Esq.

Asset-backed securities Lending Facility (TALF) Program[2] by the Federal Reserve and by private investors. The purchase price of the Treasury's total equity investment in this program shall count against the $700 billion cap provided in the Emergency Economic Stabilization Act of 2008. You can avail opportunities in the two programs below provided it meets the requirements proposed therein. Please note that the structure under each program and terms and conditions can be modified by the Treasury at any time at its sole discretion.

The Co-Investment Plan

The equity co-investment component of these programs has been designed to well align public and private investor interests and create substantial purchasing power in order to maximize the long-run value for U.S. taxpayers. Specifically, while the plan is designed to help reduce the liquidity discounts contained in legacy asset prices in the near-term, the most important way to protect taxpayers is to ensure that the government is not paying more for assets than their long-run value as determined by private investors. Since TARP funds will be invested alongside private capital on similar terms, this reduces the likelihood that taxpayers will be overpaying. Second, the Public-Private Investment Program ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns. At the same time, taxpayers will have the opportunity to participate in the asset's upside along with private investors. Similarly, the debt financing components of these programs have been structured to protect taxpayer dollars and the FDIC's Deposit Insurance Fund from credit losses to the greatest extent possible. Lastly, it is intended that private sector investors competing with one another will establish the price of the loans and securities purchased under the program, the value of which is rendered extremely difficult to ascertain. Most participants in the financial system of the United States believe that this approach is better suited to the alternatives of either hoping for banks to gradually work these assets off their books (due to the overbearing risk of a prolonged financial crisis as witnessed in the Japanese "lost decade") or of the government purchasing the assets directly originally authorized under the TARP funds by the Bush Administration (due to the risk that taxpayers will take all the risk of such a purchase).

The PPIP has two components to it – the Legacy Loans Program and the Legacy Securities Program. The remainder of this article shall explain particular characteristics of each such program for readers of this article to be potential participants.

A) The Legacy Loans Program

You can be a potential investor in the Public-Private Investment Funds ("PPIF") or a private investor group forming a PPIF. The following process under the Legacy Loans Program must be borne in mind:

a) Banks identify the assets they wish to sell: To start the process, participating banks will identify a pool of loans they would like to sell. The FDIC will conduct an analysis to determine the amount of debt financing it is willing to guarantee by employing contractors to analyze the pools at its sole discretion. The amount of leverage will not exceed a 6-to-1 debt-to-equity ratio. Assets eligible for purchase will be determined by the participating banks, their primary regulators, the FDIC and Treasury. Financial institutions of all sizes will be eligible to sell assets.

b) Pools are auctioned off to the highest bidder: The FDIC will conduct an auction for these pools of loans. Private investors shall bid for the opportunity to contribute 50% of the equity component for the fund with the Treasury contributing the remainder. Private investors are expected to include different investors including financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, pension funds, foreign investors with headquarters in the United States, private equity funds and hedge funds. Private investor groups shall be approved by the FDIC. For a bid to be considered in the auction process, the bid must be accompanied by a refundable cash deposit for 5% of the bid value. The highest bidder will have access to the Public-Private Investment Program to fund 50 percent of the equity requirement of their purchase. Note that once a bid is selected, the participating bank will have the option of accepting or rejecting the bid within a pre-established timeframe. The winning bid for the equity stake together with the amount of debt the FDIC is willing to guarantee shall define the price offered to the selling bank. Thus, for example, if a pool of residential mortgages with $100 face value obtains a highest bid for $84, FDIC would provide guarantees for $72 of financings (6/7th) which leaves $12 (1/7th) for equity. The highest bidders shall, thereby, set up individual PPIF to purchase pools of loans.

c) Financing is provided through FDIC Guarantee: If the seller accepts the purchase price, the individual PPIF would receive financing by issuing debt guaranteed by the FDIC. This debt will be initially placed at the participant banks that shall be able to resell such debt into the market if they desire. The FDIC-guaranteed debt would be collateralized by the purchased assets and the FDIC would receive a fee in return for its guarantee.

d) Treasury shall provide 50% equity: The Treasury shall provide 50% of the equity funding required on a side-by-side basis with the investor. Note that investors can choose to take less equity funding from the Treasury subject to a minimum that has not been determined. Though the Treasury shall not have control rights through its equity investment, it will receive warrants in the PPIF. So, in the example above, the Treasury would invest approximately $6 and the private investor would contribute $6.

e) Private sector partners manage the assets**:** Once the assets have been sold, private fund managers will

[2] For details of the TALF Program, see Securing Securitization – Resurrecting the "Shadow Banking System", By Andrew J. Sherman, Esq.

control and manage the assets until final liquidation, subject to strict FDIC oversight.

f) Obligations and responsibilities of the Legacy Loan PPIF

(i) PPIFs will be managed within parameters pre-established by the FDIC and Treasury, with reporting to the FDIC and oversight by FDIC. The FDIC will be responsible for providing information required by Treasury.

(ii) Private Investors may not participate in any PPIF that purchases assets from sellers that are affiliates of such investors or that represent 10% or more of the aggregate private capital in the PPIF.

(iii) Each PPIF must agree to waste, fraud and abuse protections to be defined by the Treasury and the FDIC in order to protect taxpayers.

iv) Each PPIF will be required to make certain representations, warranties and covenants regarding the conduct of their business and compliance with applicable law.

(v) Each PPIF will provide information to the FDIC in performance of its oversight role for the benefit of the Treasury and FDIC.

(vi) Each PPIF will be required to maintain a debt service coverage account, which will be stipulated in the FDIC Guaranteed Secured Debt for PPIF term sheet, to ensure that working capital for each PPIF is sufficient to meet anticipated debt servicing obligations, interest expenses and operating expenses. A portion of cash proceeds from the sale of eligible asset pools will be retained until cash flow from eligible asset pools has fully funded the debt service coverage account, at which point the escrowed cash will be released to the participant bank.

(vii) The PPIF retains control of servicing throughout operations, subject to relevant agreements.

(viii) Ongoing administration fees will be paid to the FDIC by PPIFs for oversight functions performed by the FDIC.

(ix) The FDIC will guarantee debt issued by the PPIFs to participant banks or the market as consideration for eligible asset pool purchases. In exchange for the debt guarantee, the FDIC will charge the PPIFs an annual guarantee fee. The Guarantee Fee will be charged based on outstanding debt balances and will be payable to the FDIC annually upon the anniversary date of the transaction closing date. The FDIC guarantee will be secured by the assets in the pool which will be issued as senior debt of the PPIF and will be senior to the equity provided by the private investors and the Treasury.

(x) The Treasury and the FDIC assume no obligation to reimburse or otherwise compensate Participant Banks or Private Investors for expenses or losses incurred in connection with this the proposed summary of terms or the submission of an application.

B) The Legacy Securities Program

The Treasury shall participate in the Legacy Securities Program for investing in "legacy securities" that shall initially include non-agency securities backed by mortgages on residential and commercial properties.

You can be a potential fund manager of the PPIF or a potential investor in the PPIF. The following process under the Legacy Securities Program must be borne in mind:

a) Pre-qualification to participate: A private investment manager submits a proposal for qualification as a "fund manager" and is pre-qualified to raise private capital to participate in joint investment programs with Treasury. Such pre-qualification will be based upon criteria expected to include:

(i) demonstrated capacity to raise at least $500 million of private capital;

(ii) demonstrated experience investing in the legacy securities;

(iii) a minimum of $10 billion in market value of legacy securities under management;

(iv) demonstrated operational capacity to manage funds in a manner consistent with Treasury's investment objective of generating attractive returns for taxpayers and private investors; and

(v) headquarters in the United States.

Other criteria are identified in the application.[3] The Treasury shall approve approximately five fund managers even though it may consider adding more depending on the quality of applications received. *Note, however, that in its April 6 guidance, the Treasury states that the above qualifying criteria will not be viewed strictly but holistically; failure to meet any one criterion will not necessarily disqualify a proposal.*[4] *Additionally, the Treasury is*

[3] https://treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf. Please note that the application deadline for pre-qualification as an asset manager is April 24, 2009.
[4] See http://www.treas.gov/press/releases/tg82.htm

considering opening the program for smaller fund managers after the initial pre-qualification of fund managers under the current framework.[5]

b) Treasury's equity participation: The Treasury agrees to provide an equal amount of equity capital that is raised by the Legacy Securities Public-Private Investment Fund ("PPIF"). The equity capital shall be drawn down in tranches to provide for anticipated investments and shall usually be drawn down at the same time and in the same proportion as private capital is drawn down by the PPIF. Proceeds received by the PPIF will be appropriated between the Treasury and the PPIF based on equity contributions.

c) Treasury's debt provision: The Treasury agrees to provide fund-level senior debt for the proposed PPIF. Each fund manager will have the option to obtain secured non-recourse loans from the Treasury in an agreement amount up to 50% of the PPIF's total equity capital. The Treasury may consider requests for debt financing up to 100% of the PPIF's total equity capital subject to restrictions on asset level leverage, redemption rights, disposition priorities and other factors deemed relevant by the Treasury. Approved fund managers shall have a period of time to raise private capital and will be required to submit a fund raising plan to include retail investors, if possible.

Please note that the PPIF would also be eligible to take advantage of the expanded TALF program[6] or any other Treasury program or approach private sources for obtaining debt funding for purchasing legacy securities if the fund manager so determines. This integration of TALF into the Legacy Securities Program shall result in an inclusion of non-agency residential mortgage backed securities originally rated AAA and outstanding commercial mortgage backed securities in the definition of "eligible collateral". Lending rates, minimum loan sizes and loan durations for fund managers taking advantage of the expanded TALF program have not yet been determined. For avoidance of doubt, TALF is a Federal Reserve lending program with its own set of terms, conditions and eligibility requirements even though an "eligible borrower" utilizing the TALF shall do so on the same terms and conditions as a Legacy Securities program investor utilizing TALF. More details about the TALF framework are described below.

Thus, the Treasury is currently considering the following three options to aid fund managers in the analysis of capital structure alternatives:

(i) No Treasury Debt Financing; leverage limited to Legacy TALF, any other Treasury program or debt financing raised from private sources.

(ii) Leverage limited to Senior Secured Treasury Debt Financing (up to 100% of Fund's total equity capital). No additional leverage permitted.

(iii) Unsecured Treasury Debt Financing (up to 50% of Fund's total equity capital) and additional leverage through TALF, any other Treasury program or debt financing raised from private sources, subject to total leverage requirements and covenants to be agreed upon.

Thus, for example, the fund manager commences the sales process for a potential PPIF and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the PPIF. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the PPIF (thus totaling $200 worth of debt). As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.

d) Long-term buy and hold investment: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. Fund managers will control the process of asset selection, pricing, asset liquidation, trading and disposition.

e) Obligations and responsibilities of a Legacy Securities PPIF

(i) Treasury will retain the right to cease funding of committed but undrawn Treasury equity capital and debt financing in its sole discretion.

(ii) Fund managers will be required to present monthly reports to Treasury on legacy securities purchased and disposed, current valuations of legacy securities and profits/losses included in each PPIF.

(iii) A fund manager may not, directly or indirectly, acquire legacy securities from or sell to its affiliates, any other fund or any private investor that has committed 10% or more of the aggregate private capital raised by the fund. Private investors may not be informed of potential acquisitions of specific eligible legacy securities prior to acquisition.

(iv) Fund managers must agree to waste, fraud and abuse protections for the PPIF to be defined by Treasury in order to protect taxpayers.

(v) Fund Managers must agree to provide access to relevant books and records of the PPIF for Treasury, the Special Inspector General of the TARP, the Government Accountability Office and their respective advisors and representatives to enable appropriate oversight and taxpayer protection.

[5] See https://treas.gov/press/releases/reports/legacy_securities_faqs.pdf

[6] For details of the TALF Program, see Securing Securitization – Resurrecting the "Shadow Banking System", By Andrew J. Sherman, Esq.

ABOUT THE AUTHOR

ANDREW J. SHERMAN is a Partner in the Washington, D.C. office of Jones Day**,** with over 2,400 attorneys worldwide. Mr. Sherman is a recognized international authority on the legal and strategic issues affecting small and growing companies. Mr. Sherman is an ***Adjunct Professor*** in the ***Masters of Business Administration (MBA)*** program at the ***University of Maryland and Georgetown University*** where he has taught courses on business growth, capital formation and entrepreneurship for over twenty (22) years. Mr. Sherman is the author of seventeen (17) books on the legal and strategic aspects of business growth and capital formation. His eighteenth (18th) book, **Road Rules Be the Truck. Not the Squirrel.** (http://www.bethetruck.com) is an inspirational book which was published in the Fall of 2008. Mr. Sherman can be reached at 202-879-3686 or e-mail ajsherman@jonesday.com.

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"Zone of Insolvency" Meets the "Zone of Coverage" in the Mortgage Meltdown – Liability Lessons from the Official Take-Under of Bear Stearns!

By Richard Ivar Rydstrom, Esq.,

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Part I – Issues Overview - All Sides

It was beyond another historic day on Wall Street. The Federal Reserve (Fed) hadn't made a similar move for over 50 years. Rumor had it that Bear Stearns was to file bankruptcy that Monday, March 17, 2008, but the Fed invoked an arcane regulation which effectively "forced" the take over of Bear Stearns by suitor JP Morgan Chase. This move was guaranteed by the unknowing taxpayer to the tune of $29 billion when the Fed granted access to the Discount Window and accepted collateral in amounts and quality which remains secret, uncertain and unknown. Maybe we should call it what it is: a take-under and lateral pass. Over that infamous weekend the Fed, JP Morgan Chase and Bear Stearns agreed to a $2 per share buyout; against a recent $84 per share book value. As late as January 2007, Bear Stearns had a $171 share price. JP Morgan Chase will pay $236 million (with the downside "put option" guarantee or backing of the Fed), including an option on the building. The building is said to be worth more than the deal price alone. What are the legal ramifications? What laws come into play from such conduct?

Lawsuits > Corporate Duties > Business Judgment Rule > Insurance Litigation

The Fed apparently fashioned a credit guarantee take-under (with lateral pass) template for the investment banks, which wipes out common equity while passing the revised and taxpayer guaranteed going-concern to the suitor. It circumvents, and operates outside of the bankruptcy fiefdom, at fire sale prices; at least initially.

Lawsuits >

Investor, shareholder, counterparty, creditor and employee lawsuits are likely to skyrocket around the Bear Stearns take-under or this type of resolution model. For example, JP Morgan Chase will have access to $6-7B allocated to a litigation fund. These lawsuits will further define the gray lines that exist in **"zone of insolvency"** litigation (i.e.: conflicting duties owed by directors and officers to shareholders, creditors, employees and other interested parties). The emerging and heightened duties owed when making decisions in the zone of insolvency will focus much litigation around the ***decision-making-process***. The broad issue may be defined as: what duties are owed to whom, when insolvency is foreseeable? A flood of coming lawsuits will determine whether or not (fiduciary) duties were owed to shareholders, creditors, employees, counterparties or other interested parties, which required the filing of an actual "bankruptcy" instead of the perfection of a secret take-under fire sale. Other issues that must be answered may include: whether or not Directors and Officers (Board of Directors) owe a heightened or fiduciary duty to shareholders, creditors, employees, counterparties or other interested parties when facing insolvency which requires inclusion of such parties in the decision making process?

Corporate Fiduciary Duties >

Similarly with all jurisdictions, directors and officers manage the corporation (entity) for the shareholders. For example, in California, Corporations Code 300 states in pertinent part:

> (a) … the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board. The board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

When the company is clearly solvent, the duty of care (to act prudently) and the duty of loyalty (to refrain from self-dealing) are clearly focused on the entity and the shareholders. As found in most jurisdictions, by way of example, California Corporations Code 309 (a) defines the statutory duty of care and loyalty as:

> (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be **in the best interests of the corporation and its shareholders** and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. [Emphasis added]

Extension of Duties Owed > Threshold Question: Zone of Insolvency >

Historically in California and Delaware, the general rule is that directors owe a fiduciary duty of care and loyalty to the entity and its shareholders; but not to creditors or warrant holders (Simons v Cogan (Del 1988) 549 A2d 300. However, in times of insolvency, or when operating within the zone of insolvency, a question remains: whether or not additional duties or heightened duties arise to others, namely creditors.

In times of historic illiquidity, credit impairment, and economic downturn, compounded by the existence of historic levels of securitized mortgage backed securities (MBS) facing serious devaluation, credit rating downgrades and uncertain insurance coverage, managers (and the Board of Directors) must discern whether they are in the zone of insolvency, and whether or not they owe duties to more remote constituencies, such as creditors, counterparties and employees. To make this determination, they must ascertain whether they are solvent or operating within the zone or vicinity of insolvency (Geyer v Ingersoll Publications (Del Ch 1992) 621 A2d 784). With no clear definitions of the 'zone of insolvency', directors and officers are very often operating within the zone, whether they recognize it or not. California Civil Code 3439.02 states:

> (a) A debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets.
> (b) A debtor which is a partnership is insolvent if, at fair valuations, the sum of the partnership's debts is greater than the aggregate of all of the partnership's assets and the sum of the excess of the value of each general partner's nonpartnership assets
> over the partner's nonpartnership debts.
> (c) A debtor who is generally not paying his or her debts as they become due is presumed to be insolvent.
> (d) Assets under this section do not include property that has been transferred, concealed, or removed with intent to hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable under this chapter.
> (e) Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset.

When operating in the grey area of the 'zone of insolvency', directors and officers may owe additional (fiduciary) duties to creditors, and by analogy, others such as investors, and employees (North American Catholic Education Programming Foundation, Inc., v. Gheewalla, (Del 2007) 930 A2d 92 at 101). The board is often vulnerable to legal attack for not fully acknowledging and addressing or protecting, the interests of these other parties when operating in the zone of insolvency. By failing to address, resolve or safeguard these inherent conflicts of interests among these conflicting diverse self-interests, the board may assume liability **-** for failure to do so.

The law is not settled in this area, and is uncertain in many respects. But in jurisdictions imposing such duties, directors and officers are better advised to include such diverse groups in the decision-making-process. Similar to the administration of a bankruptcy estate, creditor groups are entitled to participate in the litigation of all such issues. For example, did the Bear Stearns merger team have a duty to invite its major creditors, investors, counterparties or employee representatives to the negotiation table to avoid violating these (possibly) heightened duties? No opinion is drawn herein. The author acknowledges that there may be a business judgment defense argument that the Bear Stearns merger was in part motivated by the Feds to avoid a potential broad market meltdown that would have caused total loss to the company (and economy).

Zone of Insolvency in the Mortgage Meltdown > Key Questions >

Zone of Insolvency is the grey-matter of this tumultuous issue. What exactly is the zone of insolvency, and how do directors and officers know they are operating within it? Are the decisions of directors and officers (Board) always susceptible to attack when operating in economic times of foreseeable financial stress when credit and liquidity are uncertainty or much less available then in prior (good) times? What about banks, lenders and investment banks (like Bears Stearns) who have great amounts of Mortgage Backed Securities (MBS) on their books that are subject to probable high default rates, huge write-downs, and additional capital (call) requirements; are they operating in the zone of insolvency? What about their counterparties, especially when probable Rating Agency downgrades are foreseeable? What about holders of securitized MBS and commercial back mortgage securities (CMBS) that are facing probable write-downs, and downgrades from rating agencies, and hold "representations and warranties" from known thinly capitalized mortgage lenders, who have either gone out of business or are likely to do so at any time, and may (or may not) have insurance to cover the losses? These fact patterns and many others may support the elements of numerous causes of action that are generally accepted and/or emerging.

Causes of Action > Personal & Entity Level Liability >

There are many potential causes of action that may ensue to seek redress consistent with the theme conduct of recklessness, gross negligence or intentional conduct intended to defraud the creditors (or others) from assets sufficient to cover the foreseeable debts owed, or to defraud the creditors (or others) of a remedy. Causes of action that may encompass such theme facts may also include, breach of contract, fraud, breach of fiduciary duty, by derivative actions (North American Catholic Education Programming Foundation, Inc., v. Gheewalla, (Del 2007) 930 A2d 92 at 102), and fraudulent transfers, conspiracy to defraud creditors (others), Unfair Business Practices (California Business & Professions Code §17200), sham sale liability, RICO, and Deepening Insolvency ((Bankr. D. Del. 2003) Official Comm. of Unsecured Creditors v Credit Suisse First Boston 299 B.R. 732, 750-52). Creditors may be entitled to use derivative actions, as authorized by most courts, however, direct actions are not generally authorized as yet.

A deepening insolvency cause of action or damages element occurs when the directors and officers incur additional debt while operating in the zone of insolvency, in an attempt to bridge the insolvency gap into the solvency zone. A few courts have indicated that they would or may allow such redress or direct claim. ((Bankr. D. Del. 2007) Miller v McCown De Leeuw & Co., Inc. (In re The Brown Schools), 368 B.R. 394, and Jetpay Merchant Services, LLC. v. Miller, 2007 WL 2701636, 7 (N.D. Tex. Sept. 17, 2007).

Some cases arising out of the Delaware General Corporation Law 271 should serve as a reminder that creditors (and other like parties) who are defrauded out of repayment or assets by which to be redressed, or legal or equitable remedies, will have authority to pursue such claims. For example, the sale, lease or exchange of assets without fair consideration, or made with "disparity (is) so great as to shock the conscience of the court or warrant the conclusion that the majority was actuated by improper motives, thereby working injury to the minority…" (Massaro v Fisk Rubber Corp. 36 FSupp 382 (D Mass 1941), California General Corporation Law at 1000, 1001, and 1100, CSC California Law Affecting Business Entities). The provisions of this section are for the benefit of the stockholders and creditors and they alone can object to the transfer (Gunther v. Thompson, 211 Cal 631).

Moreover, failing to adopt a plan to pay creditors (Delaware General Corporation Law 280, 281; California General Corporation Law, 2004-2011, CSC California Law Affecting Business Entities) may result in further action against the purchaser and seller. "Creditors may pursue the corporate assets into the hands of the transferee corporation when, on the sale of corporate assets, no provision is made for the payment of corporate debts. (McKee v. Standard Minerals Corp. 156 A 193 (Ch Ct 1931); Colonial Ice Cream Co. v Southland Ice Utilities Corp., 53 F2d 932 (CD Cir 1931).
For pleading, law & motion and damages purposes, litigators may very well seek cases limited to facts that indicate that the directors and officers have failed to acknowledge that they are operating in the zone of insolvency, and failed to address, resolve or include creditors, counterparties, investors or employees from participating in the resolution of the these diverse interests. These cases with successful expert testimony would tend to show that the directors and officers acted recklessly, with gross negligence or with the intention to defraud creditors (or others), and/or to wrongfully destroy such remedies.

The defenses of such actions will revolve around the general limitations of corporate duty rules holding that no duty is due such remote parties, no direct action for a deepening insolvency cause of action or as damages exists, invocation of the Business Judgment Rule defense and the factual expert defense argument that the circumstances were merely foreseeable business risks.

However, one thing is for certain: one of the hottest areas of litigation that will arise from the mortgage meltdown will be over insurance coverage. Bad faith actions against carriers should see a rise as disputes over coverage, exclusions, and notice requirements materialize. One example of where a vast landmine of coverage disputes reside is in the buyback or repurchase demand and litigation area.

Related Insurance Coverage & Litigation >

Several types of insurance policies might afford coverage to various buyers or beneficiaries of such mortgage industry related policies, including corporate directors and officers, investment banks, investors, pension funds, assignee trusts, REMICS, owners of mortgage backed securities, shareholders, employees, lenders, and in some cases, borrowers. Coverage may be available for investigations, litigation, defense or indemnity. Directors and Officers (D&O), Errors & Omissions (E&O), Commercial General Liability (CGL), Employment Practices Liability (EPL), Credit Risk, Accounts Receivable or Private Mortgage Insurance (MI), and Investors Residential Value (IRV) insurance policies may be in play.

Whether or not directors and officers (Board of Directors) are required to give notice of a 'potential' claim to their carrier(s) or whether certain exclusions preclude coverage, will be hotly contested as investigations and lawsuits are filed and coverage requests are made. There are very short claims notice requirements (i.e. 10 days) in many of these policies, which may act to preclude coverage (in some states). There are many policy provisions that may preclude coverage or be counter intuitive to good business judgment. Moreover, this uncertainty, and/or potential or actual loss of coverage may add to the argument that the entity operated within a zone of insolvency, and therefore owed a higher or expanded duty (i.e. to creditors).

The Zone of Coverage >

Special Warning: "BuyBacks" & Potential Waiver of Insurance Coverage >

The unwary investment bank or investor demanding subprime defaulted buybacks from the unwary lender or originator, may preclude insurance coverage when adverse positions are taken which outright deny or prove that there is no liability (debt) under the repurchase agreement or buyback demand because certain credit risk policies (MI) have clauses which require the buyer to be in actual debt to gain policy coverage. So the lender industry norm of 'dispute and deny' when faced with buyback demands, may very well jeopardize insurance coverage.

Disputes might better seek further information and evidence of such demands on a loan by loan and document by document level, without an outright denial of such indebtedness, but at the same time, trigger a notice of potential claim to the carrier; but only after consultation with an expert (bad faith and mortgage industry) insurance litigator.

Furthermore, directors and officers must consider whether insurance may or may not be available for such underlying buybacks or its related litigation as a factor in determining whether the company is operating in the zone of insolvency with heightened duties, and how that might affect creditors, counterparties, investors, employees and other interested parties; including the availability of insurance (loss) coverage to each diverse related interest. Buyers of insurance must act quickly when facing investigations, buyback demands, disputes or litigation, to ascertain how to act within the zone of coverage.

Directors and officers must act immediately to seek the advice of expert insurance litigation attorneys – or face the potential of uninsured losses, personal and/or entity level liability.

Resolution of Conflicting Priorities > New Optimal Best Practices Safe Harbor >

For those cases where directors and officers include creditors, counterparties, investors, or employees to participate in the resolution of such diverse interests, such efforts of inclusion may tend to preclude such actions altogether, limit liability and lessen or preclude findings of intent or malice. Moreover, such inclusive participatory resolution strategy practices are or will become the safe harbor or optimal best practice as it benefits all related interests.

An inclusive resolution strategy can be implemented by bringing creditor, shareholder, investor, counterparty, employees or conflicting self interest groups into the **"decision-making-process"** at the time of assessment or acknowledgment of the zone of insolvency. This will also serve the interests of all related parties. However, **confidentiality** may be necessary when structuring an inclusive participatory resolution strategy. Otherwise, filing for bankruptcy protection may be the preferred step for the 'prepared' entity (directors and officers).

The Zone of Coverage Meets the Zone of Insolvency >

The author recommends that the industry consider immediate steps to ascertain optimal best practices that enhance the likelihood that related participants are operating within the "zone of coverage" before "fair value" valuations (FASB 157, etc.) more accurately recognize loss severity due to insecure or uncertain related insurance coverage (procedures), that can be used to support the argument that the entity was (knowingly) operating within the zone of insolvency; finding extended (fiduciary) duties and uninsured liabilities owed not only to first parties, but to third parties, such as creditors, and others. The author will continue this debate for industry executives on www.zoneofcoverage.com , www.procouncil.com and at upcoming AFN industry conferences.

About the Author: Richard Ivar Rydstrom is a California attorney practicing in Southern California helping banks, lenders, and servicers help borrowers, with emphasis in residential, commercial and consumer debt workouts, civil litigation, and select bankruptcy related matters. He is the Chairman of the Chairman of the Coalition for Mortgage Industry Solutions out of DC. He was published by the 110th Congress on the State of the Economy and Challenges Facing the Middle Class, Homeownership, and the Mortgage Meltdown. Mr. Rydstrom created the various solutions for the mortgage banking industry and its consumers:

Opt In Mods™
BK Mods™
Opt In Settlement™
Shared Built In Equity Mods™
QBieSam™
Quarantined Built In Equity Shared Appreciation Mods™

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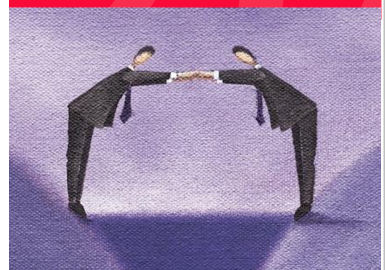

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Conference Corner:

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