

ARTICLES

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

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ABSTRACT

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 hyperrigid: 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,

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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 type of rigidity. These strategies include narrowly tailored legislation that renders the problematic 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. It also reveals the limits of such mandates. When different kinds of rigidity combine in a complex web of contracts, a comprehensive mechanism like bankruptcy may be necessary, if not always sufficient, to break the logjam.

Rewriting PSAs will not resolve today's financial crisis. Yet voluntary foreclosure prevention initiatives are unlikely to succeed as long as contract rigidities persist. The continuing foreclosure epidemic 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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I. INTRODUCTION: CONTRACT ALCHEMY

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.¹

At the heart of the global financial collapse are two kinds of rigid contracts. The first is the residential mortgage contract, which becomes problematic when too many homeowners cannot pay what they owe and yet cannot modify their debts. The second is the pooling and servicing agreement (“PSA”), which governs the management of securitized mortgage loan pools. 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 can fuel 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 media, policy, and academic attention.² We focus instead on the contractual framework for mortgage securitization and offer an early attempt to integrate the ongoing crisis into contract theory.

Our case study of mortgage securitization adds a critical dimension to theories about rigid contracts. Recent contract scholarship has stressed the welfare-enhancing properties of modification-proof contracts: boosting

1. MARY WOLLSTONECRAFT SHELLEY, *FRANKENSTEIN; OR, THE MODERN PROMETHEUS* 72 (Susan J. Wolfson ed., Pearson Educ., Inc. 2007) (1818).

2. See, e.g., *Helping Families Save Their Homes in Bankruptcy Act of 2009 and the Emergency Homeownership and Equity Protection Act: Hearing on H.R. 200 and H.R. 225 Before the H. Comm. on the Judiciary*, 111th Cong. (2009); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 *CORNELL L. REV.* 1073 (2009); Stan Liebowitz, *New Evidence on the Foreclosure Crisis*, *WALL ST. J.*, July 3, 2009, at A13; Eric Posner & Luigi Zingales, *The Better, Cheaper Mortgage Fix: How to Renegotiate All Those Bad Loans at No Cost to the Taxpayer*, *SLATE*, Mar. 2, 2009, <http://www.slate.com/id/2212649/>.

commitment between parties and helping them overcome information asymmetries and agency problems.³ The literature and policy debates on bond restructuring have struggled with similar arguments for decades.⁴ Contractual rigidity is also an essential, though implicit, element in the extensive bankruptcy literature about private contractual ordering of financial distress.⁵ Rigidity is necessary to ensure that creditors receive the contractual bankruptcy regime for which they have bargained.⁶

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.⁷ 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.

In Mary Shelley's novel, *Victor Frankenstein*, a Swiss student reared on alchemy before turning to "real" science, dreamt of animating a new species.⁸ He collected parts of corpses from charnel houses to make a beautiful giant (small parts would take too long).⁹ But when it came to life, the being turned hideous and murderous—just human enough to yearn for society, yet not human enough to join it—and in the end destroyed his creator and all that he loved.¹⁰ 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

3. See *infra* Part IV.A.

4. See *infra* Part IV.B.

5. See *infra* Part IV.B.

6. See *infra* Part IV.B.

7. See, e.g., Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134 (1994).

8. See SHELLEY, *supra* note 1, at 23–36.

9. See *id.* at 34.

10. See *id.* at 38, 176.

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 hyperrigid contracts that boost commitment in good times but function as suicide pacts in bad times.

Our Article begins in Part II with an account of RMBS design. Part III 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-remote, tax-exempt, and off-balance sheet organization), and functional (barriers to coordination).

Part IV 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 business failure. In the RMBS case study, the contracting parties have devised just such a bankruptcy-remote private regime. Where it works as designed, this regime makes contract renegotiation very costly for the parties and, we argue, for society at large. Part V elaborates the far-reaching effects of contract rigidity.

Part VI surveys techniques for overcoming the three different kinds of rigidity embodied in the design of 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 that revised private contracts, and review the surrounding jurisprudence. These New Deal laws were enacted, 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 that has parallels in RMBS. The legal literature has yet to reassess the New Deal's legislative programs in light of the ongoing crisis. As the country searches for new paradigms to animate crisis 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. It also reveals the limits of such mandates. When different kinds of rigidity combine in a complex web of

contracts, a comprehensive restructuring mechanism like bankruptcy may be necessary to break the logjam. Where such contracts are ubiquitous, even bankruptcy may not be enough.

We deliberately stop short of a New Deal–style legislative proposal to promote contract modification. Many interesting 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 among contract, bankruptcy, and crisis policy.

Rewriting hyperrigid PSAs will not resolve the financial crisis. Yet voluntary foreclosure prevention initiatives are unlikely to succeed as long as contract rigidities persist. The magical features of securitization have animated a species of contracts designed to bind people, markets, and governments with “ties only dissoluble by the annihilation of one of us.”¹¹ The continuing foreclosure epidemic 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 *ex post* systemic costs. A viable set of tools to overcome formal, structural, and functional rigidities is essential for financial stability.

II. THE SPECIES: RMBS

RMBS are a major part of U.S. capital markets. The principal amount of RMBS outstanding exceeds that of both U.S. corporate bonds and U.S. Treasury debt.¹² As of the end of 2008, there were nearly \$6.8 trillion in outstanding RMBS, accounting for nearly one-quarter of the U.S. bond market.¹³ Of the outstanding RMBS, 64 percent were issued by government-sponsored entities (“GSEs”), the Federal National Mortgage

11. *Id.* at 72.

12. See Financial Industry Regulatory Agency, The Bond Market, http://apps.finra.org/investor_information/smart/bonds/401000.asp [hereinafter FINRA] (listing mortgage-related bonds as \$8.9 trillion, corporate bonds as \$6.3 trillion, and U.S. Treasury bonds as \$5.9 trillion in a bond market of more than \$33.5 trillion) (last visited Oct. 24, 2009). Of the \$8.9 trillion in mortgage-related bonds, over \$6.8 trillion are RMBS. See *id.*; 2 INSIDE MORTGAGE FIN., 2009 MORTGAGE MARKET STATISTICAL ANNUAL 10 (2009).

13. See *supra* note 12. The remainder are commercial mortgage-backed securities (“CMBS”). 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. See VINOD KOTHARI, SECURITIZATION: THE FINANCIAL INSTRUMENT OF THE FUTURE 352 (John Wiley & Sons (Asia) Pte Ltd ed. 2006).

Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”), and carry a guaranty of timely payment of principal and interest from those entities;¹⁴ 27 percent were issued through private conduits;¹⁵ and 8 percent are guaranteed by the Government National Mortgage Association (“Ginnie Mae”) and are backed by the full faith and credit of the U.S. government.¹⁶

RMBS are also central to U.S. housing finance. About 60 percent of all outstanding residential mortgages by dollar amount are securitized.¹⁷ The share of securitized mortgages by number of contracts outstanding is much higher because the securitization rate is lower for larger “jumbo” mortgages.¹⁸ Over 90 percent of mortgages originated in recent years have been securitized.¹⁹

Residential mortgage securitization transactions are complex and varied,²⁰ but their core structure is simple.²¹ A financial institution (the

14. Most, but not all, GSE RMBS carry this guaranty. Some older series of Freddie Mac participation certificates, for example, only guarantee timely payment of interest and eventual payment of principal.

15. Private-label RMBS include all securitizations of subprime, scratch-and-dent, and “jumbo” mortgages (prime mortgages that are larger than the statutory conforming loan limit for the GSEs), and almost all alt-A securitizations.

16. 12 U.S.C. § 1721(g)(1) (2006) (Ginnie Mae full faith and credit guaranty); 2 INSIDE MORTGAGE FIN., *supra* note 12, at 10 (market shares). The GSEs are now in federal conservatorship, and their obligations carry an “effective guarant[y]” from the federal government, *see, e.g.*, Dawn Kopecki, *Fannie, Freddie Have “Effective” Guarantee, FHFA Says*, BLOOMBERG.COM, Oct. 23, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a05XSFgEISZA> (quoting Federal Housing Finance Agency Director James Lockhart), but do not enjoy a full faith and credit backing, *see* 12 U.S.C. § 1719(e) (stating explicitly that GSE debts are not government debts). The difference, if any, between the “effective guaranty” and “full faith and credit” is uncertain.

17. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS FOR THE UNITED STATES: FLOWS AND OUTSTANDINGS, FIRST QUARTER 2009, at 94 tbl.L.218 (2009).

18. *See* 2 INSIDE MORTGAGE FIN., *supra* note 12, at 13.

19. *Id.*

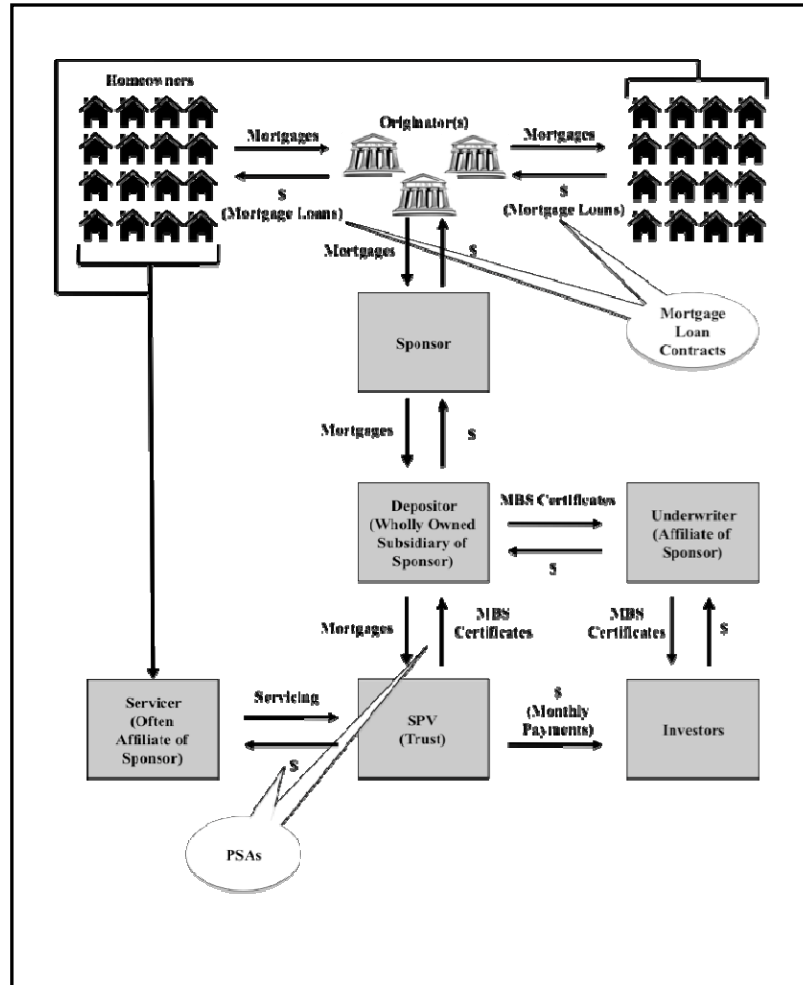
20. For a more detailed description of RMBS transactions, *see* Adam J. Levitin & Tara Twomey, *Mortgage Servicing* 9–68 (Georgetown Univ. Law Ctr., Bus., Econ., & Regulatory Pol’y Working Paper Series, Paper No. 1324023, 2009) (on file with authors).

21. There are significant distinctions within the RMBS market. The most essential is the difference in credit risk among Ginnie Mae, GSE, and private-label RMBS. Investors in Ginnie Mae and GSE RMBS are assuming interest rate risk, not credit risk; investors in private-label RMBS are also assuming credit risk. This Article is generally focused on private-label RMBS, as Ginnie Mae and GSE RMBS have more complex regulatory systems and greater flexibility for renegotiation because nonperforming loans can be purchased out of the securitized pools by the securitization sponsor, thus removing securitization-related obstacles to loan renegotiation.

Another distinction exists between true securitization and synthetic securitization through the use of credit derivatives. This Article only addresses true securitizations. For an explanation of synthetic securitizations, *see* Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP. & INT’L L. 541 (2002).

and liabilities for bankruptcy remoteness and accounting consolidation purposes.²³ The depositor then resells the loans to the SPV in exchange for the RMBS, which the depositor sells to an underwriting affiliate of the sponsor. The underwriting affiliate pays for the RMBS by reselling them to investors. These steps all take place in an integrated transaction. Figure 2 illustrates the transaction from figure 1, with these additional steps added.

FIGURE 2. Prototypical Private-Label RMBS Transaction: Expanded



23. See *infra* Part III.C.

Institutions have many different and overlapping reasons to securitize.²⁴ Some are well placed to make (originate) loans but do not want to hold long-term credit risk on their books.²⁵ By securitizing, they seek to transfer the credit risk to the investors in the securities issued by the SPV.²⁶ Such institutions 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.²⁷

Others seek to reduce their overall cost of funds.²⁸ 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.²⁹

Securitization can further reduce borrowing costs through financial engineering. Techniques such as the division of the SPV's securities into senior and subordinate "tranches" expand the potential investor base.³⁰ They allow the SPV to target new investors with tailored payment structures and credit enhancements.³¹ In particular, they permit the issuance of some securities at a higher credit rating than the overall quality of the assets in the SPV.³² Such senior securities can be sold to institutional investors that may only buy investment-grade paper.³³ Adding potential investors boosts overall demand and lowers the cost of financing.³⁴ See

24. See, e.g., COMPTROLLER OF CURRENCY, U.S. DEP'T OF TREASURY, ASSET SECURITIZATION: COMPTROLLER'S HANDBOOK 2, 4-5 (1997) [hereinafter OCC HANDBOOK]. For a detailed discussion of the advantages of securitization to issuers, see KOTHARI, *supra* note 13, at 97-102. For a discussion of why banks securitize, see Fed. Reserve Bd., Trading and Capital-Markets Activities Manual § 3020.1, at 1-2 (Jan. 2009), available at <http://federalreserve.gov/boarddocs/supmanual/trading/200901/0901trading.pdf>.

25. See KOTHARI, *supra* note 13, at 100-01.

26. See *id.* at 100-01, 104-05.

27. Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1560 (2004).

28. KOTHARI, *supra* note 13, at 97, 100.

29. See Schwarcz, *supra* note 7, at 136.

30. See KOTHARI, *supra* note 13, at 97. The typical subprime residential private-label RMBS deal has fifteen tranches. See Ingo Fender & Peter Hördahl, *Estimating Valuation Losses on Subprime MBS with the ABX HE Index—Some Potential Pitfalls*, BIS Q. REV., June 2008, at 6, 7 n.7, available at http://www.bis.org/publ/qtrpdf/r_qt0806.pdf.

31. See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1075 (1996).

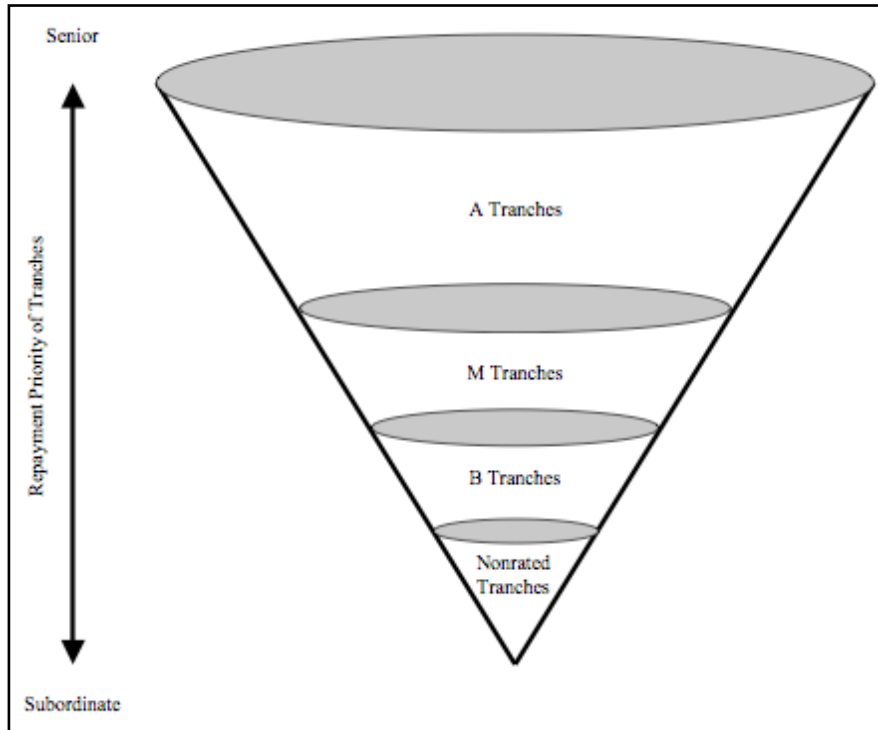
32. See *id.* at 1073.

33. *Id.* at 1071.

34. 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 percent, but the average coupon promised to the SPV investors is 6 percent, the originator can capture some of the 2 percent spread.

Figure 3 for an illustration of senior/subordinate tranching. Typically, investment-grade tranches make up the bulk (95 percent or more) of a private-label RMBS issuance.³⁵

FIGURE 3. Tranching of RMBS



Securitization can also bring accounting and tax benefits. When the originator sells assets to an SPV, it both moves them off its balance sheet and recognizes future revenue up front (gain-on-sale accounting).³⁶ Moving risky and poorly performing assets off the books makes the books look better and, for financial institutions, lowers regulatory reserve requirements.³⁷ Moreover, the sale of a potential future revenue stream

35. See Adam B. Ashcraft & Til Schuermann, Fed. Reserve Bank of N.Y., Staff Report No. 318, Understanding the Securitization of Subprime Mortgage Credit 30 (Mar. 2008), available at http://www.newyorkfed.org/research/staff_reports/sr318.pdf.

36. See KOTHARI, *supra* note 13, at 100. See also *id.* at 102 (noting that improved accounting profits “might well top the list” of the benefits of securitization).

37. See Hill, *supra* note 31, app. D, at 1123–25 (mentioning the “capital adequacy ratio” regulatory requirement, which requires institutions to maintain a certain amount of capital relative to their risk-weighted assets).

(like loan payments) for up-front cash 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.³⁸ Avoiding double taxation makes RMBS and similar instruments more attractive to investors than ordinary corporate debt securities and further lowers the cost of funds for originators.

In sum, securitization can be used to achieve a broad range of goals, including the ordinary business objectives summarized above, as well as others, ranging from political risk management³⁹ to fraud.⁴⁰ Securitization 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.⁴¹

The problem is that most investors in RMBS or any other asset-backed securities do not want a given homeowner's credit risk any more than the originator does. And they certainly do not want the originator's credit risk.⁴² Securitization has responded with solutions in the form of insurance and immutability. We discuss insurance below; we address immutability in Part III.

Insurance can come in several nonexclusive forms, commonly referred to as "credit enhancements."⁴³ First, insurance can take the form of a guarantee from the originator. This wholly or partially defeats the point of

38. See OCC HANDBOOK, *supra* note 24, at 18–19; SCHWARCZ ET AL., *supra* note 22, at 113–17 (discussing two securitization vehicles recognized by the federal tax code that specifically avoid entity-level tax); *infra* note 85.

39. See generally Claire A. Hill, *Latin American Securitization: The Case of the Disappearing Political Risk*, 38 VA. J. INT'L L. 293 (1998) (analyzing the use of cross-border securitization to reduce investors' political risk exposure).

40. Enron's structured vehicles are the most famous example.

41. This risk transfer is part of the "true sale" concept. See, e.g., SECURITIZATION OF FINANCIAL ASSETS § 2.02, at 2-14 (Jason H. P. Kravitt & Mayer Brown eds., 2d ed. Supp. 2008) (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 SCHWARCZ ET AL., *supra* note 22, at 6–8, 145; Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1585–1632 (2008) (arguing that securitization is inherently a fraudulent transfer).

42. Investors are expecting to carry interest rate and other market risk. OCC HANDBOOK, *supra* note 24, at 13, 19–20. See also SCHWARCZ ET AL., *supra* note 22, at 6–8, 145.

43. OCC HANDBOOK, *supra* note 24, at 11, 19–23.

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 receives cashflows beyond what is needed to pay the bond coupons (overcollateralization). Such excess cash is escrowed to cover potential shortfalls of incoming funds. This 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.⁴⁴

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 III discusses another approach to managing credit risk—immutability—and other less drastic barriers to payment modification.

III. 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 as a method of managing risks from securitization. We discuss the theoretical underpinnings of immutability in the next part. Below we elaborate on the role of immutability in securitization.

Originators opt to securitize, rather than simply sell, financial assets where “the ‘loss’ on each contract cannot be known with certainty” because buyers “will discount what they are willing to pay [for any given asset] If, however, [the originator] can assure a return to a buyer or investor, the deal may be worthwhile.”⁴⁵ Legal tools to assure investors

44. *Id.* at 11. We discuss tranching in more detail in Part III.D *infra*.

45. SCHWARCZ ET AL., *supra* note 22, at 9.

such a specific return seek to lock in a predictable pattern of behavior on the part of all those involved in securitization whose actions might affect cashflows, including actors that are not party to the securitization contracts—for example, homeowners, third-party creditors, and government officials. Contract rigidity in our account is a multilayered private arrangement to maximize such lock-in.

Securitization contracts have many attributes designed to make modification costly and difficult. This part explains such attributes, and classifies them into a typology of rigidities: formal, structural, and functional. We consider the barriers to amending contracts governing mortgage pool securitization separately from the barriers to amending the underlying loan contracts. Although mortgage contracts are quite rigid in their own right,⁴⁶ we focus on pool-level rigidities and limit the discussion of loan-level rigidities to those arising 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, to administer the loan pool: to send out bills, allocate payments, dun delinquent homeowners, and foreclose on homes where the loan is in default.⁴⁷ 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, for example, in exchange for a side payment.

Investors address agency risk contractually through the PSA between the servicer and the trust.⁴⁸ PSAs typically direct servicers to manage the

46. A large literature attests to this rigidity. Obstacles to mortgage modification include prepayment penalties, *see, e.g.*, Frank S. 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 WIS. L. REV. 565, 579–82, and the existence of multiple liens on the same property, which precludes senior mortgagees from making concessions that would benefit junior mortgagees before improving the debtor's payment capacity, *see id.*

47. OCC HANDBOOK, *supra* note 24, at 10. The servicer is often, but not always, a corporate affiliate of the originator. Many large servicers are subsidiaries of bank holding companies.

48. 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

loans owned by the SPV as they would their own loans,⁴⁹ 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 contracting practices that produce creditor coordination problems. To lock in such 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 1: PSA LIMITATIONS ON LOAN MODIFICATION

PSA terms often explicitly limit modification of the underlying mortgage loans. Loan modification limitations are designed to restrict the discretion of the servicer so as to mitigate agency risk in securitizations.⁵⁰

single document (the PSA). *See id.* at 13 (noting that the PSA generally governs the structure of the securitization transaction). *See also* DB Structured Prods., Inc. v. Am. Home Mortgage Holdings, Inc. (*In re* Am. Home Mortgage Holdings, Inc.), 402 B.R. 87, 100 ¶ 40, 103 ¶ 49 (Bankr. D. Del. 2009) (holding that servicing rights were severable from a mortgage loan purchase agreement and therefore were assignable by the bankrupt servicer rather than forfeited).

49. *See, e.g.*, Asset Backed Funding Corp., Option One Mortgage Corp. & Wells Fargo Bank, Pooling and Servicing Agreement (Form 8-K), at EX-4 § 3.01 (Nov. 25, 2005), available at <http://www.secinfo.com/dRSm6.z251.d.htm#6f6m> [hereinafter ABFC PSA] (“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*’).”); Goldman Sachs Mortgage Co. & Bank One, N.A., Seller’s Purchase, Warranties and Servicing Agreement (Form 8-K), at EX-10.1.3 § 4.01 (Mar. 8, 2002), available at <http://www.sec.gov/Archives/edgar/data/807641/000095017202000467/s575865.txt> (“The Servicer shall service and administer the Mortgage Loans through the exercise of the same care that it customarily employs for its own account.”).

50. Servicers are required to advance payments of principal and interest on nonperforming loans held by the SPV. The advances are reimbursable, but not with interest. One agency concern is that servicers might be tempted to modify nonperforming loans in order to avoid the obligation of making advances, even if the modified loan has a lower net present value than would result if it proceeded to foreclose on the nonperforming loan. Of course, the opposite situation—where modification would yield a greater return than foreclosure—could well hold.

Sometimes modification is forbidden outright;⁵¹ sometimes renegotiation is permitted only under limited circumstances;⁵² sometimes only certain types of renegotiation are permitted;⁵³ and sometimes third-party consent is required to renegotiate loans beyond a specified cap (typically 5 percent of the pool).⁵⁴ PSAs occasionally limit the number of renegotiations by loan or by year.⁵⁵ Additionally, servicers may be required to purchase any loans they renegotiate at the face value outstanding or at a premium.⁵⁶ Imposing

51. See, e.g., Federal National Mortgage Ass'n, Single-Family Master Trust Agreement for Guaranteed Mortgage Pass-Through Certificates § 5.3(4) (June 1, 2007), available at 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 . . ."). Note that this is not a private-label securitization and that Fannie Mae can purchase defaulted loans out of its securitized pools and modify them.

52. See, e.g., ABFC PSA, *supra* note 49, § 3.03 ("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.").

53. Morgan Stanley Capital I Inc./Trust 2006-HE1, Pooling and Servicing Agreement (Form 8-K), at EX-4 § 3.01(c) (May 11, 2006) ("Notwithstanding anything in this Agreement to the contrary . . . the Servicer shall not (i) permit any modification with respect to any Mortgage Loan that would change the Mortgage Rate, reduce or increase the principal balance (except for reductions resulting from actual payments of principal) or change the final maturity date on such Mortgage Loan . . ."); Morgan Stanley Capital I Inc./Trust 2006-NC2, Pooling and Servicing Agreement (Form 8-K), at EX-4 § 3.01(c) (May 11, 2006) (same). We thank John Hunt for bringing our attention to these particularly restrictive PSAs.

54. See, e.g., ABFC PSA, *supra* note 49, § 3.01 ("The [net interest margin security] 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.").

55. CREDIT SUISSE, THE DAY AFTER TOMORROW: PAYMENT SHOCKS AND LOAN MODIFICATIONS 7 (2007).

56. See, e.g., CWALT Inc., Prospectus Supplement, Alternative Loan Trust 2005-1cb: Mortgage Pass-Through Certificates (Form 4249(b)(5)), at S-60 (Feb. 1, 2005), available at <http://www.sec.gov/Archives/edgar/data/1269518/000095012905000801/v04622b5e424b5.txt> ("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 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 next Due Date at the applicable net mortgage rate, net of any unreimbursed advances of principal and interest on the mortgage loan made by the master servicer.");

the full cost of modification on the servicer makes them reluctant to modify; it is meant to serve as a barrier to renegotiation.

The incidence of such modification restrictions is the subject of ongoing empirical investigation. One small early sampling by Credit Suisse found that about one-third of all private-label (non-government-sponsored) securitizations had some restriction on modification.⁵⁷ Another study by Bear Stearns found that 40 percent of the private-label securitizations in a widely followed index had a 5 percent limit on modifications (absent approval by a ratings agency) and that 10 percent of the deals permitted no modification whatsoever.⁵⁸ A more extensive academic study found an absolute bar to modification in nearly 10 percent of subprime RMBS transactions in 2006, and a range of other restrictions in most other deals.⁵⁹

In the remainder of this part, we argue that the content and incidence of explicit contractual restrictions on modification of the sort discussed so far are, at best, a partial and occasionally misleading indication of the actual modification propensity of any given loan or securitization arrangement.

B. FORMAL RIGIDITY 2: STATUTORY AND CONTRACTUAL VOTING THRESHOLDS

The Trust Indenture Act of 1939⁶⁰ (“TIA”) directly impedes modification of RMBS payment terms, 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 interest payments according to the terms of its security.⁶¹ In effect, modifying the economic terms of RMBS

Complaint ¶ 34, *Greenwich Fin. Servs. Distressed Mortgage Fund, LLC v. Countrywide Fin. Corp.*, No. 650474-2008E (N.Y. Civ. Ct. Dec. 1, 2008), available at http://www.businessweek.com/pdfs/2008/1201_complaint.pdf (quoting CWALT PSA § 3.11(b)) [hereinafter *Greenwich Complaint*] (“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 . . .”).

57. See CREDIT SUISSE, *supra* note 55, at 7.

58. See Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007, at C1.

59. See John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification? Preliminary Results and Implications* 2–3, 6–10 (Mar. 25, 2009) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1369286 (surveying the 614 subprime home mortgage securitization deals from 2006).

60. 15 U.S.C. § 77aaa–77bbb (2006).

61. *Id.* § 77ppp(b) (“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

requires the consent of 100 percent 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, the 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.⁶² The TIA would bar RMBS amendments to permit such impairment and avoid default, even if avoiding default brought higher recovery values.

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 passive synthetic creature whose only purpose is to funnel highly specified cashflows to investors—differently from ordinary corporate assets.⁶³ 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 hesitate to test the limits of the TIA and face potential

the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder”).

62. 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 cashflow. The TIA does, however, require simple majority consent for waivers of past defaults. *Id.* § 77ppp(a)(1).

63. 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's permutations are numerous, and the outcome uncertain, reflecting the variety of economic and legal arrangements in the market.

litigation.⁶⁴

Even if the TIA unanimity requirement did not apply, the PSAs themselves often impose supermajority requirements for PSA amendment. Most commonly, two-thirds of each affected tranche of RMBS holders must consent to a modification of the PSA.⁶⁵ While less daunting than 100 percent, requiring the consent of two-thirds of each affected tranche gives creditors significant capacity to hold up modification. Such requirements fuel collective action problems, about which we elaborate below in Part III.D.⁶⁶

C. STRUCTURAL RIGIDITY: BANKRUPTCY REMOTENESS AND PASSIVE MANAGEMENT

In corporate bonds, bankruptcy overcomes creditor coordination problems.⁶⁷ If the debtor corporation is unable to renegotiate its bond debt

64. See, e.g., *Citibank N.A. v. MBIA Assurance S.A.*, [2006] EWHC (Ch) 3215, *aff'd*, [2007] EWCA (Civ) 11. This recent British case illustrates the deep uncertainty that exists regarding legal duties in securitization structures, as well as the tranche warfare that workouts can create. In this case, a Dutch SPV held some of the debt of Eurotunnel (owner of the English Channel tunnel or the “Chunnel”), against which it had issued bonds. *Id.* [1]–[3]. Eurotunnel had to restructure its debt obligations, and the restructuring provided for some of the Eurotunnel debt held by the SPV to be exchanged for Eurotunnel notes redeemable as Eurotunnel shares plus cash, but it included an option to exchange the debt for cash alone at 61.9 percent of par value. *Citibank*, [2007] EWCA (Civ) 11, [6]. The SPV’s indenture provided that the trustee and the credit-enhancing insurer, MBIA, had to approve such deals. *Citibank*, [2006] EWHC (Ch) 3215, [7]. MBIA instructed the trustee, Citibank, to exercise the all-cash option. *Id.* [18]. The holder of a junior tranche of SPV bonds objected to this deal. *Id.* [17]. It seems that if the all-cash option were exercised, the junior trancheholder would have been out of the money because the cash was at 61.9 percent of par value, whereas with the combination of notes redeemable as shares and cash, the junior trancheholder would have received some value. See *id.* The issue before the court was whether MBIA could direct Citibank, as trustee, to exercise the option and, if not, whose interests Citibank had to consider in evaluating whether to exercise the option. The court ruled that MBIA had the right under the indenture to direct Citibank’s action; but the case shows that there is sufficient legal uncertainty about rights and duties in securitization structures, including the duties of the trustee (like a servicer) to act in the interests of the trust as a whole, given that the junior trancheholder was willing to litigate in the U.K.’s loser-pays-all-attorney’s-fees litigation system.

65. See, e.g., ABFC PSA, *supra* note 49, § 11.01 (“[T]his agreement may be amended from time to time . . . provided, however, that 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 . . .”).

66. Some PSAs permit the trustee or servicer to execute, without RMBS holder consent, amendments to the PSA necessary to preserve real estate mortgage investment conduits’ pass-through tax status.

67. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7–19 (1986).

consensually, it can file for bankruptcy and force a debt restructuring.⁶⁸ 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.⁶⁹ It is also shielded from being dragged into the bankruptcy of the originator.⁷⁰ Such “bankruptcy remoteness” is achieved using a combination of organizational form and contract.⁷¹ 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.⁷² The Bankruptcy Code does not define “business trust,” and case law is unsettled on the definition,⁷³ 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,⁷⁴ and limiting the SPV’s activities to avoid third-party creditors who could file an involuntary petition against the SPV.⁷⁵ 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.⁷⁶

68. *See id.*

69. *See* KOTHARI, *supra* note 13, at 11–12 (describing “bankruptcy remoteness”).

70. *See id.*

71. *See* SCHWARCZ ET AL., *supra* note 22, at 54. Outright advance waivers of bankruptcy rights are historically disfavored by U.S. courts. *See, e.g., In re Weitzen*, 3 F. Supp. 698, 698 (S.D.N.Y. 1933) (“The agreement to waive the benefit of bankruptcy is unenforceable.”).

72. Only “persons” are eligible to file for bankruptcy. *See* 11 U.S.C. § 109(a) (2006). The Bankruptcy Code defines “person” to include an “individual, partnership, and corporation,” but it does not include a “governmental unit.” *Id.* § 101(41). The definition of “corporation,” however, includes a “business trust.” *Id.* § 101(9)(A)(v).

73. *See, e.g., Shawmut Bank Conn. v. First Fid. Bank (In re Secured Equip. Trust of E. Air Lines, Inc.)*, 38 F.3d 86, 88–91 (2d Cir. 1994); *In re Eagle Trust*, No. 98-2531, 1998 U.S. Dist. LEXIS 14488, at *12 (E.D. Pa. Sept. 16, 1998) (stating that “[t]he various courts that have addressed the issue have applied different factors to determine the existence of a business trust”).

74. *See, e.g., ABFC PSA, supra* note 49, § 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.”).

75. *See, e.g., id.* § 3.28(a) (stating that “the Trust is not authorized and has no power” to “borrow money or issue debt,” to “merge with another entity, reorganize, liquidate or sell assets,” or to “engage in any business or activities”).

76. *See* 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 *DEALING WITH SECURED CLAIMS AND STRUCTURED FINANCIAL PRODUCTS IN BANKRUPTCY CASES* 66 (2004) (PLI Commercial Law and Practice, Course Handbook Series 2002).

To make bankruptcy remoteness meaningful, the vehicle must be protected from the misfortunes both of the originator who sold the mortgage loans and those 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.⁷⁷ The segregation of the SPV’s assets from the originator’s is a major component of the value of securitization⁷⁸ 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.⁷⁹ The second objective—insulating investors from the underlying mortgage troubles—is advanced by the restrictions on loan modification discussed in the preceding section, and in part through the Bankruptcy Code’s prohibition on the modification of single-family principal residence mortgages.⁸⁰

77. KOTHARI, *supra* note 13, at 11. *See also id.* at 207–08 (discussing the complexity of structuring the transfer of receivables).

78. *See Case, supra* note 76, at 76 (“Because a securitization transaction is based on the premise that the assets being financed have been isolated from the risks that the transferor/originator will default on debt or enter bankruptcy, the legal conclusion that the assets after transfer to the [SPV] have ceased to be the property of the originator and have become the property of the [SPV] are critical for bankruptcy purposes. . . . Characterization of the transaction as a ‘true sale’ achieves these goals”); Kenneth M. Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of “Bankruptcy Remoteness”* 3 (May 14, 2006) (unpublished manuscript), *available at* <http://www.newyorkfed.org/research/conference/2006/cffi/Ayotte.pdf> (explaining that unlike a debtor’s collateral, which can be seized “on demand” by creditors, “assets that were transferred in a ‘true sale’ to the SPV are not considered part of the debtor’s bankruptcy estate, but instead continue to be used for the benefit of the SPV investors”).

79. KOTHARI, *supra* note 13, 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. In that event, the securitization would be treated as an unperfected secured financing, with little or no prospect of recovery for the investors. *See* First Interim Report of Neal Batson, Court-Appointed Examiner at 43, *In re Enron Corp.*, 2009 Bankr. LEXIS 2094 (Bankr. S.D.N.Y. Aug. 4, 2009) (No. 01-16034 (AJG)), *available at* http://www.enron.com/media/1st_Examiners_Report.pdf (“One of the more important considerations in this analysis that is common to many of the Selected Transactions is the existence of one or more instruments . . . that had the economic effect of transferring both the obligation to repay the financing and the economic risks and rewards of the ‘sold’ asset back to Enron.”). *See also Case, supra* note 76, at 81–83 (noting that fraudulent transfers are avoidable in bankruptcy proceedings and mentioning ways to ensure that a securitization is not treated as a fraudulent transfer). Similarly, where the originator is a U.S. bank not subject to the Bankruptcy Code, securitization requires measures to prevent the assets from being dragged into bank resolution proceedings by the Federal Deposit Insurance Corporation. *See OCC HANDBOOK, supra* note 24, at 19–20 (discussing the structure of various levels of risk in securitization transactions); SCHWARCZ ET AL., *supra* note 22, at 151–54.

80. *See* 11 U.S.C. § 1322(b)(2) (2006). *See generally* Levitin, *supra* note 46 (discussing the policy assumptions behind the home loan modification prohibition and testing these policy assumptions empirically).

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 dominant 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 section⁸¹ and by conflicts of interest between senior and subordinate creditors described in the next section.⁸² Bankruptcy-remote organization rules out involuntary changes.⁸³

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.

Most PSAs restrict mortgage renegotiation to loans that are in default or where default is imminent or reasonably foreseeable⁸⁴ in order to protect the SPV's pass-through tax and off-balance sheet accounting status. Allowing modifications under less dire conditions 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 RMBS.⁸⁵ Moreover, because

81. See *supra* Part III.B.

82. See *infra* Part III.D.

83. If the SPV could file or be placed in bankruptcy, it could reject the PSA with the servicer as an executory contract. See 11 U.S.C. § 365(a), (h). The servicer would receive only an unsecured prepetition claim for damages, and the SPV would then be free to recontract for servicing under nonrestrictive terms. All contracts may be breached of course, regardless of bankruptcy, but rejection of a contract under § 365 of the Bankruptcy Code is treated as a prebankruptcy breach, rather than a postbankruptcy breach, which changes the treatment of the counterparty's claim. See *id.* § 365(g).

To reject a contract under § 365, the 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 such that "the failure of either to complete performance would constitute a material breach excusing the performance of the other." 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 ongoing mutual obligations, the MBS holders do not, and unless the PSA is severable, the nonexecutory nature of the MBS holders' relationship with the SPV might render the PSA nonexecutory and therefore not rejectable.

84. Hunt, *supra* note 59, at 7.

85. Most RMBS are structured to qualify as real estate mortgage investment conduits ("REMICs") under the Internal Revenue Code. See 26 U.S.C. § 860A (2006) (REMIC tax treatment). Generally, investors in a Subchapter C corporation are subject to double taxation—the corporation is

the originator is often the servicer, overly active management of the securitized loans 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.⁸⁶

taxed directly on its earnings, and then the investors are taxed on any distributions from the corporation. REMICs, however, receive pass-through tax status, meaning that the investors, rather than the entity, are taxed on the REMIC's earnings. *Id.* § 860A(b). *See also* ACCOUNTING FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Fin. Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000) (off-balance sheet accounting treatment).

To qualify as a REMIC, the entity must be essentially passive in its management of mortgages. SCHWARCZ ET AL., *supra* note 22, at 114. It is limited in its ability to change what mortgage loans it owns, *see* 26 U.S.C. § 860D(a)(4) (limiting REMICs to holding "qualified mortgages" and "permitted investments"); *id.* § 860G(a)(3) (defining "qualified mortgage"); *id.* § 860G(a)(5) (defining "permitted investments"), or to alter the terms of the mortgage loans, *see* 26 C.F.R. § 1.860G-2(b) (2008). To qualify as a REMIC under the Internal Revenue Code, substantially all of the 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." *Id.* § 860G(a)(3). It includes "foreclosure property," *see id.*, which is defined as property "which is acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC," *id.* § 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. 26 C.F.R. § 1.860G-2(b). 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 percent tax. 26 U.S.C. § 860F(a).

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), (e). Most relevant for mortgage modification purposes is the specific category describing certain yield changes as significant modifications. *See id.* § 1.1001-3(e)(2). A modification that results in a change in the yield on the mortgage loan of greater of twenty-five basis points, or 5 percent of the annual unmodified yield, is considered significant. *Id.* § 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. *Id.* § 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 nonqualified mortgages, the trust loses its REMIC status. Second, the trust will incur 100 percent taxation on the net gain in the exchange deemed to have occurred in the modification. Therefore, too many modifications without imminent default will result in the loss of the SPV's REMIC pass-through status, not just for specific transactions, but overall. The Internal Revenue Service 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, 1054-55.

Because pass-through tax status is a crucial element of RMBS' 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.

86. 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 can recognize the gain on the sale of the mortgage loans in its transaction with the SPV, the SPV must be "qualified,"

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 autopilot until the securities they issue are paid off. This effectively impedes renegotiation of the PSA and the underlying assets.

D. FUNCTIONAL RIGIDITY: COORDINATION PROBLEMS FROM TRANCHING, RESECURITIZATION, AND INSURANCE

Loan- and pool-level rigidities are reinforced through tranching, resecuritization, and third-party insurance. Non-government-sponsored RMBS issued by an SPV are typically tranching—divided into a stepped senior/subordinated payment priority system where the subordinated tranches are first in line to absorb losses from reduced mortgage payments.⁸⁷ Each tranche usually carries a different rate of return and a different credit rating.⁸⁸ Sometimes the tranching is done separately for principal and interest payments due on the mortgages.⁸⁹

Senior/subordinate tranching is a hallmark of private-label asset securitization.⁹⁰ This contrasts with corporate finance practice, where

which means *inter alia* that the originator must have no control over the assets. *See* ACCOUNTING FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Fin. Accounting Standards No. 140, ¶¶ 8–13 (Fin. Accounting Standards Bd. 2008), *available at* http://www.fasb.org/pdf/aop_FAS140.pdf (amending the 2000 version). 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. Securities and Exchange Commission 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 the Comm. on Fin. Servs., U.S. House of Representatives (July 24, 2007), *available at* <http://financialservices.house.gov/072407SEC.pdf>; Letter from Conrad Hewitt, SEC Chief Accountant, to Arnold Hanish, Chairman of the Comm. on Corporate Reporting, Fin. Executives Int’l, and Sam Ranzilla, Chairman of the Prof’l Practice Executive Comm., Am. Inst. of Certified Pub. Accountants (Jan. 8, 2008), *available at* <http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>.

87. *See* OCC HANDBOOK, *supra* note 24, at 19–20.

88. *See id.* *See also* FRANK J. FABOZZI, ANAND K. BHATTACHARYA & WILLIAM S. BERLINER, MORTGAGE-BACKED SECURITIES: PRODUCTS, STRUCTURING, AND ANALYTICAL TECHNIQUES 23 (2007); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1331–32 (2009).

89. *See* OCC HANDBOOK, *supra* note 24, at 24.

90. FABOZZI ET AL., *supra* note 88, at 22–24. Private-label securitization covers all securitization other than by Fannie Mae, Freddie Mac, and Ginnie Mae. Fannie Mae, Freddie Mac, and Ginnie Mae RMBS are not tranching for credit risk, as all GSE RMBS have a GSE credit guaranty and all Ginnie Mae RMBS bear a federal guaranty. Some Fannie Mae, Freddie Mac, and Ginnie Mae collateralized mortgage obligations (“CMOs”) are tranching for prepayment priority, however, as a way of allocating interest rate risk.

bonds issued under a single indenture are not tranching. 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 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.⁹¹ 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 may have no incentive to cooperate in a renegotiation, 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 of renegotiation accrues to the “fulcrum” tranche that is in the money if there is a modification and out of the money in a foreclosure.⁹²

The SPV has neither the funds nor the authority to pay off dissenting trancheholders. As a result, if either senior or subordinate tranches’ consent is required to modify the PSA or the underlying mortgages, renegotiation will likely stall 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

91. See Standard & Poor’s RatingsDirect, U.S. Housing’s Long and Winding Road to Recovery 8 (Apr. 14, 2009), available at http://www2.standardandpoors.com/spf/pdf/fixedincome/US_Housing_Long.pdf.

92. This is related to David Skeel’s idea of a “pivotal” class in corporate bankruptcy. See David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 480 (1992).

subordination agreements to the extent they are enforceable outside of bankruptcy.⁹³ 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 and judicial process of bankruptcy. Unlike bankruptcy, which is heavily negotiated and can give third parties (“parties in interest”) a voice in reorganization, contractual loss allocation is locked in, along with the attendant incentive structure and externalities.

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”).⁹⁴

A CMO is a securitization backed by mortgage-backed securities rather than by mortgages.⁹⁵ 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.⁹⁶ CMOs and CDOs are themselves then tranced.⁹⁷ Senior CMO and CDO tranches can receive investment-grade ratings because of the credit enhancement provided by the subordinated tranches.⁹⁸ 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 who are restricted to purchasing investment-grade securities. The non-investment-grade components of CMOs and CDOs can themselves be resecuritized once again into what are known as CMO²s and CDO²s, with the senior tranches of the CMO²s and CDO²s receiving investment-grade ratings.⁹⁹ 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

93. 11 U.S.C. § 510(a) (2006).

94. FABOZZI ET AL., *supra* note 88, at 23–24.

95. *Id.* at 23.

96. See McCoy et al., *supra* note 88, at 1331. CDOs are often actively managed. Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Legal and Economic Issues in Litigation Arising from the 2007–2008 Credit Crisis* 10–11 (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Faculty Discussion Paper No. 612, 2008), available at <http://ssrn.com/abstract=1096582>.

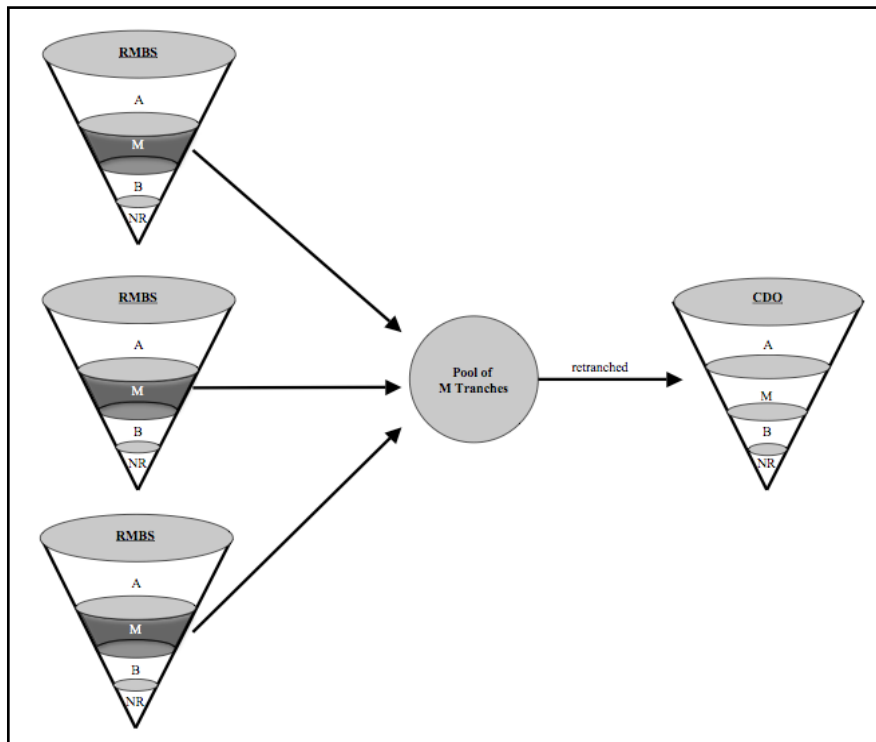
97. See McCoy et al., *supra* note 88, at 1331.

98. See *id.*

99. FABOZZI ET AL., *supra* note 88, at 23; McCoy et al., *supra* note 88, at 1331.

A.”¹⁰⁰ Securitization has turned dross into gold, or at least non-investment-grade dross into AAA-rated dross. See Figure 4 for an illustration of how mezzanine tranches of RMBS deals are resecured into a CDO.

FIGURE 4. Resecuritization of RMBS into a CDO



The upshot of this financial alchemy is that to control 100 percent of an RMBS issuance in order to alter a PSA, one would also have to own 100 percent of multiple CMOs and CDOs to alter the CMOs' and CDOs' PSAs, and of multiple CMO²s and CDO²s to alter the CMO²s' and CDO²s' PSAs. This process can occur separately for multiple mortgages on the same property. When amending the underlying mortgages requires a vote, resecured interests similarly must be taken into account. Securing a supermajority vote is only slightly less complicated.

The final obstacle to obtaining consent for PSA and mortgage modification combines elements of resecuritization and insurance. The

100. Lloyd Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES (London), Feb. 8, 2009, at 7.

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 9500 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").¹⁰¹ The NIM is typically securitized separately into a NIM security ("NIMS"),¹⁰² and the NIMS is often insured by a financial institution. NIMS insurers' consent is typically required both to modify PSAs and to modify the underlying mortgages beyond limited thresholds.¹⁰³ NIMS insurers hold positions similar to equity holders for SPVs. Even more so than junior trancheholders 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.

E. SUMMARY: RIGID BY DESIGN

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 structure or organizational form, and a financial structure prone to coordination problems. As part of this design, tax treatment, accounting, tranching, and insurance have the powerful effect of reinforcing commitment to pay, even though that is not their primary purpose.

It bears emphasis that layered rigidity is not an accidental byproduct of securitization design; for private-label residential mortgage securitization, at least, layered rigidity is among its central premises. This is so even where rigidity is not the primary goal of a particular design feature (such as tax treatment), and where real-life securitization contracts may fail to achieve perfect immutability. This can be seen from a comparison of private-label RMBS with commercial mortgage-backed

101. FABOZZI ET AL., *supra* note 88, at 199.

102. *Id.*

103. *Id.*

securities (“CMBS”).

CMBS are structured very differently from RMBS. In particular, they are designed with the need for workouts in mind. There is greater heterogeneity among CMBS PSAs than RMBS PSAs, but CMBS PSAs commonly contain several flexibility-enhancing features that are rare among, or entirely absent from, RMBS. First, CMBS usually feature a special default servicer that assumes management of any loans that are sixty or more days delinquent.¹⁰⁴ CMBS special servicers are subject to many fewer restrictions than private-label RMBS servicers. They are often explicitly authorized to do principal reductions, interest rate reductions, reamortizations, term stretchouts, and temporary forbearance.¹⁰⁵

104. CMBS servicers cannot generally modify performing loans without risking adverse tax consequences for the trust. See Lingling Wei, *New Rules Ease the Restructuring of CMBS Loans*, WALL ST. J., Sept. 16, 2009, at C6 (noting that the U.S. Department of Treasury had relaxed some tax provisions in light of such adverse consequences).

105. See, e.g., Bear Stearns Commercial Mortgage Securities Trust 2002-TOP6, Pooling and Servicing Agreement (Form 8-K), at EX-4.1 § 9.5(c) (Apr. 3, 2002), available at [http://www.secinfo.com/\\$/SEC/Registrant.asp?CIK=1168574](http://www.secinfo.com/$/SEC/Registrant.asp?CIK=1168574) (“Subject to the Servicing Standard and Sections 9.39 and 9.40, and the rights and duties of the Master Servicer under Section 8.18, the Special Servicer may enter into any modification, waiver or amendment (including, without limitation, the substitution or release of collateral or the pledge of additional collateral) of the terms of any Specially Serviced Mortgage Loan, including any modification, waiver or amendment to (i) reduce the amounts owing under any Specially Serviced Mortgage Loan by forgiving principal, accrued interest and/or any Prepayment Premium, (ii) reduce the amount of the Scheduled Payment on any Specially Serviced Mortgage Loan, including by way of a reduction in the related Mortgage Rate, (iii) forbear in the enforcement of any right granted under any Mortgage Note or Mortgage relating to a Specially Serviced Mortgage Loan, (iv) extend the Maturity Date of any Specially Serviced Mortgage Loan and/or (v) accept a principal prepayment on any Specially Serviced Mortgage Loan during any period during which voluntary Principal Prepayments are prohibited, provided, in the case of any such modification, waiver or amendment, that (A) the related Mortgagor is in default with respect to the Specially Serviced Mortgage Loan or, in the reasonable judgment of the Special Servicer, such default is reasonably foreseeable, (B) in the reasonable judgment of the Special Servicer, such modification, waiver or amendment would increase the recovery on the Specially Serviced Mortgage Loan to Certificateholders on a net present value basis (the relevant discounting of amounts that will be distributable to Certificateholders to be performed at related Mortgage Rate) In no event, however, shall the Special Servicer (i) extend the Maturity Date of a Specially Serviced Mortgage Loan beyond a date that is two years prior to the Rated Final Distribution Date”); Credit Suisse Commercial Mortgage Trust/Series 2007-C1, Pooling and Servicing Agreement (Form 8-K), at EX-4.1 § 3.20(a) (Apr. 2, 2007), available at <http://www.secinfo.com/dRSm6.us2.c.htm#1stPage> [hereinafter Credit Suisse 2007-C1 PSA] (“The Special Servicer (solely as to the Specially Serviced Mortgage Loans) or the Master Servicer (solely as to the Performing Mortgage Loans) may (consistent with the Servicing Standard) agree to any modification, waiver or amendment of any term of, extend the maturity of, defer or forgive interest (including Default Interest and Post-ARD Additional Interest) on and principal of, defer or forgive late payment charges and Yield Maintenance Charges on, permit the release, addition or substitution of collateral securing, and/or permit the release, addition or substitution of the Borrower on or any guarantor of, any Mortgage Loan”); Credit Suisse Commercial Mortgage Trust Series 2007-C5, Pooling and Servicing Agreement (Form 8-K), at EX-4.1 § 3.20(d) (Nov. 27, 2007), available at <http://www.secinfo.com/dRSm6.u2fr.c.htm#ggyk> [hereinafter Credit Suisse 2007-C5 PSA]

Second, compensation for CMBS special default servicers incentivizes them to perform workouts that are economically beneficial for the CMBS investors as a whole. CMBS special default servicers are paid an annual percentage of the principal for all loans being serviced (that is, loans in default).¹⁰⁶ If the loan is worked out and begins to perform, however, the CMBS special servicer then receives a higher percentage fee of every payment made of principal and interest.¹⁰⁷ This gives the CMBS special servicer an incentive to get the loan performing again, but also not to modify it more than necessary, as its compensation is based on the payments on the modified loan.

CMBS PSAs also provide that special servicers are reimbursed with interest (at prime) for servicing advances.¹⁰⁸ This contrasts with RMBS

(“Notwithstanding Sections 3.20(a)(ii) and 3.20(c), but subject to Sections 3.20(e) and 3.20(f), the Special Servicer may (i) reduce the amounts owing under any Specially Serviced Mortgage Loan by forgiving principal, accrued interest and/or any Yield Maintenance Charge or Static Prepayment Premium, (ii) reduce the amount of the Monthly Payment on any Specially Serviced Mortgage Loan, including by way of a reduction in the related Mortgage Rate, (iii) forbear in the enforcement of any right granted under any Note or Mortgage relating to a Specially Serviced Mortgage Loan, (iv) extend the maturity of any Specially Serviced Mortgage Loan, (v) waive Excess Interest if such waiver conforms to the Servicing Standard, (vi) permit the release or substitution of collateral for a Specially Serviced Mortgage Loan and/or (vii) waive a Yield Maintenance Charge or Static Prepayment Premium or accept a Principal Prepayment during any lockout period; provided that (A) the related Borrower is in default with respect to the Specially Serviced Mortgage Loan or, in the judgment of the Special Servicer, such default is reasonably foreseeable and (B) in the sole good faith judgment of the Special Servicer and in accordance with the Servicing Standard, such modification would result in recovery that equals or exceeds recovery for liquidation on the subject Mortgage Loan to Certificateholders . . . as a collective whole, on a present value basis (the relevant discounting of amounts that will be distributable to Certificateholders or a B Loan Holder or Companion Loan Holder to be performed at a rate not less than the related Mortgage Rate).”).

CMBS PSAs will typically place limits on term stretchouts. Like RMBS PSAs, they limit term stretchouts to ensure that the trusts’ revenues will have durations that match the trusts’ obligations.

106. See, e.g., Credit Suisse 2007-C5 PSA, *supra* note 105, § 3.11(b); *id.* § 1.01 (defining “Special Servicing Fee” and “Special Servicing Fee Rate” as thirty-five basis points per annum per loan, with a minimum \$4000 per month, reducible by the Directing Certificateholder.).

107. See, e.g., *id.* § 3.11(b) (“The Special Servicer shall also be entitled to additional servicing compensation in the form of a Workout Fee with respect to each Corrected Mortgage Loan at the Workout Fee Rate. The Workout Fee shall be payable out of, and shall be calculated by application of the Workout Fee Rate to, each collection of interest, other than Default Interest and Excess Interest, and principal . . . received on such Mortgage Loan for so long as it remains a Corrected Mortgage Loan. The Workout Fee with respect to any Corrected Mortgage Loan will cease to be payable if such Mortgage Loan again becomes a Specially Serviced Mortgage Loan; provided that a new Workout Fee will become payable if and when such Mortgage Loan again becomes a Corrected Mortgage Loan.”); *id.* § 1.01 (defining “Workout Fee” and “Workout Fee Rate” as 1 percent).

108. See, e.g., *id.* § 3.03(d) (“In connection with its recovery of any Servicing Advance . . . [the] Servicer, the Special Servicer and the Trustee shall each be entitled to receive . . . interest at the Reimbursement Rate in effect from time to time, accrued on the amount of such Servicing Advance from and including the date made to, but not including, the date of reimbursement”); *id.* § 1.01

PSAs, which do not provide for servicers to be reimbursed for the interest expense of servicing advances. Compensation for interest expense means that special servicers will not rush either to overmodify a loan so it will perform, which would terminate the obligation to make servicing advances, or to foreclose and liquidate the property, which would also end the duty to make advances.

A third flexibility-enhancing feature of CMBS is a mechanism that vests a single investor with decisionmaking and monitoring capability. In CMBS deals, there is either a controlling party or controlling class representative entitled to disclosures from the servicer and trustee and empowered to direct or veto a variety of trust management decisions. Some CMBS PSAs feature a controlling party, referred to as the “Directing Certificateholder” or “Controlling Certificateholder,” who is the holder of the majority of the residual class of claims.¹⁰⁹ Other CMBS PSAs permit the residual class of claims to elect a “Controlling Class Representative.”¹¹⁰

Critically, the identity of the controlling party shifts with the performance of the trust’s assets because the residual class is not a fixed class. Instead, it adjusts according to where the cashflow waterfall stops at

(defining “Reimbursement Rate” as “the Prime Rate”); Morgan Stanley Capital I Trust Commercial Mortgage 2007-Top25, Pooling and Servicing Agreement (Form 8-K), at EX-4.1 § 4.5 (Feb. 14, 2007) (“Any unreimbursed Advance funded from the Master Servicer’s, the Special Servicer’s or the Trustee’s own funds shall accrue interest on a daily basis, at a per annum rate equal to the Advance Rate, from and including the date such Advance was made to but not including the date on which such Advance has been reimbursed”); *id.* § 1.1 (defining “Advance Rate” as “a per annum rate equal to the Prime Rate as published in the ‘Money Rates’ section of The Wall Street Journal from time to time or such other publication as determined by the Trustee in its reasonable discretion”).

109. There is variation in PSA terminology for this controlling shareholder.

110. See, e.g., Credit Suisse 2007-C5 PSA, *supra* note 105, § 1.01 (defining “Controlling Class” to be, “[a]s of any date of determination, the Class of Principal Balance Certificates with the lowest payment priority pursuant to Sections 4.01(a) and 4.01(b), that has a then outstanding Class Principal Balance that is not less than 25% of its initial Class Principal Balance; provided that, if no Class of Principal Balance Certificates has a Class Principal Balance that satisfies the foregoing requirement, then the Controlling Class shall be the Class of Principal Balance Certificates with the lowest payment priority pursuant to Sections 4.01(a) and 4.01(b), that has a then outstanding Class Principal Balance greater than zero . . . [and] [a]s of the Closing Date, the Controlling Class shall be the Class S Certificates”); *id.* (defining the “Series 2007-C5 Directing Certificateholder” as “[t]he particular Holder . . . of Certificates of the Controlling Class selected by the Holders . . . of Certificates representing more than 50% of the Percentage Interests in the Controlling Class . . . ; provided, however, that until a Series 2007-C5 Directing Certificateholder is so selected or after receipt of a notice from the Holders . . . of Certificates representing more than 50% of the Percentage Interests in the Controlling Class that a Series 2007-C5 Directing Certificateholder is no longer designated, the particular Certificateholder . . . that beneficially owns Certificates of the Controlling Class that represents the largest aggregate Percentage Interest in the Controlling Class shall be the Series 2007-C5 Directing Certificateholder”).

any point in time.¹¹¹ Thus, as the junior-most tranches find themselves out of the money, control shifts upward in the capital structure. This means that out-of-the-money junior tranches therefore have no say over decisions that will no longer impact them. Likewise senior, well-in-the-money tranches also have no say over decisions from which they are insulated by virtue of still-in-the-money subordinated tranches. Instead, the CMBS controlling party system means that an investor with money immediately on the line is involved with management of the trust's assets. CMBS PSAs recognize that the interests of the controlling party might conflict with those of other investors, and explicitly waive claims against the controlling party except for actions taken negligently or in bad faith or for willful misfeasance.¹¹²

The CMBS controlling party is entitled to special information disclosures from the servicer and trustee.¹¹³ The CMBS controlling party is

111. See, e.g., Credit Suisse 2007-C1 PSA, *supra* note 105, § 1.01 (“‘Controlling Class’ shall mean, as of any date of determination, the eligible Class of Principal Balance Certificates with the lowest payment priority pursuant to Sections 4.01(a) and 4.01(b), that has a then outstanding Class Principal Balance that is not less than 25% of its initial Class Principal Balance; provided that, if no eligible Class of Principal Balance Certificates has a Class Principal Balance that satisfies the foregoing requirement, then the Controlling Class shall be the eligible Class of Principal Balance Certificates with the lowest payment priority pursuant to Sections 4.01(a) and 4.01(b), that has a then outstanding Class Principal Balance greater than zero. . . . As of the Closing Date, the Controlling Class shall be the Class T Certificates.”); *id.* § 3.23(a) (“The Holders . . . of Certificates representing more than 50% of the Class Principal Balance of the Controlling Class shall be entitled in accordance with this Section 3.23 to select a representative (each, a ‘Controlling Class Representative’) having the rights and powers specified in this Agreement (including those specified in Section 3.24) or to replace an existing Controlling Class Representative.”).

112. See, e.g., *id.* § 3.24(c) (“Each Certificateholder acknowledges and agrees, by its acceptance of its Certificates, that: (i) the Controlling Class Representative may have special relationships and interests that conflict with those of the Holders of one or more Classes of Certificates; (ii) the Controlling Class Representative may act solely in the interests of the Holders of the Controlling Class; (iii) the Controlling Class Representative does not have any duties to the Holders of any Class of Certificates other than the Controlling Class (and with respect to such Controlling Class Holders shall have no liability for any action taken or omitted which does not constitute negligence, bad faith or willful misfeasance); (iv) the Controlling Class Representative may take actions that favor interests of the Holders of the Controlling Class over the interests of the Holders of one or more other Classes of Certificates; and (v) the Controlling Class Representative shall have no liability whatsoever for having so acted or for any action taken or omitted, and no Certificateholder may take any action whatsoever against the Controlling Class Representative or any director, officer, employee, agent or principal thereof for having so acted.”).

113. See, e.g., *id.* § 3.24(a) (“Upon reasonable request, the Special Servicer shall provide the Controlling Class Representative with any information in such Special Servicer's possession with respect to such matters [as foreclosure and modification and real estate-owned sales], including, without limitation, its reasons for determining to take a proposed action. The Master Servicer or the Special Servicer, as applicable, shall notify the Controlling Class Representative of any release or substitution of collateral for a Mortgage Loan even if such release or substitution is in accordance with the related Mortgage Loan Documents.”); *id.* § 11.10 (“The Trustee, the Master Servicer or the Special Servicer, as the case may be, shall deliver to the Controlling Class Representative a copy of each notice

also empowered to direct or veto a variety of trust management decisions, including foreclosures, modifications, amendment or waivers of monetary terms and material nonmonetary terms, settlements with mortgagors, and real estate–owned (“REO”) sales.¹¹⁴ While CMBS servicers have authority

or other item of information such Person is required to deliver to the Rating Agencies pursuant to Section 11.09, in each case simultaneously with the delivery thereof to the Rating Agencies, to the extent not already delivered pursuant to this Agreement.”).

114. See, e.g., *id.* § 3.24(a) (“The Controlling Class Representative will be entitled to advise the Special Servicer with respect to the Special Servicer’s taking, or consenting to the Master Servicer’s taking, any of the actions identified in clauses (i) through (x) of the following sentence. In addition, notwithstanding anything in any other Section of this Agreement to the contrary, but in all cases subject to Section 3.20(g) and Section 3.24(b), the Special Servicer will not be permitted to take, or consent to the Master Servicer’s taking, any of the actions identified in clauses (i) through (x) of this sentence, unless and until such Special Servicer has notified the Controlling Class Representative in writing of such Special Servicer’s intent to take or permit the particular action and the Controlling Class Representative has consented (or has failed to object) thereto in writing within five Business Days of having been notified thereof in writing and having been provided with all reasonably requested information with respect thereto: (i) any proposed foreclosure upon or comparable conversion (which may include acquisitions of an REO Property) of the ownership of the property or properties securing any Specially Serviced Mortgage Loans as come into and continue in default; (ii) any modification, amendment or waiver of a monetary term (including any change in the timing of payments but excluding the waiver of Default Charges) or any material non-monetary term (excluding any waiver of a ‘due-on-sale’ or ‘due-on-encumbrance’ clause, which clauses are addressed in clause (ix) below) of a Mortgage Loan; (iii) any acceptance of a discounted payoff with respect to any Specially Serviced Mortgage Loan; (iv) any proposed sale of an REO Property for less than the Stated Principal Balance of, and accrued interest (other than Default Interest and Post-ARD Additional Interest) on, the related Mortgage Loan, except in connection with a termination of the Trust Fund pursuant to Section 9.01; (v) any determination to bring an REO Property into compliance with applicable environmental laws or to otherwise address Hazardous Materials located at an REO Property; (vi) any release of collateral for any Mortgage Loan (other than in accordance with the specific terms which do not provide for lender discretion of, or upon satisfaction of, such Mortgage Loan); (vii) any acceptance of substitute or additional collateral for any Specially Serviced Mortgage Loan (other than in accordance with the specific terms of such Mortgage Loan); (viii) any release (other than in accordance with the related Mortgage Loan Documents and in an amount less than \$50,000) of Earn-Out Reserve Funds or related Letter of Credit with respect to a Mortgaged Property securing a Mortgage Loan; (ix) any waiver of a due-on-sale or due-on-encumbrance clause in any Mortgage Loan; and (x) any consent to a change in franchise with respect to a hospitality loan or a change in the property manager of a Mortgage Loan with a principal balance greater than \$5,000,000; provided that, if the Special Servicer or the Master Servicer, as applicable, determines that immediate action is necessary to protect the interests of the Certificateholders (as a whole), the Special Servicer or the Master Servicer, as the case may be, may take any such action without waiting for the response of the Controlling Class Representative to the Special Servicer. In addition, subject to Section 3.24(b), the Controlling Class Representative may direct the Special Servicer to take, or to refrain from taking, such actions as such Controlling Class Representative may deem advisable or as to which provision is otherwise made herein. Upon reasonable request, the Special Servicer shall provide the Controlling Class Representative with any information in such Special Servicer’s possession with respect to such matters, including, without limitation, its reasons for determining to take a proposed action. The Master Servicer or the Special Servicer, as applicable, shall notify the Controlling Class Representative of any release or substitution of collateral for a Mortgage Loan even if such release or substitution is in accordance with the related Mortgage Loan Documents.”).

to act on their own, they are subject to direction of the controlling party.¹¹⁵ CMBS controlling parties also have a powerful disciplinary tool at their disposal to ensure special servicer cooperation: CMBS controlling parties may fire the special servicer without cause.¹¹⁶ In contrast, RMBS servicers may be dismissed only for very limited, specified causes. In RMBS, the effective principals (the RMBS investors) have little ability to discipline servicers; at best they are disciplined reputationally, but in an industry as opaque as servicing, reputation is at most weak market discipline.¹¹⁷ The dismissal power means that CMBS special servicers are likely to be attuned to the interests of the residual tranche. CMBS PSAs thus create a structure that ensures better principal-agent interest alignment and control.

CMBS PSAs show that it is possible to have a much more flexible securitization structure than what prevails for RMBS. Because securitization need not be inherently inflexible, we must therefore ask why RMBS PSAs are more rigid than CMBS PSAs. Part of the answer may lie in the nature of the securitized assets. CMBS typically have many fewer underlying properties. Instead of thousands or tens of thousands of mortgage loans in RMBS, there are typically dozens or hundreds in CMBS.

115. See, e.g., *id.* § 3.24(b) (“Notwithstanding anything herein to the contrary, (i) the Special Servicer shall not have any right or obligation to consult with or to seek and/or obtain consent or approval from the Controlling Class Representative prior to acting . . . and (ii) no advice, direction or objection from or by the Controlling Class Representative, as contemplated by Section 3.24(a) or any other provision of this Agreement, may (and the Master Servicer and Special Servicer shall ignore and act without regard to any such advice, direction or objection that such Master Servicer or Special Servicer, as the case may be, has determined, in its reasonable judgment, would) (A) require or cause the Master Servicer, such Special Servicer or the Trustee to violate applicable law, the terms of any Mortgage Loan or any other Section of this Agreement, including such Master Servicer’s or Special Servicer’s obligation to act in accordance with the Servicing Standard, (B) result in an Adverse REMIC Event with respect to either Trust REMIC or an Adverse Grantor Trust Event with respect to the Grantor Trust, (C) expose the Trust, the Depositor, the Master Servicer, the Special Servicer, the Trustee, or any of their respective Affiliates, members, managers, officers, directors, employees or agents, to any material claim, suit or liability, or (D) expand the scope of the Master Servicer’s or Special Servicer’s responsibilities under this Agreement.”).

116. See, e.g., *id.* § 3.25(a) (“Subject to Section 3.25(b), the Controlling Class Representative may, upon not less than ten days’ prior written notice to the respective parties hereto, remove any existing Special Servicer hereunder (with or without cause) and appoint a successor Special Servicer; provided that, if any such removal is made without cause, then the costs of transferring the special servicing responsibilities to a successor Special Servicer will, upon such removal or other termination, be paid by the Certificateholders of the Controlling Class.”); Credit Suisse 2007-C5 PSA, *supra* note 105, § 7.01(d) (“The Series 2007-C5 Directing Certificateholder shall be entitled to terminate the rights and obligations of the Special Servicer under this Agreement, with or without cause, upon 10 Business Days prior written notice to the Master Servicers, the Special Servicer and the Trustee, and to appoint a successor Special Servicer . . .”).

117. See Levitin & Twomey, *supra* note 20, at 68–69 (discussing the limitations of reputational discipline for RMBS servicers).

The loans in a CMBS pool are much larger, though, than the loans in an RMBS pool. Loans in CMBS pools are also much more heterogeneous, featuring individually negotiated loans with unique covenants and terms. While private-label RMBS feature many so-called exotic home mortgage products, there are a limited number of flavors of these exotic products; they have nowhere near the diversity of commercial loan structures.

Because CMBS have many fewer loans, but for much larger amounts, a single default is much more costly to CMBS holders than it is for RMBS holders. Therefore, if x percent of the loans in a CMBS pool default, it will have a much greater effect than *if* x percent of the loans in an RMBS pool default. Lesser collateral diversification means that, all else being equal, CMBS holders are more sensitive to default risk and therefore will value loss mitigation more than RMBS holders. This factor weighs in favor of having more flexible workout possibilities in CMBS PSAs.

Another factor potentially explaining the greater flexibility of CMBS structures is the fact that commercial real estate market trends have been more cyclical than residential real estate trends. There have been regional residential market downturns in recent memory, but never a national housing depression since the Great Depression. Accordingly, RMBS investors were less likely to anticipate the need for loss mitigation flexibility than CMBS investors, and did not demand it. Indeed, if RMBS investors had anticipated the default rates between 2007 and the present, they might not have purchased RMBS at all.

Ultimately, the reason that CMBS have more flexible structures than RMBS appears to be because loss mitigation is expensive. The CMBS special servicing structure adds another party and thus cost. The success fee paid for reperforming loans, and the interest paid on servicing advances in CMBS, reduces the yield available for CMBS investors. Moreover, the special servicer discretion and the control party feature in CMBS adds uncertainty to the investment. It means that CMBS are less likely to be automatons than RMBS. While there are benefits to discretion, it can also impose costs. CMBS thus feature a level of agency risk that RMBS do not, but this also facilitates workouts. The nature of CMBS collateral means that CMBS investors are more likely to demand flexible structures than RMBS investors; *ex ante*, RMBS underwriters and investors do not tend to think that flexibility is a good value proposition.

The comparison with CMBS shows that the hyperrigidity of RMBS is not the inevitable byproduct of securitization. Instead, it is the product of conscious design tradeoffs driven by cost considerations. RMBS investors

want greater yield, and RMBS sellers want higher prices. Loss mitigation is expensive, and neither RMBS investors nor sellers want to pay for it. The result is externalization of some of the costs of rigidity on homeowners, communities, and the market, with the others borne by RMBS investors themselves.

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,¹¹⁸ pervasive distress may create new financial and reputational pressures,¹¹⁹ and informal coordination mechanisms may spring up to overcome the obstacles built into the formal framework. Recent litigation¹²⁰ and crisis experience so far suggest that design rigidities in securitization do in fact work to impede modification to some extent.¹²¹

The core argument of this part has been that it is impossible to

118. Cf. Hunt, *supra* note 59, at 10–12 (recommending the implementation of certain measures that would facilitate interpreting PSAs as allowing mortgage loan modification).

119. This appears to have been the case with Ocwen Financial, a major subprime servicer that began doing principal modifications of defaulted mortgages it serviced without regard to PSAs. See Kate Berry, *Debt Forgiveness: Ocwen Enters Uncharted Waters*, AM. BANKER, June 24, 2008, at 1. 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.

120. See, e.g., Greenwich Complaint, *supra* note 56, ¶3 (“The . . . object of this action is a declaration that, under the substantially identical agreements that govern the trust that sold the securities owned by plaintiffs and the 373 other trusts in the CWL and CWALT securitizations that sold the securities owned or held by other members of the plaintiff class, Countrywide is required to purchase any loan on which it agrees to reduce the payments [as required by the terms of the PSA].”).

121. See Posting of Joe Nocera to N.Y. Times Executive Suite, <http://executivesuite.blogs.nytimes.com/2008/11/18/what-securitization-problem-the-fdic-weighs-in/> (Nov. 18, 2008, 18:45 EST) (citing both 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, and that the FDIC feels less legally and financially constrained than private actors to test the limits of the contractual framework. See COMPTROLLER OF CURRENCY, U.S. DEP'T OF TREASURY, OCC AND OTS MORTGAGE METRICS REPORT: DISCLOSURE OF NATIONAL BANK AND FEDERAL THRIFT MORTGAGE LOAN DATA, FOURTH QUARTER 2008, at 23 (2009), available at <http://www.occ.treas.gov/ftp/release/2009-37a.pdf> (finding significantly higher redefault rates for securitized loans than for other loans and attributing the difference to the decreased flexibility of securitized loans); Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, 36 FORDHAM URB. L.J. 509, 525–29 (2009) (interpreting modification data to suggest virtually no reduction in payment flows to securitization vehicles); Tomasz Piskorski, Amit Seru & Vikrant Vig, *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis* 1–2, 21–22 (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 09-02, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646 (finding less renegotiation and more foreclosures among securitized loans than among those held directly by the lender).

determine the actual rigidity of a contract by looking only, or even principally, at “What . . . Subprime Securitization Contracts Actually Say About Loan Modification.”¹²² To be sure, contract language is important. Yet it is not determinative and can be misleading. Rigidity is a product not just of the formal contractual limits on modification but also of the identity and structure of transaction participants (including insurers and guarantors), market structures (including investor dispersion), and contracting practices (such as resecuritization). A covenant prohibiting amendment may be ineffective where alternative debt restructuring techniques are available,¹²³ while a mere supermajority approval requirement may be insurmountable where investors are numerous, far flung, and lack incentives to modify.

The role of securitization and PSAs as barriers to mortgage modification will no doubt evolve with experience, including litigation.¹²⁴ Establishing the relationship between the incidence of modification and the factors we have described, along with many other factors that might turn out to be relevant, will take empirical work of the sort that is only beginning to appear at this writing.¹²⁵ For our purposes, it is enough that the contractual arrangements we study are designed to be rigid and that

122. See Hunt, *supra* note 59. Hunt’s empirical study of PSA language is extremely valuable, but the question it explores does not cover the full range of contract rigidity.

123. See, e.g., Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, INT’L FIN. L. REV., Dec. 2000, at 17 (describing a debt restructuring in the face of an explicit prohibition and a unanimous consent requirement for modification).

124. E.g., Greenwich Complaint, *supra* note 56. To date, litigation over improper servicing action has not materialized, excluding the *Greenwich Financial Services* case, which was predicated on Countrywide’s unique PSAs, as well as Countrywide’s settlement with the California and Illinois attorneys general, in which Countrywide pledged to modify mortgages it had securitized and was servicing. See, e.g., Stipulated Judgment and Injunction ¶ 6.3.1–3, *People v. Countrywide Fin. Corp.*, No. LC083076 (Cal. Super. Ct. Oct. 20, 2008), available at http://ag.ca.gov/cms_attachments/press/pdfs/n1618_cw_judgment.pdf. See also David Greising, *Deal to Help 21,000 in State Keep Homes*, CHI. TRIB., Oct. 6, 2008, at C1.

125. See, e.g., Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Atlanta, Working Paper No. 2009-17, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1433777 (comparing the incidence of modification between securitized and portfolio loans and arguing that redefault risk, not securitization, is responsible for low rates of modification). The authors also note the rarity of explicit modification bans in securitization contracts. *Id.* at 24. On the other hand, recent government data suggest a dramatic difference in the type of modification effected by portfolio and investor-held mortgages: the latter accounted for eight out of 17,574 principal reductions in the first two quarters of 2009, despite there being more than twice as many investor-held mortgages modified (223,274 compared to 104,244). See Cong. Oversight Panel, *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months* 56, 57 fig.21, 59 fig.23 (Oct. 9, 2009), available at <http://cop.senate.gov/documents/cop-100909-report.pdf>. Similarly, term extensions are rare for private-label securitization mortgage modifications, but not for loans in portfolio. *Id.* at 60 fig.24, 61 fig.25. Relating this research and data to the underlying law and institutions is a rich subject for further empirical study.

they are perceived as such by key constituents, including investors, servicers, and borrowers.¹²⁶

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 it does not create money where there is none. There are limits to the alchemy. The next two parts put PSAs in theoretical context and further consider the implications of PSA design for managing widespread financial distress.

IV. THE GENUS: RMBS AS IMMUTABLE CONTRACTS

A. FORM, STRUCTURE, AND FUNCTION IN CONTRACT IMMUTABILITY

Contract doctrine disfavors modification bans. Justice Cardozo's pronouncement—"Those who make a contract, may unmake it. The clause which forbids a change, may be changed like any other"¹²⁷—remains for the most part an accurate description of judicial attitudes. In contrast, some modern contract theory has good things to say about immutable contracts. Letting parties forswear even sensible future 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 midperformance.¹²⁸ It can also help minimize agency costs.¹²⁹

One way to achieve immutability is with express, formal amendment restrictions, if they were enforced by the courts. The benefits of such restrictions are most apparent in bilateral contracts. In multilateral contracts—such as bonded debt—the benefits become attenuated because these contracts are hard to modify even without express commitment to that effect, owing to the extensive coordination efforts that are required to bring

126. See *supra* notes 120–21, 125.

127. *Beatty v. Guggenheim Exploration Co.*, 122 N.E. 378, 381 (N.Y. 1919). The clause at issue was a bar on oral modification. See *id.*

128. See, e.g., PATRICK BOLTON & MATHIAS DEWATRIPONT, *CONTRACT THEORY* 573–75 (2005); 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) (describing four situations in which immutability would be theoretically desirable); Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 210–24 (1997); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 611–14 (2003).

129. See Jolls, *supra* note 128, at 209–19. Cf. Levitin & Twomey, *supra* note 20, at 89 (suggesting that servicers would be more likely to accept prohibitions of modification-barring provisions if such prohibitions were accompanied by clarifications that servicers owed duties of care to all beneficiaries as opposed to individual tranches).

the parties together.¹³⁰

The demand for de facto immutability, however, 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 forgo modification up front to signal willingness to pay;¹³¹ and both parties discount heavily the possibility of insolvency, or inability to pay, and any potential recovery values. By definition, neither party accounts for the spillover effects of immutability, as discussed in Part V 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 theoretical turn in favor of immutability. Advocates of immutability in bond contracts sought to protect bondholder minorities from corrupt, ignorant, and/or passive majorities.¹³² Arguing against immutability, proponents of composition—or debt restructuring—worry that minority holdout creditors might push an otherwise viable firm into liquidation.¹³³ This could result in spillovers and deadweight losses not offset by anyone's gains. The composition proponents therefore advocated flexible contracts, including low-threshold amendment terms.¹³⁴

A high-profile inflection in the debate occurred in the 1930s, when Securities and Exchange Commission (“SEC”) Chairman (later–Supreme Court Justice) William O. Douglas reacted to reports of corporate insiders buying and voting bonds to appropriate for equity a recovery that rightly belonged to debt.¹³⁵ Douglas advocated what became the unanimity

130. See Davis, *supra* note 128 (noting coordination problems in contracts involving multiple parties).

131. 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 & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1712 (2006).

132. See Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 250–52 (1987) (noting that William O. Douglas and the Securities and Exchange Commission intended immutability to induce bankruptcy because of their distrust of insider control of bond issues).

133. *Id.* at 235–39 (referring to minority holdups as the “buoying up effect”). See also Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 449–50 (1993) (citing municipal bondholder complaints about unanimity as an obstacle to compromise in 1933).

134. See, e.g., Roe, *supra* note 132, at 266–67 (discussing the flaws of immutability as a “bondholder protection”).

135. See H. COMM. ON INTERSTATE & FOREIGN COMMERCE, H.R. REP. NO. 1016, TRUST INDENTURE BILL OF 1939, at 24, 30–33 (1939); S. COMM. ON BANKING & CURRENCY, S. REP. NO. 248, TRUST INDENTURE ACT OF 1939, at 4–8 (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. See, e.g., Lee C. Buchheit & G. Mitu Gulati,

requirement of the TIA,¹³⁶ a victory for immutability. As noted earlier, the law requires each creditor's consent to amend payment terms. It thus gives creditors effective veto power over compositions. Against this background, debtors and creditors should 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 sought to confine it to the public, judicial realm. For Douglas, the need to control insider abuse justified the costs of bankruptcy.¹³⁷

Although the TIA applies to RMBS, the debates that led to its enactment have limited relevance in the securitization context because 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 states cannot go bankrupt; however, like corporate debtors, they may require composition to survive. Amendment clauses in sovereign bond contracts attracted policy and

Sovereign Bonds and the Collective Will, 51 EMORY L.J. 1317, 1332 (2002); Roe, *supra* note 132, at 256–57 (citing Enoch v. Brandon, 220 N.Y.S. 294, 296 (1927), and contemporaneous treatises).

136. Trust Indenture Act (TIA) of 1939, 15 U.S.C. §§ 77aaa–77bbb (2006).

137. 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: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 162–69 (1992). These were single-asset real estate bonds, issued against the earning power of a particular mortgaged building, often not yet completed. 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 interest was essentially a description of the real estate bond industry. See TIA § 310, 15 U.S.C. § 77jjj.

Single-asset real estate bonds were in some ways forerunners of securitization as they provided a dedicated cashflow to investors based on real estate mortgage payments. They also were forerunners of the 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." GRANT, *supra*, at 163. Interestingly, it appears that the market began to respond to the problems of single-asset real estate bonds before the TIA. For example, the single-asset real estate bonds at issue in the famous case of *Aladdin Hotel*, which were issued in 1938, contained a contractual unanimous consent provision. *Aladdin Hotel Co. v. Bloom*, 200 F.2d 627, 628–30 (8th Cir. 1953). The Aladdin still stands in downtown Kansas City.

academic attention during the financial crises of the mid-1990s. Most sovereign bonds were then issued under New York law and, although exempt from the TIA, required unanimous creditor consent to amend payment terms.¹³⁸ Policymakers and academics widely expected the unanimity requirements to delay composition and encourage holdouts; the absence of the bankruptcy valve would only exacerbate coordination problems.¹³⁹

As with corporate bonds¹⁴⁰ and RMBS, the argument against rigidity in sovereign bond contracts emphasizes externalities. Absent an orderly renegotiation framework, a debt overhang can depress investment and growth in a country for years; sovereign default can trigger economic collapse, bank failures, job losses, and contagion in financial markets.¹⁴¹ Because everyone understood the macroeconomic policy risks, it was thought that debtors and creditors would hold up other governments and organizations, such as the International Monetary Fund (“IMF”), for side payments, potentially imposing costs on U.S. taxpayers, among others.¹⁴²

The counterargument for rigidity in this context tracks contract theory. It evokes information asymmetries and the challenge of disciplining sovereign debtors: it is hard to tell “good” borrowers from “bad” ones.¹⁴³

138. The reasons for this are disputed and, in any case, irrelevant here. Sovereign bonds are specifically exempt from the TIA. *See* 15 U.S.C. § 77dd. Conventional wisdom holds that unanimity provisions were mindlessly copied from corporate bond indentures, *see* Buchheit & Gulati, *supra* note 135, at 1331, or naively inserted in Brady bonds, which represented restructured loans, to deter redefault, *see* James Hurlock & Troy Alexander, *The Fire Next Time: The Dangers in the Next Debt Crisis*, INT’L FIN. L. REV., Mar. 1996, at 14, 14–15 (discussing the development of Brady bonds).

139. *See, e.g.*, Anne Krueger, First Deputy Managing Dir., IMF, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address at the National Economists’ Club Annual Members’ Dinner (Nov. 26, 2001), *available at* <http://www.imf.org/external/np/speeches/2001/112601.htm>.

140. *See* Roe, *supra* note 132, at 232–35.

141. *See generally* BARRY EICHENGREEN ET AL., CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS (1995) (arguing for majority modification provisions in sovereign bond contracts); Hurlock & Alexander, *supra* note 138 (arguing that new rigid sovereign bonds will be more difficult to manage in distress than older sovereign loans).

142. *See, e.g.*, Jeremy Bulow & Kenneth Rogoff, *Multilateral Developing-Country Debt Rescheduling Negotiations: A Bargaining-Theoretic Framework* (IMF, Working Paper No. 88/35, 1988), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=884729 (referring to sovereign debt restructuring as a tripartite negotiation with creditor country taxpayers); John B. Taylor, Under Sec’y of the Treasury for Int’l Affairs, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at “Sovereign Debt Workouts: Hopes and Hazards?” Institute for International Economics Conference (Apr. 2, 2002), *available at* <http://www.treasury.gov/press/releases/po2056.htm> (suggesting an official subsidy for debtors and creditors to adopt collective action provisions in sovereign bonds).

143. *See supra* note 128 and accompanying text. For a discussion of how to deal with a defaulting sovereign, *see, for example*, Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina’s Default*, 6 CHI. J. INT’L L. 311, 326–32 (2005) (examining the specific case

Fiscal ability and political willingness to pay are notoriously hard to disentangle.¹⁴⁴ Suing foreign governments is of limited use because the assets available to satisfy a judgment are either immune¹⁴⁵ or in the home country and out of creditors' reach. And like corporate insiders, government affiliates (such as agencies and state-owned enterprises) are not shy about buying and voting government bonds to the detriment of private bondholders.¹⁴⁶

For reasons that had more to do with political economy than contract theory, advocates of composition prevailed in 2003 when the sovereign bond documentation standard shifted away from unanimity.¹⁴⁷ Perhaps the most remarkable aspect of this 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.¹⁴⁸ Meanwhile, countries found ways to default and restructure with or without unanimity.¹⁴⁹ At least for now, it appears that formal barriers to amendment in sovereign debt contracts did not make 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

of Argentina in the 1990s).

144. To some extent all sovereign debtors must be good debtors since, as Walter Wriston observes, countries never go bankrupt. Walter B. Wriston, *Banking Against Disaster*, N.Y. TIMES, Sept. 14, 1982, at A27. See also FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES 38 (2006) (arguing that the effort to disentangle ability and willingness to pay may be futile).

145. This is the case, for example, with embassies and military bases.

146. See *CIBC Bank & Trust Co. v. Banco Central do Brasil*, 886 F. Supp. 1105, 1107 (S.D.N.Y. 1995) (considering a case in which the creditors of Brazil sought to prevent a Brazilian government instrumentality from voting Brazilian government debt); William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 56–60 (2004) (citing Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1 (1996)); *id.* at 64–71 (arguing for intercreditor good faith duties); Buchheit & Gulati, *supra* note 135, at 1339–42 (analyzing the facts of the *CIBC* case and considering the implications regarding how courts will treat intercreditor duties of sovereign debtors). Some have argued that “insider” status should extend to all institutions regulated by the sovereign borrower. Emerging Mkts. Creditors Ass’n, Model Covenants for New Sovereign Debt Issues 1 (May 3, 2002) (on file with authors).

147. See Gelpern & Gulati, *supra* note 131, at 1628–29.

148. See *id.* at 1712.

149. For example, Ecuador, Argentina, and Uruguay, among others, established corporate restructuring tools, such as exchange offers and exit consents, to limit the impact of unanimity. See STURZENEGGER & ZETTELMEYER, *supra* note 144, at 147–201, 211–26. See also Buchheit, *supra* note 123.

effective immutability in contracts. Some writers—notably Mark Roe and Kevin Davis—make a point of distinguishing the two.¹⁵⁰ Each stresses that institutional design and covenants that stop short of banning modification can go a long way toward 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 III, 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, as in a term prohibiting modification, or less so, as in the TIA's voting thresholds and PSAs' buyback requirement for modified mortgages. In either case, such provisions impose formal constraints or conditions on renegotiation. *Structural* rigidity is a product of institutional 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, resecuritization, 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.¹⁵¹ Like corporations, securitization vehicles have multiple classes of creditors that are vulnerable to holdup tactics and other collective action problems.¹⁵² Trust organization, tax and accounting features, senior/subordinate tranching, and resecuritization add more layers of structural and functional rigidity on top of statutory and contractual barriers to modification. This combination makes RMBS more effectively immutable than either corporate or sovereign bonds. RMBS rigidity in the face of real financial distress creates negative externalities, which is the subject of Part V.

150. See Davis, *supra* note 128; Roe, *supra* note 132. 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.

151. See *infra* Part V.

152. See, e.g., Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventative Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279, 290–91 (2007) (describing how tranche warfare acts as a barrier to modification).

B. RIGID CONTRACTS IN BANKRUPTCY THEORY

The quest for immutability in securitization design is consistent with contract theory's prediction that parties may commit to forgo *ex post* modification in exchange for savings *ex ante*. It is also consistent with a strain of bankruptcy theory, known as contractual bankruptcy,¹⁵³ which predicts that parties to business contracts will seek to opt out of the Bankruptcy Code in favor of contractual ordering of the disposition of an insolvent firm's assets. Advocates of contractual bankruptcy argue that such private ordering is more efficient than the public ordering mandated by Congress.¹⁵⁴ Private contracts can be drafted to reflect the idiosyncratic preferences of particular debtors and creditors as to 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 over a quarter century, beginning with Douglas Baird and Thomas Jackson's "creditors' bargain" theory of bankruptcy.¹⁵⁵

From the creditors' bargain theory, several proposals for contractual bankruptcy emerged. Early proposals did not advocate contracting *out* of bankruptcy *per se* (which was disfavored by the courts¹⁵⁶), but rather proposed using bankruptcy as a mechanism for enforcing the prebankruptcy, contractually determined priority scheme and for avoiding rent extraction by managers and "out-of-the-money" claimants. Thus, Baird envisioned a reformed Chapter 11 that would be used as a vehicle to

153. Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1199 & n.6 (2005).

154. 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."); Warren & Westbrook, *supra* note 153, at 1201 (stating that contractualists believe "that a bankruptcy regime negotiated in the marketplace will be far more efficient than the standardized 'contract' provided by Congress in the Bankruptcy Code").

155. 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. See, e.g., Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982). 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., *id.*; JACKSON, *supra* note 67, at 7-19; 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) (explaining how the absolute priority rule deals with these issues in various contexts); 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, 105-09 (1984) [hereinafter Baird & Jackson, *Corporate Reorganizations*]; Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

156. SCHWARCZ ET AL., *supra* note 22, at 54.

conduct going-concern sales of firms free and clear of claims, with the sale proceeds then being divided among creditors according to absolute priority.¹⁵⁷ Variations on the sale method were proposed by Lucien Arye Bebchuk;¹⁵⁸ by Philippe Aghion, Oliver Hart, and John Moore;¹⁵⁹ and by Barry Adler.¹⁶⁰ These proposals added increasing flexibility to the sale process, but all envisioned a mandatory, judicially supervised process that enforced a contractually determined, nonbankruptcy priority system.

Michael Bradley and Michael Rosenzweig took the idea of contractual bankruptcy a step further and proposed removing it from the courts.¹⁶¹ They merely followed the logic of making Chapter 11 a mandatory sale process. This process 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.

157. Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 145–46 (1986).

158. See 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. *Id.* 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. *Id.* at 785–88. The lowest priority class to bid in would own the company, with everyone senior being paid in full. *Id.* at 782–83, 785–88. The seniority of classes of creditors would be contractually determined and would include the bankruptcy bidding option. See *id.* at 781–88.

159. See Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523 (1992). Aghion, Hart, and Moore responded to Bebchuk's proposal with one in which a judge would allocate rights in the bankrupt firm among the claims holders and solicit bids for control of the firm. *Id.* at 524. As they explained,

[The] 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 also 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. (footnote omitted).

160. See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319–24 (1993) [hereinafter Adler, *Financial Theories*]. Adler rejects the common pool justification for bankruptcy and proposes an alternative automated bankruptcy regime in which an insolvent firm's equity is transferred to the highest-priority class of creditors that cannot be paid on time rather than using a bidding process. This process would be specified under the terms of financial instruments issued by the firm. See Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1110 & n.13 (1994) (arguing that "Chameleon Equity"—a multipriority contractual hierarchy of preferred equity—would better resolve financial distress than bankruptcy legislation); Adler, *Financial Theories*, *supra*, at 323–33 (same); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 352–57 (1997) (same); Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994) (same).

161. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078 (1992).

Robert Rasmussen¹⁶² and Alan Schwartz¹⁶³ have each since proposed less 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 a degree of rigidity in their contractual design in order to ensure that creditors actually get the benefit of their bargain. This aspect of contractual bankruptcy is particularly stark in the proposals that stress mandatory, automatic implementation and minimize the role of the courts.

Contractual bankruptcy has been criticized on the ground that it fails to consider anything other than efficiency.¹⁶⁴ Furthermore, its central

162. 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 consented to change it. Because creditors would know the 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 would not price credit based on the organizational choices of their debtor. *See* Rasmussen, *supra* note 154.

163. 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 (a “renegotiation contract” regime). Alan Schwartz, Essay, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1827–30 (1998) [hereinafter Schwartz, *Contract Theory Approach*]. A “renegotiation-proof” contract . . . will induce the firm to choose the optimal bankruptcy system in the event of insolvency.” *Id.* at 1827. Absent the entry of a new creditor, however, the terms of the contract to ensure the optimal bankruptcy regime would remain locked in. “The contract is called renegotiation proof because no party will have an incentive to propose changes in it in light of later events.” *Id.* Alternatively, in a “renegotiation contract” regime, creditors rely on the unincentivized firm to choose the optimal bankruptcy regime. If reorganization is likely to 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 are adjusted to reflect the deal negotiated by the newest creditor of the firm. *See id.* at 1831. Such a readjustment would ensure that the firm remains incentivized to choose the optimal regime. *See id.* at 1827. 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 consume. *See id.* at 1827. *See also* Alan Schwartz, Essay, *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.”).

164. *See, e.g.*, Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 85–91 (1995) (describing the debate over the efficiency as a valid criterion); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 762 (1991) (“At best, the economic account offers an undermining explanation of a bankruptcy system that recognizes noneconomic outcomes as independent values. At worst, the economic account does not explain ‘bankruptcy law’ at all, but merely restates its own economic assumptions. . . . In contrast, the value-based account is founded on a deeper understanding of the

efficiency claim has been called into question. Some scholars have questioned whether contractual bankruptcy would create new inefficiencies from redistribution, offsetting any efficiency gains.¹⁶⁵ Others have asked whether the transaction costs involved in a contractual bankruptcy regime would outweigh the efficiency gains.¹⁶⁶ In a recent article, Elizabeth Warren and Jay Lawrence Westbrook test the efficiency of contractual bankruptcy in a multidistrict empirical study of business bankruptcy filings from 1994.¹⁶⁷ Warren and Westbrook find support for both the redistribution and the transaction costs critiques of contractual bankruptcy; however, their findings extrapolate from federal bankruptcy data¹⁶⁸—as the law stands, real firms may not contract out of bankruptcy.

Securitization offers a rare natural experiment for the contractual approach.¹⁶⁹ The bankruptcy-remote SPV (the firm) functionally opts out

concern to which bankruptcy law is addressed. Bankruptcy law is a response to the problem of financial distress—not only as an economic, but as a moral, political, personal, and social problem that affects its participants.”); Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75 (1996) (examining the debate over normative justifications for bankruptcy policy); 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) (counseling against “any closed-end theory or understanding of the law”); Elizabeth Warren, Essay, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 336–40 (1993) [hereinafter Warren, *Bankruptcy Policymaking*]. Other important considerations have been proposed. See, e.g., Jean Braucher, *Bankruptcy Reorganization and Economic Development*, 23 CAP. U. L. REV. 499, 517–18 (1994) (arguing for the need to protect employee interest because of inability to diversify labor capital); Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5 (1996) (arguing for the 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); Warren, *Bankruptcy Policymaking*, *supra*, at 352–61 (suggesting various distributional goals besides economic efficiency and emphasizing the need to internalize costs of business failure); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9 (arguing for the need to account for the interests of the community, including potential customers, suppliers of the firm, and taxing authorities).

165. See, e.g., Lucian Arye Bebchuck & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 548–49 (citing transaction costs); Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2243 (2000); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 830–37 (2004). See generally Lynn M. LoPucki, Essay, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999) (criticizing Schwartz’s model); Warren & Westbrook, *supra* note 153 (using empirical data to critique the contractualist position).

166. See Rasmussen, *supra* note 154, at 114–16 (discussing the adverse selection problem); Warren & Westbrook, *supra* note 153, at 1201–02.

167. Warren & Westbrook, *supra* note 153, at 1201–02.

168. See *id.* at 1202.

169. See Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 649–53 (1992) (noting various ways in which secured credit can serve as a bankruptcy contract); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L.

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 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 the position they wish to have 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.¹⁷⁰ 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.”¹⁷¹

Securitization's natural experiment in contractual bankruptcy 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 earlier, these two factors are central to securitization's design and are perhaps the most important features of securitization for investors.¹⁷²

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 category of problems with contractual bankruptcy in addition to redistribution and transaction costs: this category comprises spillover effects from locking the parties into a precommitted resolution framework, or contract rigidity. Because contractual bankruptcy models limit themselves to the context of the firm, they do not consider spillovers beyond the firm.¹⁷³ Contractualists leave the problem to the

REV. 515, 597–99 (1999) (suggesting that securitization transactions should be enforceable as bankruptcy waiver contracts). Cf. Schwartz, *Contract Theory Approach*, *supra* note 163, at 1833 (“Because bankruptcy contracts are currently illegal, there is no data about real contracts that could support [the argument that differences in creditor preferences of bankruptcy systems could be overcome.]”).

170. This is sometimes reinforced by covenants. See *supra* note 75. The major exception would be claims and counterclaims from obligors on the SPV's assets.

171. Schwartz, *Contract Theory Approach*, *supra* note 163, at 1833.

172. See *supra* Part III.C–D.

173. See, e.g., Schwartz, *Contract Theory Approach*, *supra* note 163, at 1814.

market.¹⁷⁴ But thick markets are not always there to pick up the slack, and maximizing the value of a bankruptcy estate maximizes social welfare if and only if the marginal increase in welfare from the particular bankruptcy regime offsets the marginal decrease in welfare from the regime's externalities.¹⁷⁵

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 of contractual bankruptcy for consumers would be prohibitively high and would necessitate accounting for numerous involuntary creditors, as well as for creditors who cannot easily adjust their behavior for the many bespoke bankruptcy regimes that would be available to 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 them.

And yet that is precisely what securitization accomplishes. Securitization transforms consumer debt into business debt. The resulting transformation has profound implications for the application of a contractual bankruptcy regime, embodied in RMBS PSAs, designed to inhibit the reworking of the securitized consumer debts, forcing consumer debt out of the social policy world of the Bankruptcy Code and into the private ordering of securitization contracts.¹⁷⁶

In sum, securitization is the embodiment of contractual bankruptcy. For the device to work, its contracts must be rigid. Contractual bankruptcy theories, however, do not consider the full range of spillover effects created by rigidity. The problem of spillover effects is particularly salient in residential mortgage securitization for two reasons. First, the enormous size of the market creates the risk that any disruptions would affect the broader financial system and the macroeconomy. Second, because residential

174. *E.g., id.* at 1817 (“It 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.”); Baird & Jackson, *Corporate Reorganizations*, *supra* note 155, at 101–02 (“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.” (footnote omitted)).

175. So thoroughly has the firm-centered framing of the bankruptcy debate taken root that even its most vigorous critics, such as Warren, ultimately succumb to it after expanding the list of constituents slightly to include communities surrounding the firm. *See, e.g.,* Warren, *Bankruptcy Policymaking*, *supra* note 164, at 352–61 (suggesting various distributional goals besides economic efficiency).

176. *See supra* notes 104–17 and accompanying text.

mortgage securitization effectively transforms consumer debt into business debt, it imparts elements of contractual bankruptcy to relationships that it was never meant to cover. The next part elaborates on spillover effects from securitization.

V. SPILLOVERS: CONTRACTS AS SUICIDE PACTS

As discussed in Part III, 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 spillover effects: for communities, for other creditors, for the financial markets, and for the economy as a whole. These spillover effects 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 the negative spillovers.

Before proceeding to catalogue 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.¹⁷⁷ If this homeowner cannot pay his or her loan according to its original terms, the homeowner 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.¹⁷⁸ 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 importantly for our purposes, even if homeowners asked for and received a better interest rate in exchange for giving up *ex post* workout

177. Compare Adelino et al., *supra* note 125, at 14, 25–26 (finding a small role for contract frictions in the context of renegotiation and suggesting that modifications were not necessarily in the best interest of investors), with Cong. Oversight Panel, *supra* note 125 (noting differences in modification type based on securitization status).

178. See Levitin & Twomey, *supra* note 20, at 73–75 (discussing cognitive issues in mortgage lending). See also Bar-Gill, *supra* note 2 (explaining how the contractual design features of subprime loans can be explained as responses to the imperfect rationality of borrowers).

options, their arrangement might be costly for others who have nothing to do with either the mortgage or the securitization contracts. The remainder of this part considers the effects of residential mortgage securitization on the broader economy and society.

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 impose new costs on communities, as foreclosed properties are often magnets for crime and fire;¹⁷⁹ push down the price of neighboring properties;¹⁸⁰ and reduce property tax revenue for local governments.¹⁸¹ Foreclosures also have unquantifiable costs as debtors' relocation affects social relationships.¹⁸² Foreclosures have even been linked to public health problems such as the spread of the West Nile Virus.¹⁸³

Second, restrictive PSAs can contribute to a collective action problem of the sort that produces bank runs.¹⁸⁴ Where there is a wave of foreclosures, the real estate market becomes 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 costs on RMBS holders and on mortgagees generally, quite apart from the

179. See, e.g., WILLIAM C. APGAR & MARK DUDA, COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY'S MORTGAGE FORECLOSURE BOOM 6 (2005), available at http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf; Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851, 855-56 (2006).

180. See, e.g., APGAR & DUDA, *supra* note 179, at 5; DAN IMMERGLUCK & GEOFF SMITH, WOODSTOCK INST., THERE GOES THE NEIGHBORHOOD: THE EFFECT OF SINGLE-FAMILY MORTGAGE FORECLOSURES ON PROPERTY VALUES (2005), available at http://www.woodstockinst.org/index.php?option=com_docman&task=doc_download&gid=52 (estimating that in Chicago the 3750 foreclosures that took place between 1997 and 1998 reduced surrounding property values by almost \$6 million); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57 (2006) (same).

181. See GLOBAL INSIGHT, THE MORTGAGE CRISIS: ECONOMIC AND FISCAL IMPLICATIONS FOR METRO AREAS 2 (2007), available at <http://www.vacantproperties.org/resources/documents/USCMmortgagereport.pdf>; John Kroll, *Foreclosure Study Says Vacant Properties Cost Cleveland \$35+ Million*, PLAIN DEALER (Cleveland), Feb. 19, 2008, available at http://blog.cleveland.com/metro/2008/02/foreclosure_study_says_vacant.html.

182. See Adam J. Levitin, *Helping Homeowners: Modification of Mortgages in Bankruptcy*, 3 HARV. L. & POL'Y REV. ONLINE 1, 1 (2009), http://www.hlpronline.com/Levitin_HLPR_011909.pdf; Levitin, *supra* note 46, at 569.

183. See Daniel Denoon, *Foreclosures Worsen Spread of West Nile*, CBSNEWS.COM, Oct. 23, 2008, <http://www.cbsnews.com/stories/2008/10/02/health/webmd/main4495947.shtml>.

184. See Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968).

effects on the holders and mortgagees under any given PSA.

Third, restrictive PSAs can help drive down the financial markets. U.S. 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.¹⁸⁵ 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 IV.B, the securities are designed to fit models where failure is near impossible, or at worst, precisely compartmentalized. These models are ill equipped to predict recovery values from widespread foreclosures. Moreover, servicers have never gone through a foreclosure epidemic in a downturn; they lack the administrative capacity to process foreclosures on a large scale. 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, even in good economic times, private-label RMBS rarely trade; they are illiquid, noncommodity products. A relatively moderate downturn might be expected to render RMBS and the structured products based on RMBS even harder to value.¹⁸⁶

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.

Fourth, brittle PSAs also have implications for the economy as a whole. This category of spillover effects is the macroeconomic counterpart of two categories already described: foreclosures on a large scale depress

185. See, e.g., Gillian Tett, Aline Van Duyn & Paul J. Davies, *A Re-Emerging Market?: Bankers Are Seeking Simpler Ways to Sell on Debt*, FIN. TIMES (London), July 1, 2008, at 9 (noting the decades-old emergence of securitization and its significant growth since 2000).

186. This discussion 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.*

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 with the securitization market. A credit crunch depresses consumption and investment and, ultimately, growth.

Although securitization contracts generate significant externalities and impose costs on a wide range of constituencies beyond the contracting parties, they are designed to limit the government's capacity to mitigate their potential adverse impact on the economy. Bankruptcy remoteness, tranching, and resecuritization limit intervention options in distress. Of these, bankruptcy remoteness is the most obvious constraint 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 to social policy considerations.¹⁸⁷

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

VI. OVERCOMING RIGIDITIES: NEW DEAL TOOLS

History reveals a menu of standard responses to rigid contracts. First, there is statutory bankruptcy, designed and mandated by the legislature. Under the Bankruptcy Code, the debtor can avoid antimodification features in its own contracts.¹⁸⁸ This is the method used to avoid contractual rigidities in corporate bonds and farm mortgages.¹⁸⁹ A similar approach

187. Other implications for government intervention are less visible. When the link between debtor and creditor has been severed—replaced with impermeable, hyperrigid layers of securitization—regulatory tools premised on the existence of that link become worthless. For example, regulatory accounting treatment of a portfolio loan on the creditor's books can have a direct effect on that creditor's willingness to restructure the 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 with the borrower. The same dynamic holds with conventional debt securities. In contrast, where assets are RMBS, changing the accounting treatment on the investor's books would have little or no impact on the prospects of restructuring the underlying mortgage since the relationship between the value of the mortgage and the value of the RMBS slice held by any given investor is indirect at best. (This is true even without taking into account the formidable challenge of valuing RMBS in a depressed market.)

188. 11 U.S.C. § 365(a) (2006).

189. See JACKSON, *supra* note 67; *infra* Part VI.C.

was mooted to overcome rigidity by treaty in sovereign debt contracts.¹⁹⁰

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: the government used a combination of state foreclosure moratoria (sticks)¹⁹¹ and federal refinancing subsidies (carrots). Again, analogues were considered for sovereign debt contracts.¹⁹² Recent proposals directed at RMBS PSAs follow suit. One such proposal would take away favorable tax treatment for securitizations unless antimodification provisions were removed (a stick).¹⁹³ Others, including the Obama administration's Making Home Affordable Program, offer servicers bounties for every loan they modify (carrots).¹⁹⁴

190. An attempt to establish a sovereign bankruptcy regime by treaty using antirigidity 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 Krueger, *supra* note 139 (presenting the IMF's proposal of such a system in 2002). See generally Brad Setser, IPD Task Force on Sovereign Debt, *The Political Economy of the SDRM* (June 8, 2009) (unpublished manuscript, on file with authors) (describing the political forces that led to the failure of the IMF's proposed sovereign debt restructuring mechanism ("SDRM") on worldwide policy debates). For normative objections to the sovereign bankruptcy regime, see Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. LAW 613, 627–40 (2001). See generally Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001* (IMF, Working Paper No. 02/133, 2002) (on file with authors) (surveying the recent history of sovereign bankruptcy proposals).

191. See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 415–16, 422–23 (1934).

192. 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* 170–74 (2001); Andy Haldane & Mark Kruger, *The Resolution of International Financial Crises: Private Finance and Public Funds* 10–15 (Nov. 2001) (unpublished manuscript), available at <http://www.bankofengland.co.uk/publications/other/financialstability/boeandboc.pdf>. U.S. officials raised the idea of paying the parties to sovereign bond contracts to adopt majority modification provisions. See Taylor, *supra* note 142. 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. See, e.g., *Treaty Concerning the Encouragement and Reciprocal Protection of Investment, U.S.-Uru., Annex G, ¶ 2(b)(iii)*, Nov. 4, 2005.

193. See Michael S. Barr & James A. Feldman, *Ctr. for Am. Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages* 2–3 (Apr. 2008), available at http://www.americanprogress.org/issues/2008/04/pdf/reimc_brief.pdf.

194. See, e.g., U.S. Dep't of Treasury, *Homeowner Affordability and Stability Plan Fact Sheet 5* (Feb. 18, 2009), available at <http://www.treas.gov/press/releases/20092181117388144.htm>; Press Release, U.S. Dep't of Treasury, *Neel Kashkari Remarks on GSE, HOPE Now Streamlined Loan Modification Program* (Nov. 11, 2008), available at <http://www.treas.gov/press/releases/archives/200811.html>. See also Christopher Mayer, Edward Morrison & Thomasz Piskorski, *A New Proposal for Loan Modifications*, 26 YALE J. ON REG. 417, 420 (2009).

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.¹⁹⁵ 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 may cause social harm. One approach involves narrowly tailored legislation that renders the offending contractual language unenforceable on public policy grounds. This 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 beginning in 1935, 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 creditor coordination problems.¹⁹⁶

These examples 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.¹⁹⁷ 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 shoe

195. See Howell E. Jackson, Op-Ed, *The Paulson Plan Should Target Bad Loans, Not Burned Investors*, CHRISTIAN SCI. MONITOR, Sept. 25, 2008, available at <http://www.csmonitor.com/2008/0925/p09s02-coop.html>; Lauren E. Willis, *Stabilize Home Mortgage Borrowers, and the Financial System Will Follow* 1–2 (Loyola Law Sch. L.A., Legal Studies Paper No. 2008-28, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273268. Both Jackson and Willis contend that the federal government should exercise eminent domain, but eminent domain power could also be exercised by the states. The potential expense of a widescale exercise of eminent domain is one factor that reduces its appeal as a solution.

196. See *infra* Part VI.C.

197. BARRY EICHENGREEN, *GOLDEN FETTERS: THE GOLD STANDARD AND THE GREAT DEPRESSION, 1919–1939*, at 329 (1992); WILLIAM E. LEUCHTENBURG, *FRANKLIN D. ROOSEVELT AND THE NEW DEAL* 38–39, 42–43 (1963).

boxes.”¹⁹⁸ Withdrawals accelerated on rumors of dollar devaluation,¹⁹⁹ even as the president-elect remained coy about his monetary intentions.²⁰⁰

On March 5, 1933, President Roosevelt invoked the Trading with the Enemy Act of 1917 to declare a national bank holiday and bar all transactions in gold.²⁰¹ A law to this effect followed days later.²⁰² By mid-April, Roosevelt announced that he would take the United States off the gold standard.²⁰³ A new monetary framework passed within weeks as part of a farm bill.²⁰⁴ It gave the executive discretion to inflate by remonetizing silver, printing money, or changing the gold content of the dollar, but did not mandate devaluation.²⁰⁵ As the year wore on, fears of “marching farmers” and “an agrarian revolution” in New Deal policy circles eclipsed the calls for stable money.²⁰⁶ On January 30, 1934, Congress enacted the Gold Reserve Act, requiring a 40 percent minimum reduction in the value of the dollar, and directing all gold coin to be melted into bullion.²⁰⁷ Roosevelt formally devalued the next day.²⁰⁸

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.’”²⁰⁹ The formulation was ubiquitous in obligations of the United States, foreign and subnational

198. LEUCHTENBURG, *supra* note 197, at 39.

199. EICHENGREEN, *supra* note 197, at 324–29. Roosevelt’s Attorney General Homer Cummings later claimed that between February and early March, more than \$476 million in gold had been withdrawn from Federal Reserve banks and the U.S. Treasury, of which \$311 million appeared to head abroad. Oral Argument of Attorney General Homer Cummings at 265, *Norman v. Balt. & Ohio R.R.*, 294 U.S. 240 (1935) [hereinafter Cummings Argument].

200. See LEUCHTENBURG, *supra* note 197, at 38. See also Kenneth W. Dam, *From the Gold Clause Cases to the Gold Commission: A Half Century of American Monetary Law*, 50 U. CHI. L. REV. 504, 504 (1983) (citing Roosevelt’s campaign criticism of Hoover’s alleged soft money leanings).

201. See Michal R. Belknap, *The New Deal and the Emergency Powers Doctrine*, 62 TEX. L. REV. 67, 73 (1983).

202. Emergency Banking Relief Act, ch. 1, §§ 2, 3, 48 Stat. 1, 1–2 (1933).

203. LEUCHTENBURG, *supra* note 197, at 50.

204. See Agricultural Adjustment Act, Pub. L. No. 73-10, § 43(b), 48 Stat. 31, 52–53 (1933).

205. *Id.* §§ 2, 43(b), 48 Stat. at 32, 52–53.

206. See ARTHUR M. SCHLESINGER, JR., *THE COMING OF THE NEW DEAL*, 237, 242 (First Mariner Books 2003) (1958). See also LEUCHTENBURG, *supra* note 197, at 51.

207. Gold Reserve Act of 1934, ch. 6, Pub. L. No. 73-87, §§ 5, 12, 48 Stat. 337, 340, 342–43.

208. Proclamation No. 2072, 48 Stat. 1730 (Jan. 31, 1934).

209. *Ignore Indenture “Payable in Gold”: Agents for Bonds with Coupons Due Fail to Give Coin When Demand Is Made; Court Action Possible*, N.Y. TIMES, May 2, 1933, at 2; Randall S. Kroszner, *Is It Better to Forgive Than to Receive? An Empirical Analysis of the Impact of Debt Repudiation 2* (Nov. 2003) (unpublished manuscript, on file with the University of Chicago Graduate School of Business).

governments, railroads, utilities, and corporations.²¹⁰ 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.²¹¹ The total amount of gold clause debt outstanding also far exceeded the size of the U.S. economy.²¹² Enforcement of the term (as either gold or gold value) in conjunction with dollar devaluation would have increased a significant portion of the country's public and private debt by nearly 70 percent and caused "mass bankruptcy."²¹³

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.²¹⁴ In the United States, they gained popularity in the wake of the monetary chaos of the Civil War.²¹⁵ 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.²¹⁶ But like many indexation devices, these clauses created economic rigidity: they purported to lock the debtor into a commitment to pay a prespecified value

210. See *Gold Obligations Are \$100,000,000,000; Federal Bonds Total \$22,000,000,000*, N.Y. TIMES, May 27, 1933, at 2.

211. Cummings Argument, *supra* note 199, at 255–56, 265. 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 was a subject of dispute in subsequent litigation. See, e.g., *id.*; Henry M. Hart, Jr., *The Gold Clause in United States Bonds*, 48 HARV. L. REV. 1057, 1071 (1935).

212. See U.S. Dep't of Commerce, Bureau of Econ. Analysis, National Income and Products Accounts, Table 1.1.5: Gross Domestic Product, available at <http://bea.gov/national/nipaweb/SelectTable.asp> (select Table 1.1.5) (listing U.S. GDP as \$56.4 billion in 1933 and \$66.0 billion in 1934).

213. Kroszner, *supra* note 209, at 2. See also Cummings Argument, *supra* note 199, at 256 (warning of a return to chaos).

214. For example, news reports in 1933 cite a British case construing similar clauses against the creditor. See, e.g., Turner Catledge, *Gold-Bond Clause Awaits Court Test*, N.Y. TIMES, May 7, 1933, at XX2 (reporting a case in which a British court substituted currency as an example of Britain's experience with gold clause debt). Creditors' briefs in the subsequent U.S. *Gold Clause Cases* refer to indexed Serbian and Brazilian debt. See, e.g., Oral Argument of Reconstruction Finance Corp. at 277, *Norman v. Balt. & Ohio R.R.*, 294 U.S. 240 (1935). The Court itself highlights German reparation obligations. See *Norman*, 294 U.S. at 299 n.3. See also Arthur Nussbaum, *Comparative and International Aspects of American Gold Clause Abrogation*, 44 YALE L.J. 53, 60–61 (1934) (noting the numerous other countries that abrogated gold clauses). See generally KEITH S. ROSENN, LAW AND INFLATION 130–54, 267–88 (1982) (discussing more recent domestic and international experiences with contract indexation); Artur Nussbaum, *Multiple Currency and Index Clauses*, 84 U. PA. L. REV. 569, 579–582 (1936) (comparing the U.S. experience with indexation to that of European countries).

215. See Dam, *supra* note 200, at 507; Daniel W. Levy, *A Legal History of Irrational Exuberance*, 48 CASE W. RES. L. REV. 799, 856 (1998).

216. However, the prevailing view of the law of negotiable instruments at the time would have made renegotiation difficult or impossible. See *supra* note 135.

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 House committee report, later quoted by the Supreme Court:

These 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 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.²¹⁷

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.²¹⁸ In response, creditors sued.

Four cases challenging the constitutionality of the joint resolution reached the Supreme Court in January 1935. Two of the cases involved private railroad obligations; the other two involved 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*.²¹⁹ They were the subject of numerous law review articles leading up to the argument,²²⁰ and were foremost among the president’s preoccupations. Roosevelt described the cases in terms of essential sovereign prerogatives.²²¹ He briefly considered ways of pressuring the Court to uphold the joint resolution and prepared a scathing radio address to deliver in the event of an adverse ruling.²²²

217. *Text of the Two Reports on the Gold Resolution*, N.Y. TIMES, May 30, 1933, at 2.

218. Joint Resolution to Assure Uniform Value to the Coins and Currencies of the United States, H.R.J. Res. 192, 73d Cong. (1933) (known as the “Gold Clause resolution”).

219. See, e.g., *Second Gold Fight in Supreme Court: RFC Appeals Case to Test Validity of President’s Decree Voiding Clause in Contracts; Bond Payment at Stake*, N.Y. TIMES, Nov. 6, 1934, at 2.

220. See John P. Dawson, *The Gold Clause Decisions*, 33 MICH. L. REV. 647, 676 n.57 (1935) (citing ten articles published in the run-up to the Supreme Court argument, all predicting that the joint resolution would be sustained).

221. ARTHUR M. SCHLESINGER, JR., *THE POLITICS OF UPHEAVAL, 1935–1936*, at 256 (First Mariner Books 2003) (1960). Administration advocates referred to the litigants as people who wanted “\$1.69 for their dollar.” *Id.* Characteristically, the creditors painted a different picture: a \$1000 bank deposit paid back at an arbitrary discount. Norman C. Norman, Letters to the Editor, *Our Gold Certificates*, N.Y. TIMES, June 1, 1933.

222. SCHLESINGER, *supra* note 221, at 257–58; KATHLEEN M. SULLIVAN & GERALD GUNTHER, *CONSTITUTIONAL LAW* 24 (15th ed. 2004) (providing an excerpt from the drafted radio address).

Roosevelt's worries were misplaced. Chief Justice Hughes delivered the Court's opinion on February 18, 1935, ruling unequivocally in favor of the government on private contracts, and only nominally against it in the cases involving redenomination of federal government bonds.²²³ The private contract opinion was far reaching. Hughes rejected out of hand the creditors' arguments on retroactive regulation, takings, and due process grounds.²²⁴ He specifically refused to characterize the gold measure as a constitutional emergency, which might have fixed its duration.²²⁵

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 that interpreted broadly the power to coin and regulate the value of U.S. currency.²²⁶ The central argument in the opinion reinforced what was then, and continues to be, a widely held view²²⁷: that private contracts must not be read to interfere with legitimate public

Roosevelt's Fireside Chat of March 9, 1937, in which he proposed his "Court-packing" plan, began by recounting the narrow 5-4 majority by which the gold clause legislation was upheld, and argued that it was too dangerous for reforms to depend on a single vote. See FDR'S FIRESIDE CHATS 85 (Russell D. Buhite & David W. Levy eds., 1992).

223. See *Perry v. United States*, 294 U.S. 330, 358 (1935); *Norman v. Balt. & Ohio R.R.*, 294 U.S. 240 (1935). See also *Nortz v. United States*, 294 U.S. 317 (1935); *United States v. Bankers Trust Co.*, 294 U.S. 240 (1935). We focus on private contracts in this Article. The decisions on government debt said that 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. See *Perry*, 294 U.S. at 358; *Nortz*, 294 U.S. at 329-30. 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 generally Hart, *supra* note 211. For a more recent view, see Dam, *supra* note 200, at 518-25.

224. See generally *Norman*, 294 U.S. 240 (rejecting the plaintiffs' retroactivity, takings, and due process claims).

225. See *id.* at 308-09 (grounding the decision on Congress's power to regulate commerce without addressing the parties' arguments on the status of emergency measures).

226. See, e.g., *id.* at 303 ("The broad and comprehensive national authority over the subjects of revenue, finance and currency is 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 . . .").

227. See, e.g., Dawson, *supra* note 220, at 676 n.57 (citing the general expectation that the Court would uphold the resolution); John Dickinson, *The Gold Decisions*, 83 U. PA. L. REV. 715, 715 (1935) ("The decision in the private bond cases was distinctly conservative . . ."). See also Richard D. 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*, [*Norman*] was an easy case."); Seth P. Waxman, *The Physics of Persuasion: Arguing the New Deal*, 88 GEO. L.J. 2399, 2416 (2000) (arguing that the private contracts cases were the easiest *Gold Clause Cases* to argue). For an example of a modern-day view of the federal government's power to regulate private contracts, see *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 732-34 (1984).

policymaking.

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 operation 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.²²⁸

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,”²²⁹ spoke for the four dissenters.²³⁰ 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 indiscipline and despotism, and pronounced the Constitution “gone.”²³¹

But Wall Street seemed to see things differently. As soon as the Court’s decision was announced, both stocks and bonds rallied—perhaps recognizing the need to remove a debt overhang, or perhaps relieved to see the end of at least some of the uncertainty of the previous year.²³²

Over time, the *Gold Clause Cases* on private contracts came to reinforce the proposition that Congress had broad power to rewrite such contracts where they interfered with otherwise lawful federal policies.²³³ This power was particularly expansive with respect to the macroeconomy.

228. *Norman*, 294 U.S. at 309–10. 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 preëempt the federal field. To me this seems a monstrous doctrine. These claimants are upon federal territory. They are squatters in the public domain, and when the Government needs the territory they must move on.

Cummings Argument, *supra* note 199, at 257.

229. SCHLESINGER, *supra* note 221, at 260.

230. See *Norman*, 294 U.S. at 316 (McReynolds, J., dissenting).

231. LEUCHTENBURG, *supra* note 197, at 144; SCHLESINGER, *supra* note 221, at 260; *Justice McReynolds’ Remarks on Gold Case Decision*, WALL ST. J., Feb. 23, 1935, at 1.

232. See Kroszner, *supra* note 209, at 10–25 (tracing the progression of the *Gold Clause Cases* and evaluating the impact of the gold clause abrogation).

233. See, e.g., *Seese v. Bethlehem Steel Co. Shipbuilding Div.*, 168 F.2d 58, 62 (4th Cir. 1948) (citing *Norman* to refute a claim that the government’s interference with a private contract constituted a taking).

It was used to render perfectly sensible contract terms unenforceable where their ubiquity alone was perceived to harm the public.²³⁴ 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).²³⁵

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 and widespread term (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 “bigness” with a dose of consumer protection.²³⁶ 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.²³⁷ PUHCA required utility holding companies to register with the SEC and, in the so-called death sentence provision, gave the SEC authority to break up registered companies whose structures it deemed uneconomic or unnecessarily complex.²³⁸ 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.

234. See *Norman*, 294 U.S. at 313–14; *Second Gold Fight*, *supra* note 219.

235. See, e.g., *Norman*, 294 U.S. at 310.

236. LEUCHTENBURG, *supra* note 197, at 156–57 (quoting Louis Brandeis); SCHLESINGER, *supra* note 221, at 307 (quoting Sen. Burton K. Wheeler’s remarks introducing the Wheeler-Rayburn bill that became PUHCA). See also JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 247 (1995) (referring to PUHCA’s enforcement as “the most effective antitrust enforcement program in United States history”).

237. See SCHLESINGER, *supra* note 221, at 302–05; SELIGMAN, *supra* note 236, at 127–31.

238. See Public Utility Holding Company Act (PUHCA) of 1935, Pub. L. No. 74-333, § 11(b), 49 Stat. 803, 820–21 (repealed 2005); SCHLESINGER, *supra* note 221, at 306. 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 complicate[d]” and served no useful purpose. PUHCA § 11(b), 49 Stat. at 820–21; SCHLESINGER, *supra* note 221, at 306, 308.

By 1932, thirteen corporate groups controlled three-quarters of private electricity generation in the United States; the three largest held over 40 percent.²³⁹ 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 nonvoting stock, which gave a small group of industrialists and 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.²⁴⁰ Classified boards, interlocking directorates, and voting trusts completed the governance picture. Congressional committee and independent commission reports also revealed massive accounting irregularities and scandalous intragroup loan and transfer pricing schemes.²⁴¹

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.²⁴² 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”; and the term “private socialism” appeared often in the debates of the day to condemn the antidemocratic power concentration in the utilities’ hands.²⁴³ 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.

239. SCHLESINGER, *supra* note 221, at 303–04; SELIGMAN, *supra* note 236, at 127. Schlesinger writes of control; Seligman describes sixteen holding companies with “ownership interests” in over 90 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 the National Power Policy Committee all investigated the holding company problem in great detail. Their reports, published in 1935, formed the basis for the legislation. SELIGMAN, *supra* note 236, at 128–30.

240. SELIGMAN, *supra* note 236, at 127–28 (citing FED. TRADE COMM’N, UTILITY CORPORATIONS, Part 72-A, at 136–54 (1935)). At the extreme, an investment of \$23,000 could buy control of a \$1.2 billion empire. *Id.* at 128.

241. SCHLESINGER, *supra* note 221, at 303–04; SELIGMAN, *supra* note 236, at 128–29.

242. See SCHLESINGER, *supra* note 221, 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.

243. See *id.* at 303–05, 307, 310, 312.

Excessive leverage was blamed for a disproportionately high bankruptcy rate among utilities following the stock market crash of 1929.²⁴⁴ The utilities had argued that debt financing was 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.²⁴⁵ 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 slowed²⁴⁶ 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.”²⁴⁷ Several years after PUHCA’s enactment, in a speech geared to promote its enforcement, William O. Douglas (then chairman of the SEC) called “[d]iversity of risk . . . merely a slogan for the security salesman.”²⁴⁸

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.”²⁴⁹ Wendell Willkie, then president of the Commonwealth & Southern utility group, sought to distinguish financial engineering—the “technical development” of the holding company device²⁵⁰—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.”²⁵¹ He failed.

244. SELIGMAN, *supra* note 236, at 127–28. 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 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 were greatly magnified by comparatively small changes in the earnings of the operating companies. The common stock 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, 101–02 (1946) (footnote omitted).

245. See SCHLESINGER, *supra* note 221, at 308; SELIGMAN, *supra* note 236, at 179–82.

246. LEUCHTENBURG, *supra* note 197, at 158.

247. SCHLESINGER, *supra* note 221, at 304.

248. William O. Douglas, Address to the American Bar Association (July 26, 1938), *excerpted in* SELIGMAN, *supra* note 236, at 181.

249. SCHLESINGER, *supra* note 221, at 309.

250. *Id.* at 320.

251. *Id.* at 308. Schlesinger characterized Willkie’s effort as an attempt to present the holding company as “an affable, inarticulate giant.” *Id.* at 320.

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.²⁵² Simplification was a central and plainly stated object of Title I of PUHCA, which dealt with the holding companies.²⁵³ The Act sought to eliminate “undue and unnecessary” structural complexity because it was bad as such, because it begot 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.”²⁵⁴

Once Roosevelt and his circle decided to get rid of the holding companies, they chose between two models. Treasury Department officials proposed taxing the companies out of existence, imposing an intercompany dividend levy.²⁵⁵ The National Power Policy Committee proposed administrative dismantling.²⁵⁶ PUHCA embodied the second model. Although it gave the SEC 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.²⁵⁷

It is useful to compare PUHCA with the later approach of the Investment Company Act of 1940,²⁵⁸ which similarly targeted financial complexity and abuse. The Investment Company Act was a deliberately moderate measure, designed to pass a hostile Congress.²⁵⁹ 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

252. *Id.* at 304.

253. Public Utility Holding Company Act (PUHCA) of 1935, Pub. L. No. 74-333, § 1(c), 49 Stat. 803, 804 (repealed 2005).

254. *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 100 (1946).

255. *Cf. Michael S. Barr & James A. Feldman, Ctr. for Am. Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages* (Apr. 2008), available at http://www.americanprogress.org/issues/2008/04/pdf/reimc_brief.pdf (proposing the use of tax penalties to incentivize mortgage modifications).

256. SCHLESINGER, *supra* note 221, at 305.

257. *See* PUHCA § 11(b)(2), 49 Stat. at 821.

258. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (2006).

259. *See* SELIGMAN, *supra* note 236, at 222, 226–27.

stood in the way of federal policy.

PUHCA's tumultuous birth foreshadowed its equally dramatic enforcement path, which spanned two decades.²⁶⁰ Opponents of the law prophesied financial chaos and economic meltdown, mass liquidation, national paralysis, and the financial ruin of widows and orphans.²⁶¹ The utilities first resisted registration, repeatedly, and often successfully, challenging PUHCA's constitutionality in the lower courts, where Republican appointees still held sway.²⁶² It took intricate maneuvering for the SEC to get the Supreme Court to uphold the constitutionality of the registration provisions only.²⁶³ The risk of testing the Section 11(b) 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.²⁶⁴

In the meantime, successive SEC chairmen implemented PUHCA flexibly to avoid a court challenge.²⁶⁵ Official outreach and cajoling failed miserably at first. Before enforcement began in earnest around 1940 (as the courts were becoming safe territory for the SEC), the utilities generally failed to take advantage of Section 11(e) of PUHCA, which allowed them to design reorganization plans of their own.²⁶⁶ But by the early 1940s, the credible threat of judicial enforcement combined with the SEC'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. This 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.²⁶⁷

260. *See id.* at 127–38, 181–83, 218–22, 241–64.

261. *See* SCHLESINGER, *supra* note 221, at 308, 310.

262. *See* SELIGMAN, *supra* note 236, at 131–38, 250.

263. *See* Elec. Bond & Share Co. v. SEC, 303 U.S. 419 (1938).

264. *See* SELIGMAN, *supra* note 236, at 250.

265. *See id.* at 179–80.

266. Public Utility Holding Company Act (PUHCA) of 1935, Pub. L. No. 74-333, § 11(e), 49 Stat. 803, 822 (repealed 2005) (providing that a holding company or a subsidiary of a holding company could “submit a plan . . . for the divestment of control, securities, or other assets, or for other action . . . for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions” required under the death sentence section).

267. *See* SELIGMAN, *supra* note 236, at 252–55, 257. *Otis & Co. v. SEC*, 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 that the term “liquidation” both in the contract and in bankruptcy law did not apply to Section 11 proceedings. It also held—like the *Norman* Court before it—that contracts “cannot be permitted to operate” in the aftermath of contrary federal legislation. *See id.* at 638.

It bears emphasis, however, that the catalytic effect of SEC actions was 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 Co. affirmed the constitutionality of the death sentence in 1946. In *North American Co. v. SEC*, 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 a reasonable regulation, reasonably implemented; and that an SEC divestment order was not a taking under the Fifth Amendment.²⁶⁸ *American Power & Light Co. v. SEC* was decided several months later. It rejected a vagueness challenge to Section 11 standards; in particular, it held that the standards prohibiting “unduly or unnecessarily complicate[d]” structures were not vague. The Court also reemphasized that Congress was “completely uninhibited” by the Commerce Clause in choosing its regulatory means to override previously lawful contracts.²⁶⁹ Echoing *North American*, it observed that “the federal . . . power is as broad as the economic needs of the nation.”²⁷⁰ 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 a 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.”²⁷¹ 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 to financial stability from asset securitization. PUHCA’s approach to overcoming these threats also holds lessons for overcoming structural rigidity in modern contracts even as it reveals the extent of the challenge. Where the obstacles to contract modification lie in complex legal structures, reorganizing may take years and considerable technical and

268. *N. Am. Co. v. SEC*, 327 U.S. 686 (1946).

269. *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 100 (1946).

270. *Id.* at 104.

271. Robert M. Blair-Smith & Leonard Helfenstein, *A Death Sentence or a New Lease on Life? A Survey of Corporate Adjustments Under the Public Utility Holding Company Act*, 94 U. PA. L. REV. 148, 201 (1945) (internal quotation marks omitted).

political savvy. It is much harder than cutting isolated terms out of boilerplate contracts. Sustained administrative mandates with ample discretion here replaced 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 the New Deal experience in fighting the farm mortgage crisis. That experience illustrates the intractable challenge of functional rigidity in the form of creditor coordination problems. New Deal policymakers attempted to deal with the crisis through bankruptcy law and encouraging voluntary workouts, but they failed because they never managed to address the power of secured creditors.

Between 1929 and 1933, one-third of American farmers lost their farms in foreclosure; 200,000 Americans lost farms in 1933 alone.²⁷² The farm foreclosure crisis of the Great Depression triggered massive federal intervention in agriculture, agriculture finance, and rural development.²⁷³ Among the key pieces of New Deal farm legislation was the Emergency Farm Mortgage Act of 1933,²⁷⁴ which authorized the Federal Land Banks (“FLBs”)²⁷⁵ to refinance farm mortgage loans on generous terms,²⁷⁶ and

272. See Lee J. Alston, *Farm Foreclosures in the United States During the Interwar Period*, 43 J. ECON. HIST. 885, 886–88 & tbl.1 (1983). See also MICHAEL L. COOPER, *DUST TO EAT: DROUGHT AND DEPRESSION IN THE 1930S*, at 28 (2004); DAVID E. HAMILTON, *FROM NEW DAY TO NEW DEAL: AMERICAN FARM POLICY FROM HOOVER TO ROOSEVELT, 1928–1933*, at 148–69 (1991) (describing the farm credit crisis); VAN L. PERKINS, *CRISIS IN AGRICULTURE: THE AGRICULTURAL ADJUSTMENT ADMINISTRATION AND THE NEW DEAL, 1933*, at 10–35 (1969) (same); THEODORE SALOUTOS & JOHN D. HICKS, *AGRICULTURAL DISCONTENT IN THE MIDDLE WEST: 1900–1939* (1951).

273. See, e.g., Civilian Conservation Corps Act, Pub. L. No. 75-163, 50 Stat. 319 (1937) (creating the Civilian Conservation Corps); Rural Electrification Act of 1936, Pub. L. No. 74-604, 49 Stat. 1363 (creating the Rural Electrification Administration); Soil Conservation and Domestic Allotment Act, Pub. L. No. 74-46, 49 Stat. 163 (1935); Federal Farm Mortgage Corporation Act of 1934, Pub. L. No. 73-88, 48 Stat. 344; Authority Act of 1933, Pub. L. No. 73-17, 48 Stat. 58, *upheld by* *Ashwander v. TVA*, 297 U.S. 288, 339–40 (1936); Emergency Farm Mortgage Act of 1933, Pub. L. No. 73-10, 48 Stat. 41 (repealed 1947); Agricultural Adjustment Act of 1933, Pub. L. No. 73-10, 48 Stat. 31.

274. Emergency Farm Mortgage Act, 48 Stat. 41.

275. The Federal Farm Loan Act of 1916, Pub. L. No. 64-158, 39 Stat. 360 (repealed 1971), established twelve 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. *Id.* § 3, 39 Stat. at 360–62. One of these members 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. See *id.* § 7, 39 Stat. at 365–67. The NFLAs’ membership and stock ownership were restricted to farm mortgage borrowers. *Id.*

temporarily guaranteed the interest on the FLBs' bonds to ensure refinancing liquidity.²⁷⁷ 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 percent of the value of the land plus 20 percent of the buildings thereon.²⁷⁸ 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.²⁷⁹ Farmers were limited, however, to a maximum 75 percent loan-to-value refinancing on farm land, and FLBs' 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

§ 8, 39 Stat. at 367–68. An 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 an FLB mortgage. *Id.* § 7, 39 Stat. at 365–67.

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 an FLB loan via the NFLA, a farmer had to purchase stock equal to 5 percent of the loan in one of the NFLAs. *Id.* § 8, 39 Stat. at 367–68. The stock served as collateral for the loan, in addition to the mortgaged property. *Id.* § 11, 39 Stat. at 369–70. 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 percent of the loan. *Id.* § 7, 39 Stat. at 365–67. 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. *Id.* §§ 7–8, 39 Stat. at 365–68.

The FLBs funded their loans to the NFLAs by issuing tax-exempt, mortgage-backed bonds through the Federal Farm Loan Board. *See id.* § 26, 39 Stat. at 380 (exemption from taxation). An FLB that wished to raise capital outside of a stock sale would provide mortgages as security to the Federal Farm Loan Board, which would issue bonds against the mortgages. *Id.* § 18, 39 Stat. at 375–76. 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. *Id.* § 21, 39 Stat. at 377–78. There was no federal guaranty 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. *Id.* § 16, 39 Stat. at 374–75. 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.*

276. ARCHIBALD M. WOODRUFF, JR., *FARM MORTGAGE LOANS OF LIFE INSURANCE COMPANIES* 138–39 (1937). The refinanced loans were to be at reduced interest rates and with amortization payments deferred for five years. *Id.* at 139.

277. *Id.* at 139. The FLBs were permitted to issue bonds with interest backed by the U.S. government until the sooner of the yield on their bonds being no more than 4 percent or two years after issuance. *Id.*

278. *Id.*

279. *Id.* These loans were at 5 percent interest, with amortization commencing three years after issuance. Emergency Farm Mortgage Act § 32, 48 Stat. at 48. The amortization period was between ten and twenty years. *See id.* The loans were originally for a maximum of \$5000. *Id.* The lending limit was raised in 1934 to \$7500. Federal Farm Mortgage Corporation Act of 1934, Pub. L. No. 73-88, sec. 10, § 32, 48 Stat. 344, 347. The Farm Loan Commissioner's loans were financed by a loan from the Reconstruction Finance Corporation. Emergency Farm Mortgage Act § 32, 48 Stat. at 48.

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.²⁸⁰

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 and extensions: 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.²⁸¹

Federal bankruptcy law provided a possible mechanism to overcome coordination problems: imposing composition terms on nonconsenting creditors. Thus, in 1933, Congress enacted Section 75 of the Bankruptcy Act, entitled "Agricultural Compositions and Extensions."²⁸² Under this

280. WOODRUFF, *supra* note 276, at 145. This book was published as the winner of Williams College's David A. Wells, Class of 1847 Prize for best economics essay, subject to the curious restriction that

[n]o 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.

Walter Buckingham Smith, *Foreword to* WOODRUFF, *supra* note 276, at iii. This Article would not qualify.

281. WOODRUFF, *supra* note 276, at 145–46.

282. Act of 1933, Pub. L. No. 72-420, § 75, 36 Stat. 1467, 1470–73 (codified at 11 U.S.C. § 75 (1933)). The law had a sunset provision of 1938. *Id.* § 75(c), 36 Stat. at 1473.

provision, “conciliation commissioners” were created in rural areas as adjuncts of federal courts. Financially distressed farmers could file petitions for debt adjustment.²⁸³ The adjustment could be a composition, which entailed fractional payment of the unsecured debts, or an extension, which entailed the postponement of the debt’s maturity date.

To achieve an agricultural composition or extension, a majority vote of creditors, in both dollar amount and number, was required,²⁸⁴ 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.²⁸⁵ The composition or extension was to be confirmed if the court found that the composition or extension was an “equitable and feasible method of liquidation for secured creditors and of financial rehabilitation for the farmer.” The court also had to find that it was in the “best interests of all creditors,” proposed and accepted in good faith, and not usurious.²⁸⁶

The compositions failed to deal with farmers’ financial distress. From June 1934 to June 1937, there were only about 1700 compositions approved out of nearly 13,700 petitions filed.²⁸⁷ 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 (dollar amount and number) gave mortgage creditors an effective veto over any composition, as they likely held the majority of debt by dollar amount. The veto held by secured creditors meant that restructuring efforts were 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 1934.²⁸⁸ The Act sought to create a

283. *See id.* § 75(c), 36 Stat. at 1473.

284. *Id.* § 75(g), 36 Stat. at 1472.

285. *Id.* § 75(j), 36 Stat. at 1472.

286. *Id.* § 75(i), 36 Stat. at 1472.

287. 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).

288. Frazier-Lemke Farm Bankruptcy Act of 1934, Pub. L. No. 73-486, 48 Stat. 1289, *invalidated* by *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935) (current version at 11 U.S.C.

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.²⁸⁹ The Act then gave the farmer two options.

First, if the affected secured creditors consented, the farmer could purchase property back from the estate at its newly appraised value by making deferred payments over six years at 1 percent interest with a balloon payment for 85 percent of the value at the end of the contract.²⁹⁰ The appraisal was to be at “fair and reasonable value, not necessarily the market value.”²⁹¹ The farmer gained title and possession to the property immediately,²⁹² and the completion of the payments discharged all claims, including mortgage debt.²⁹³ Thus, the farmer could repurchase his estate for its depressed market value, even if it was less than the value of the debt.²⁹⁴

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 if it paid a reasonable annual rental fee.²⁹⁵ At the end of the five years, the debtor could redeem the property by paying the newly appraised price of the property.²⁹⁶

Thus, the choice for a secured creditor was between five years of rental payments based on a reduced property valuation, after which the debtor had the option to purchase, or six years of backloaded purchase price payments, also based on the newly reduced valuation. There was little functional difference between these choices. Both were essentially a right for the debtor to rent for five years at reduced rates. If the debtor could afford market rental rates, the debtor could retain the property at his or her

§ 203(a) (1940)).

289. *Id.*

290. *Id.* § 3, 48 Stat. at 1290.

291. *Id.* § 1, 48 Stat. at 1289.

292. *Id.* § 2, 48 Stat. at 1289–90.

293. *Id.* § 6, 48 Stat. at 1290.

294. This is essentially what is allowed in a redemption under § 722 of the Bankruptcy Code. 11 U.S.C. § 722 (2006). In redemption, the debtor need only pay the allowed secured claim, which cannot be greater than the fair market value of the property. *See id.* §§ 506(a)(1), 722. Redemption, however, does not allow for deferred payments, which makes it of little value to most debtors, as they are not flush 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.

295. Frazier-Lemke Act of 1934 § 7, 48 Stat. at 1291.

296. *Id.*

will.²⁹⁷

Less than a year after the enactment of the Frazier-Lemke Act, the Supreme Court struck down the law as an unconstitutional taking.²⁹⁸ A scaled-down version of the Act, the Frazier-Lemke Act of 1935, was passed three months later.²⁹⁹ The revised version, upheld by the Supreme Court,³⁰⁰ functioned mainly as an extension of the equity of redemption allowed by many states' foreclosure laws.³⁰¹

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 the Act required the debtor to make rental payments.³⁰² At the end of the three years, the debtor could redeem the property for its appraised "reasonable market value."³⁰³ A secured creditor could, however, insist on a public auction of its collateral, at which it could credit bid,³⁰⁴ subject to the debtor having ninety days to redeem the property at the auction sale price plus 5 percent annual interest.³⁰⁵ If a mortgagee credit bid at the sale, 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 states³⁰⁶ and the successive iterations of the Frazier-Lemke Act, spurred voluntary compositions in which creditors took write-downs to the 75 percent "cumulative-loan-to-

297. *Cf.* U.S. Sav. Ass'n of Tex. v. Timbers of Inwood Forest, 484 U.S. 365 (1988) (finding that an undersecured creditor was not entitled to postpetition interest—economically equivalent to market rents—on foreclosure value of property).

298. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).

299. Frazier-Lemke Act of 1935, Pub. L. No. 74-384, 49 Stat. 942.

300. Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, 300 U.S. 440 (1937).

301. *E.g.*, Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 447-48 (1934); Roe, *supra* note 132.

302. Frazier-Lemke Act of 1935 §§ 5-6, 49 Stat. at 943-45.

303. *Id.* §§ 4, 6, 49 Stat. at 942-45.

304. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 594-95 (1935).

305. Frazier-Lemke Act of 1935 § 6, 49 Stat. at 943-45.

306. HART, *supra* note 287, at 140-41 (noting that twenty-two states passed moratorium laws preventing foreclosure sales).

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 [federally guaranteed] 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.³⁰⁷

Yet despite the appearance of progress, there was no significant decline in the average rate of farm foreclosures until after 1940.³⁰⁸ Given that state foreclosure moratoria already 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, and there were 2,350,000 mortgaged farms in 1935,³⁰⁹ a year when 30 percent of the FLBs’ farm mortgages were in default or foreclosure.³¹⁰ Both versions of the Frazier-Lemke Act essentially provided the farmer-debtor with more time to recover financially, but neither version reduced debt burdens. The redemption provisions in the Act were of little use to farmers who lacked cash, and the delay provided did little to add to that from states’ foreclosure moratoria.³¹¹ Bankruptcy, in the limited form available in the 1930s, 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 both the simplicity of the Gold Clause resolution and PUHCA’s combination of draconian law and administrative discretion. 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, the farm foreclosure 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

307. *Id.* at 154.

308. HAMILTON, *supra* note 272; PERKINS, *supra* note 272; SALOUTOS & HICKS, *supra* note 272.

309. HART, *supra* note 287, at 143.

310. *Id.* at 139 fig.12.

311. *See generally* Home Bldg. & Loan Ass’n v. Blaisdell, 290 U.S. 398 (1934).

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 Union.³¹² 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.³¹³ 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.³¹⁴ Prior to 1986, the Bankruptcy Code was not well suited to small farmers who wished to keep their farms. Chapter 7 requires surrendering the farm, and many farmers are ineligible for Chapter 13 repayment plans because of their large secured farm debts.³¹⁵ Furthermore, Chapter 11 reorganization was too complicated and expensive, and it 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

312. Farm Credit Administration, History of FCA and the FCS, http://www.fca.gov/about/history/historyFCA_FCS.html (last visited Sept. 1, 2009).

313. See NEIL E. HARL, *THE FARM DEBT CRISIS OF THE 1980S*, at 275 (1990).

314. See 11 U.S.C. § 1222(b)(2) (2006).

315. See 11 U.S.C. § 109(e) (creating secured and unsecured debt limits as part of Chapter 13 eligibility).

provision but was made permanent in 2004.³¹⁶ 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.

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 to target any particular contract term or legal structure—was an imperfect fix, but it offers the most promising one to date for a foreclosure epidemic rooted in financial complexity and contract rigidity.

VII. CONCLUSION: BREAKING THE SPELL

We began this Article with a survey of contractual rigidities embedded in the design of RMBS PSAs. 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 have cited them as reasons for not restructuring. Formal, structural, and functional rigidities together can produce a near-immutable contract³¹⁷—a rare creature ostensibly barred by contract and bankruptcy doctrine, one that combines the features of mundane commercial promises and complex financial products in an effort to make itself impervious to individual 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 was mooted in Congress in early 2009.³¹⁸

316. Originally, Chapter 12 had a sunset of September 30, 1993. It was later extended to a sunset of September 30, 1998, and then made permanent.

317. See Davis, *supra* note 128.

318. See TARP Reform and Accountability Act of 2009, H.R. 384, 111th Cong. § 205 (“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,

The Gold Clause episode also highlights the fact that rigidity as such is not a problem in our analysis; rather, it is *pervasive* rigidity that can harm communities, drive down asset prices, and depress growth. Thus, instead of banning or rewriting antimodification provisions, the state might prefer to sell a limited number of “rigidity licenses”³¹⁹ to give parties that value them the benefits revealed in the theoretical literature,³²⁰ while preventing the harmful spillover effects from pervasive rigidity.³²¹ Licensing comes closest to offering ex ante predictability, which may be particularly useful in designing financial arrangements to succeed old-style securitization. But banning, rewriting, and licensing share a limitation: all three are hard to take beyond formal rigidity. Where the obstacle to modification is not a readily identifiable, ubiquitous term, but a varied, potentially numerous, and occasionally amorphous set of structures and practices, a surgical strike may be impractical: too hard to specify ex ante and too broad or too narrow ex post. A varied and amorphous practice is effectively unquantifiable, hence difficult to control through licensing.

Contractual and statutory triggers are another way of addressing the effects of ubiquitous rigidity in advance. Contracting parties that seek rigidity to obtain information and to discipline counterparties get neither of these benefits when the entire economy is in a free fall: good agents and debtors look just like the bad ones, and no amount of discipline can bring back vanished markets and cashflows. Therefore, parties should have no trouble agreeing that their antimodification devices do not apply beyond a specified set of market or macroeconomic parameters. A purely contractual mechanism of this sort would evoke elements of indexation discussed earlier, and of a traditional *force majeure* clause. The state can also prescribe or imply such triggers in all or some categories of contracts, which would be a form of countercyclical regulation of contracts.³²² In

or the range of permissible modifications . . .”). Cf. Mayer et al., *supra* note 194, at 417 (proposing legislative mortgage contract modification).

319. We are grateful to Ian Ayres for this insight.

320. See, e.g., Jolls, *supra* note 128, at 203–06, 236–37.

321. Note that the reasons for banning antimodification provisions are not limited to our arguments about spillover effects. See, e.g., *Beatty v. Guggenheim Exploration Co.*, 122 N.E. 378, 381 (N.Y. 1919) (invalidating an antimodification clause essentially on freedom of contract grounds—which can cut both ways).

322. Cf. Marcus Miller & Joseph Stiglitz, *Bankruptcy Protection Against Macroeconomic Shocks: The Case for a “Super Chapter 11”* (Dec. 1999) (unpublished manuscript), available at <http://www2.warwick.ac.uk/fac/soc/csgr/research/keytopic/global/milrstig.pdf> (recommending across-the-board “Super Chapter 11” debt relief triggered by exchange rate devaluation); Posner & Zingales, *supra* note 2 (recommending ex post mortgage modification in line with property value reductions by zip code). See generally RICHARD E. SPEIDEL, *CONTRACTS IN CRISES* (2007) (discussing the application of the contractual doctrine of excuse in response to government interference with contracts in crisis).

either case, the nub of the problem becomes identifying a trigger that is sufficiently precise and that properly balances public and private concerns. A trigger that is too generous would eviscerate the antimodification device even in good times and make it worthless for the parties; a trigger that is too stingy would not solve the rigidity problem and its spillover effects.

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 SEC—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 formidable 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 resolution model, or administrative mandates of the PUHCA sort, would solve today's mortgage securitization dilemma outright—although both might help to some extent. 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.³²³ However, while bankruptcy is comprehensive in its coverage of obligations and creditors of any given debtor, as far as the debtors are concerned, it is still a case-by-case device. This creates a problem where failure is ubiquitous because of an economic downturn: the judicial and administrative systems may not have the capacity to process all the bankruptcy cases in time to mitigate the

323. On April 30, 2009, the Senate voted 45-51 against an amendment to S. 896 (111th Cong.), the Helping Families Save Their Homes Act of 2009, which would have allowed principal residence mortgage modification in Chapter 13 bankruptcy. The House version of the bill, H.R. 1106, had a bankruptcy modification provision, but due to the amendment's defeat in the Senate, the final law did not provide for bankruptcy modification. See Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1632. The final version was passed on May 20, 2009.

spillover effects of rigidity. Here too, contractual and statutory modification triggers described earlier may serve as safety valves before or outside bankruptcy.

Apart from any particular solution, 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 designed 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. Moreover, the very threat of government intervention to rewrite contracts that the parties claim are too rigid to modify may act as an incentive to find private routes to modification. Contracts that claimed to be immutable in 2008 might acquire surprisingly flexible interpretations a year later, in the legislative shadow.

Even so, overcoming rigidity in the manner of the New Deal initiatives we describe is costly: it may undermine confidence in contract enforcement, and if used frequently or incautiously, it 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, consumer protection, and many other forms of economic regulation. When a contract becomes a suicide pact, the Supreme Court has said repeatedly that Congress may rewrite it.

It is important to leave the decision to rewrite contracts in the hands of the legislature; the executive may find it too easy and tempting to use. We can only hope that abrogation is a tool that will be used sparingly and responsibly after considered debate. If the legislature abuses it, everyone will pay the price.³²⁴ But if it intervenes in a targeted way in response to real cataclysms, we expect that faith in the law will survive. It might, in fact, 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 government's ability to regulate—and sometimes to rewrite—contracts that threaten society.

324. See Horacio Spector, *Constitutional Transplants and the Mutation Effect*, 83 CHI.-KENT L. REV. 129, 144–45 (2008) (arguing that Argentina's experience rewriting contracts every ten years is unlike the United States' experience rewriting them every hundred).