

The Changing Landscape in Sales of Residential Mortgage Loans

(Session on Secondary Market Issues)

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Negotiations between buyers and sellers of residential mortgage loans have changed significantly in the past two years (and the last two months). Major reasons:

- **Proliferation of anti-predatory lending statutes (and related growth in assignee liability)**
- **Advent of Regulation AB**
- **Burgeoning risk of mortgage fraud**
- **Increasing level of borrower defaults and foreclosures, particularly in connection with subprime loans**
- **Implosion of subprime lenders**

- **Anti-predatory lending statutes have blossomed.** Based on a widespread perception that federal laws (*e.g.*, Reg. Z, Home Ownership Equity Protection Act) aren't sufficiently protective of consumers, many states, counties and even cities and townships have enacted anti-predatory lending legislation. Many of these statutes provide for assignee liability, without the safe harbor of a due diligence defense (*e.g.*, New York Banking Law § 6-1, Ga. Code § 7-6A).
- **Over two dozen states now have anti-predatory laws on the books. Will federal legislation be enacted to preempt these state laws? Sample headline: “Sen. Christopher Dodd, D-CT, is wavering on anti-predatory lending legislation, but Sen. Charles Schumer, D-NY, said he would draft a bill mandating a national system of supervision for mortgage brokers, along with a suitability standard.”**

Advent of Regulation AB



- **Effective in 2005 to 2006, mortgage-backed securities were required by the SEC to include additional disclosures about the performance of pools of mortgage-backed securities, as well as about the originators and servicers responsible for the loans in such pools.**
- **Originators (not defined by the SEC) whose loans constitute 10 percent or more of a pool have to be identified. Each originator whose loans constitute 20 percent or more of a pool has to provide information about the organizational structure, size and performance of the originator's portfolio, as well as information about the originator's underwriting criteria. Loan performance information must track back at least three years for either the loans to be included in the pool or for previous loans similar to those to be assigned to the pool.**

Regulation AB: Fallout for Sellers



- **As a result, buyers are adding new language to standard form mortgage loan purchase agreements (MLPAs). The American Securitization Forum (ASF) has proposed certain model provisions to be included in MLPAs, and these model provisions, although opposed by many loan sellers, have gained wide acceptance in the secondary mortgage market.**
- **Regulation AB has caused buyers to (i) become more focused on mortgage loan sellers' businesses, especially net worth and litigation experience, (ii) be less flexible with respect to the negotiation of representations, warranties and remedies, and (iii) be more insistent on receiving legal opinions in connection with mortgage loan sale transactions.**
- **Problem for originators who don't service: static pool reporting requirements.**

The Increasing Risk of Mortgage Fraud



- At the end of 2005, according to an FBI press conference, law enforcement officials characterized mortgage fraud as a “growing epidemic,” with organized rings of real estate operatives bilking consumers and lenders out of billions of dollars.
- In 2006, mortgage fraud continued to grow. According to a story published on December 14, 2006, in the Christian Science Monitor, real estate fraud has now firmly emerged on the FBI’s radar as the country’s fastest-growing white collar crime. This report states that (i) industry losses ran to at least \$606 million in 2006, (ii) the Treasury Department’s suspicious-activity reports were up 35 percent in 2006, and (iii) the Internal Revenue Service’s criminal case numbers in mortgage fraud have been doubling every two years through the first half of this decade.
- Result: buyers are often no longer willing to accept any risk of fraud; sellers are usually required to accept a strict liability standard.

Subprime Implosion and its Effect



- According to www.foreclosures.com, foreclosure filings for 2006 reached nearly one million, a 51 percent increase over 2005. California topped the nation with 157,417 foreclosure filings, up 94.3% over the 81,012 filings in 2005.
- MBA recently reported that subprime mortgages accounted for 13.6 percent of all home mortgages in the U.S., and nearly 13 percent of these mortgages were delinquent by the end of the third quarter of 2006.
- Subprime lenders, faced with growing delinquencies and repurchase demands from investors, are declaring bankruptcy (e.g., New Century Mortgage Corporation) or otherwise exiting the industry.
- Result: Wall Street investors' tolerance for risky investments (interest-only, zero downpayment and no-doc loans) has waned, and buyers generally can be expected to increase due diligence efforts significantly.

Some issues are still worth negotiating!



- **Buyers are still willing to negotiate, particularly with credit-worthy sellers with a good track record. Most buyers will even negotiate the terms of seller guides (provided that the seller has some bargaining power).**
- **Failure to negotiate MLPAs and seller guides may result in a very one-sided contract; when the chips are down, a one-sided contract imposing strict liability on the seller may give the buyer all the ammo it needs, and may cause the seller a great deal of trouble.**
- **Certain provisions, which can be very helpful to the seller, may be hard for a buyer to refuse, for a variety of reasons.**

1. Material Breaches and Causality



When should seller's breach trigger buyer's right to exercise remedies?

- **Should only “material breaches” trigger the exercise of remedies? Should a causal connection be required between “material breaches” and the exercise of remedies?**
- **Seller's position: Only a breach by a seller of a representation, warranty or covenant (whether entity, or loan-level), which breach materially and adversely affects the value or marketability of the related mortgage loan(s) (or the seller's interest therein), should trigger repurchase or other remedies.**
- **Buyer's position: A breach is a breach; once a breach occurs – any breach – the buyer should be able to put loan(s) back to the seller.**

2. Early Payment Defaults



Should the buyer have the right to demand repurchase of “early payment default” loans?

- **Seller’s position:** The buyer should accept all the risks and rewards of ownership, including the exposure to the borrower’s credit risk. Early payment default provisions jeopardize “true sale” treatment.
- **Buyer’s position:** Early payment defaults are often indicators of fraud; repurchase obligations for early payment defaults are standard in the industry.

3. Early Payoffs and Premium Recapture



Should the MLPA provide for a penalty or premium recapture in the event of an “early pay-off?” Should any such premium recaptures be pro-rated? Should the buyer be obligated to recapture the applicable amount from any other available source (including any prepayment charge paid by the borrower) before pursuing the seller?

- **Seller’s position:** Sellers would prefer not to provide for the recapture of premiums or other economic penalties in the event of early pay-off by the borrower; buyers should be willing to take the credit risk (buyers’ refusal to do so raises “true sale” issues). If a buyer insists on such a premium recapture provision, the buyer should be required to pursue other available sources of compensation, such as prepayment penalties from the borrower – no “double-dipping” should be allowed.
- **Buyer’s position:** In the event of an early pay-off, the buyer does not get the benefit of its bargain. Early pay-offs may be an indicator of flawed underwriting or mortgage fraud. “Double-dipping” is appropriate to compensate the buyer for added administrative costs.

4. Materiality and Knowledge Qualifications and Related Issues



Should the seller be allowed to qualify its representations and warranties with materiality or knowledge?

Seller's position: It is fundamentally unfair for all representations and warranties to be made without qualification. Mortgage lending is, at least to some extent, an art, not a science; buyers must be willing to take some risk. Buyers should conduct due diligence prior to purchase to satisfy themselves that the loans are investment quality; sellers shouldn't be strictly liable for any and all defects.

Buyer's position: Assignee liability and mortgage fraud are on the rise. The seller has the best opportunity to prevent fraud, and to ensure that the mortgage product, and the closing process, complied with all applicable law.

5. Buyer Representations and Warranties



Should a buyer be willing to make representations, warranties and covenants, such as a covenant that it will service the loans in accordance with accepted servicing practices?

- **Seller's position:** As in most other contracts for asset purchases, the seller is entitled to receive comfort in the form of certain fundamental representations and warranties about the buyer and its ability to honor its obligations in the mortgage loan purchase agreement.
 - **Buyer's position:** Sellers are entitled to receive cash for qualifying mortgage loans. There should be very few obligations on the part of buyers that survive the closing of the purchase transaction; sellers, therefore, don't need the protection offered by buyer representations and warranties. Sellers can take comfort in the fact that most mortgage loan investors (as well as their servicers, if applicable) are subject to rigorous oversight by secondary market regulators, such as the SEC and (if applicable) banking regulators.
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6. Timely Notice of Default; Cure Periods



Should the buyer be required to give the seller written notice of material breaches? Should breaches by the seller be subject to a cure period (with the right to extend such period under certain circumstances)?

- **Seller's position:** A “hair-trigger” default is in nobody’s best interest. A seller should be allowed to exercise reasonable efforts to cure a breach before the buyer is entitled to exercise the dramatic remedy of repurchase.
- **Buyer's position:** Sellers that want to avoid repurchases should avoid breaching the contract of sale. Buyers need to be able to act swiftly to exercise their remedies, especially when mortgage fraud is or may be implicated.

7. Limitations on Indemnifications

Should seller indemnifications be limited? Should such indemnifications, for example, exclude punitive and consequential damages?

- **Seller's position:** Indemnification clauses should be reciprocal. Losses should be limited to actual, direct, and out-of-pocket losses. Consequential, punitive, special and indirect damages should be excluded. Seller is not the absolute guarantor of the borrower's credit.
- **Buyer's position:** All losses that are attributable to the seller's breach should be covered by the indemnification, which should not be reciprocal...sellers don't need this protection, as they are receiving cash up front.

8. Non-Solicitation

Should non-solicitation clauses in MLPAs permit reasonable advertising and marketing activities by the seller?

- **Seller's position:** Non-solicitation clauses should be carefully reviewed and circumscribed to permit reasonable advertising and marketing activities. The effectiveness of such clauses should be of limited duration. Such clauses should not prohibit activities not related to mortgage lending.
- **Buyer's position:** A seller should never be allowed to target borrowers for refinancing of loans sold to the buyer. Any permissive language in a non-solicitation clause must be narrowly and carefully drafted.

9. Structure of MLPA and Ancillary Documents



Is the MLPA a stand-alone, “evergreen” document (which incorporates a purchase price and terms letter) or does it incorporate a Seller Guide? If the latter, how can the terms be amended? Whose underwriting guidelines apply?

- **Seller’s and Buyer’s positions: Both parties should strive to ensure that the mortgage loan purchase agreement represents a meeting of the minds and that it accurately reflects the intent of the parties. The agreement should be clear on (among other things): (i) how individual mortgage loans come under the purview of the agreement, (ii) how the agreement can be amended, and (iii) what ancillary documents (such as purchase price and terms letters, and underwriting guidelines) are incorporated by reference into the agreement.**

10. Appraisals and Appraisers: Limitations on Buyer's Ability to Challenge Valuations



Should the buyer be entitled to challenge the valuation of the mortgaged property? If so, for how long a period may such a challenge be made ?

- **Seller's position:** Sellers seek to eliminate or strictly limit buyers' rights, post-closing, to challenge appraisals. No "Monday morning quarterbacking" unless there is clear evidence of fraud.
- **Buyer's position:** Buyers seek the maximum amount of flexibility to challenge appraisals, particularly if fraud is suspected.

11. Specific Indemnifications in Lieu of Repurchase



Should the seller be allowed to offer a specific indemnification in lieu of repurchase if the seller is willing to waive all defenses? Under what circumstances should such an indemnification right be granted?

- **Seller's position:** The seller may prefer to give the buyer a specific indemnification whereby the seller waives all defenses to repurchase, allows the buyer (or its servicer) to foreclose on or otherwise liquidate the collateral, and agrees to indemnify the buyer for any shortfall.
- **Buyer's position:** Buyers usually prefer to obtain cash from the seller pursuant to a repurchase. If, however, the loan is performing, it may be in buyer's best interest to obtain such an indemnification. In some cases, the buyer may want to require that the seller escrow funds or otherwise secure the seller's obligations under the specific indemnification.

12. Grant of a Security Interest in the Mortgage Loans



Should the seller, prior to the sale date, be willing to grant to the buyer a security interest in the mortgage loans? Should the buyer be entitled to insist on such a security interest?

- **Seller's position:** Buyers are not entitled to a mandatory grant of a security interest prior to the closing of the sales transaction. This is “having your cake and eating it too.”
- **Buyer's position:** While buyers are fond of this provision, they will usually agree to waive or modify it; most standard form MLPAs and seller guides contain this provision, and it will apply unless it is negotiated out of the agreement.

13. Consideration of Regulation AB



Should sellers accept new Regulation AB provisions without negotiation?

- **Seller's position:** Some Regulation AB provisions are overly broad, and need to be qualified. Some sellers simply don't have the ability to comply with certain reporting requirements imposed by buyers in response to Regulation AB.
- **Buyer's position:** Buyers aren't trying to "sweeten the deal;" they are simply trying to ensure that they will be able to comply with new SEC rules and regulations.

14. Legal Opinions; “True Sale” Opinions



Should sellers be willing to provide legal opinions in connection with MLPAs? What about “true sale” opinions?

- **Seller’s position**: Legal opinions can add significant cost and delay. They shouldn’t be required unless the seller is a start-up, or has had financial or regulatory problems.
- **Buyer’s position**: In light of the growth of assignee liability and fraud, buyers need this protection from all (or most) sellers.

Additional Contractual Provisions



- **Buyer's knowledge of actual defects**
- **Seller is not an absolute guarantor**
- **Product-specific concerns (interest only loans, option ARMs, HELOCs, second-lien loans)**
- **Reconstitution of representations and warranties; number of allowed assignees of buyer**
- **Venue for resolution of conflicts; governing law**
- **Timing of delivery of documents before triggering repurchase**
- **Buyer's right to review files**
- **Confidentiality/privacy of data (GLB concerns)**

Additional Contractual Provisions (continued)



- **Substitution rights**
- **Correct use of defined terms**
- **MERS; Electronic document delivery (imaging); Electronic signature**
- **Remedies in agreement are the sole remedies**
- **Seller's standard of care and limitation of liability (particularly regarding interim servicing)**
- **Mitigation of losses language; no right of setoff by the buyer**
- **Sunset clause for liability under representations and warranties**
- **Language to avoid: "best efforts;" characterization of the seller as "trustee"**

Additional Contractual Provisions (continued)



- **Limitations on assignment rights of seller and buyer**
- **Mortgage loan schedule (can seller provide all of the items listed?)**
- **Giving buyer a power of attorney (or appointing buyer employees as officers of seller)**

Conclusion



The foregoing is by no means an exhaustive list of all the potential issues that can arise in the negotiation of an MLPA or seller guide. Buyers and sellers are advised to seek experienced counsel to assist in identifying and addressing such issues. An MLPA or seller guide that has been competently negotiated by both parties with careful consideration of the issues discussed above will make it considerably more likely that the resulting contract will be balanced and fair to both sides.

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THANK YOU!



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