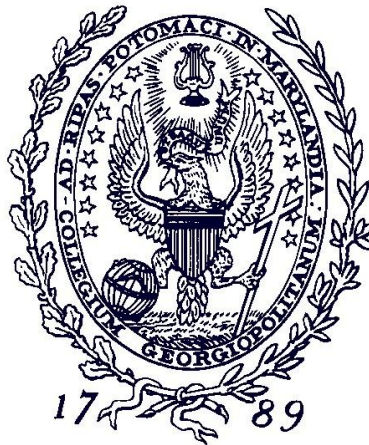


# **REWRITING FRANKENSTEIN CONTRACTS: WORKOUT PROHIBITIONS IN RESIDENTIAL MORTGAGE-BACKED SECURITIES**

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**REWRITING FRANKENSTEIN CONTRACTS:**  
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ANNA GELPERN<sup>†</sup>  
 ADAM J. LEVITIN<sup>‡</sup>

*Modification-proof contracts boost commitment and can help overcome information problems. But when such rigid contracts are ubiquitous, they can function as social suicide pacts, compelling enforcement despite significant externalities. At the heart of the current financial crisis is a contract designed to be hyper-rigid: the pooling and servicing agreement (PSA), which governs residential mortgage securitization. The PSA combines formal, structural and functional barriers to its own modification with restrictions on the modification of underlying mortgage loans. Such layered rigidities fuel foreclosures, with spillover effects for homeowners, communities, financial institutions, financial markets, and the macroeconomy.*

*This Article situates PSAs in the context of theoretical and policy debates about contract rigidity, bond contract modification, and contractual bankruptcy. We propose a typology of contract rigidities, ranging from formal prohibition on amendment (formal rigidity) to extreme collective action problems (functional rigidity). We then draw on New Deal jurisprudence for strategies to overcome each kind of rigidity. These strategies include narrowly tailored legislation that renders the problem terms unenforceable on public policy grounds, administrative restructuring mandates, and special bankruptcy regimes.*

*The New Deal experience highlights the spillover effects of widespread contract practices, the limits of voluntary modification, and the utility of targeted government mandates to rewrite problematic terms. However, it also reveals the limits of such mandates. When different*

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*kinds of rigidity combine in a complex web of contracts, a comprehensive mechanism like bankruptcy may be necessary to break the logjam.*

*Rewriting PSAs will not resolve today's financial crisis. Yet voluntary foreclosure prevention initiatives are unlikely to succeed for as long as contract rigidities persist. The experience with PSAs also holds an important lesson for the future: even where contract rigidity makes perfect sense for the parties, pervasive rigidities can have catastrophic consequences for financial stability and for society.*

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*Yet you, my creator, detest and spurn me, thy creature, to whom thou art bound by ties only dissoluble by the annihilation of one of us.*

-Mary Shelley, Frankenstein or the Modern Prometheus

### **INTRODUCTION: CONTRACT ALCHEMY**

At the heart of the global financial collapse are two kinds of rigid contracts rife with negative externalities. The first is the residential mortgage contract, which becomes problematic when too many homeowners cannot pay what they owe, yet cannot modify their debts. The second is the pooling and servicing agreement (PSA), which governs the management of securitized mortgage loan pools. The PSAs are designed to preclude or severely constrain the modification of both the securitization arrangement and the underlying mortgages. Both mortgage contract and PSA rigidities drive foreclosures on a large scale, with spillover effects on communities, financial institutions, financial markets, and the macroeconomy.

To date, the mortgage contract has drawn the bulk of policy attention. We focus instead on the contractual framework for mortgage securitization, and offer an early attempt to integrate the crisis into contract theory.

Our case study of mortgage securitization adds a critical dimension to theories about rigid contracts. Recent contributions to contract theory have stressed the welfare-enhancing properties of modification-proof contracts: boosting commitment between parties, helping them overcome information asymmetries and agency problems. The literature and policy debates on bond restructuring have struggled with similar arguments for decades. Contractual rigidity is also an essential element in the extensive bankruptcy literature about private contractual ordering of bankruptcy in lieu of statutory rules. Rigidity is necessary to ensure that creditors receive the contractual bankruptcy regime for which they have bargained.

We argue that rigidity's welfare valence is more complex. While rigidity may be sensible among the contracting parties, when it becomes widespread in financial contracts, it can produce

catastrophic externalities. Residential mortgage securitization offers an example.

Securitization has been described as financial alchemy, a process that can change unremarkable financial assets into valuable ones, like lead into gold.<sup>1</sup> Although medieval alchemists contributed much to science and industry, they never made gold, and failed to achieve their grandest promise of eternal life. Recent experience in the largest securitization market, residential mortgage-backed securities (RMBS), conjures up less wholesome tales of scientific progress.

Victor Frankenstein, a Swiss student reared on alchemy before turning to “real” science, dreamt of animating a new species. He collected parts of corpses from charnel houses to make a beautiful giant (small parts would take too long). But when it came to life, the being turned hideous and murderous – just human enough to yearn for society, yet not enough to join it – and in the end destroyed his creator and all that he loved. Frankenstein’s story, with its themes of hubris-tainted brilliance, of ordinary substance magically transformed, of lost control and immutable ties, holds lessons for the immutable contracts that underlie RMBS and the crisis they have fueled.

Like Frankenstein’s doomed masterpiece, securitization contracts combine elements of the ordinary, such as high-threshold voting requirements to change payment terms, common in corporate bonds, with magical features of financial alchemy, such as bankruptcy remoteness, tranching, and resecuritization. The result is a layering of rigidities designed to produce a species of hyper-rigid contracts that boost commitment in good times, but function as suicide pacts in bad times.

Our Article begins in Part I with an account of RMBS design. Part II highlights features of the design that can serve as legal and practical obstacles to contract modification. Securitization contracts can be rigid in three ways: formal (contractual prohibition on amendment), structural (bankruptcy-

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<sup>1</sup> Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134 (1994).

remote, tax-exempt, and off-balance sheet organization) and functional (barriers to coordination).

Part III puts the case study in theoretical context. It situates the PSA as an exponent of contract rigidity in the literature on bilateral and bond contract modification. We draw on the writing about asset securitization to show that – consistent with contract theory – layered rigidity is a key element of RMBS design. We then link the discussion of contract rigidity to the bankruptcy theory debate about so-called “contractual bankruptcy”—proposals to let firms and creditors choose a private regime for dealing with failure.<sup>2</sup> In the RMBS case study, the contracting parties have devised just such a bankruptcy-remote private regime. This regime makes contract renegotiation very costly for the parties, and, we argue, for the society at large. Part IV elaborates the externalities from contract rigidity.

Part V surveys techniques for overcoming the three different kinds of rigidity we identified in RMBS PSAs. After a brief overview of contract modification proposals in connection with the current financial crisis, we look back at three examples of New Deal legislation to revise private contracts. These were designed, respectively, to take the United States off the gold standard, to restructure public utilities, and to stop farm foreclosures. Each sought to overcome a distinct set of contract obstacles with parallels in RMBS. We then review the jurisprudence upholding the New Deal measures. The legal literature has yet to reassess the New Deal’s legislative programs in light of the ongoing crisis. As the country searches for a new paradigm to animate politics and governance, a critical appraisal of specific New Deal programs is an important place to start.

The New Deal experience highlights the spillover effects of pervasive contract practices, the limits of voluntary modification initiatives in the face of collective action problems, and the utility of targeted government mandates to rewrite problematic terms. However, it also reveals the limits of such mandates. Where different kinds of rigidity combine in a complex web of contracts, a

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<sup>2</sup> See *infra* text accompanying notes \_\_\_\_.

comprehensive restructuring mechanism like bankruptcy may be necessary to break the logjam.

We deliberately stop short of a New Deal-style legislative proposal to promote contract modification. Many good ideas are on the table at this writing; no doubt more will emerge as we go to print. None takes a comprehensive view of the rigidity problem. We argue that the problem is not susceptible to a silver bullet, but rather sits at the heart of the intractable relationship between contract and bankruptcy.

Rewriting hyper-rigid PSAs will not resolve the financial crisis. Yet voluntary foreclosure prevention initiatives are unlikely to succeed for as long as contract rigidities persist. The magical features of securitization have animated a species of contracts bound to people, markets and governments with “ties only dissoluble by the annihilation of one of us”.<sup>3</sup> The experience with PSAs holds an important lesson for the future: even where rigidity makes perfect sense for the contracting parties, widespread barriers to modification can unleash catastrophic social consequences. The *ex-ante* benefits of modification-proof contracts must be weighed against their potential systemic costs *ex-post*. A viable set of tools to overcome formal, structural, and functional rigidities is essential for financial stability.

## **I. MEET THE SPECIES: RMBS**

RMBS are a major part of the U.S. capital markets. The principal amount of RMBS outstanding exceeds both U.S. corporate bond and U.S. Treasury debt.<sup>4</sup> As of the end of 2007,

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<sup>3</sup> MARY SHELLY, FRANKENSTEIN (1818, 2007) 102.

<sup>4</sup> FINRA, The Bond Market, at <http://apps.finra.org/investor/Information/smart/bonds/401000.asp> (listing mortgage-related bonds as \$7.2 trillion, corporate bonds at \$5.8 trillion, and US Treasury bonds at \$4.5 trillion). Of the \$7.2 trillion in mortgage-related bonds, over \$6.6 trillion are RMBS. Inside Mortgage Finance, Mortgage Market Statistical Annual (2008).

there were nearly \$6.6 trillion in RMBS outstanding, accounting for nearly a quarter of the U.S. bond market.<sup>5</sup>

RMBS are also central to U.S. housing finance. About 60% of all outstanding residential mortgages by dollar amount is securitized. The share of securitized mortgages by number of contracts outstanding is much higher because the securitization rate is lower for larger “jumbo” mortgages.<sup>6</sup> In recent years, over 90% of mortgages originated have been securitized.<sup>7</sup>

Residential mortgage securitization transactions are complex and varied,<sup>8</sup> but their core structure is simple. A financial institution (the originator) owns a pool of mortgage loans, which it either made itself or bought. Rather than hold these mortgage loans and the credit risk on its own books, it sells them to a shell entity (special purpose vehicle, or SPV), typically structured as a trust. The trust raises the funds to pay for the loans by issuing certificated securities, which are much like bonds whose payments are secured by the loans in the trust. The certificates are known as residential mortgage-backed securities (RMBS). Figure 1, below, illustrates a simplified prototypical RMBS transaction.

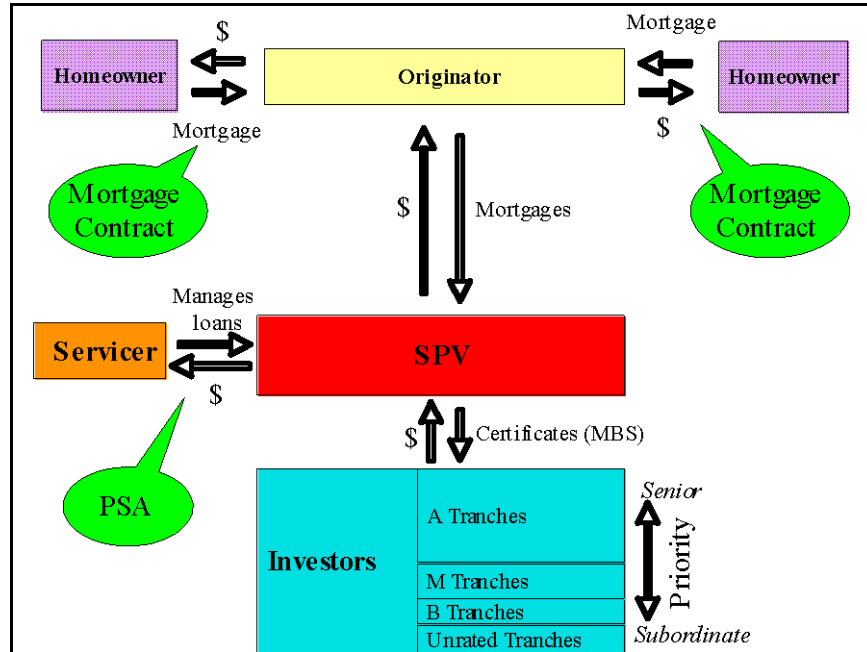
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<sup>5</sup> FINRA, The Bond Market, at <http://apps.finra.org/investor/Information/smart/bonds/401000.asp> (listing US bond market at \$29.6 trillion, with mortgage-related bonds as \$7.2 trillion). Of the \$7.2 trillion in mortgage-related bonds, over \$6.6 trillion are RMBS. Inside Mortgage Finance, Mortgage Market Statistical Annual (2008). The true share of mortgage-related securities may be higher because home-equity loans and home-equity lines of credit are usually categorized as “asset-backed” rather than “mortgage-backed” securities. VINOD KOTHARI, SECURITIZATION: THE FINANCIAL INSTRUMENT OF THE FUTURE, 325-353 (2006).

<sup>6</sup> Inside Mortgage Finance, Mortgage Market Statistical Annual.

<sup>7</sup> *Id.*

<sup>8</sup> See Adam J. Levitin & Tara Twomey, Reforming Mortgage Servicing, working paper (2009), for a more detailed description of RMBS transactions.

**Figure 1. Prototypical RMBS Transaction**

Institutions have many different and overlapping reasons to securitize.<sup>9</sup> Some want to make (originate) loans, but do not want to hold the credit risk on their books. By securitizing, they seek to transfer the credit risk to the investors in the securities issued by the SPV.

Others seek to reduce their overall cost of funds. Raising money through securitization can be cheaper than taking out loans or issuing securities directly, because the borrowing cost is based on the quality of the transferred assets, not the overall risk profile of their seller.<sup>10</sup>

Securitization can also reduce borrowing costs through financial engineering. Techniques such as the division of the SPV's securities into senior and subordinate "tranches" expand the

<sup>9</sup> See KOTHARI, *supra* note 5, at 97-102, for a detailed discussion of the advantages of securitization to originators.

<sup>10</sup> Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1559 (2004)..

potential investor base. They allow the SPV to target new investors with tailored payment structures and credit enhancements. In particular, they permit the issuance of some securities at a higher credit rating than the overall quality of the assets in the SPV.<sup>11</sup> Such senior securities can be sold to institutional investors that may only buy investment grade paper.<sup>12</sup> Adding potential investors boosts demand and lowers the cost of financing.<sup>13</sup>

Another set of motivations goes to the originator's business model. Some institutions simply want to lend more and to make money off up-front fees rather than interest payment streams. Securitization turns delayed payment streams, like periodic loan payments, into up front cash. Securitization thus increases liquidity, which enables more lending.<sup>14</sup>

Securitization can also bring accounting and tax benefits. When it sells assets to an SPV, the originator both moves them off its balance sheet and recognizes future revenue up front (gain-on-sale accounting).<sup>15</sup> Moving risky and poorly performing assets off the books makes the books look better, and, for financial institutions, lowers regulatory reserve requirements.<sup>16</sup> The sale of a potential future revenue stream, like loan payments, for up-front cash moreover may produce an immediate revenue boost on the originator's books, which can be appealing in many respects, including when executive compensation is pegged to short-term results. And some securitization structures, especially for RMBS, are designed to avoid federal entity-level taxation for the SPV; so that only the investors' income is subject to federal taxation. Avoiding double taxation makes RMBS and similar instruments

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<sup>11</sup> Claire A. Hill, *Securitization: A Low Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1063 (1996).

<sup>12</sup> *Id.* at 1071.

<sup>13</sup> The originator need not and does not normally pass on all its cost savings from securitization to its borrowers. Thus if the securitized assets are mortgage loans with an annual yield of 8%, but the average coupon promised to the SPV investors is 6%, the originator can capture some of the 2% spread.

<sup>14</sup> Schwarcz, *supra* note 10, at 1560.

<sup>15</sup> KOTHARI, *supra* note 5, at 102 (noting that improved accounting profits "might well top the list" of the benefits of securitization.).

<sup>16</sup> Hill, *supra* note 11, at 1125.

more attractive than ordinary corporate debt securities to investors, and further lowers the cost of funds for originators.

In sum, securitization can be used to achieve a broad range of goals, including all the ordinary business objectives summarized above, as well as others ranging from political risk management<sup>17</sup> to fraud.<sup>18</sup> It is a financial engineering tool with many uses. But with the possible exception of fraud, achieving an originator's objectives requires the transfer of credit risk to someone else.<sup>19</sup>

The problem is that most investors in RMBS or any other asset-backed securities do not want a homeowner's credit risk any more than the originator does. And they certainly do not want the originator's credit risk.<sup>20</sup> Securitization has responded with solutions in the form of insurance and immutability. We discuss insurance below; we address immutability in Part II.

Insurance can come in several non-exclusive forms, commonly referred to as "credit enhancements." First, insurance can take the form of a guarantee from the originator. This wholly or partly defeats the point of the transfer for the originator, and leaves the investors with the originator's credit risk. Second, insurance can be embedded in the structure of the securitization vehicle. For example, some securitizations are designed so that the SPV would receive cashflows beyond what is needed to pay the bond coupons (overcollateralization). This excess cash is escrowed to cover potential shortfalls of incoming funds. This

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<sup>17</sup> See, generally, Claire A. Hill, *Latin American Securitization: The Case of the Disappearing Political Risk*, 38 VA. J. INT'L L. 293 (1998).

<sup>18</sup> Enron's structured vehicles are the most famous example.

<sup>19</sup> This risk transfer is part of the "true sale" concept. See, e.g., JASON H.P. KRAVITT, *SECURITIZATION OF FINANCIAL ASSETS* § 2.02 (2d ed. 1996) (broadly defining a "true sale" as "a transfer of financial assets that, for the purpose of specific laws, accounting principles or regulatory concerns, constitutes a sale of such assets as distinguished from a financing of the seller thereof secured by such assets.") See also Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008) (arguing that securitization is inherently a fraudulent transfer).

<sup>20</sup> They are expecting to carry interest rate and other market risk. OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC), *COMPTROLLER'S HANDBOOK FOR NATIONAL BANK EXAMINERS* s. [20] (\_\_\_\_). (OCC HANDBOOK).

cash may or may not be enough to cover the risk to investors. In either case, the originator may not want to bear the cost of overcollateralizing the SPV, which involves having funds sit in escrow, yielding a low return.

Third, the senior/subordinate tranching discussed earlier can be understood as a form of insurance that some investors provide to the others: if the SPV does not generate sufficient cashflows to pay all creditors, the subordinate creditors agree to absorb losses from reduced cashflows first, up to the amount due to them.<sup>21</sup>

Finally, insurance can come from a third party, such as an insurance company that guarantees some or all payments to the investors if the SPV fails to pay.

Insurance alone does not eliminate the problem of credit risk; it simply shifts the risk to the insurer. Insurance can be expensive or partial, but even where it is cheap and comprehensive, it is only as good as the credit of the insurer. Part II discusses another approach to managing credit risk: immutability and other, less drastic, barriers to payment modification.

## **II. SECURITIZATION'S RIGIDITIES**

Contracts that cannot be modified are more likely to perform according to their original terms. This is the idea behind the quest for immutability to manage risks from securitization. We discuss its theoretical underpinnings in the next Part; below we elaborate on the role of immutability in securitization.

Securitization contracts have many attributes designed to make modification costly and difficult. This Part explains these attributes, and classifies them into a typology of rigidities: formal, structural, and functional. We consider barriers to amending contracts governing mortgage pool securitization separately from barriers to amending the underlying loan contracts. Although

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<sup>21</sup> We discuss tranching in more detail in Part II.D *infra*.

mortgage contracts are quite rigid in their own right,<sup>22</sup> we focus on pool-level rigidities, and limit the discussion of loan-level rigidities to those arising solely from securitization arrangements.

Barriers to amendment in securitization contracts generally respond to agency concerns. RMBS have myriads of investors in pools of thousands of mortgage loans. Transaction costs make it impractical for the investors to manage the underlying loan portfolio. Their debtor – the trust that owns the loans – is an inanimate shell that does not make much of a manager. The solution is for the investors to hire an agent, called a servicer,<sup>23</sup> to administer the loan pool: for example, to send out bills, allocate payments, dun delinquent homeowners, and foreclose on homes where the loan is in default. Delegating management to the servicer in turn creates agency risks for investors, including the risk that the servicer will renegotiate the underlying loans, reducing payments to the pool.

Investors address agency risk by contract, through the Pooling and Servicing Agreement (PSA) between the servicer and the trust.<sup>24</sup> PSAs typically direct servicers to manage the loans

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<sup>22</sup> A large literature attests to this rigidity. Obstacles to mortgage modification include prepayment penalties, *see, e.g.*, Frank Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 CORNELL L. REV. 288 (1987), statutory restrictions on mortgage modification in bankruptcy, *see* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. 565 (2009), and the existence of multiple liens on the same property, which preclude senior mortgagees from making concessions that would benefit junior mortgagees before improving the debtor's payment capacity.

<sup>23</sup> The servicer is often, but not always, a corporate affiliate of originator. Many large servicers are subsidiaries of bank holding companies.

<sup>24</sup> Three kinds of agreements form the core of a securitization transaction: a pooling agreement, in which the SPV purchases a pool of assets from the originator or an intermediary; a servicing agreement between the servicer and the SPV that sets forth the duties and compensation of the servicer; and an indenture, which sets forth the rights of the investors in the SPV's securities and the duties of the trustee that oversees the securities and the SPV. Typically these three agreements are combined into a single document (the PSA).

owned by the SPV as they would their own loans,<sup>25</sup> subject to specific limits on discretion to mitigate loan losses. Thus, where a lender maximizing recovery for its own account might renegotiate a distressed mortgage loan, a PSA may preclude the servicer from doing the same by methods ranging from formal prohibition to *de facto* coordination problems. To lock in the limits, the PSA further constrains its own modification using similar methods. Loan and pool-level constraints combine in a layered structure that is designed to be unusually rigid.

Below we detail the three kinds of rigidity layered in securitization arrangements: explicit restrictions on amendment, rigidities that stem from the organizational form of the SPV, and those that stem from creditor collective action problems.

#### ***A. Formal Rigidity I: PSA Limitations on Loan Modification***

PSA terms often explicitly limit modification of the underlying mortgage loans. Sometimes modification is forbidden outright;<sup>26</sup> sometimes only certain types of renegotiation are

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<sup>25</sup> See, e.g., Asset Backed Funding Corporation, Depositor, Option One Mortgage Corporation, Servicer, and Wells Fargo Bank, N.A., Trustee, Pooling and Servicing Agreement, Dated as of October 1, 2005, ABFC 2005-OPT1 Trust, ABFC Asset-Backed Certificates, Series 2005-OPT1, § 3.03, at <http://www.sec.gov/Archives/edgar/data/1343316/000091412105002222/as871211-ex4.txt> (“The Servicer, as independent contract servicer, shall service and administer the Mortgage Loans in accordance with this Agreement and the normal and usual standards of practice of prudent mortgage servicers servicing similar mortgage loans and, to the extent consistent with such terms, in the same manner in which it services and administers similar mortgage loans for its own portfolio, and shall have full power and authority, acting alone, to do or cause to be done any and all things in connection with such servicing and administration which the Servicer may deem necessary or desirable and consistent with the terms of this Agreement (the “Servicing Standard”); Seller’s Purchase, Warranties and Servicing Agreement, Date, as of Dec. 1, 2001, between Goldman Sachs Mortgage Company and Bank One, N.A., § 4.01, at <http://www.secinfo.com/dsVsj.3Es.8.htm#ytyf> (“The Servicer shall service and administer the Mortgage Loans through the exercise of the same care that it customarily employs for its own account.”).

<sup>26</sup> See, e.g., See, e.g., Federal National Mortgage Association, Single-Family Master Trust Agreement for Guaranteed Mortgage Pass-Through Certificates evidencing undivided beneficial interests in Pools of Residential

permitted;<sup>27</sup> and sometimes third-party consent is required to renegotiate loans beyond a specified cap (typically 5% of the pool).<sup>28</sup> PSAs occasionally limit the number of renegotiations by loan or by year.<sup>29</sup> Additionally, servicers may be required to purchase any loans they renegotiate at the face value outstanding or at a premium.<sup>30</sup> This serves as a barrier to modification by making it very costly.

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Mortgage Loans, June 1, 2007, § 5.3(4), at [http://www.fanniemae.com/mbs/pdf/singlefamilytrustagreement\\_June2007.pdf](http://www.fanniemae.com/mbs/pdf/singlefamilytrustagreement_June2007.pdf) (“For so long as a Mortgage Loan remains in a Pool, the Mortgage Loan may not be modified if the modification has the effect of changing the principal balance (other than as a result of a payment actually received from or on behalf of the Borrower), changing the Mortgage Interest Rate (other than in accordance with any adjustable rate provisions stated in the Mortgage Documents), or delaying the time of payment beyond the last scheduled payment date of that Mortgage Loan.”).

<sup>27</sup> See, e.g., Asset Backed Funding Corporation, Depositor, Option One Mortgage Corporation, Servicer, and Wells Fargo Bank, N.A., Trustee, Pooling and Servicing Agreement, Dated as of October 1, 2005, ABFC 2005-OPT1 Trust, ABFC Asset-Backed Certificates, Series 2005-OPT1, § 3.03, at <http://www.sec.gov/Archives/edgar/data/1343316/000091412105002222/as871211-ex4.txt> (“In the event that any payment due under any Mortgage Loan is not paid when the same becomes due and payable, or in the event the Mortgagor fails to perform any other covenant or obligation under the Mortgage Loan and such failure continues beyond any applicable grace period, the Servicer shall take such action as it shall deem to be in the best interest of the Certificateholders. With respect to any defaulted Mortgage Loan, the Servicer shall have the right to review the status of the related forbearance plan and, subject to the second paragraph of Section 3.01, may modify such forbearance plan; including extending the Mortgage Loan repayment date for a period of one year or reducing the Mortgage Interest Rate up to 50 basis points.”).

<sup>28</sup> See, e.g., *id.* § 3.03 (“The NIMS Insurer’s prior written consent shall be required for any modification, waiver or amendment if the aggregate number of outstanding Mortgage Loans which have been modified, waived or amended exceeds 5% of the number of Mortgage Loans as of the Cut-off Date.”).

<sup>29</sup> Credit Suisse, *The Day After Tomorrow: Payment Shocks and Loan Modifications*, April 5, 2007.

<sup>30</sup> See, e.g., CWALT Inc., Alternative Loan Trust 2005-1cb, Prospectus Supplement, Dated Sept. 24, 2004, S-49 at <http://www.secinfo.com/dsvRu.zPe.htm> (“The master servicer may modify any Mortgage Loan, provided that the master servicer purchases the Mortgage Loan from the trust fund immediately following the modification. A Mortgage Loan may not be modified unless the modification includes a change in the interest

The incidence of such modification restrictions is unknown. One small sampling by Credit Suisse found that about a third of all private-label (non-government-sponsored) securitizations had some restriction on modification.<sup>31</sup> Another study by Bear Stearns found that 40% of the private-label securitizations in a widely followed index had a 5% limit on modifications, absent approval by a ratings agency, and that 10% of the deals permitted no modification whatsoever.<sup>32</sup> A more extensive study by John P. Hunt found an absolute bar to modification in nearly 10% of subprime RMBS deals in 2006, and a range of other restrictions in most other deals.<sup>33</sup>

### ***B. Formal Rigidity II: Statutory and Contractual Voting Thresholds***

The Trust Indenture Act of 1939 (TIA) directly impedes modification at the level of the loan pool in the SPV, which may in turn deter modification of the underlying assets. Like most U.S. corporate bonds, RMBS are subject to the TIA, which requires each investor's consent to modify its right to receive principal and

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rate on the related Mortgage Loan to approximately a prevailing market rate. Any purchase of a Mortgage Loan subject to a modification will be for a price equal to 100% of the Stated Principal Balance of that Mortgage Loan, plus accrued and unpaid interest on the Mortgage Loan up to the first day of the month in which such proceeds are to be distributed at the applicable net mortgage rate, net of any unreimbursed advances of principal and interest on the Mortgage Loan made by the master servicer.”); CWALT 2005-36, Pooling and Servicing Agreement, § 3.11(b) (“Countrywide may agree to a modification of any Mortgage Loan (the ‘Modified Mortgage Loan’) if ... Countrywide purchases the Modified Mortgage Loan from the Trust Fund ...”).

<sup>31</sup> Credit Suisse, *The Day After Tomorrow: Payment Shocks and Loan Modifications*, April 5, 2007.

<sup>32</sup> Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES Mar. 22, 2007, at C1.

<sup>33</sup> John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications*, Berkeley Center for Law, Business, and Economics working paper, Mar. 25, 2009, at [http://www.law.berkeley.edu/files/bclbe/Subprime\\_Securitization\\_Contracts\\_3.2\\_5.09.pdf](http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Contracts_3.2_5.09.pdf). [insert discussion of Hunt's methodology...] [Add Ed Morrison study if it is ready to cite.]

interest according to the terms of its security.<sup>34</sup> In effect, modifying the economic terms of RMBS requires the consent of 100% of their holders. Unanimity is hard to achieve because securities are held by a great multitude of creditors worldwide. Simply failing to contact one can be fatal.

In the first instance, TIA works as a constraint on amending RMBS to reduce payments to the creditors, either by altering credit enhancement arrangements or changing cashflows to reflect a restructuring of the underlying assets. Indirectly, this constraint on amending RMBS may in turn limit the servicer's capacity to renegotiate the underlying mortgage loans. Most loan modifications – reductions in principal or interest rates or extension of maturities – could reduce payments to the SPV and thereby impair payments to RMBS holders to the point of pushing the vehicle itself into default.<sup>35</sup> TIA would bar RMBS amendments to avoid default.

The extent to which TIA strictures actually function as a barrier to amendment is uncertain. It is not generally cited among the obstacles to underlying loan modification. There is no case law directly on point. On its face, the TIA only requires that an investor's *right* to payment not be impaired; it does not govern management of the SPV's assets any more than it governs management of corporate assets for corporate bonds. Protection of the right to payment is not the same as prescribing a means of generating income to pay the debt.

Yet, it is conceivable that a court might treat assets of an SPV – a pass-through synthetic creature whose only purpose is to funnel highly specified cashflows to investors – differently from

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<sup>34</sup> 15 U.S.C. §77ppp(b) provides “Notwithstanding any other provision of the indenture. . . the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder. . . .”

<sup>35</sup> The TIA does not require any particular threshold of consent for other modifications to the indenture, but most RMBS supererogate and require either a simple majority vote or a two-thirds majority vote for modifications not affecting cash flow. The TIA does, however, require a simple majority consent for waivers of past defaults. 15 U.S.C. § 77ppp(a)(1).

ordinary corporate assets.<sup>36</sup> Uncertainty surrounding the application of the TIA in securitization may in turn act as a constraint on both mortgage and PSA modification, as risk-averse servicers will be unlikely to test the limits of the TIA and face potential litigation.<sup>37</sup>

Even if the TIA unanimity requirement did not apply, the PSAs themselves often impose supermajority requirements for PSA amendment. Most commonly, 2/3s of each affected tranche of RMBS holders must consent to a modification of the PSA.<sup>38</sup> While less daunting than 100%, requiring the consent of 2/3s of each affected tranche gives creditors significant capacity to hold up

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<sup>36</sup> The servicer might argue that the real alternative to modification is not payment on the original schedule, but unpredictable recovery from foreclosures. Investors might respond that foreclosure need not compromise the SPV's – and hence the investors' – right to receive the original principal and interest on schedule; it is just a means of collecting some of the payments through a sale of collateral. The argument permutations are numerous and the outcome uncertain, reflecting the variety of economic and legal arrangements in the market.

<sup>37</sup> This does appear to be the case with Ocwen Financial, a major subprime servicer that began doing principal modifications of defaulted mortgages it serviced without regard to PSAs. Kate Berry, *Debt Forgiveness: Ocwen Enters Uncharted Waters*, AM. BANKER, June 24, 2008, at \_\_. Ocwen lacked a captive funding source, so foreclosures were very expensive for it, as it was obligated to make servicing advances of principal and interest on foreclosed mortgages until it realized funds on the property. Servicing advances are recoverable, but without interest, so the time value can place a heavy strain on a servicer's liquidity.

<sup>38</sup> Asset Backed Funding Corporation, Depositor, Option One Mortgage Corporation, Servicer, and Wells Fargo Bank, N.A., Trustee, Pooling and Servicing Agreement, Dated as of October 1, 2005, ABFC 2005-OPT1 Trust, ABFC Asset-Backed Certificates, Series 2005-OPT1, § 11.01 (“no such amendment or waiver shall (x) reduce in any manner the amount of, or delay the timing of, payments on the Certificates which are required to be made on any Certificate without the consent of the Holder of such Certificate, (y) adversely affect in any material respect the interests of the Holders of any Class of Certificates or the Swap Provider in a manner other than as described in clause (x) above, without the consent of the Holders of Certificates of such Class evidencing at least 66 2/3% of the Voting Rights evidenced by such Class”).

modification. Such requirements fuel collective action problems, which we elaborate below in Part II.D.<sup>39</sup>

### ***C. Structural Rigidity: Bankruptcy Remoteness and Passive Management***

In corporate bonds, bankruptcy overcomes creditor coordination problems. If the debtor corporation is unable to renegotiate its bond debt consensually, it can file for bankruptcy and force a debt restructuring. This possibility creates pressure for a consensual deal. Bankruptcy, however, is either formally unavailable or practically inaccessible for RMBS.

A typical securitization SPV is structured so that it cannot file for bankruptcy.<sup>40</sup> It is also shielded from being dragged into the bankruptcy of the originator. Such “bankruptcy remoteness” is achieved using a combination of organizational form and contract.<sup>41</sup> For example, most SPVs that issue RMBS are organized as trusts, because trusts, excluding “business trusts,” are not “persons” eligible to file for bankruptcy under the Bankruptcy Code.<sup>42</sup> The Bankruptcy Code does not define “business trust,” and case law is unsettled on the definition, so most SPVs take further steps to achieve bankruptcy remoteness by prohibiting the trust from filing a voluntary bankruptcy petition, making all parties to the securitization transaction covenant not to file an involuntary petition against the SPV,<sup>43</sup> and limiting the SPV’s activities to

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<sup>39</sup> Some PSAs permit the trustee or servicer to execute without RMBS holder consent amendments to the PSA necessary to preserve REMIC pass-thru tax status.

<sup>40</sup> See KOTHARI, *supra* note 5, at 11-12.

<sup>41</sup> STEVEN L. SCHWARCZ *ET AL.* SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 54 (2004).

<sup>42</sup> Only “persons” are eligible to file for bankruptcy. 11 U.S.C. § 109(a). The Bankruptcy Code defines “person” as including an “individual, partnership, and corporation, but does not include governmental unit...” 11 U.S.C. § 101(41). The term “corporation,” however, is defined as including a “business trust.” 11 U.S.C. §101(9)(A)(v). The term “business trust” is not defined by the Code, and there is considerable confusion in case law as to what it includes. See, e.g., *Shawmut Bank Conn. v. First Fidelity Bank (In re Secured Equip. Trust of E. Air Lines)*, 38 F.3d 86 (2d Cir. 1994); *In re Eagle Trust*, 1998 U.S. Dist. LEXIS 14488 (E.D. Pa. Sept. 16, 1998).

<sup>43</sup> See, e.g., *Pooling and Servicing Agreement*, ABFC 2005-OPT1

avoid third-party creditors who could file an involuntary petition against the SPV.<sup>44</sup> Organizational forms that qualify as “persons” for bankruptcy purposes may require additional contractual commitments, such as high-threshold voting requirements to file a voluntary petition.<sup>45</sup>

To make bankruptcy remoteness meaningful, the vehicle must be protected from the misfortunes of both the originator who sold the mortgage loans, and of the original debtors. The first of these objectives is achieved with a “true sale” – ensuring that the originator does not retain a residual interest in the mortgage loans, so that such interest does not become an asset of the originator’s bankruptcy estate.<sup>46</sup> The segregation of the SPV’s assets from the originator’s is a major component of the value of securitization,<sup>47</sup> and is typically memorialized in two opinion letters – a “true sale” opinion and a “non-consolidation” opinion from the law firm representing the securitization transaction’s sponsor. The second objective – insulating investors from the underlying mortgage troubles – is achieved at least in part with restrictions on loan modification discussed in the preceding section, and in part

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Trust, § 3.28(b) (“Each party to this Agreement agrees that it will not file an involuntary bankruptcy petition against the Trustee or the Trust Fund or initiate any other form of insolvency proceeding until after the Certificates have been paid.”).

<sup>44</sup> See, e.g., *id.*, § 3.28(a) (“the Trust is not authorized and has no power to: (1) borrow money or issue debt; (2) merge with another entity, reorganize, liquidate or sell assets; or (3) engage in any business or activities.”).

<sup>45</sup> Stephen H. Case, *I Thought I Put That Where You Couldn’t Reach It: Bankruptcy-Remote Entities, Special-Purpose Vehicles and Other Securitization Issues*, in 840 PRACTICING LAW INSTITUTE COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 51, 66 (2002).

<sup>46</sup> To this end, a securitization transaction will involve a “true sale” and “non-consolidation” opinion letters from a law firm regarding the transaction being a true sale and that the assets of the SPV cannot be consolidated with the originators’. KOTHKARI, *supra* note 5, at 208. The concern is that the securitization could be declared a fraudulent conveyance by the originator, and the securitized assets could be consolidated with the originator’s. The securitization would be treated as an unperfected secured financing, with little or no prospect of recovery for the investors.

<sup>47</sup> See Kenneth Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of “Bankruptcy Remoteness”*, working paper, May 14, 2006, at <http://www.newyorkfed.org/research/conference/2006/cffi/Ayotte.pdf>

through the Bankruptcy Code's prohibition on the modification of single-family principal residence mortgages.<sup>48</sup>

By contracting out of bankruptcy, the securitization SPV creates structural pool-level rigidity absent in ordinary corporate bonds. If the underlying assets do not generate enough cash to meet the SPV's liabilities, the only option is a sequence of defaults on the creditor hierarchy. Voluntary renegotiation of amounts due to creditors is made difficult by the high-threshold voting requirements described in the previous section, and by conflicts of interest between senior and subordinate creditors described in the next section. Bankruptcy remote organization rules out involuntary changes.<sup>49</sup>

The SPV's bankruptcy-remote organization dovetails with another structural feature of the pooling arrangement that contributes to loan-level rigidity: passive management. The SPV's capacity to avoid entity-level taxation and to remain off the originator's books usually hinges on being passively managed. An actively run business is no mere pass-through. Similarly, a servicer that really treats the SPV's assets as its own risks having regulators do the same.

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<sup>48</sup> 11 U.S.C. § 1322(b)(2). *See generally* Levitin, *supra* note 22 (discussing the policy assumptions behind the modification prohibition and testing the policy assumptions empirically).

<sup>49</sup> If the SPV could file or be placed in bankruptcy, it could reject the PSA with the servicer as an executory contract, with the servicer receiving only an unsecured prepetition claim for damages, 11 U.S.C. §§ 365(a), (h). The SPV would then be free to recontract for servicing under non-restrictive terms. All contracts may be breached, of course, regardless of bankruptcy, but rejection of a contract under section 365 of the Bankruptcy Code is treated as a pre-bankruptcy breach, rather than a post-bankruptcy breach, which changes the treatment of the counterparty's claim.

To be rejected under section 365, a contract must be executory, a term not defined in the Bankruptcy Code, but commonly held to mean that material performance is due from both parties to the contract. *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN L. REV. 439, 460 (1973). Because most PSAs are also part of the MBS indenture, there is the question of whether the PSA is executory. While the servicer and the SPV have on-going mutual obligations, the MBS holders do not, and unless the PSA is severable, the non-executory nature of the MBS holders' relationship with the SPV might render the PSA non-executory and therefore not rejectable.

Almost all PSAs restrict mortgage renegotiation to loans that are in default or where default is imminent or reasonably foreseeable,<sup>50</sup> in order to protect the SPV's pass-through tax and off-balance sheet accounting status. Allowing modifications elsewhere may indicate that the servicer is actively managing the SPV's assets. Active management would in turn trigger a new layer of taxation on the SPV's income, in addition to the tax investors pay on their income from the MBS.<sup>51</sup> Moreover, because

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<sup>50</sup> Hunt, *supra* note 33, at 7.

<sup>51</sup> See 26 U.S.C. § 860A *et seq.* (REMIC treatment); SFAS No. 140 (off-balance sheet accounting treatment). Most RMBS are structured to qualify as real estate mortgage investment conduits (REMICs) under the Internal Revenue Code. 26 U.S.C. 860A. Generally, investors in a Subchapter C corporation are subject to double taxation—the corporation is taxed directly on its earnings, and then the investors are taxed on any distributions from the corporation. REMICs, however, receive pass-thru tax status, meaning that the investors, rather than the entity, are taxed on the REMIC's earnings. 26 U.S.C. § 860A(b).

To qualify as a REMIC, however, the entity must be essentially passive in its management of mortgages. SCHWARCZ, *ET AL.*, *supra* note 41, at 114. It is limited in its ability to change what mortgage loans it owns: 26 U.S.C. §§ 860D(a)(4) (limiting REMICs to holding “qualified mortgages” and “permitted investments”); 860G(a)(3) (defining “qualified mortgage”); 860G(a)(5) (defining “permitted investments”), or to alter the terms of the mortgage loans. To qualify as a REMIC under the Internal Revenue Code, substantially all of a REMIC's assets must be “qualified mortgages” and permitted investments. 26 U.S.C. § 860D(a)(4). “Qualified mortgage” is defined as “any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property.” 26 U.S.C. § 860G(a). It includes “foreclosure property,” 26 USC § 860G(a)(3), which is defined as “property which is acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC.” 26 U.S.C. § 860G(a)(8)(B).

The Treasury regulations note, however, that if a mortgage is significantly modified, other than in the event of a “default or reasonably foreseeable default,” “then the modified [mortgage] is treated as one that was newly issued in exchange for the unmodified obligation that it replaced,” which means that the modified mortgage will not be a qualified mortgage. The tax consequence of this recharacterization is that the deemed disposition of the unmodified obligation will be a prohibited transaction that is subject to a 100% tax. 26 C.F.R. § 1.806G-2(b); 26 U.S.C. § 860F(a)(2).

The relevance of a mortgage modification depends on whether the modification is considered “significant” under one of five specific categories. 26 C.F.R. § 1.1001-3(b). Most relevant for mortgage modification purposes, is the specific category describing certain yield changes as significant

the originator is often the servicer, overly active management of the securitized loans (beyond “normal servicing activity”) could suggest that it did not truly sell the risk. In response, regulators could require the servicer/originator to bring the loans back onto its balance sheet, defeating the point of securitization.<sup>52</sup>

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modifications. A modification that results in a change in the yield on the mortgage loan of greater of 25 basis points or 5 percent of the annual unmodified yield is considered significant. 26 C.F.R. § 1.1001-3(e)(2)(ii).

If a modification does not fit into any of the specific significant modification categories, then whether the modification alters legal rights or obligations in an economically significant manner must be analyzed. 26 C.F.R. § 1.1001-3(e)(1). Moreover, all modifications are considered collectively. *Id.*

Two consequences flow from a modification being significant. First, the modified mortgage held by the trust will not be a qualified mortgage. If a trust has too many non-qualified mortgages, the trust loses its REMIC status. Second, the trust will incur 100% taxation on the net gain in the deemed exchange that occurred in the modification. Therefore, too many modifications where there is not imminent default will result in the loss of the SPV’s REMIC pass-thru status, not just for specific transactions, but overall. The IRS has relaxed application of REMIC rules to mortgage loan modification programs where the mortgage is secured by owner-occupied property and there is a significant risk of foreclosure. *See* Rev. Proc. 2008-28, 2008-23 I.R.B. 1054.

Because pass-through tax status is a crucial element of RMBS’s economic value, trusts are often structured to ensure that REMIC status is protected, such as by specifically limiting servicers’ ability to modify loans in ways that would endanger REMIC status.

<sup>52</sup> Accounting concerns dovetail with tax exemption requirements; both require the trust to be passively managed. The servicer is frequently the originator and in order to ensure that the securitized assets may be removed from the originator’s balance sheet and that the originator may recognize the gain on the sale of the mortgage loans in its transaction with the SPV, the SPV must be “qualified”, which means, *inter alia* that the originator must have no control over the assets. Statement of Financial Accounting Standards 140. Financial accounting standards do not specify what would constitute “control,” but the possibility of balance sheet consolidation makes originator-servicers chary of active management of securitized mortgages, including modification of their terms. SEC Staff, however, have indicated that they do not believe that modifications of imminently defaulting loans would require on-balance sheet accounting. Letter from Christopher Cox, SEC Chairman to Rep. Barney Frank, Chairman of Committee on Financial Services, United States House of Representatives, dated July 24, 2008, at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/sec\\_response072507.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/sec_response072507.pdf); Letter from Conrad Hewitt, Chief Accounting, SEC to Mr. Arnold Hanish, Chairman of the Committee on Corporate Reporting, Financial Executives

In sum, SPVs are structured as immortal automatons: they cannot go bankrupt, and they are immune to management discretion. Once launched, they are meant to operate more or less on auto-pilot until the securities they issue are paid off. This effectively precludes renegotiation of the PSA and the underlying assets.

***D. Functional Rigidity: Coordination Problems from Tranching, Resecuritization and Insurance***

The preceding pool- and loan-level rigidities are reinforced through tranching, resecuritization, and third-party insurance.

The RMBS issued by an SPV are typically trached—divided into a stepped senior/subordinated payment priority system where the subordinated tranches are first in line to absorb losses from reduced mortgage payments. Each tranche usually carries a different rate of return and a different credit rating. Sometimes the tranching is done separately for principal and interest payments due on the mortgages.

Senior/subordinate tranching is a hallmark of RMBS. This contrasts with corporate finance practice, where bonds issued under a single indenture are not trached. Senior/subordinate tranching under a single indenture creates incentives against modification: junior tranches, which stand to lose the most from reducing flows into the SPV, may block modification or hold it up for ransom. In corporate bond practice, where securities of different ranking are issued under different indentures, junior creditors are only in a free-rider position: senior creditors may restructure if they wish, even if the juniors will benefit from their concessions. In contrast, the holders of a subordinated tranche of RMBS have a potential veto over renegotiation of the PSA.

Consider a situation in which a renegotiation of the underlying mortgages would reduce the aggregate payment streams to RMBS investors, but less so than if there were no

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International and Mr. Sam Ranzilla, Chairman of the Professional Practice Executive Committee, The Center for Audit Quality, American Institute of Certified Public Accountants, dated Jan.8, 2008, at <http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>.

renegotiation. The modified mortgage loans would be more valuable than if they defaulted and went into foreclosure, but less valuable than if they performed as originally intended. The loss from renegotiation would be borne first by the subordinated tranches. The subordinated tranches have little incentive to allow renegotiation of the underlying mortgages unless they receive some of the benefit from it. If the subordinated tranches are “out of the money,” they will not consent to the modification of the PSA unless they get a side payment.

Likewise, the senior-most tranches have no incentive to cooperate, as they incur none of the benefit from modifying the mortgages – they will get paid no matter what, and might even get paid faster with foreclosure. All the benefit accrues to the “fulcrum” tranche that is in the money if there is a modification, and out of the money in a foreclosure.<sup>53</sup>

The SPV has neither the funds nor the authority to pay off dissenting tranche holders. As a result, if either senior or subordinate tranches’ consent is required to modify the PSA or the underlying mortgages, no solution is possible absent side payments from outside the securitization structure.

Tranching also means that even if an SPV were not bankruptcy remote, it is much less likely to end up in bankruptcy. Bankruptcy enforces subordination agreements to the extent they are enforceable outside of bankruptcy.<sup>54</sup> This reduces the value of bankruptcy for RMBS holders, since the incentives described above continue unchanged in bankruptcy. Senior/subordinate tranching substitutes contractual ordering of distress (absolute priority) for the statutory ordering of bankruptcy. Unlike bankruptcy, which is heavily negotiated and can give third parties (“party in interest”) a voice in reorganization, this contractual loss allocation is locked in, along with the attendant incentive structure and externalities

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<sup>53</sup> This is similar to David Skeel’s idea of a “pivotal” class in corporate bankruptcy. David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 480 (1992).

<sup>54</sup> 11 U.S.C. § 510(a).

More collective action problems arise through resecuritization. Because the riskier tranches of an RMBS issuance are not investment grade, they cannot be sold to entities like pension plans and mutual funds. These tranches are often resecuritized, either into collateralized mortgage obligations (CMOs) or collateralized debt obligations (CDOs).

A CMO is a securitization backed by mortgage-backed securities rather than by mortgages. A CDO is a securitization backed by a variable pool of assets, potentially including mortgage-backed securities, as well as other types of securitizations, bonds, and loan interests. CMOs and CDOs are themselves then tranced. Senior CMO and CDO tranches can receive investment grade ratings because of the credit enhancement provided by the subordinated tranches. Thus it is possible to transform non-investment grade tranches of RMBS into investment-grade tranches of CMOs and CDOs that can be sold to conservative institutional investors. The non-investment grade components of CMOs and CDOs can themselves be resecuritized once again into what are known as CMO<sup>2</sup>s and CDO<sup>2</sup>s, with the senior tranches of the CMO<sup>2</sup>s and CDO<sup>2</sup>s receiving investment grade ratings. This process can be repeated an endless number of times. The result is impressive. The CEO of Goldman Sachs observed that “[i]n January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments ... rated triple A.”<sup>55</sup> Securitization has turned dross into gold, or, at least, non-investment grade dross into AAA-rated dross.

The upshot of this financial alchemy is that to control 100% of an RMBS issuance in order to alter a PSA, one would also have to own 100% of multiple CMOs and CDOs to alter the CMOs’ and CDOs’ PSAs and of multiple CMO<sup>2</sup>s and CDO<sup>2</sup>s to alter the CMO<sup>2</sup>s’ and CDO<sup>2</sup>s’ PSAs. This process can occur separately for multiple mortgages on the same property. When amending the underlying mortgages requires a vote, resecuritized interests similarly must be taken into account.

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<sup>55</sup> Lloyd Blankfein, *Do not Destroy the Essential Catalyst of Risk*, THE FIN. TIMES (London) (Feb. 9, 2009) 7.

The final obstacle to obtaining consent for PSA and mortgage modification combines elements of resecuritization and insurance. The following example illustrates. An SPV's income can exceed the coupons it must pay certificate holders. For example, the SPV may be overcollateralized, so that it holds 10,000 mortgages, but only needs to hold 9,500 performing mortgages to meet its bond coupon obligations. Alternatively, the coupons might be fixed rate, but the mortgages might be adjustable rate, so if the adjustable rate exceeds the coupon rate, the SPV will retain the difference. In such cases, the SPV can have substantial residual value after all investors are paid.

The residual value of the SPV after the certificate holders are paid is called the Net Interest Margin (NIM). The NIM is typically resecuritized separately into an NIM security (NIMS), and the NIMS is often insured by a financial institution. The NIMS insurer's consent is typically required both to modify PSAs and to modify the underlying mortgages beyond limited thresholds. The NIMS insurer holds a position similar to an equity holder for the SPV. Even more so than junior tranche holders in the very first securitization, NIMS insurers have little incentive to cooperate. They have nothing to lose, but there is no money or authority for the SPV to pay them off.

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In sum, securitization creates multiple kinds and layers of contractual rigidity that prevent the renegotiation of RMBS and the underlying assets, even when renegotiation would be the welfare-maximizing outcome. Securitization design farms out and wills away credit risk through a combination of explicit contractual commitment, legal organizational form and a financial structure prone to coordination problems. As part of this design, tax treatment, accounting, tranching, and insurance have a powerful effect of reinforcing commitment to pay, even though that is not their primary purpose.

It is difficult to predict how these rigidities will work in practice to constrain mortgage and PSA modification absent policy

intervention. Courts might interpret formal constraints liberally,<sup>56</sup> pervasive distress may create new financial and reputational pressures, and informal coordination mechanisms may spring up to overcome the obstacles built into the formal framework. Crisis experience so far suggests that design rigidities in securitization do in fact work to impede modification to some extent.<sup>57</sup>

Yet rigidity alone – or iron-clad commitment to pay – does not beget capacity to pay. Contractual discipline of the sort described in the preceding passages may fortify weak-willed debtors and servicers, but does not generate money where there is none. There are limits to the alchemy. The next two parts put the PSAs in theoretical context, and further consider the implications of PSA structures for managing widespread financial distress.

### **III. MEET THE GENUS: PSAS AS IMMUTABLE CONTRACTS**

#### ***A. Form, Structure and Function in Contract Immutability***

Modern contract theory has good things to say about immutable contracts. Letting parties forswear even sensible future

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<sup>56</sup> See Hunt, *supra* note 33 (arguing to for a liberal construction of PSA restrictions on mortgage loan modification).

<sup>57</sup> See Joe Nocera, *What Securitization Problem? The F.D.I.C. Weighs In*, Executive Suites Blog, The New York Times (Nov. 18, 2008) at <http://executivesuite.blogs.nytimes.com/2008/11/18/what-securitization-problem-the-fdic-weighs-in/> (citing industry arguments that securitization contracts preclude modification, and the FDIC's contrary interpretation). At a minimum, this suggests that the contractual framework was designed to be rigid and is perceived as such by the relevant market actors, but that the F.D.I.C. feels less legally and financially constrained than such private actors to test the limits of the contractual framework. See also Alan M. White, *Rewriting Contracts Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, FORDHAM URBAN L.J. (forthcoming 2009) (interpreting modification data to suggest virtually no reduction in payment flows to securitization vehicles); Tomasz Piskorski, *et al.*, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis*, Working Paper, Columbia Business School, 2008, at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1321646](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646); COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK MORTGAGE LOAN DATA, FOURTH QUARTER 2008, 23 (2009), available at <http://www.occ.treas.gov/ftp/release/2009-37a.pdf>.

renegotiation is a common theoretical response to information and incentive problems in contracting: it can encourage disclosure and optimal investment up front, and discourage holdup behavior mid-performance.<sup>58</sup> It can also help minimize agency costs.<sup>59</sup>

One way to achieve immutability is with express, formal amendment restrictions. The benefits of such restrictions are most apparent in bilateral contracts. They become attenuated in contracts – such as bonded debt – that involve a great multitude of parties and may be hard to modify even without express commitment to that effect, simply owing to the extreme coordination effort required to bring the parties together.<sup>60</sup>

However, the demand for *de facto* immutability remains in bond contracts: creditors seek to deter opportunistic default (unwillingness, as distinct from inability, to pay); debtors want to lower borrowing costs and agree to forego modification up front to signal willingness to pay;<sup>61</sup> both parties discount heavily the possibility of insolvency, or inability to pay, and any recovery values in the event. By definition, neither party accounts for externalities from immutability, discussed in Part IV below.

The literature on bond contract modification is steeped in history and market particulars. The basic parameters of the bond debate were in place half a century before the latest contract theory turn in favor of immutability. Advocates of immutability in bond contracts sought to protect bondholder minorities from corrupt,

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<sup>58</sup> See e.g., PATRICK BOLTON & MATHIAS DEWATRIPONT, *CONTRACT THEORY* 574 (2005); Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 205 (1997); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law* 113 YALE L.J. 541, 611-614 (2003); see Kevin E. Davis, *The Demand for Immutable Contracts: Another Look at the Law and Economics of Contract Modifications* 81 N.Y.U. L. REV. 487, 494-504 (2006) (theory and literature overview).

<sup>59</sup> *Id.* and Levitin & Twomey, *supra* note 8.

<sup>60</sup> Davis, *supra* note 35 (noting coordination problems in contracts involving multiple parties).

<sup>61</sup> The signaling mechanism may be ineffective where, for example, good and bad borrowers alike can easily adopt contracts that bar modification. See e.g., Anna Gelpern & G. Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, \_\_\_\_ (2006).

ignorant, and/or passive majorities.<sup>62</sup> Arguing against immutability, proponents of composition worried that minority holdout creditors might push an otherwise-viable firm into liquidation, with spillovers and deadweight losses not offset by anyone's gains. They promoted flexible contracts, including low-threshold amendment terms.

A high-profile inflection in the debate occurred in the 1930s, when SEC Chairman (later Supreme Court Justice) William O. Douglas in the 1930s reacted to reports of corporate insiders voting bonds to appropriate for equity a recovery that rightly belonged to debt.<sup>63</sup> Douglas advocated what became the unanimity requirement of the Trust Indenture Act of 1939, a victory for immutability. As noted earlier, the law requires each creditor's consent to amend payment terms, giving it effective veto power over composition. Against this background, debtors and creditors have a binary choice between securing each bondholder's consent, and restructuring in bankruptcy under judicial supervision. The existence of the bankruptcy alternative was crucial: the compromise did not forbid modification altogether, but confined it to the public, judicial realm. For Douglas, the need to control insider abuse justified the costs of bankruptcy.<sup>64</sup>

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<sup>62</sup> Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 236-246, 250-256 (1987).

<sup>63</sup> Senate Comm. On Banking and Currency, Trust Indenture Act of 1939: Report to Accompany S. 2065, S. Rep. No. 248, 76<sup>th</sup> Cong., 1<sup>st</sup> Sess. 20 (1939); House Comm. On Interstate and Foreign Commerce, Trust Indenture Bill of 1939, H.R. Rep. No. 1016, 76<sup>th</sup> Cong., 1<sup>st</sup> Sess. 35 (1939). Roe and others observe that these stories were in fact unusual because the law of negotiable instruments at the time gave each bondholder veto power over the terms of his contract as a condition of negotiability. Roe, *supra* note 62; Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L. J. 1317, \_\_ (2002).

<sup>64</sup> The consent provisions of the TIA also served another function; they protected bondholders against conflicts of interest between bond trustees and bond issuers. The TIA's restrictions responded to the widespread chicanery in the real estate-bond market in the 1920s and 30s. The likes of "Straus bonds" "Greenebaum bonds", and "Miller bonds," financed the construction of Manhattan's most famous art deco skyscrapers. See JAMES GRANT, MONEY OF THE MIND 166 (1992). These were single-asset real estate bonds, issued against the earning power of a particular mortgaged building often not yet completed.

Although the TIA prohibition applies to RMBS, the debates that led to its enactment have limited relevance in the securitization context because the bond-issuing shells either cannot or are extremely unlikely to reorganize in bankruptcy. Under the current regime, their distress must be resolved by contract. Recent controversy surrounding amendment restrictions in sovereign bond contracts offers an analogy.

Like securitization SPVs, sovereign governments cannot go bankrupt. Amendment clauses in sovereign bond contracts attracted policy and academic attention during the financial crises of the mid-1990s. Most sovereign bonds were then issued under New York law, and, though exempt from the TIA, required unanimous creditor consent to amend payment terms.<sup>65</sup> Policy

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Real estate bonds of the '20s and '30s featured all manner of self-dealing and conflicts of interest, including having the underwriter or the underwriter's affiliate serve as bond indenture trustee. A "pet trustee" did not serve as an effective monitor of bond performance or advocate for the bondholders. Such malfeasances were a major impetus for the TIA's enactment. Indeed, the Act's original list of conflicts of interests is essentially a description of the real estate bond industry. *Id.* 166-169.

Single-asset real estate bonds were in some ways forerunners of securitization, as they provided a dedicated cash flow to investors based on real estate mortgage payments. They also were forerunners of the collateralized debt obligation (CDO)—a securitization vehicle whose assets (which might be actively managed) consist heavily of interests in other securitizations. Thus, S.W. Straus & Co. was, by the mid-1920s, marketing "collateral trust bonds," which were described by a court as "a potpourri of indifferent subordinate mortgages owned by the borrower and pledged as security, besides debentures of corporations owning real estate. *Id.* at 164. Interestingly, the market appears to have begun to respond to the problems of single-asset real estate bonds before the TIA. Thus, the single-asset real estate bonds at issue in the famous case of *Aladdin Hotels*, which were issued in 1938 contained a contractual unanimous consent provision. *Aladdin Hotel Corp. v. Bloom*, 200 F.2d 627, 628-30 (8<sup>th</sup> Cir. 1953).

<sup>65</sup> The reasons for this are disputed and in any case irrelevant here. Sovereign bonds are specifically exempt from the Trust Indenture Act of 1939. Conventional wisdom holds that unanimity provisions were mindlessly copied from corporate bond indentures, *see* Buchheit & Gulati, *supra* note 63, or naively inserted in Brady Bonds, which represented restructured loans, to deter re-default. James Hurlock & Troy Alexander, *The Fire Next Time: The Dangers in the Next Debt Crisis*, 15 INT'L FIN. L. REV. 14 (1996).

makers and academics widely expected unanimity to delay composition and encourage holdouts; the absence of the bankruptcy valve would exacerbate coordination problems.

As with corporate bonds and RMBS,<sup>66</sup> the argument for flexibility in sovereign bond contracts emphasizes externalities. Absent an orderly renegotiation framework, a debt overhang can depress investment and growth in a country for years; while sovereign default can trigger economic collapse, bank failures, job losses and contagion throughout the financial markets.<sup>67</sup> Since everyone understood the macroeconomic policy risks, debtors and creditors would hold up governments and organizations such as the International Monetary Fund for side payments, potentially imposing costs on U.S. taxpayers among others.<sup>68</sup>

The counter-argument for rigidity in this context tracks contract theory: it evokes information asymmetries and the challenge of disciplining sovereign debtors.<sup>69</sup> Fiscal ability and political willingness to pay are notoriously hard to disentangle; it is hard to tell “good” borrowers from “bad” ones.<sup>70</sup> Suing foreign

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<sup>66</sup> See Roe, *supra* note 62.

<sup>67</sup> See generally, e.g., BARRY EICHENGREEN, ET AL., CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS (1995) (arguing for majority modification provisions in sovereign bond contracts); James Hurlock & Troy Alexander, *The Fire Next Time: The Dangers in the Next Debt Crisis*, 15 INT’L FIN. L. REV. 14 (1996) (arguing that new and rigid sovereign bonds would be more difficult to manage in distress than old sovereign loans).

<sup>68</sup> See, e.g., Jeremy Bulow & Kenneth Rogoff, *Multilateral Negotiations for Rescheduling Developing Country Debt: A Bargaining-Theoretic Framework*, 35 IMF STAFF PAPERS 644 (1988) (sovereign debt restructuring as a tri-partite negotiation with creditor country taxpayers); John B. Taylor, Under Sec’y of Treasury for Int’l Affairs, *Sovereign Debt Restructuring: A US Perspective*, Speech at the Conference on “Sovereign Debt Workouts: Hopes and Hazards,” Peter G. Peterson Institute for International Economics (Apr. 2, 2002), available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=455> (suggesting official subsidy for debtors and creditors to adopt collective action provisions in sovereign bonds).

<sup>69</sup> *Supra* note 58 and accompanying text; for the sovereign parallel, see e.g., See Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina’s Default*, 6 CHI. J. INT’L L. 311 (2005). [Shleifer].

<sup>70</sup> Hence Walter Wriston’s observation that countries never go bankrupt. Walter B. Wriston, *Banking Against Disaster*, N.Y. TIMES, Sept. 14, 1982, at A27; see FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT

governments is of limited use because the assets to satisfy a judgment are either immune (embassies, military bases) or in the home country and out of creditors' reach. And like corporate insiders, government affiliates (agencies, state-owned enterprises) are not shy about buying and voting government bonds to the detriment of private bondholders.<sup>71</sup>

For reasons that had more to do with political economy than contract theory, advocates of flexibility prevailed in 2003, when sovereign bond documentation standard shifted away from unanimity.<sup>72</sup> Perhaps the most remarkable aspect of the shift was that eliminating formal contractual rigidity appeared to make little difference. After 2003, borrowers adopted majority modification provisions without regard to credit quality, casting doubt on the signaling value of modification terms. Meanwhile, countries found ways to default and restructure with or without unanimity.<sup>73</sup> At least for now, it appears that formal barriers to amendment in sovereign debt contracts had not made them immutable. It is difficult to tell what, if any, extra cost such barriers might have imposed on composition.

This experience highlights the difference between formal rigidity and effective immutability in contracts. Some writers – notably Mark Roe and Kevin Davis – make a point of

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DEFAULTS AND LESSONS FROM A DECADE OF CRISES 38 (2007) (arguing that the effort to disentangle ability and willingness to pay may be futile).

<sup>71</sup> CIBC Bank and Trust Co. v. Banco Central do Brasil, 886 F. Supp. 1105 (1995); Buchheit & Gulati, *supra* note 63; William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 56–61 (2004) (citing Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1 (1996))(arguing for inter-creditor duties). Some have argued that “insider” status should extend to all institutions regulated by the sovereign borrower. EMCA, MODEL COVENANTS FOR NEW SOVEREIGN DEBT ISSUES (May 3, 2002), available at [http://www.emcreditors.com/pdf/model\\_convenants.pdf](http://www.emcreditors.com/pdf/model_convenants.pdf).

<sup>72</sup> Gelpern & Gulati, *supra* note 61.

<sup>73</sup> See Sturzenegger & Zettelmeyer, *supra* note 71. Ecuador, Uruguay, and Argentina, among others, used established corporate restructuring tools, such as exchange offers and exit consents, to limit the impact of unanimity.

distinguishing the two.<sup>74</sup> Each stresses that institutional design and covenants that stop short of banning modification can go a long way to immutability. Conversely, formal prohibition might mean little where restructuring techniques and market norms let parties circumvent their contracts – a view borne out by the sovereign bond experience.

As noted in Part II, obstacles to RMBS modification are not just formal; they are also structural and functional. *Formal rigidity* is a creature of contract and statute. It can be direct – a term prohibiting modification – or less so, as in the TIA’s voting thresholds and the PSA’s buyback requirement for modified mortgages. In either case, such provisions impose formal constraints or conditions on renegotiation. *Structural rigidity* is a product of legal and organizational design. For example, the trust, off-balance sheet accounting, and pass-through tax forms, as well as the bankruptcy-remote features of RMBS present obstacles to modification, even where it is not their principal goal. *Functional rigidity* goes to the economic incentives of contracting parties. RMBS features such as tranching, re-securitization and insurance are not designed primarily to preclude modification, yet they create coordination problems and powerful disincentives for junior creditors and insurers to cooperate in any renegotiation.

RMBS recall sovereign bonds both in their bankruptcy remoteness, and in some of the spillover effects from their enforcement in distress, discussed further in Part IV. Moreover, though neither sovereigns nor securitization vehicles have equity in the traditional sense of the word (common stock with management rights), both have multiple classes of creditors that are, at least in theory, vulnerable to insider abuse of the sort that had worried Douglas.<sup>75</sup> However, trust organization, tax and accounting

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<sup>74</sup> Moreover, while Roe favors contractual composition and majority voting, Davis appears to take no position on immutability as such, even as he comes out against enforcement of no-amendment clauses.

<sup>75</sup> Patrick Bolton & David Skeel, *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2004) (arguing for enforcement of absolute priority in sovereign debt); Kurt Eggert, *What Prevents Loan Modifications?*, HOUSING POL’Y DEBATE, Vol. 18, No. 2, 290-91 (2007) (describing tranche warfare).

features, senior/subordinate tranching, and resecuritization add layers of structural and functional rigidity on top of statutory and contractual barriers to modification. The combination makes RMBS more effectively immutable than sovereign bonds. RMBS rigidity in the face of real financial distress creates negative externalities, the subject of Part IV.

### **B. Rigid by Design**

It bears emphasis that layered rigidity is not an accidental by-product of securitization design. This is so even where rigidity is not the primary goal of a particular design feature, such as tax treatment. Moreover, securitization literature advocates rigidity even where securitization design may not achieve perfect immutability in practice. [Authors' note: Insert discussion from Schwarcz<sup>76</sup> and others on SPV design and intentional rigidity. Consider pricing data and discussions.]

### **C. Rigid Contracts in Bankruptcy Theory**

The quest for immutability in securitization design is consistent with contract theory's prediction that parties may commit to forego modification *ex post* in exchange for savings *ex ante*. It is also consistent with a strain of bankruptcy theory, known as "contractual bankruptcy,"<sup>77</sup> which argues that private ordering of the disposition of an insolvent firm's assets is more efficient than the public ordering of the Bankruptcy Code, mandated by Congress.<sup>78</sup> Private contracts can be drafted to reflect the idiosyncratic preferences of particular debtors and creditors regarding the relative values of future bankruptcy protection and current cost of credit. The debate over the relative merits of public and private ordering has dominated bankruptcy scholarship for

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<sup>76</sup> Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515 (1999),

<sup>77</sup> Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1, 3 n.6 (2005).

<sup>78</sup> See, e.g., Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53 (1992) ("[A] firm's ability to file for bankruptcy reorganization should be determined by the firm's investors rather than by the government"). See also Warren & Westbrook, *supra* note **Error! Bookmark not defined.**, at 2-3.

over a quarter century, beginning with Douglas Baird and Thomas Jackson's "creditors' bargain" theory of bankruptcy.<sup>79</sup>

From the creditors' bargain theory, several proposals for contractual bankruptcy emerged. As these proposals began, they were not for contracting *out* of bankruptcy, *per se*, but rather using bankruptcy as a mechanism for enforcing the pre-bankruptcy contractually determined priority scheme and avoiding rent extraction by managers and out-of-the-money claimants. Thus, Baird himself envisioned a reformed Chapter 11 that would be used as a vehicle to conduct going-concern sales of firms free and clear of claims, with the sale proceeds then being divided among creditors according to absolute priority.<sup>80</sup> Variations on the sale method were proposed by Lucien Arye Bebchuk,<sup>81</sup> Philippe Aghion, Oliver Hart, and John Moore,<sup>82</sup> and Barry Adler.<sup>83</sup> These

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<sup>79</sup> The creditors' bargain theory explains bankruptcy law as reflecting the bargain that creditors would reach about the disposition of an insolvent firm absent coordination problems. The driving insight of the creditors' bargain theory is that bankruptcy is designed to overcome a common pool problem and prevent a destructive race to seize the firm's assets. *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857 (1982); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-19 (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988).

<sup>80</sup> Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, J. LEGAL STUDIES 127, 145-148 (1986).

<sup>81</sup> Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776-77 (1988). Bebchuk called for an "automated" bankruptcy, aimed at avoiding a fire sale and a judicial valuation. In Bebchuk's design, absolute priority (determined *ex ante* by contract) would be enforced in all reorganizations and liquidations through a system in which existing classes of creditors and equity holders would be required to purchase all senior interests at face value or forfeit their own interest. The lowest priority class to bid-in would own the company, with everyone senior being paid in full. The seniority of classes of creditors would be contractually determined and would include the bankruptcy bidding option.

<sup>82</sup> Philippe Aghion *et al.*, *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523, 524 (1992). Aghion, Hart, and Moore responded to

proposals added increasing flexibility to the sale process, but all envisioned a mandatory, judicially supervised process that enforced a contractually determined non-bankruptcy priority system.

Michael Bradley and Michael Rosenzweig took the idea of contractual bankruptcy a step further and proposed removing it from the courts.<sup>84</sup> They were merely following the logic of making Chapter 11 a mandatory sale process. This would allow creditors to bargain up front for where they would fit in the firm's priority structure, and the outcome would reflect the idiosyncratic preferences of any particular creditor/debtor pair as to the proper balance between cost of capital and bankruptcy rights. Robert Rasmussen<sup>85</sup> and Alan Schwartz<sup>86</sup> have each since proposed less

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Bebchuk's proposal with one in a judge would allocate rights in the bankrupt firm among the claims holders and solicit bids for control of the firm.<sup>82</sup> As they explained, their "proposed scheme is a decentralized variant on Chapter 7, in which *noncash* (as well as cash) *bids are allowed*, and *ownership of the firm is homogenized* (to all equity), so that *the owners can decide* (by vote) *which of the bids to accept*. However, insofar as noncash bids allow for reorganization/recapitalization, [the] proposal can be viewed as a decentralized version of Chapter 11, in which conflicts of interest among different claimant groups are avoided through homogenization of ownership." *Id.* (emphasis original).

<sup>83</sup> Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319–24 (1993) (proposing an alternative automated bankruptcy regime in which an insolvent firm's equity would be transferred to the highest-priority class of creditors that could not be paid on time, rather than by bidding in. The process would be specified under the terms of financial instruments issued by the firm.). *See also* Barry E. Adler, Finance's Theoretical Divide and the Proper Role of Insolvency Rules, 67 S. CAL. L. REV. 1107 (1994) (arguing that "Chameleon Equity"—a multi-priority contractual hierarchy of preferred equity would better resolve financial distress than bankruptcy legislation); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) (same); Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994) (same); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997) (same).

<sup>84</sup> Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078 (1992).

<sup>85</sup> Rasmussen has proposed a different model of contract bankruptcy, where firms may choose a bankruptcy regime in their organizational charter from a menu of state-provided options. The choice would be locked in, unless every creditor consents to change it. Because creditors would know the

drastic contract bankruptcy alternatives that contemplate a substantial degree of private autonomy for handling firm distress. While there are significant differences among various contractual bankruptcy proposals, they all require some degree of rigidity in their contractual design to ensure that creditors actually get the benefit of their bargain.

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applicable bankruptcy regime before extending credit, they could price accordingly. The firm would thus be able to balance between lower present costs of capital and greater bankruptcy protection in the future, which would produce (absent hyperbolic discounting) the most efficient outcome. Involuntary creditors would continue to be protected by mandatory rules, since they do not price credit based on the organizational choices of their debtor. Rasmussen, *supra* note **Error! Bookmark not defined.**, at 117.

<sup>86</sup>Alan Schwartz has proposed another model of contractual bankruptcy, where firms and their creditors choose between a contractually locked-in (“renegotiation-proof”) insolvency regime and one that is chosen by the firm (“renegotiation contracts”). A “renegotiation-proof” contract ... will induce the firm to choose the optimal bankruptcy regime.<sup>86</sup> Absent the entry of a new creditor, however, the terms of the bribe to ensure the optimal bankruptcy regime would remain locked-in. Alan Schwartz, *A Contract Theory Approach to Business* bankruptcy system in the event of insolvency. The contract is called renegotiation proof because no party will have an incentive to propose changes in it in light of later events.” Alternatively, in a “renegotiation contract” regime, creditors rely on the unincentivized firm to choose the optimal bankruptcy regime. If reorganization would have a sufficiently higher value than liquidation, creditors would do better under a renegotiation regime. To address the concern that the optimal bankruptcy regime may change over time, Schwartz introduces a middle ground between lock-in and firm choice -- a “partially renegotiation proof” contract, in which a firm’s creditors’ “renegotiation proof” contracts would be adjusted to reflect the deal negotiated by the newest creditor of the firm. Such a readjustment would ensure that the firm would remain incentivized to choose the optimal *Bankruptcy*, 107 YALE L.J. 1807, 1827-1830 (1998). To ensure an optimal renegotiation proof contract, the firm must be bribed to permit it to keep a percentage of the insolvency monetary return, regardless of the specific regime. This will incentivize the firm to choose the regime that maximizes monetary returns, so long as it is a high enough percentage to offset any private benefits the firm wishes to consumer. *Id.* See also Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 343 (1999) (“If the rule against contracting for a preferred bankruptcy system were relaxed, parties would write “bankruptcy contracts” that would induce a borrowing firm to choose the system that would be optimal for it and its creditors were it to become insolvent.”).

Contractual bankruptcy has been criticized on the grounds that it fails to consider anything other than efficiency,<sup>87</sup> and its central efficiency claim has been called into question. Some scholars have questioned whether contractual bankruptcy would create new inefficiencies from redistribution, offsetting any efficiency gains.<sup>88</sup> Others have questioned whether the transaction costs involved in a contractual bankruptcy regime would outweigh the efficiency gains.<sup>89</sup> In a recent article, Elizabeth Warren and

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<sup>87</sup> Elizabeth Warren, *Bankruptcy Policy*, *supra* note **Error! Bookmark not defined.** (suggesting various distributional goals besides economic efficiency); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 30 (1991) (arguing for the need to account for the interests of the community, including potential customers, suppliers of the firm, and taxing authorities); Donald Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 762 (1991) (explaining that a value-based account of bankruptcy views financial distress as “not only as an economic, but as a moral, political, personal, and social problem that affects its participants”); Elizabeth Warren, *Bankruptcy Policy in an Imperfect World*, 92 MICH. L. REV. 336, 354-56 (1993) (emphasizing the need to internalize costs of business failure); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 962 (1991); Jean Braucher, *Bankruptcy Reorganization and Economic Development*, 23 CAP. U. L. REV. 499, 517-18 (1994) (arguing for need to protect employee interest because of inability to diversify labor capital); Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75 (1995); Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75 (1996); Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5, 26-34 (1996) (arguing for need to protect employee interest because of inability to diversify labor capital); Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1032-34 (1987) (same).

<sup>88</sup> Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 539, 548-49 (2001); Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2243 (2000); Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999); Warren & Westbrook, *supra* note 77, at 6; Bebhuck & Fried, *The Uneasy Case*, *supra* note **Error! Bookmark not defined.** Bebhuck & Fried, *The Uneasy Case Reply*, *supra* note **Error! Bookmark not defined.**; See generally Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 811 & n.52 (2004).

<sup>89</sup> See Rasmussen, *supra* note 78, at 100, 114-16, Warren & Westbrook, *supra* note **Error! Bookmark not defined.**, at 6.

Jay Lawrence Westbrook test the efficiency of contractual bankruptcy on a multidistrict empirical study of business bankruptcy filings from 1994. Warren and Westbrook find support for both the redistribution<sup>90</sup> and the transaction costs<sup>91</sup> critiques of contractual bankruptcy; however, their findings extrapolate from federal bankruptcy data – contractual bankruptcy is illegal for real firms.

Securitization offers a rare natural experiment for the contractualist approach.<sup>92</sup> The bankruptcy-remote SPV (the firm) functionally opts out of federal bankruptcy law. The rights of the creditors of the SPV are governed by the PSA, in particular its tranching and payment schedule provisions. The senior/subordinate structure of the tranching creates an absolute priority regime for the creditors of the SPV. Creditors are free to bargain for the terms of the securities that they buy—different SPVs have different tranching arrangements, and investors are free to purchase wherever they wish to be in the SPV’s capital structure. Securitization even deals with the problem of involuntary creditors who cannot “bargain”: because the SPV is essentially a passive entity that merely holds assets, it is unlikely to incur liability to involuntary creditors.<sup>93</sup> In sum, securitization effectively creates a self-executing contractual bankruptcy regime: this vast market shows that Schwartz was correct when he observed that “bankruptcy contracting would occur if it were permitted.”<sup>94</sup>

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<sup>90</sup> Warren & Westbrook, *supra* note 77, at 7.

<sup>91</sup> *Id.*

<sup>92</sup> Cf. Schwartz, *supra* note **Error! Bookmark not defined.**, at 1834 (“Because bankruptcy contracts are currently illegal, there is no data about real contracts that could support this argument.”). See also Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 597-99 (1999) (suggesting that securitization transactions should as enforceable bankruptcy waiver contracts); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645-49 (1992) (noting that secured credit card serve as a bankruptcy contract).

<sup>93</sup> The major exception would be claims and counterclaims from obligors on the SPV’s assets.

<sup>94</sup> Schwartz, *supra* note **Error! Bookmark not defined.**, at 1834.

Securitization's natural experiment in contractual bankruptcy thus appears to be successful. Firms will securitize only if securitization offers a lower cost of capital than other methods of finance. Securitization will only offer a lower cost of capital than direct debt or equity financing if it offers creditors greater benefits. The very existence of securitization proves its efficiency, at least from the perspective of the firm. Of course, this efficiency is due to more factors than bankruptcy remoteness and the certainty of priority in distribution; however, as noted in the preceding section, these two factors are central to securitization design and perhaps the most important features of securitization for investors.

Yet the experience with mortgage securitization also gives reason for skepticism about the efficiency claims of contractual bankruptcy. The mortgage crisis has revealed a third efficiency problem with contractual bankruptcy – the problem of externalities – in addition to redistribution and transaction costs. Because contractual bankruptcy models limit themselves to the context of the firm, they do not consider externalities<sup>95</sup> Contractualists leave the problem of externalities to the market.<sup>96</sup> But thick markets are not always there to pick up the slack, and maximizing value of a bankruptcy estate maximizes social welfare if and only if the marginal increase in welfare from the particular bankruptcy regime

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<sup>95</sup> *Id.* at 1814.

<sup>96</sup> According to Schwartz, “[i]t is unnecessary for bankruptcy law to protect communities when thick markets exist. In a thick market, there are good substitutes for the firm’s performance.” *Id.* at 1817. *Cf.* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97,101-102 (1984) (“The failure of a firm affects many who do not, under current law, have cognizable ownership interests in the firm outside of bankruptcy. The economy of an entire town can be disrupted when a large factory closes. Many employees may be put out of work. The failure of one firm may lead to the failure of those who supplied it with raw materials and those who acquired its finished products. Some believe that preventing such consequences is worth the costs of trying to keep the firm running and justifies placing burdens on a firm's secured creditors.”).

offsets the marginal decrease in welfare from the regime's externalities.<sup>97</sup>

The debates surrounding contractual bankruptcy have all been in the context of business bankruptcy. There is an unspoken recognition that consumer bankruptcy policy is different. The transaction costs for contractual bankruptcy for consumers would be prohibitively high, and would necessitate accounting for numerous involuntary creditors and creditors who cannot easily adjust their behavior to account for differences in bankruptcy regimes among consumers. The efficiency benefits of a standardized bankruptcy regime for consumers are so manifest, that there has been no attempt to apply contractual bankruptcy to consumers.

And yet that is precisely what securitization accomplishes. Securitization transforms consumer debt into business debt. This transformation has profound implications for the application of a contractual bankruptcy regime like the one found in securitization to securitized consumer debt. The contractual bankruptcy regime embedded in securitization is designed to inhibit the reworking of the consumer debts, and force consumer debt out of social policy world of the Bankruptcy Code into the private ordering of securitization contracts.

Securitization is embodiment of contractual bankruptcy. For the device to work, its contracts must be rigid. However, contractual bankruptcy theories do not consider the full range externalities from rigidity. The problem of externalities is particularly salient in residential mortgage securitization for two reasons. First, the enormous size of the market creates the risk that any disruptions in it would affect the macroeconomy. Second, because securitization effectively transforms consumer debt into

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<sup>97</sup> So thoroughly has the firm-centered framing of the bankruptcy debate taken root that even its most vigorous critics, like Warren, ultimately succumb to it after expanding the list of constituents slightly to include communities surrounding the firm. Elizabeth Warren, *Bankruptcy Policy*, *supra* note **Error! Bookmark not defined.** (suggesting various distributional goals besides economic efficiency); Elizabeth Warren, *A Theory of Absolute Priority*, *supra* note 87; Elizabeth Warren, *Bankruptcy Policy in an Imperfect World*, *supra* note 87.

business debt, it imparts elements of contractual bankruptcy onto relationships it was never meant to cover. The next Part elaborates the broader set of externalities from securitization.

#### **IV. EXTERNALITIES: CONTRACTS AS SUICIDE PACTS**

As discussed in Part II, RMBS PSAs constrain the modification of two kinds of contracts. First, they restrict amendment of underlying mortgage loans. Second, they restrict amendment of the RMBS themselves. Combined, these restrictions create four sets of negative externalities: externalities for communities; externalities for other creditors; externalities for the financial markets; and externalities for the economy as a whole. These stem from pervasive foreclosures, from complexity and illiquidity in RMBS, and from downward pressure on asset prices. PSA design also makes it difficult for the government to regulate securitization contracts to mitigate their spillover effects.

Before proceeding to catalogue the PSAs' effects on the economy and society, it is useful to set out their effect on the debtor-homeowner, who is not party to the PSA contract and does not know its terms. A homeowner whose loan has been securitized under a restrictive PSA does not have the same workout options as one whose loan has not been securitized, or one whose loan is sold under a PSA that is more amenable to modification. If this homeowner cannot pay her loan according to its original terms, she is more likely to lose the house. Whether homeowners do, would or could get a price break to compensate them for this commitment is an open question. Homeowners and lenders do not know at the time of origination whether the loan will be securitized, much less under what terms. But even if they had perfect information, borrowers might not ask for or receive proper compensation.<sup>98</sup> Where securitization under restrictive PSAs is pervasive, it is unlikely that contractual rigidity would help creditors detect bad borrowers *ex-ante*: bad apples would not opt out. More

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<sup>98</sup> See Levitin & Twomey, *supra* note 8 (discussing cognitive issues in mortgage lending). See also Oren Bar-Gill, [The Law, Economics and Psychology of Subprime Mortgage Contracts](#), 94 CORNELL L. REV. (2009).

importantly for our purposes, even if homeowners asked for and received a better interest rate for giving up ex-post workout options, their arrangement might be costly for others who have nothing to do with either the mortgage or the securitization contracts.

First, where most home loans are securitized under restrictive PSAs, one would expect more foreclosures in an economic downturn. A high foreclosure rate creates negative externalities for communities. Foreclosures push down the price of neighboring properties,<sup>99</sup> reduce property tax revenue for local governments,<sup>100</sup> and impose new costs on communities, as foreclosed properties are often magnets for crime and fire.<sup>101</sup> Foreclosures also have non-quantifiable costs, as debtors' relocation affects social relationships.<sup>102</sup>

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<sup>99</sup> See, e.g., DAN IMMERGLUCK & GEOFF SMITH, WOODSTOCK INSTITUTE, *THERE GOES THE NEIGHBORHOOD: THE EFFECT OF SINGLE-FAMILY MORTGAGE FORECLOSURES ON PROPERTY VALUES* i-ii (2005), available at [http://www.woodstockinst.org/index.php?option=com\\_docman&task=doc\\_download&gid=52](http://www.woodstockinst.org/index.php?option=com_docman&task=doc_download&gid=52). Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POLICY DEBATE 57 (2006); Mark Duda & William C. Apgar, *Mortgage Foreclosures in Atlanta: Patterns and Policy Issues*, A Report Prepared for NeighborWorks America, December 15, 2005, at [www.nw.org/Network/neighborworksprogs/foreclosuresolutions/documents/foreclosure1205.pdf](http://www.nw.org/Network/neighborworksprogs/foreclosuresolutions/documents/foreclosure1205.pdf).

<sup>100</sup> Laura Johnston, *Vacant Properties Cost Cleveland \$35 Million, Study Says*, CLEVELAND PLAIN DEALER, Feb. 19, 2008; Global Insight, *The Mortgage Crisis: Economic and Fiscal Implications for Metro Areas*, Report Prepared for The United States Conference of Mayors and The Council for the New American City, 2007, at <http://www.vacantproperties.org/resources/documents/USCMmortgagereport.pdf>.

<sup>101</sup> See, e.g., Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUDIES, 851 (2006); William C. Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom*, May 11, 2005, at [http://www.995hope.org/content/pdf/Apgar\\_Duda\\_Study\\_Short\\_Version.pdf](http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf).

<sup>102</sup> See Levitin, *supra* note 22; Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 HARV. L. & PUB. POL'Y REV. (online) (Jan. 19, 2009), at [http://www.hlpronline.com/Levitin\\_HLPR\\_011909.pdf](http://www.hlpronline.com/Levitin_HLPR_011909.pdf).

Second, restrictive PSAs can contribute to another collective action problem, of the sort that produces bank runs.<sup>103</sup> Where there is a wave of foreclosures, the real estate market is flooded with properties, pushing down home prices. Creditors that might not have foreclosed otherwise, rush to salvage what is left of their investment. Mass foreclosures can create a negative feedback loop that begets more foreclosures and greater losses for lenders. Thus, restrictive PSAs impose externalities on RMBS holders and on mortgagees generally, quite apart from the effects on the holders and mortgagees under any given PSA.

Third, restrictive PSAs impose negative externalities on the financial markets. United States RMBS are among the world's most widely held securities; trillions of dollars in derivative products further amplify and transmit their effects. Despite its size, the RMBS market in its present form is very young compared to the corporate bond market. Its pricing models rely on a relatively short performance history, and a very thin market infrastructure.<sup>104</sup> Comparing the RMBS and corporate bond markets' handling of failure is instructive. Although the RMBS pricing models take into account the possibility of nonpayment on an occasional mortgage, they do not account for large-scale failure. As noted in [Part IIIB], the securities are designed to fit models where failure is near-impossible. As a result, these models are ill-equipped to predict recovery values from widespread foreclosures. Moreover, servicers have never gone through a foreclosure epidemic in a downturn, and lack the administrative capacity to process them. In contrast, corporate bonds benefit from a long performance history and an established infrastructure to handle distress, including numerous renegotiation options. In the worst case, creditors can look to the company's liquidation value. It would take a combination of economic collapse and a breakdown of the U.S. bankruptcy system for corporate liquidation values to lose meaning. In contrast, a relatively moderate downturn might

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<sup>103</sup> Garrett Hardin, *The Tragedy of the Commons*, 168 SCI. 1243 (1968).

<sup>104</sup> See, e.g., Gillian Tett & Aline Van Duyn, *A Re-Emerging Market?*, THE FINANCIAL TIMES (London), Jul. 1, 2008.

be expected to render RMBS and the structured products based on RMBS hard to value.<sup>105</sup>

Securities whose recovery value is difficult or impossible to determine either trade at a deep discount, or become illiquid. Illiquidity in the RMBS market reverberates worldwide. As financial institutions incur losses from exposure to RMBS and market risk, they may respond by hoarding cash, which in turn squeezes consumer and business credit. A downward spiral ensues.

Brittle PSAs also have implications for the economy as a whole. This fourth category of spillover effects is the macroeconomic counterpart of the two already described: foreclosures on a large scale depress aggregate spending power and real estate asset prices, and illiquidity in the RMBS market fuels a downward price spiral in financial assets. Where real estate prices are predicated on a liquid market in asset-backed securities, they collapse where there is no liquidity in the securitization market. A credit crunch depresses consumption and investment, and ultimately growth.

Although they generate significant externalities, securitization contracts are designed to limit the government's capacity to mitigate their adverse impact on the economy. Bankruptcy remoteness, tranching and resecuritization limit intervention options in distress. Bankruptcy remoteness has the most obvious effect on regulation and crisis response, since by its terms, this feature eliminates the state's role in managing financial distress. Securitization replaces a statutory bankruptcy regime with a contractual one that is more brittle, less transparent, and largely immune from social policy considerations.<sup>106</sup>

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<sup>105</sup> The discussion in the text does not address RMBS attributes that may make valuation difficult, but that do not relate to PSA rigidity. These include leverage, opacity, and poor due diligence. *See, e.g., id.*

<sup>106</sup> Other implications for government intervention are less obvious. When the link between debtor and creditor has been severed – replaced with impermeable, hyper-rigid layers of securitization – regulatory tools premised on the existence of the link become worthless. For example, regulatory accounting treatment of a conventional loan on the creditor's books can have a direct effect

The next part reviews historical experience of responding to contracts with significant spillover effects that warranted government intervention.

## **V. OVERCOMING RIGIDITIES**

History reveals a menu of standard responses to rigid contracts. First, there is statutory bankruptcy, designed and mandated by legislative enactment. In a statutory bankruptcy, the debtor can avoid anti-modification provisions in its own contracts.<sup>107</sup> This is the method used to avoid contractual rigidities in corporate bonds and farm mortgages.<sup>108</sup> A similar approach was mooted to overcome rigidity in sovereign debt contracts.<sup>109</sup>

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on that creditor's willingness to restructure that loan. Marking assets to market creates an incentive to modify a problem asset where renegotiation can produce a mark-to-market gain: if a bank is carrying an impaired mortgage at 50 cents on the dollar, it has the incentive to grant a homeowner relief, so long as the modified instrument can be valued at more than 50 cents. Regulatory forbearance (for example, letting the bank carry the loan at 80 cents) might force some loss-sharing. The same dynamic holds with conventional debt securities. In contrast, where the asset is an RMBS, changing its accounting treatment on the investor's books would have little or no impact on the prospects of restructuring the underlying mortgage. (This is true even without taking into account the formidable challenge of valuing RMBS in a depressed market.) Restructuring is precluded by the terms and structure of the intervening securitization arrangement.

<sup>107</sup> 11 U.S.C. §365.

<sup>108</sup> An attempt to establish a sovereign bankruptcy regime by treaty using anti-rigidity arguments, among others, failed in 2003. Statutory sovereign bankruptcy was a political nonstarter: no state would cede authority over its debt management to an international body; no debtor or creditor was prepared to accept an IMF-run regime, even a weak one; and no other governance options were on the table. See Brad Setser, *The Political Economy of SDRM in SOVEREIGN DEBT RESTRUCTURING* (Joseph Stiglitz & Jose Antonio Ocampo, Eds., forthcoming). For normative objections, see Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, J. INT'L ECON. LAW 613-682 (2001). See also Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001* (Int'l Monetary Fund Working Paper No. 02/133, 2002).

<sup>109</sup> European and Canadian governments advocated mandatory sovereign debt standstills. See PAUL BLUSTEIN, *THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLING THE IMF*

Second, governments can offer parties special incentives to circumvent or change their contracts. These incentives can take the form of sticks or carrots. Special incentives were used to deal with farm mortgage foreclosures during the Great Depression through a combination of state foreclosure moratoria (sticks)<sup>110</sup> and federal refinancing subsidies (carrots). Similar approaches were mooted to overcome rigidity in sovereign debt contracts.<sup>111</sup> Recent proposals directed at RMBS PSAs follow suit. One would take away favorable tax treatment for securitizations unless anti-

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170–74 (2001); Andy Haldane & Mark Kruger, *The Resolution of International Financial Crises: Private Finance and Public Funds* (Nov. 2001) (unpublished paper of the Bank of England and Bank of Canada), <http://www.bankofengland.co.uk/publications/other/financialstability/boeandboc.pdf>. U.S. officials mooted the idea of paying the parties to sovereign bond contracts to adopt majority modification provisions. John B. Taylor, Under Secretary of Treasury for International Affairs, *Speech at the Conference: Sovereign Debt Workouts: Hopes and Hazards?* (April 2, 2002), *available at* <http://www.treasury.gov/press/releases/po2056.htm>. On the other hand, the latest standard U.S. bilateral investment treaties (BITs) deny expropriation protection to creditors under sovereign bonds that require unanimous consent to amend payment terms. *Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment*.

<sup>110</sup>*Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

<sup>111</sup> European and Canadian governments advocated mandatory sovereign debt standstills. *See* PAUL BLUSTEIN, *THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLER THE IMF* 170–74 (2001); Andy Haldane & Mark Kruger, *The Resolution of International Financial Crises: Private Finance and Public Funds* (Nov. 2001) (unpublished paper of the Bank of England and Bank of Canada), <http://www.bankofengland.co.uk/publications/other/financialstability/boeandboc.pdf>. U.S. officials mooted the idea of paying the parties to sovereign bond contracts to adopt majority modification provisions. John B. Taylor, Under Secretary of Treasury for International Affairs, *Speech at the Conference: Sovereign Debt Workouts: Hopes and Hazards?* (April 2, 2002), *available at* <http://www.treasury.gov/press/releases/po2056.htm>. On the other hand, the latest standard U.S. bilateral investment treaties (BITs) deny expropriation protection to creditors under sovereign bonds that require unanimous consent to amend payment terms. *Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment*.

modification provisions were removed.<sup>112</sup> Others, including the Obama Administration's Home Affordability and Stability Plan (HASP) offer servicers bounties for every loan they modify.<sup>113</sup>

Third, government can simply use its eminent domain power to seize the contractual rights and slice through the Gordian knot of contractual rigidities. Thus, Howell Jackson and Lauren Willis have both proposed mass nationalization of mortgage loans from securitization vehicles, which the government could then renegotiate without regard to contractual limitations.<sup>114</sup> The threat of nationalization, of course, can itself be used as a stick to encourage voluntary renegotiations.

There are other ways of dealing with contractual rigidities that present serious social externalities. One approach involves narrowly tailored legislation that renders the offending contractual language unenforceable on public policy grounds. It was used in the New Deal to overcome gold indexation when the United States devalued the dollar. Another approach, used to break up utility holding companies in the 1930s and thereafter, involves broad and flexible administrative mandates to simplify complex financial structures. In addition, a combination of foreclosure moratoria and statutory bankruptcy was used twice over the past century to help restructure troubled farm mortgages that suffered from significant coordination problems.

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<sup>112</sup> Michael Barr & James A. Feldman, Center for American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, at [http://www.americanprogress.org/issues/2008/04/pdf/reimc\\_brief.pdf](http://www.americanprogress.org/issues/2008/04/pdf/reimc_brief.pdf).

<sup>113</sup> See, e.g., U.S. Treasury, Home Affordability and Stability Plan Fact Sheet, at <http://www.ustreas.gov/news/index2.html>; Press Release, Treasury Interim Assistant Secretary for Financial Stability Neel Kashkari Remarks on GSE, HOPE NOW Streamlined Loan Modification Program, available at <http://www.treas.gov/press/releases/hp1264.htm> (last visited Feb. 16, 2009); Christopher Mayer *et al.*, *A New Proposal for Loan Modifications*, 26 YALE J. REG. \_\_\_\_ (2009).

<sup>114</sup> Lauren E. Willis, Stabilize Home Mortgage Borrowers, and the Financial System Will Follow, Loyola-LA Legal Studies Paper No. 2008-28 (Sept. 24, 2008), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1273268](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273268); Howell E. Jackson, *Build a better bailout*, CHRISTIAN SCI. MONITOR, Sept. 25, 2008, at <http://www.csmonitor.com/2008/0925/p09s02-coop.html>. Eminent domain power could also be exercised by the states.

We chose these examples because they hold lessons for different aspects of PSA rigidity: formal contractual restraint, organizational structure (notably complexity) and functional rigidity in the form of coordination problems. We summarize the experience below.

### A. *Gold Clauses and Formal Rigidity*

When Franklin Roosevelt took office on March 4, 1933, state-mandated bank closures were spreading across the country.<sup>115</sup> Thousands of financial institutions failed or teetered on the brink. Where banks were open, people lined up “with satchels and paper bags to take gold and currency away from the banks to store in mattresses and old shoeboxes.”<sup>116</sup> Withdrawals accelerated on rumors of dollar devaluation,<sup>117</sup> even as the president-elect remained coy about his monetary intentions.<sup>118</sup>

On March 5, 1933, FDR invoked the Trading with the Enemy Act of 1917 to declare a national bank holiday and bar all transactions in gold.<sup>119</sup> A law to this effect followed days later. By mid-April, Roosevelt announced that he would take the United States off the gold standard.<sup>120</sup> A new monetary framework passed within weeks as part of a farm bill.<sup>121</sup> It gave the Executive

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<sup>115</sup> BARRY EICHENGREEN, *GOLDEN FETTERS: THE GOLD STANDARD AND THE GREAT DEPRESSION 1919-1939*, 329 (1996); WILLIAM E. LEUCHTENBERG, *FRANKLIN D. ROOSEVELT AND THE NEW DEAL* 38-39, 42-43 (1963).

<sup>116</sup> LEUCHTENBERG, *supra* note 115, at 39.

<sup>117</sup> EICHENGREEN, *supra* note 115, at 324-329. Roosevelt’s Attorney General Homer Cummings later claimed that between February and early March, over \$476 billion in gold had been withdrawn from Federal Reserve banks and the U.S. Treasury, of which \$311 billion appeared to head abroad. Argument of Attorney General Homer Cummings in *Norman v. Baltimore & Ohio R.R. Co.* 294 U.S. 240 (1935) (“Cummings Argument”)

<sup>118</sup> LEUCHTENBERG, *supra* note 115, at 38, 42. See also Kenneth W. Dam, *From the Gold Clause Cases to the Gold Commission: Half Century of American Monetary Law*, 50 U. CHI. L. REV. 504 (1983) (citing Roosevelt’s campaign criticism of Hoover’s alleged soft money leanings).

<sup>119</sup> See Michael R. Belknap, *The New Deal and the Emergency Powers Doctrine*, 62 TEX. L. REV. 67, 73 (1983).

<sup>120</sup> LEUCHTENBERG, *supra* note 115, at 50.

<sup>121</sup> Agricultural Adjustment Act, 73 Pub. L. 10, 48 Stat 31, 52, 53 (1933).

discretion to inflate by remonetizing silver, printing money, or changing the gold content of the dollar, but did not mandate devaluation. As the year wore on, fears of “marching farmers” and “an agrarian revolution” in New Deal policy circles eclipsed the calls for stable money.<sup>122</sup> On January 30, 1934, the Congress enacted the Gold Reserve Act requiring a 40% minimum reduction in the value of the dollar, and directing all gold coin to be melted into bullion. Roosevelt formally devalued the next day.

From the start, the President’s monetary activism faced an obstacle in private contracts. Roughly \$100 billion in long-term bond contracts contained what the New York Times described at the time as “the familiar clause, ‘principal and interest payable in the United States gold coin of present standard of weight and fineness.’”<sup>123</sup> The formulation was ubiquitous in obligations of the United States, foreign and subnational governments, railroads, utilities, and corporations.<sup>124</sup> Available gold supply in the United States was reported at about \$4 billion at the time; it was at \$11 billion worldwide – a small fraction of the amount ostensibly owing to the creditors, if the clauses were to be read literally as promises to deliver gold.<sup>125</sup> The total amount of gold clause debt outstanding also far exceeded the size of the U.S. economy. Enforcement of the term (as either gold or gold value) in conjunction with dollar devaluation would have increased a

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<sup>122</sup> LEUCHTENBERG at 51; ARTHUR M. SCHLESINGER, JR., *THE COMING OF THE NEW DEAL 1933-1935*, 237, 243 (1958).

<sup>123</sup> *Ignore Indenture Payable in Gold: Agents for Bonds with Coupons Due Fail to Give Coin When Demand Is Made; Court Action Possible; Issues of French Municipalities Soar in Price on Offer to Settle in Metal*, N.Y. TIMES, May 2, 1933, at 2.

<sup>124</sup> *Gold Obligations Are \$100,000,000; Federal Bonds Total \$22,000,000*, N.Y. TIMES, May 27, 1933, at 2.

<sup>125</sup> Cummings Argument, *supra* note 117. Whether the clauses were to be read as promising payment in gold coin or in paper dollars, but in the amount equivalent to the gold value of the debt at the time of the contract, was not entirely clear, and a subject of dispute in subsequent litigation. *Id.* See also, e.g., Henry M. Hart, Jr., *Gold Clause in United States Bonds*, 48 HARV. L. REV. 1057, 1071 (1934-1935).

significant portion of the country's public and private debt by nearly 70% and caused "mass bankruptcy."<sup>126</sup>

The gold clauses represented a simple indexation mechanism to protect creditors from devaluation, commonplace throughout history and still popular in many parts of the world.<sup>127</sup> In the United States, they gained popularity in the wake of the monetary chaos of the Civil War.<sup>128</sup> The gold term itself was not a source of legal rigidity in the contemporary contract theory sense; creditors could agree to change or abandon indexation.<sup>129</sup> But like many indexation devices, these clauses created economic rigidity: they purported to lock the debtor in a commitment to pay pre-specified value notwithstanding inflation. And the *ubiquity* of the clause worked as a policy constraint on the government. Congressman Steagall articulated the spillover argument as follows in a committee report, later quoted by the Supreme Court:

The gold clauses render ineffective the power of the government to create a currency. If the gold clause applied to a very limited number of contracts and

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<sup>126</sup> Randall S. Kroszner, *Is It Better to Forgive (Partially) Than to Receive? An Empirical Analysis of the Impact of Debt Repudiation* (Working Paper 2004). See also, Cummings Argument, *supra* note 117 (warning of "a return to chaos").

<sup>127</sup> News reports in 1933 cite to a British case construing similar clauses against the creditor; creditors' briefs in the subsequent U.S. gold clause cases refer to indexed Serbian and Brazilian debt; the Court itself highlights German reparation obligations. See, e.g., Turner Catledge, *Gold-Bond Clause Awaits Court Test*, N.Y. TIMES, May 7, 1933, at XX2 (reporting on Britain's experience with gold clause debt). See generally, Artur Nussbaum, *Multiple Currency and Index Clauses*, 84 U. PA. L. REV. 569, 579-582 (1936) (comparing U.S. experience with indexation with that of European countries); KEITH S. ROSENN, *LAW AND INFLATION* (1982) 130-166, 267-294 (discussing more recent domestic and international experiences with contract indexation). See also Artur Nussbaum, *Comparative and International Aspects of American Gold Clause Abrogation*, 44 YALE L.J. 53 at 60-61 (1934). [Cf. U.S. inflation-indexed bonds and Argentina's GDP-indexed bonds. NOTE debtor's rigidity is creditor's flexibility.]

<sup>128</sup> See e.g., See Daniel W. Levy, *A Legal History of Irrational Exuberance*, 48 CASE W. RES. L. REV. 799, 856 (1998); Dam, *supra* note 118, at 506-508.

<sup>129</sup> However, the law of negotiable instruments at the time would have made renegotiation difficult or impossible.

security issues, it would be a matter of no particular consequence, but in this country virtually all obligations, almost as a matter of routine, contain the gold clause. ... [N]o currency system ... can meet the requirements of a situation in which many billions of dollars of securities are expressed in a particular form of the circulating medium, particularly when it is the medium upon which the entire credit and currency structure rests.<sup>130</sup>

The Congress responded on June 5, 1933 with a joint resolution that rendered the gold clauses unenforceable, and allowed nominal payments “dollar for dollar” to discharge the underlying obligation. Creditors sued.

Four cases challenging the constitutionality of the joint resolution reached the Supreme Court in January 1935, two involving private debtors (both railroads), and two involving U.S. government debt. The press closely followed their path; they were front-page material in *The New York Times* and *The Wall Street Journal*.<sup>131</sup> They were the subject of numerous law review articles leading up to the argument,<sup>132</sup> and foremost among the President’s preoccupations. Roosevelt described the cases in terms of essential sovereign prerogatives.<sup>133</sup> He briefly considered ways of pressuring the court to uphold the joint resolution, and had a

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<sup>130</sup> *Text of the Two Reports on the Gold Resolution*, N.Y. TIMES, May 30, 1933, 2.

<sup>131</sup> *Second Gold Fight in Supreme Court, RFC Appeals Case to Test Validity of President’s Decree Voiding Clause in Contracts; Bond Payment at Stake, Action Is Identical with One Involving Interest Settlement on B.&O. Securities*, N.Y. TIMES, November 6, 1934, at 2.

<sup>132</sup> See John Dawson, *The Gold Clause Decisions*, 33 MICH. L. REV. 647, 676-677 n. 57 (1934-1935) (citing ten articles published in the run up to the Supreme Court argument, all predicting that the Joint Resolution would be sustained).

<sup>133</sup> Administration advocates referred to the litigants as people who “wanted \$1.69 for their dollar.” ARTHUR M. SCHLESINGER, JR., *THE POLITICS OF UPHEAVAL* 256 (1988). Characteristically, the creditors painted a different picture, of a \$1,000 bank deposit paid back at an arbitrary discount. Norman C. Norman, *Our Gold Certificates*, Letter to the Editor, N.Y. TIMES, June 1, 1933,

scathing radio address ready to deliver in the event of an adverse ruling.<sup>134</sup>

FDR's worries were misplaced. Chief Justice Hughes delivered the court's opinion on February 18, ruling unequivocally in favor of the government on private contracts, and only nominally against it in the cases involving redenomination of federal government bonds.<sup>135</sup> The private contract opinion was far-reaching. Hughes rejected out of hand the creditors' arguments on retroactive regulation, takings and due process grounds. He specifically refused to characterize the gold measure as a constitutional emergency, which might have fixed its duration.

Instead, the Chief Justice framed the government's power to rewrite private contracts as incidental to the entire macroeconomic policy remit, relying on earlier decisions interpreting broadly the power to coin and regulate the value of U.S. currency.<sup>136</sup> The central argument in the opinion reinforced what was then, and continues to be, a widely held view<sup>137</sup> that

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<sup>134</sup> SCHLESINGER, *POLITICS OF UPHEAVAL*, *supra* note 133, at 257-260; GERALD GUNTHER & KATHLEEN M. SULLIVAN, *CONSTITUTIONAL LAW* 23 (1997).

<sup>135</sup> We focus on private contracts in this Article. The decisions on government debt said the United States did in fact repudiate its debt, but the plaintiffs suffered no damage because they had no use for gold, and, thanks to deflation, had lost no purchasing power. *Nortz v. United States*, 294 U.S. 317, 329-30 (1935); *Perry v. United States* 294 U.S. 330 (1935). The opinion's peculiar reasoning attracted the bulk of the commentary in the aftermath of the Gold Clause Cases. For a prominent contemporary criticism of the government debt decisions, *see* Hart, *supra* note 125. For a more recent view, *see* Dam, *supra* note 118.

<sup>136</sup> "The broad and comprehensive national authority over the subjects of revenue, finance and currency ... derived from the aggregate of the powers granted to the Congress, embracing the powers to lay and collect taxes, to borrow money, to regulate commerce with foreign nations and among the several States, to coin money, regulate the value thereof, and of foreign coin ..." *Norman v. Baltimore & Ohio R.R. Co.* 294 U.S. 240, 304. This portion of the opinion relied heavily on *Juilliard v. Greenman*, 110 U.S. 421 (1884).

<sup>137</sup> *See, e.g.,* Dawson, *supra* note 118 (citing general expectation that the Court would uphold the resolution); John Dickinson, *The Gold Decisions*, 83 U. PA. L. REV. 715, 716 (1935) ("The decision in the private bond cases was distinctly conservative ..."). *See also* Seth P. Waxman, *The Physics of Persuasion: Arguing the New Deal*, 88 GEO. L.J. 2399, 2416 (2000) (arguing

private contracts must not be read to interfere with legitimate public policy making:

There is no constitutional ground for denying to the Congress the power expressly to prohibit and invalidate contracts although previously made, and valid when made, when they interfere with the carrying out of the policy it is free to adopt. ... To subordinate the exercise of the Federal authority to the continuing operating of previous contracts would be to place to this extent the regulation of interstate commerce in the hands of private individuals and to withdraw from the control of the Congress so much of the field as they might choose by “prophetic discernment” to bring within the range of their agreements.<sup>138</sup>

Although the decision was widely expected, the other side offered its share of drama. Justice McReynolds, “his face set and red, his high-pitched southern voice quivering with cold anger”, spoke for the four dissenters. In extemporaneous remarks later reported in *The Wall Street Journal*, he declared the episode a “confiscation of private rights and ... repudiation of national obligations”, compared Roosevelt to Nero for both his monetary

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that the private contracts cases were the easiest Gold Clause Cases to argue); see also Richard Friedman, *Switching Time and Other Thought Experiments: The Hughes Court and Constitutional Transformation* 142 U. PA. L. REV. 1891, 1924 (1994) (“For the Justices that had constituted the majority in *Blaisdell*, this [Norman] was an easy case.”). For a modern-day view of the Federal government’s power to regulate private contracts, see, e.g. *Pension Benefit Guaranty Corp. v. R. A. Gray & Co.*, 467 U.S. 717 (1984).

<sup>138</sup> 294 U.S. 240, 309-310. Cummings was yet more colorful: “[T]hese gold contracts have invaded the federal field. It is not a case of federal activity reaching out into a private area. So obsessed are our opponents by the idea of the sanctity of contracts that they are even prepared to assert their validity when they preempt the federal field. To me this seems a monstrous doctrine. These claimants are in federal territory. They are Squatters in the public domain, and when the Government needs the territory they must move on.” Cummings Argument, *supra* note 117.

indiscipline and despotism, and pronounced the Constitution “gone”.<sup>139</sup>

But Wall Street seemed to see things differently. As soon as the court decision was announced, both stocks and bonds rallied – perhaps recognizing the need to remove a debt overhang, or relieved to see the end of at least some of the uncertainty of the previous year.<sup>140</sup>

Over time, the Gold Clause Cases on private contracts came to reinforce the proposition that the Congress has broad power to rewrite such contracts where they interfered with otherwise lawful federal policies.<sup>141</sup> This power was particularly expansive with respect to the macroeconomy, used to render perfectly sensible contract terms unenforceable where their ubiquity alone created negative externalities for the public. The substance of potentially offending terms was secondary – specifying it in advance would require “prophetic discernment” (a *bon mot* from an earlier case quoted by all sides and the court in the gold episode).

Yet for purposes of overcoming contract rigidity, the lesson of the Gold Clause episode is narrow. The Joint Resolution and the jurisprudence it inspired targeted a single boilerplate clause that had populated a large portion of long-term debt contracts in the United States. A similar measure might help address formal rigidity in securitization contracts where it is a function of a similarly distinct set of widespread terms (for example, an outright prohibition on underlying mortgage modification). It would do little to overcome structural or functional rigidity.

### ***B. Utility Holding Companies and Structural Rigidity***

Our next example, the Public Utility Holding Company Act of 1935 (PUHCA), addresses structural rigidity. PUHCA was an antitrust and industrial policy initiative, a New Deal strike against

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<sup>139</sup> SCHLESINGER, *POLITICS OF UPHEAVAL*, *supra* note 133, at 260; *Justice McReynolds' Remarks on Gold Case Decision*, WALL ST. J., February 23, 1935, at 1; LEUCHTENBERG, *supra* note 115 at 144.

<sup>140</sup> Kroszner, *supra* note 126.

<sup>141</sup> *See, e.g., Seese v. Bethlehem Steel Co., Shipbuilding Div.*, 168 F.2d 58 (1948).

“bigness” with a dose of consumer protection.<sup>142</sup> Title I of the law sought to break up a system of holding companies that had controlled most of the power transmission in the country using complex and highly leveraged corporate structures. PUHCA required utility holding companies to register with the Securities and Exchange Commission (S.E.C.), and, in the so-called “death sentence” provision, gave the S.E.C. authority to break up registered companies whose structures it deemed uneconomic or unnecessarily complex.<sup>143</sup> Although PUHCA is known primarily as an instance of successful deconcentration, our interest lies in the law’s effectiveness at countering financial complexity, leverage, and regulatory arbitrage.

By 1932, thirteen corporate groups controlled three-quarters of private electricity generation in the United States; the three largest held over forty per cent.<sup>144</sup> The groups were structured as pyramids to maximize control and leverage. At the top were financial and service firms, which held small controlling blocks of stock in further tiers of holding companies, which in turn held controlling positions in operating companies. Each company in the pyramid was capitalized overwhelmingly with bonds and non-voting stock, which gave a small group of industrialists and

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<sup>142</sup> LEUCHTENBERG, *supra* note 115, at 156-157, quoting Louis Brandeis; SCHLESINGER, *POLITICS OF UPHEAVAL* *supra* note 133, at 307 (quoting Sen. Burton K. Wheeler’s remarks introducing the Wheeler-Rayburn bill that became PUHCA). See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (2003) 247 (referring to PUHCA’s enforcement as “the most effective antitrust enforcement program in United States history.”).

<sup>143</sup> PUHCA, 74 Pub. L. 333, 49 Stat 803, § 11(b) (1935). Early drafts of the law compelled dissolution; the version that passed put the burden on the SEC to prove that the structures were “unduly or unnecessarily complicated” and served “no useful purpose.” *Id.* and SCHLESINGER, *POLITICS OF UPHEAVAL*, *supra* note 133, at 306.

<sup>144</sup> SCHLESINGER, *POLITICS OF UPHEAVAL*, *supra* note 133, at 303-304; SELIGMAN, *supra* note 142, at 127. (Schlesinger writes of control, Seligman describes sixteen holding companies with “ownership interests” in over ninety percent of the nation’s private electrical output.) The statistics in both accounts come from three reports on the utility holding companies. The Federal Trade Commission, the House Interstate Commerce Committee, and National Power Policy Committee all investigated the holding company problem in great detail. Their reports, published in 1935, formed the basis for the legislation.

financiers with common stock at the top of the pyramid effective control of the entire system, in exchange for what was often a tiny investment.<sup>145</sup> Classified boards, interlocking directorates, and voting trusts completed the governance picture. Congressional committee and independent commission reports also revealed massive accounting irregularities and scandalous intra-group loan and transfer pricing schemes.<sup>146</sup>

In an age of stark rhetoric, the utilities attracted some of the starkest. “Evil” and “holding companies” stuck together in official and private statements, from Roosevelt to Will Rogers.<sup>147</sup> Judge Robert E. Healy, counsel to the Federal Trade Commission, described the holding company system as “a parasite and excrescence”; then-Tennessee Valley Authority director David Lilienthal called it a “tapeworm.” The term “private socialism” appeared often in the debates of the day to condemn the anti-democratic power concentration in the utilities’ hands.<sup>148</sup> Such sentiments were motivated by blatant fraud, operational inefficiencies, and effective exploitation of the rate-paying populace by skimming from the top of the pyramid. Other factors driving the outrage in 1935 evoke today’s securitization debates more directly: financial leverage, complexity, and the concomitant escape from regulation.

Excessive leverage was blamed for a disproportionately high bankruptcy rate among utilities since the stock market crash of 1929.<sup>149</sup> The utilities had argued that debt financing was

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<sup>145</sup> SELIGMAN, *supra* note 142, citing FEDERAL TRADE COMMISSION, UTILITY CORPORATIONS REPORT, Part 72-A, at 136-154 (1935). At the extreme, an investment of \$23,000 could buy control of a \$1.2 billion empire.

<sup>146</sup> SCHLESINGER, THE POLITICS OF UPHEAVAL, *supra* note 133, at 304.

<sup>147</sup> *Id.* at 305, 312. Schlesinger recounts Roosevelt’s Freudian slip in the 1935 State of the Union address: where his text read “abolition of the evil features of holding companies,” the President said “abolition of the evil of holding companies.” *Id.* at 305.

<sup>148</sup> *Id.* at 303-305, 307, 310, 312.

<sup>149</sup> SELIGMAN, *supra* note 142, at 129-130. The Supreme Court later framed the control, leverage, and financial speculation problems as linked:

Most of the financing of the various companies in the structure occurred through the sale to the public of bonds and preferred

essential for investment, and that the operating companies could not have secured enough capital to supply power to the country on their own, without geographically diversified funding vehicles. In this view, a diversified enterprise had the capacity to carry more debt, and would be more resilient in a downturn. But by the late 1920s, investment slowed,<sup>150</sup> while the failure rate flew in the face of the diversification argument. W.M.W. Splawn, special counsel to the Congressional committee investigating the holding companies, criticized their financing methods as borderline sham: “they manufacture nothing ... except securities.”<sup>151</sup> Several years after PUHCA’s enactment, in a speech geared to promote its enforcement, William O. Douglas (then Chairman of the S.E.C.) called “[d]iversity of risk ... merely a slogan for the security salesman.”<sup>152</sup>

Convoluting financial organization made the leverage problem intractable. General Electric Chairman Owen D. Young admitted privately that the utility structures were “so complicated that I feel sure that most of the men responsible for operating them were misled by their own mechanisms.”<sup>153</sup> Wendell Willkie, then President of the Commonwealth & Southern utility group, sought to distinguish financial engineering – the “technical development”

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stock having low fixed returns and generally carrying no voice in the managements. ... [A] relatively small but strategic investment in common stock ... in the higher levels of a pyramided structure often resulted in absolute control of underlying operating companies ... A tremendous ‘leverage’ in relation to that stock was thus produced; the earnings of the top holding company might quickly rise in value and just as quickly fall, making it a natural object for speculation and gambling.

Am. Power & Light Co. v. SEC, 329 U.S. 90, 101-102 (1946).

<sup>150</sup> LEUCHTENBERG, *supra* note 115, at 158.

<sup>151</sup> SCHLESINGER, *THE POLITICS OF UPHEAVAL*, *supra* note 133, at \_\_\_\_.

<sup>152</sup> William O. Douglas, *Address to the American Bar Association* (1938), excerpted in SELIGMAN, *supra* note 142, at 181.

<sup>153</sup> Quoted in SCHLESINGER, *THE POLITICS OF UPHEAVAL*, *supra* note 133, at 309.

of the holding company device<sup>154</sup> – from the few bad apples who abused it during “a crazy period [the 1920s] when men went crazy and did a lot of foolish things.”<sup>155</sup> He failed.

Financial, legal and organizational complexity achieved “through every tactic which could occur to the fertile minds of Sullivan & Cromwell” made the holding companies effectively impervious to regulation.<sup>156</sup> A central and plainly stated object of PUHCA’s Title I, which dealt with the holding companies, was simplification.<sup>157</sup> The Act sought to eliminate “undue and unnecessary” structural complexity because it was bad as such, because it begat inequity, and because it took economic and financial activity outside the state’s purview. The Supreme Court later amplified this sentiment, interpreting PUHCA’s death sentence section “to prevent the use of [interstate commerce] channels to propagate and disseminate the evils which had been found to flow from unduly complicated systems and from inequitable distributions of voting power.”<sup>158</sup>

Once Roosevelt and his circle decided to get rid of the holding companies, they chose between two models. Treasury Department officials proposed to tax the companies out of existence, imposing an inter-company dividend levy. The National Power Policy Committee proposed administrative dismantling.<sup>159</sup> PUHCA embodied the second model. Although it gave the S.E.C. discretion to simplify, it also required the elimination of “great-grandfather” structures – where three or more tiers of holding company subsidiaries separated the top and the bottom of the corporate pyramid.<sup>160</sup>

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<sup>154</sup> Schlesinger characterized Willkie’s effort as an attempt to present the holding company as “an affable, inarticulate giant”. SCHLESINGER, *THE POLITICS OF UPHEAVAL*, *supra* note 133, at 320.

<sup>155</sup> *Id.* at 308-309.

<sup>156</sup> *Id.* at 304.

<sup>157</sup> PUHCA, 74 Pub. L. 333, 49 Stat 803, § 1(c) (1935).

<sup>158</sup> *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 100 (1946).

<sup>159</sup> SCHLESINGER, *THE POLITICS OF UPHEAVAL*, *supra* note 133, at 305.

<sup>160</sup> PUHCA, 74 Pub. L. 333, 49 Stat 803, § 11(b)(2) (1935).

It is useful to compare PUHCA with the later approach of the Investment Company Act of 1940,<sup>161</sup> which similarly targeted financial complexity and abuse. The Investment Company Act was a deliberately moderate measure, designed to pass a hostile Congress.<sup>162</sup> As such, it limited itself to prospective regulation. PUHCA was emphatically retrospective, much like the Gold Clause resolution. It dismantled existing contracts and corporate structures that had been perfectly legal but now stood in the way of federal policy.

PUHCA's tumultuous birth<sup>163</sup> foreshadowed its equally dramatic enforcement path, which spanned two decades.<sup>164</sup> Opponents of the law prophesied financial chaos and economic meltdown, mass liquidation, national paralysis, and the financial ruin of widows and orphans.<sup>165</sup> The utilities first resisted registration, repeatedly and often successfully challenging PUHCA's constitutionality in the lower courts, where Hoover appointees still held sway.<sup>166</sup> It took intricate maneuvering for the S.E.C. to get the Supreme Court to uphold the constitutionality of the registration provisions only.<sup>167</sup> The risk of testing the "death sentence" was too high in the late 1930s; it had to wait until more judges sympathetic to the New Deal came onto the bench.<sup>168</sup>

In the meantime, successive S.E.C. chairmen implemented PUHCA flexibly to avoid a court challenge.<sup>169</sup> Official outreach and cajoling failed miserably at first. Before enforcement began in earnest around 1940 (about the time the courts were becoming safe territory for the S.E.C.), the utilities generally failed to take advantage of Section 11(e), which allowed them to design reorganization plans of their own. But by the early 1940s, the

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<sup>161</sup> Codified at 15 U.S.C. § 80a-1 through a-64.

<sup>162</sup> SELIGMAN, *supra* note 142, at 222, 227.

<sup>163</sup> SCHLESINGER, THE POLITICS OF UPHEAVAL, *supra* note 133, at 303-324.

<sup>164</sup> SELIGMAN, *supra* note 142, at 127-138, 181-183, 218-222, 241-264.

<sup>165</sup> SCHLESINGER, THE POLITICS OF UPHEAVAL, *supra* note 133, at 308, 310.

<sup>166</sup> SELIGMAN, *supra* note 142, at 127-138.

<sup>167</sup> Elec. Bond & Share Co. v. SEC, 303 U.S. 419 (1938).

<sup>168</sup> SELIGMAN, *supra* note 142, at 248, 250.

<sup>169</sup> *Id.* at 179-180, 218.

credible threat of enforcement combined with the S.E.C.'s adaptable administrative enforcement strategy, helped break the logjam. In particular, the SEC secured the cooperation of common stock holders – the most junior claimants who stood to lose everything in reorganization – with tax breaks and distribution formulas based on going-concern values, which allowed them to recover even where preferred stock did not get paid in full. Analysts reported that both common and preferred stock rose after filing Section 11 plans.<sup>170</sup>

It bears emphasis, however, that the catalytic effect of S.E.C actions obtained in the context of significantly stepped-up enforcement and more wide-ranging court challenges. Two cases brought by the subsidiary holding companies of Electric Bond & Share and decided in 1946 affirmed the constitutionality of the death sentence. In *North American Company v. S.E.C.*, the Court ruled that ownership and distribution of holding company securities across state lines subjected the companies to federal regulation under the Commerce Clause, that PUHCA constituted reasonable regulation reasonably implemented, and that an S.E.C. divestment order was not a taking under the Fifth Amendment.<sup>171</sup> *American Power & Light v. S.E.C.* was decided several months later. It rejected a vagueness challenge to Section 11 standards, such as “unduly and unnecessarily complicated.” The Court also re-emphasized that the Congress was “completely uninhibited” by the Commerce Clause in choosing its regulatory means to override previously lawful contracts. Echoing *North American Co.*, it observed that “federal power is as broad as the economic needs of

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<sup>170</sup> *Id.* at 252-255, 257. *Otis & Co. v. S.E.C.* 323 U.S. 624 (1945) rejected a challenge to the SEC's policy of ignoring absolute priority in Section 11 cases. The Supreme Court held both that the term liquidation in the contract and in bankruptcy law did not apply to Section 11 proceedings, but also – like the *Norman* court before it – that contracts “cannot be permitted to operate” in the aftermath of contrary federal legislation. 323 U.S. 624, 638.

<sup>171</sup> *N. Am. Co. v. SEC*, 327 U.S. 686 (1946). (“We may assume without deciding that the ownership of securities, considered separately and abstractly, is not commerce. But when it is considered in the context of public utility holding companies and their subsidiaries, its relationship to interstate commerce is so clear and definite as to make any other conclusion unreasonable”).

the nation.”<sup>172</sup> The brief opinion used the word “evil” at least a dozen times.

But as with the Gold Clause Cases, hostilities subsided as time went on and the business community began to see the benefits of PUHCA. According to contemporary observers,

There is increased recognition that these steps in the enforcement of the Act have been akin to surgical operation, through which the dead skin (the top holding company) was being cut away from the pores (the operating companies) in order to allow the latter to breathe.<sup>173</sup>

The surgery – PUHCA’s administrative mandates – succeeded at countering not only anticompetitive industrial concentration, but also financial complexity, leverage, and regulatory arbitrage.

Complexity, leverage, and regulatory arbitrage are often cited among the risks from asset securitization to financial stability. PUHCA’s approach to overcoming these also holds lessons for overcoming structural rigidity, even as it reveals the extent of the challenge. Where the obstacles to contract modification lie in complex legal structures, reorganizing them may take years, and considerable technical and political savvy. It is much harder than cutting isolated terms out of boilerplate contracts. Sustained administrative mandates with ample discretion here replace the surgical legislative strike of the Gold Clause Resolution.

### ***C. Farm Mortgages: A Failed Response to Functional Rigidity***

The lessons of PUHCA and the Gold Clause episode for overcoming contract rigidities are essentially optimistic. Not so with New Deal experience fighting the farm mortgage crisis, which illustrates the intractable challenge of functional rigidity in the

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<sup>172</sup> Am. Power & Light v. SEC, 329 U.S. 90, 104 (1946).

<sup>173</sup> Robert Blair-Smith & Leonard Helfenstein, *A Death Sentence of A New Lease on Life*, 94 U. PA. L. REV. 148, 201 (1945), also quoted in Am. Power & Light v. SEC, 329 U.S. 90, 118 (1946).

form of creditor coordination problems. New Deal policy makers attempted to deal with it through bankruptcy law and encouraging voluntary workouts, but failed because they never managed to address the power of secured creditors.

Between 1929 and 1933, a third of American farmers lost their farms in foreclosure; 200,000 lost farms in 1933 alone.<sup>174</sup> The farm foreclosure crisis of the Great Depression triggered massive federal intervention in agriculture and agriculture finance.<sup>175</sup> Among the key pieces of New Deal farm legislation was the Emergency Farm Mortgage Act of 1933,<sup>176</sup> which authorized the Federal Land Banks,<sup>177</sup> to refinance farm mortgage

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<sup>174</sup> MICHAEL L. COOPER, *DUST TO EAT: DROUGHT AND DEPRESSION IN THE 1930S* 28 (2004); DAVID E. HAMILTON, *FROM NEW DAY TO NEW DEAL: AMERICAN FARM POLICY FROM HOOVER TO ROOSEVELT, 1928–1933* (1991); VAN L. PERKINS, *CRISIS IN AGRICULTURE: THE AGRICULTURAL ADJUSTMENT ADMINISTRATION AND THE NEW DEAL, 1933* (1969); THEODORE SALOUTOS & JOHN D. HICKS, *AGRICULTURAL DISCONTENT IN THE MIDDLE WEST, 1900–1939*. (1951). Lee J. Alston, *Farm Foreclosures in the United States During the Interwar Period*, 43 J. ECON. HIST. 885, 886 (1983).

<sup>175</sup> Agricultural Adjustment Act of 1933, May 12, 1933, ch 25, 48 Stat. 31, 7 USCS §§ 601-605, 607-623;; Emergency Farm Mortgage Act of 1933, May 12, 1933, ch 25, 48 Stat. 41, 12 USCS §§ 347, 462b, 636, 637, 723, 771, 781 810, 821, 823 nt., 963a, 992, 993, 1016--1019; 43 USCS §§ 403, 404; Federal Farm Mortgage Corporation Act of 1934, 48 Stat. 344; Resettlement Administration; Farm Security Administration of 1935; Tennessee Valley Authority Act (ch. 32, 48 Stat. 58, codified as amended at 16 U.S.C. § 831, *et seq.*, upheld *Ashwander v. TVA*, 297 U.S. 288 (1936); Emergency Conservation Work Act of 1933 (creating Civilian Conservation Corps); Soil Conservation and Domestic Allotment Act, 49 Stat. 163 (1935) April 27, 1935, ch 85, 49 Stat. 163, 16 USCS §§ 590a-590i, 590j--590q; Rural Electrification Act of 1936 (creating the Rural Electrification Administration), May 20, 1936, ch 432, 49 Stat. 1363, 7 USCS §§ 901-914.

<sup>176</sup> 73 P.L. 10; 73 Cong. Ch. 25; 48 Stat. 31.

<sup>177</sup> The Federal Farm Loan Act of 1916,, 39 Stat. 360, 64 P.L. 158; 64 Cong. Ch. 245; established 12 Federal Land Banks (FLBs) in districts that mirrored those of the Federal Reserve System. The FLBs were supervised by the Federal Farm Loan Board, which was comprised of the Treasury Secretary and four other members, Federal Farm Loan Act of 1916, § 3, 39 Stat. 360, 64 P.L. 158; 64 Cong. Ch. 245, one of whom served as the Board's executive and the Farm Loan Commissioner. *Id.* The FLBs' stock could be held by state and federal governments and private entities, but a substantial portion was to be held by hundreds of National Farm Loan Associations (NFLAs), which were also created by the Federal Farm Loan Act, § 7 39 Stat. 360, 365-66, 64 P.L. 158; 64

loans on generous terms,<sup>178</sup> and temporarily guaranteed the interest on the Federal Land Banks' bonds to ensure refinancing

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Cong. Ch. 245, and whose membership and stock ownership was restricted to farm mortgage borrowers. Federal Farm Loan Act of 1916, § 8, 39 Stat. 360, 368, 64 P.L. 158; 64 Cong. Ch. 245. A NFLA could be formed by any group of ten or more natural persons owning or about to own farm land that could serve as collateral for a FLB mortgage. Federal Farm Loan Act of 1916, § 7, 39 Stat. 360, 366, 64 P.L. 158; 64 Cong. Ch. 245.

In the FLB system, farmers obtained loans from their local NFLA (or if there was none, from an FLB agent or even directly). To obtain a FLB loan via the NFLA, a farmer had to purchase stock equal to 5% of the loan in one of the NFLAs. Federal Farm Loan Act of 1916, § 8, 39 Stat. 360, 368, 64 P.L. 158; 64 Cong. Ch. 245. The stock served as collateral for the loan, in addition to the mortgaged property. Federal Farm Loan Act of 1916, § 11, 39 Stat. 360, 380, 64 P.L. 158; 64 Cong. Ch. 245. The NFLAs were permitted to take only first mortgages in farm property. The NFLA funded the loan by borrowing from the local FLB. To do so, the NFLA purchased stock in the local FLB equal to 5% of the loan. Federal Farm Loan Act of 1916, § 7, 39 Stat. 360, 367, 64 P.L. 158; 64 Cong. Ch. 245. This stock served as collateral, in addition to the mortgage on the farm property. When the loan was repaid, the NFLA's stock in the FLB was retired as was the borrower's stock in the NFLA. Federal Farm Loan Act of 1916, §§ 7-8, 39 Stat. 360, 367-68, 64 P.L. 158; 64 Cong. Ch. 245.

The FLBs funded their loans to the NFLAs by issuing tax-exempt mortgage-backed bonds through the Federal Farm Loan Board. Federal Farm Loan Act of 1916, § 26, 39 Stat. 360, 380, 64 P.L. 158; 64 Cong. Ch. 245 (tax-exempt). An FLB that wished to raise capital outside of a stock sale would provide would provide mortgages as security to the FFLB, which would issue bonds against the mortgages. Federal Farm Loan Act of 1916, §§ 18-22, 39 Stat. 360, 375-79, 64 P.L. 158; 64 Cong. Ch. 245. The FLB providing the mortgage collateral for the bonds would be primarily liable on the bonds, but there was a cross guaranty by the other FLBs. Federal Farm Loan Act of 1916, § 21, 39 Stat. 360, 377, 64 P.L. 158; 64 Cong. Ch. 245. There was no federal guarantee of the bonds whatsoever, although the federal government regulated the bonds' issuance. As the major assets of the FLBs were farm mortgages, these bonds were essentially farm mortgage-backed securities.

In addition to the FLBs, the Federal Farm Loan Act created joint-stock land banks. These were federally-chartered entities that had virtually the same powers as FLBs, but in which no government investment was permitted. Federal Farm Loan Act of 1916, § 16, 39 Stat. 360, 374, 64 P.L. 158; 64 Cong. Ch. 245. The joint-stock land banks were limited to operating in two contiguous states. *Id.* The joint-stock land banks issued bonds via the Federal Farm Loan Board just like FLBs, but the bonds were physically distinguished. *Id.*

<sup>178</sup> ARCHIBALD M. WOODRUFF, JR., FARM MORTGAGE LOANS OF LIFE INSURANCE COMPANIES 139 (1937). The refinanced loans were to be at a reduced interest rates and with amortization payments deferred for 5 years.

liquidity.<sup>179</sup> The refinancing, however, had to be a first mortgage and could not be for more than the amount of the unpaid principal, up to 50% of the value of the land plus 20% of the buildings thereon.<sup>180</sup> Farmers could also get additional low-cost loans from the Land Bank Commissioner, secured by a first or second mortgage on their realty and personalty.<sup>181</sup> However, farmers could get at most 75% loan-to-value refinancing on farm land. The Federal Land Banks' and Land Bank Commissioner's loans were only available if all senior mortgage debt was retired. In other words, the refinancing had to satisfy all prior liens. As the leading monograph on the topic observes:

In virtually all cases the sum of the Land Bank and the Commissioner's loans more than covered the amount of the first mortgage. In badly distressed cases, however, there frequently were several mortgages, first, second, and third, in addition to tax delinquencies, miscellaneous judgments, and other debts. In such cases the reduction of principal was essential to Federal refinancing. The question was who was to take the loss.<sup>182</sup>

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<sup>179</sup> The FLBs were permitted to issue bonds with interest backed by USG until the sooner of the yield on their bonds being no more than 4% or two years. The Emergency Farm Mortgage Act of 1933, § 21, 73 P.L. 10; 73 Cong. Ch. 25; 48 Stat. 31, 41-42.

<sup>180</sup> The Emergency Farm Mortgage Act of 1933, § 22, 73 P.L. 10; 73 Cong. Ch. 25; 48 Stat. 31, 42.

<sup>181</sup> These loans were at 5% interest, with amortization commencing three years after issuance. The Emergency Farm Mortgage Act of 1933, § 32, 73 P.L. 10; 73 Cong. Ch. 25; 48 Stat. 31, 48. The amortization period was between 10 and 20 years. *Id.* The loans were originally for a maximum of \$5,000. *Id.* The lending limit was raised in 1934 to \$7,500. Federal Farm Mortgage Corporation Act of 1934, §10, 73 P.L. 88; 73 Cong. Ch. 7; 48 Stat. 344. The Farm Loan Commissioner's loans were financed by a loan from the Reconstruction Finance Corporation. The Emergency Farm Mortgage Act of 1933, § 32, 73 P.L. 10; 73 Cong. Ch. 25; 48 Stat. 31, 48.

<sup>182</sup> ARCHIBALD M. WOODRUFF, JR., *FARM MORTGAGE LOANS OF LIFE INSURANCE COMPANIES* 145-46 (1937). This book was published as the winner of Williams College's David A. Wells, Class of 1847 Prize for best economics essay prize, subject to the curious restriction that:

Although there was no problem of formal contractual rigidity for 1930s farm mortgages, there was a collective action problem among assorted farm creditors, who could not agree who should incur the write-down loss necessary for the farmer to refinance. The response to this collective action problem was to rely on state law creditors' compositions—voluntary state law arrangements under which a debtor's creditors collectively agreed to a structure of debt forgiveness. But under state law, no creditor could be compelled to accept less than what it was owed. Collective action problems ensued; state law composition attempts often failed. Extraordinary state resources were brought in to no avail:

To facilitate the adjudication of debt revision, the Farm Credit Administration requested the governors of the states to appoint special committees to bring borrowers and creditors together ... Since the committees lacked authority to compel reductions, many cases went through hearing after hearing and much wrangling before any adjudication could be effected.<sup>183</sup>

Federal bankruptcy law provided a possible mechanism to overcome coordination problems by imposing composition terms on non-consenting creditors. Thus, in 1933, Congress enacted Section 75 of the Bankruptcy Act, entitled "Agricultural

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No subject shall be selected for competitive writing on investigation and no essay shall be considered which in any way advocates or defends the spoliation of property under form or process of law; or the restriction of Commerce in times of peace by Legislation, except for moral or sanitary purposes; or the enactment of usury laws; or the impairment of contracts by the debasement of coin; or the issue and use by Government of irredeemable notes or promises to pay intended to be used as currency and as a substitute for money; or which defends the endowment of such "paper," "notes" and 'promises to pay' with the legal tender quality."

This Article would not qualify.

<sup>183</sup> *Id.* at 146.

Compositions and Extensions.”<sup>184</sup> Under this provision “conciliation commissioners” were created in rural areas as adjuncts of federal courts. Financially distressed farmers could file petitions for debt adjustment.<sup>185</sup> The adjustment could be a composition, which entailed fractional payment of the unsecured debts or an extension, which entailed the extension of the maturity date of the debt.

To achieve an agricultural composition or extension, a majority vote of creditors in both amount and number was required,<sup>186</sup> and in the case of a composition, priority claims (including secured debt, tax claims, and wages) had to be paid in full. An agricultural composition or extension could, however, extend the maturity date of any type of debt.<sup>187</sup> The composition or extension was to be confirmed if the court found the composition an “equitable and feasible method of liquidation for secured creditors and of financial rehabilitation for the farmer,” in the “best interests of all the creditors,” and proposed and accepted in good faith and not usurious.<sup>188</sup>

The compositions failed to deal with farmers’ financial distress. From June 1934 to June 1937, there were only about 1,700 compositions approved out of nearly 13,700 petitions filed.<sup>189</sup> Whether the other petitions resulted in voluntary arrangements is unclear. While little is known about the operation of agricultural compositions and extensions under section 75, the dual majority vote requirements (amount and number) gave mortgage creditors an effective veto over any composition, as they would likely hold the majority of debt by amount. The veto held by secured creditors meant that restructuring efforts were

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<sup>184</sup> 36 Stat. 1467, Pub. L. No. 420 (Mar. 3, 1933), 72d Cong. Sess. II. The law had a sunset of 1938. 11 U.S.C. § 75(c) (1933).

<sup>185</sup> 11 U.S.C. § 75(c) (1933).

<sup>186</sup> 11 U.S.C. § 75(g).

<sup>187</sup> 11 U.S.C. § 75(j).

<sup>188</sup> 11 U.S.C. § 75(i).

<sup>189</sup> ALBERT GAILORD HART, *DEBT AND RECOVERY: A STUDY OF CHANGES IN THE INTERNAL DEBT STRUCTURE FROM 1929 TO 1937 AND A PROGRAM FOR THE FUTURE* 143 (1938).

inevitably hobbled, especially when the problematic debt was the secured mortgage.

In stark contrast to the SEC's flexible treatment of priorities in PUHCA liquidations, the strict implementation of section 75 to satisfy secured creditors rendered the section largely incapable of restructuring farm mortgages. It could help farmers with their other debts, but this was of little use for a farmer whose primary financial obligation was a mortgage.

Recognizing the shortcomings of section 75, Congress passed the Frazier-Lemke Farm Bankruptcy Act of 1934,<sup>190</sup> which sought to create a legal mechanism for farm reorganization that would cover secured debt and prod voluntary compositions. The Frazier-Lemke Act of 1934 permitted a farmer who could not obtain the requisite consents for a composition to declare bankruptcy, at which point the farmer's property, excluding property exempt at state law, passed into the bankruptcy estate, subject to any liens. The Act then gave the farmer two options.

First, if the affected secured creditors assented, the farmer could purchase property back from the estate at its newly appraised value by making deferred payments over six years at 1% interest with a balloon payment for 85% of the value at the end.<sup>191</sup> The appraisal was to be at "fair and reasonable value, not necessarily market value."<sup>192</sup> The farmer gained title and possession to the property immediately,<sup>193</sup> and the completion of the payments discharged all claims, including mortgage debt.<sup>194</sup> Thus, the farmer could repurchase his estate for its depressed market value, even if it was less than the value of the debt.<sup>195</sup>

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<sup>190</sup> 73 P.L. 486; 73 Cong. Ch. 869; 48 Stat. 1289 (June 28, 1934).

<sup>191</sup> Frazier-Lemke Act of 1934, § 3, 73 P.L. 486; 73 Cong. Ch. 869; 48 Stat. 1289 (1934).

<sup>192</sup> *Id.* § 1..

<sup>193</sup> *Id.* § 2.

<sup>194</sup> *Id.* § 6.

<sup>195</sup> This is essentially what is allowed in a redemption under section 722 of the Bankruptcy Code, 11 U.S.C. § 722, as the debtor need only pay the allowed secured claim, which cannot be greater than the fair market value of the property. 11 U.S.C. § 506. Redemption, however, does not allow for deferred payments, which makes it of little value to most debtors, as they are not flush

Alternatively, if the affected secured creditors did not consent, the bankruptcy court was required to stay all proceedings for five years, during which time the debtor retained possession of the property, subject to paying a reasonable annual rental fee.<sup>196</sup> At the end of the five years, the debtor could redeem the property by paying the newly appraised price of the property.<sup>197</sup>

Less than a year after the enactment of the Frazier-Lemke Act of 1934, the Supreme Court struck down the law as an unconstitutional taking.<sup>198</sup> A scaled-down version of the Act, the Frazier-Lemke Act of 1935 was passed three months later.<sup>199</sup> The revised version, upheld by the Supreme Court,<sup>200</sup> functioned mainly as an extension of the equity of redemption allowed by many states' foreclosure laws.<sup>201</sup>

So long as the mortgagor's equity of redemption had not been foreclosed, the 1935 Frazier-Lemke Act permitted it to be extended for up to three years, during which time the debtor retained possession of the property, but required the debtor to make rental payments.<sup>202</sup> At the end of the three years, the debtor could redeem the property for its appraised "reasonable market value."<sup>203</sup> A secured creditor could, however, insist on a public auction of its collateral, at which it could credit bid,<sup>204</sup> subject to

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with cash. The Frazier-Lemke Act, in contrast, restored the income-producing farm to the debtor immediately and allowed the debtor to use the farm's income to redeem the farm.

<sup>196</sup> Frazier-Lemke Act of 1934, § 7, 73 P.L. 486; 73 Cong. Ch. 869; 48 Stat. 1289.

<sup>197</sup> *Id.*

<sup>198</sup> *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (May 27, 1935), *reh'g denied*, 296 U.S. 661 (Oct. 14, 1935).

<sup>199</sup> Frazier-Lemke Act of 1935, 74 P.L. 384; 74 Cong. Ch. 792; 49 Stat. 942 (Aug. 28, 1935).

<sup>200</sup> *Wright v. Vinton Branch of Mountain Trust Bank*, 300 U.S. 440 (Mar. 29, 1937).

<sup>201</sup> *See, e.g., Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934) and *supra* note 62

<sup>202</sup> Frazier-Lemke Act of 1935, § 2, 74 P.L. 384; 74 Cong. Ch. 792; 49 Stat. 942 (Aug. 28, 1935).

<sup>203</sup> *Id.* § 6.

<sup>204</sup> *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 594-95 (May 27, 1935), *reh'g denied*, 296 U.S. 661 (Oct. 14, 1935).

the debtor having 90 days to redeem the property at the auction sale price plus 5% annual interest.<sup>205</sup> If a mortgagee credit bid at the sale, then the redemption price would be the amount of the mortgage debt outstanding.

At best, then the revised Frazier-Lemke Act gave a farm debtor three years of living as a renter with an option to buy, but only by paying off the full mortgage. Compared with the original 1934 Frazier-Lemke Act, the 1935 version gave the debtor less time to buy back the farm for more money. Creditors suffered a delay, but avoided a write-down.

Nevertheless, the promise of federal subsidy, combined with the existence of foreclosure moratoria in many states<sup>206</sup> and the successive iterations of the Frazier-Lemke Act, spurred voluntary compositions in which creditors took the write-downs to the 75% cumulative loan to value ratio necessary to permit government-supported refinancing. A major post-Depression study of debt adjustment noted:

A creditor who blocked a settlement by refusing to accept a scale-down lost his chance to exchange his claim for Federal Farm Mortgage Corporation bonds. Eventually the creditor might recover by a private settlement or by foreclosure; but in view of moratorium laws, depressed values of farm lands, and the expensiveness of long-drawn-out proceedings, many creditors preferred the certainty of part payment to the possibility of ultimate full collection.<sup>207</sup>

Yet despite the appearance of progress, there was no significant decline in the average rate of farm foreclosures until after 1940.<sup>208</sup> Given that state foreclosure moratoria already

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<sup>205</sup> Frazier-Lemke Act of 1935, § 6, 4 P.L. 384; 74 Cong. Ch. 792; 49 Stat. 942 (Aug. 28, 1935).

<sup>206</sup> HART, *supra* note **Error! Bookmark not defined.**, at 140-41.

<sup>207</sup> *Id.* at 154.

<sup>208</sup> DAVID E. HAMILTON, *FROM NEW DAY TO NEW DEAL: AMERICAN FARM POLICY FROM HOOVER TO ROOSEVELT, 1928-1933* (1991); VAN L. PERKINS, *CRISIS IN AGRICULTURE: THE AGRICULTURAL ADJUSTMENT*

offered the delay imposed by the 1935 Frazier-Lemke Act, it appears that few farmers saw much advantage in filing for bankruptcy. Relatively few farm bankruptcy petitions were filed between 1934 and 1937. Around 10,500 farmers filed for bankruptcy, out of 2,350,000 mortgaged farms in 1935,<sup>209</sup> a year when 30% of the federal land banks' farm mortgages were in default or foreclosure.<sup>210</sup> Bankruptcy did not provide the solution to the farm mortgage crisis of the Depression.

In retrospect, it looks like the New Deal approach to farm foreclosures lacked the simplicity of the Gold Clause resolution and PUHCA's combination of draconian law and administrative discretion. But unlike the Gold Clause resolution, the farm foreclosure initiatives operated on a more complex series of contracts and had to juggle a number of competing interests. Unlike PUHCA, these initiatives did not strive for grand industrial restructuring for the long term, but sought to stem immediate losses. No farm initiative could have afforded to delay implementation until it could face a friendlier Supreme Court. In the end, the New Dealers settled on a fairly conventional sticks-and-carrots approach to address intractable collective action problems in the context of plummeting farm prices. By and large, they failed.

#### ***D. Farm Mortgages Revisited: Chapter 12 of the Bankruptcy Code***

The limitations of New Deal farm relief were a lesson learned, and, as a result, the federal response to the next major farm finance crisis in the 1980s specifically targeted collective action problems involving multiple secured creditors.

The 1970s were a boom time for American agriculture. Farmers borrowed heavily to expand their operations to meet the demand for U.S. agricultural exports, particularly to the Soviet

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ADMINISTRATION AND THE NEW DEAL, 1933 (1969); THEODORE SALOUTOS & JOHN D. HICKS. *AGRICULTURAL DISCONTENT IN THE MIDDLE WEST, 1900-1939*. (1951).

<sup>209</sup> HART, *supra* note \_\_\_, at 143.

<sup>210</sup> *Id.* at 139.

Union.<sup>211</sup> Inflation helped, as it raised the prices of farm products and boosted the value of farmland while keeping farm debts constant. The anti-inflationary policies of the 1980s and declining demand for U.S. agricultural exports left many farmers overleveraged, having expanded on credit to meet demand that no longer existed. By 1985, between two and three hundred thousand farmers were on the brink of failure.

Farmers frequently had multiple secured creditors, who often failed to agree on restructuring terms.<sup>212</sup> Fully secured creditors were more likely to push for liquidation, while undersecured creditors tended to favor restructuring.

Congress responded in 1986 by restructuring the farm credit system yet again. In addition, however, Congress enacted Chapter 12 of the Bankruptcy Code, which permitted family farmers and fishermen to modify their mortgages.<sup>213</sup> Prior to 1986, the Bankruptcy Code was not well suited for small farmers who wished to keep their farms. Chapter 7 required surrendering the farm; many farmers were ineligible for Chapter 13 repayment plans because of their large secured farm debts;<sup>214</sup> while Chapter 11 reorganization was too complicated and expensive, and gave creditors a veto over the reorganization plan. Chapter 12 copied many of the features of Chapter 13, but removed the eligibility requirements that prevented farmers from using it, and restricted its application to family farmers and fishermen. Chapter 12 was initially enacted with a sunset provision, but was made permanent in 2004.<sup>215</sup> While Chapter 12 could not restructure American agriculture, it was successful at creating a mechanism through which farmers could renegotiate secured debt and avoid preventable foreclosures.

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<sup>211</sup> Farm Credit Administration, History of FCA and the FCS, *at* [http://www.fca.gov/about/history/historyFCA\\_FCS.html](http://www.fca.gov/about/history/historyFCA_FCS.html).

<sup>212</sup> NEIL E. HARL, THE FARM DEBT CRISIS OF THE 1980S 275 (1990).

<sup>213</sup> 11 U.S.C. § 1222(b)(2).

<sup>214</sup> *See* 11 U.S.C. § 109(e) (creating secured and unsecured debt limits as part of Chapter 13 eligibility).

<sup>215</sup> Originally Chapter 12 had a sunset of Sept. 30, 1993. It was later extended to a sunset of Sept. 30, 1998, and then made permanent.

The experience of the 1930s exposed ways in which secured credit created functional rigidities in farm mortgage contracts. Functional obstacles to modification are grounded in the economics of financial transactions; they do not always have a clear legal predicate in contract or statute. A comprehensive bankruptcy regime designed to reflect the economics of farm finance, rather than target any particular contract term or legal structure, was an imperfect fix, but the most promising one to date.

### **CONCLUSION: BREAKING THE SPELL**

We began this Article with a survey of contractual rigidities embedded in the RMBS PSA. These contracts are unusual because they layer formal restraints on modification, legal structures that serve as obstacles to renegotiation, and economic incentives that make renegotiation functionally difficult or impossible. Market participants appear to perceive these features as barriers to modification, and cite them as reasons for not restructuring. Formal, structural, and functional rigidities together produce what is in fact a near-immutable contract<sup>216</sup> – a rare creature that combines the features of mundane commercial promises and complex financial products to make itself impervious to credit risk.

We have also outlined ways of dealing with these three categories of rigidity. Formal rigidity presents the simplest problem. The Gold Clause episode and the Supreme Court jurisprudence it produced suggest that it would be relatively simple to legislate away both the contractual and TIA barriers to amending RMBS PSAs. Narrowly-targeted legislation could make the clauses unenforceable on public policy grounds. Indeed, a proposal along these lines has been mooted in Congress in early 2009.<sup>217</sup>

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<sup>216</sup> See Davis, *supra* note 35.

<sup>217</sup> H.R. 384, TARP Reform and Accountability Act of 2009, § 205 111<sup>th</sup> Cong. (“Notwithstanding any other provision of law, and notwithstanding any investment contract between a servicer and a securitization vehicle or investor, a servicer--(i) shall not be limited in the ability to modify mortgages, the number of mortgages that can be modified, the frequency of loan modifications, or the range of permissible modifications...”). *Cf.*, Christopher

The PUHCA experience reveals the utility of combining muscular legislation with administrative discretion in countering structural rigidity. In the RMBS context, legislation could impose recovery values on securitization vehicles, mandate simplification of financial structures, and provide for the regulatory and accounting treatment of the result. An administrative agency – possibly, but far from obviously, the S.E.C. – might be charged with determining specific restructuring terms, and negotiating with the industry representatives. Here too, Congressional authority is well established to impose financial reorganization to advance reasonable public policy goals, such as financial stability and revival of the housing market.

We are left with functional rigidity. The experience with restructuring secured farm debt in the 1930s suggests that this is the most intractable kind of contract rigidity, susceptible at best to comprehensive treatment in bankruptcy. Enforcement suspensions and public subsidies may have helped on the margins, but they did not go a long way to solve what proved to be intractable coordination problems.

Perversely, the fact that RMBS PSAs combine all three layers of rigidity may be cause for optimism. We do not believe that either legislative amendment on the Gold Clause model, or administrative mandates of the PUHCA sort, would solve today's mortgage securitization dilemma outright—although both might help on the margins. Bankruptcy might offer a more durable solution, but it looks like the most politically daunting of the three options, since it is by definition permanent and comprehensive, rather than temporary and narrow. On the other hand, unless public policy addresses the rigidities head on, the U.S. economy and financial system will remain inextricably linked to a species of Frankenstein contracts that appear so far to be impervious to subsidy and suasion. Reducing rigidity may not work alone, but it may alter the incentives calculus for securitization participants and facilitate other measures to address the foreclosure crisis.

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Mayer, Edward Morrison, & Tomasz Piskorski, *A New Proposal for Loan Modifications*, \_\_ Yale J. Reg. \_\_ (2009) (proposing legislative mortgage contract modification).

Even so, overcoming rigidity in the ways we propose is costly: it may undermine confidence in contract enforcement, and if used frequently or incautiously, may undermine faith in the rule of law. Yet while contract enforcement is a central tenet of the free market system, the law has long countenanced exceptions in the form of bankruptcy, antitrust law, and many other forms of economic regulation. Where negative externalities turn a contract into a suicide pact, the Supreme Court has said repeatedly that the Congress may rewrite it.

It is important to leave the decision to abrogate contracts in the hands of the legislature. We can only hope that abrogation is a tool that will be used sparingly and responsibly. If the legislature abuses it, everyone will pay the price.<sup>218</sup> But if it intervenes in a targeted way in response to real cataclysms, we expect that faith in the law would survive, and might grow stronger when combined with faith in the government's ability to protect society from Frankenstein contracts. Financial stability depends not only on parties' ability to bind themselves with enforceable contracts, but also on the ability to regulate – including sometimes to rewrite – contracts that threaten society.

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<sup>218</sup> See Horacio Spector, *Constitutional Transplants and the Mutation Effect*, 83 CHI.-KENT L. REV. 129 (2008) (arguing that Argentina's experience with rewriting contracts every ten years is unlike the United States' experience doing it every hundred).