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Written Testimony of

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Subcommittee on Capital Markets and Government Sponsored Enterprises

"Investor Protection: The Need to Protect Investors from the Government"

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Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation. Professor Levitin has previously served as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP) and as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

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Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony, and he is not testifying on behalf of any organization.

Mr. Chairman Garrett, Ranking Member Waters, Members of the Subcommittee:

The topic of this afternoon's hearing is "the need to protect investors from the government." Specifically, today's hearing references three episodes in which it is alleged that the Obama Administration has treated investors unfairly: the treatment of secured bondholders in the Chrysler bankruptcy; the Argentine debt litigation; and the federal-state mortgage servicing settlement.

The three episodes on which this hearing is to focus must each be judged by their own merits, and I address each episode in turn, below. It is risible, however, to contend based on these three entirely unconnected and ultimately *sui generis* episodes that investors need "protection" from the government. To the contrary, recent events have shown that if anything investors have greater need of government protection. While some investors may be unhappy with the outcomes of each of these episodes, they can reasonably complain of unfair treatment only in regard to the federal-state mortgage servicing settlement, and even then it is not clear what the extent of the harms are. There are serious flaws with the mortgage-servicing settlement, but treatment of investors is far from foremost among them.

As an initial matter, however, it is important to clarify what is at issue here. The implication from this hearing is that the Obama Administration is somehow "anti-investor." Each of the three episodes cited as evidence for this proposition involves Administration actions that are unfavorable to particular groups of well-connected investors with the ability to successfully lobby for Congressional action. Yet that hardly makes the actions "anti-investor." Indeed, actions that are unfavorable to one set of investors are frequently favorable to another set, and in at least two of the episodes involved, the Administration's actions were favorable to many more investors than they were unfavorable. In short, these episodes could just as easily be spun as examples of the Obama Administration's solicitous concern for investors.

For example, senior lienholders in the Chrysler bankruptcy had a limited recovery, yet the success of the bankruptcy benefitted investors in other auto manufacturers by preventing a domino chain of failures throughout the auto industry. A court ruling adverse to the handful of holdout investors in the Argentine debt litigation would help the 92% of Argentine bondholders who accepted Argentina's exchange offer by ensuring that the majority of Argentine bondholders get paid according to the terms of their settlement. Actions that transfer liability from banks to mortgage investors harm mortgage investors, but help bank investors.

The problem, then, is not a bias against investors as a group, but rather a picking and choosing among investors. Of course, this sort of picking and choosing is what Congress and the Administration effectively do all the time when either passing laws, making regulations, or deciding how and when to enforce them. While one can debate whether the picking and choose has been done correctly, it is not a matter of disfavoring investors as a class.

THE CHRYSLER BANKRUPTCY

Chrysler filed for bankruptcy on April 30, 2009, after lengthy attempts to restructure its debt to avoid bankruptcy. Immediately after filing for bankruptcy, Chrysler received debtor in possession (DIP) financing from the United States and Canadian governments, which enabled it to continue operations while in bankruptcy. The bankrupt companies ("Old Chrysler") subsequently sold its "good" assets pursuant to section 363 of the Bankruptcy Code[1] to a newly formed company ("New Chrysler").

As part of the sale, New Chrysler paid Old Chrysler $2 billion and also assumed certain liabilities of Old GM and Old Chrysler, including the firms' collective bargaining agreements with the United Auto Workers (UAW) and Canadian Auto Workers (CAW) and liability for certain health care and retiree benefits. New Chrysler directly assumed liability for non-unionized employees' health care and retirement benefits. Chrysler's approximately $10.6 billion in liability for unionized employee healthcare and retiree benefits was assumed by a newly created Voluntary Employee Benefit Association (VEBA) in exchange for New Chrysler providing the funding for the VEBA. Thus, going forward, the healthcare liabilities of unionized Chrysler employees—a major liability that hindered the company's competitiveness before bankruptcy—are the responsibility of the VEBA, not New Chrysler.

The New Chrysler VEBA was funded with a $4.6 billion 14-year New Chrysler note and 55% of the equity in New Chrysler. A consortium of the Italian auto manufacturer Fiat, the United States and Canadian governments, owned the remaining 45% of New Chrysler's equity.

The proceeds of the sale of the "good" assets of Old Chrysler were dispersed according to the requirements of the Bankruptcy Code under a plan of liquidation along with the proceeds from the liquidation of the "bad" assets to the creditors of Old Chrysler. The first lien secured claims on Old Chrysler received a distribution of approximately 29%. The Old Chrysler plan of liquidation was approved by 96% of secured claims (76 of 79 claims) representing over 99% of the dollar amount of secured claims.[2] In both cases, the sale proceeds only managed to cover part of all secured lenders' claims (first and junior liens) against Old Chrysler; the sales were insufficient to generate returns for general unsecured creditors' claims.

The Chrysler bankruptcy was basically a textbook affair;[3] indeed, Chrysler is such a good illustration of the normal operation of a bankruptcy that it is the first case I present to students in my business bankruptcy course. The major anomaly in these cases is the involvement of the United States government as DIP financier.

While there are questions of whether the government's provision of DIP financing was in fact authorized under the Emergency Economic Stabilization Act (namely, whether Chrysler was a "financial company"),[4] it is clear that absent the government's provision of DIP financing, Chrysler would have had to shut down operations and liquidate. Chrysler's unsecured creditors, such as bondholders, would have had zero recovery in a liquidation, and its $7 billion in secured debt would have been able to realize only the liquidation value of their collateral, likely less than a $2 billion recovery.

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[1] 11 U.S.C. § 363.

[2] *In re* Old Carco LLC (f/k/a Chrysler LLC) *et al*, 09-50002 (AJG) (Bankr. S.D.N.Y. Mar. 9, 2010), Docket No. 6577, at 3 (Declaration of Jeffrey B. Ellman Certifying the Tabulation of Votes on, and the Results of Voting with Respect to, Second Amended Joint Plan of Liquidation of Debtors and Debtors in Possession).

[3] *See* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 101 (2009).

[4] *See* Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC), 576 F.3d 108, 121-123 (2d Cir. 2009) (finding the plaintiffs lacked standing to challenge the use of the TARP funds in the Chrysler bankruptcy because they lacked an injury in fact).

Liquidation would have brought no benefit to any investors on account of their Chrysler debt or stock. Moreover, assuming that the investors were diversified in their investments and generally long on the economy, it would likely have brought them significant losses in their other holdings. The failure of Chrysler would have triggered the failure of General Motors (and vice-versa) because of reliance on common suppliers, which would have also failed absent steady orders from both manufacturers. Moreover, the failure of either Chrysler or GM would have resulted in the failure of other auto manufacturers, domestic and foreign, again because of shared suppliers. For example, it is quite likely that a failure of Chrysler would have brought down Nissan. These failures would have cascaded up and down the American industrial base, affecting first, second, and third-tier suppliers (suppliers to suppliers to suppliers). The economic and social dislocation would have been widespread and almost unimaginable in extent. It goes without saying that the collapse of the United States industrial sector would have greatly harmed many investors.

As it stands, Chrysler and GM have emerged from bankruptcy as success stories. This is not to say that all jobs were saved—Chrysler and GM laid off thousands of employees before they filed for bankruptcy and shut down numerous dealerships, again affecting thousands of jobs. Nonetheless, Chrysler and GM have exited bankruptcy and are again operating profitably, for the first time in years.

So what, if anything, occurred in the Chrysler bankruptcy that might be anti-investor? The major argument is that the sale price for the "good" assets of Old Chrysler was too low, which had the effect of siphoning off value from the creditors of Old Chrysler (including the UAW and CAW) to the owners of New Chrysler (including the UAW and CAW VEBA). Because of the Bankruptcy Code's priority scheme, the effect, it is alleged, was to enable a greater recovery for the UAW and CAW than would have occurred had the assets been sold at their real value, and that this harmed investors in Old Chrysler.

This argument depends entirely on the assumption that the sale price was too low. There is no evidence to support that assumption, and was rejected by the Second Circuit Court of Appeals.[5] The Bankruptcy Court in both cases approved an arms-length transaction; other parties were welcome to bid, but none did.[6] Simply put, in 2009, with credit markets frozen, there was no other market demand for the good assets of the auto companies of this scale as going concerns. Chrysler had nearly $7 billion in secured debt, meaning that a bidder would have to pay over $7 billion to purchase the Chrysler assets free and clear of the liens other than under a 363 sale.

There is simply no evidence that there were *any* other parties prepared to bid on the Chrysler assets, much less bidders who would have bid over the $2 billion paid by the New Chrysler consortium. To believe that there were such bidders abounding, only to be frustrated by the bidding procedures requirement of assuming the collective bargaining agreements, is to defy credulity, not least because case law makes abundantly clear that Bankruptcy Courts must entertain the highest bid presented, regardless of whether it conforms to bidding procedures.[7] As

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[5] *See* Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC), 576 F.3d 108 (2d Cir. 2009).

[6] Bids were required to be "qualified bids," but despite criticism of the "qualified bid" definition from some commentators, *see e,g.,* David Skeel, *The Real Cost of the Auto Bailouts,* WALL ST. J., June 6, 2011, creditors did not appeal the sale procedures regarding what was a "qualified bid."

[7] *See, e.g.*, Corp. Assets, Inc. v. Paloian, 368 F.3d 761 (7th Cir. 2004); In re Wintex, 158 B.R. 540 (D. Mass. 1992); In re Financial News Network, Inc., 126 B.R. 152 (S.D.N.Y. 1991); In re Edwards, 228 B.R. 552 (Bankr. E.D.

New Chrysler was the only bidder, it was the market. Thus, the sale price was the market price and therefore fair. None of this is in any way controversial as a matter of bankruptcy law.[8] While one can reasonably argue that the section 363 sale process needs clearer statutory protections, the sale of assets from Old Chrysler to New Chrysler was par for the course in 363 sales as they are currently conducted.

At the end of the day, there is no question that the UAW fared better than many other unsecured creditors and even than first lien secured creditors. That better treatment, however, was provided by the United States government, not by the bankruptcy estate. But for the favorable treatment of the UAW, the United States government would not have served as purchaser for the Chrysler assets, which would have meant a liquidation of Chrysler and a recovery for secured creditors of likely less than the 29 cents on the dollar generated by the $2 billion going-concern purchase price. The United States arguably paid an inflated price for the Chrysler assets in order to fund the UAW VEBA, and doing so not only saved Chrysler, but also GM and a slew of other American industrial firms, thereby protecting *those firms*' investors. Given the social and economic consequences of the failure of either Chrysler or GM, the government would have been playing a grossly irresponsible, high-stakes game of "chicken" had it not assisted the firms.

Whether the United States government should have assisted the UAW is a question about which there is a separate debate, but it does not implicate the issue of whether the government treated investors fairly. Investors did not pay for the treatment of the UAW in the Chrysler bankruptcy, so to cast the episode as somehow anti-investor is unfair to the Obama Administration, which managed to make the best of a bad situation in the midst of a financial crisis created under the watch of the Bush Administration.[9]

THE ARGENTINE DEBT LITIGATION

A second example of the Obama Administration's abuse of investors cited in the notice of this hearing was the filing of an *amicus curiae* brief by the Treasury Department in litigation regarding Argentine sovereign debt. In December 2001, Argentina suspended payments on its approximately $80 billion of public foreign debt, the largest sovereign debt default in history. Argentina managed to restructure 92% of this debt through exchange offers in 2005 and 2010 in which creditors were offered new debt with more generous terms ("exchange bonds") in exchange for their old debt. After reopening the exchange offer in 2010, Argentina passed a law that prohibits payment to non-exchanging bondholders on terms better than those under the exchange bonds.[10]

The old Argentine debt documentation contained "*pari passu*" (hand-in-hand) clauses. Historically, these clauses have always been interpreted to mean that the debt cannot be legally

Pa. 1998).

[8] BFP v. Resolution Trust Corp., 511 U.S. 531 (1994).

[9] Indeed, a subsequent study has found that the Chrysler bankruptcy engendered a *positive* response from bondholders in unionized firms, who subsequently demanded a smaller premium for the bonds of unionized firms. *See* Deniz Anginer & A. Joseph Wharburton, *The Chrysler Effect: The Impact of the Chrysler Bailout on Borrowing Costs*, Jan. 2011, *at* http://www.clevelandfed.org/research/conferences/2011/4-14-2011/Anginer_Warburton.pdf.

[10] Republic of Argentina, Law 26,547 (Dec. 9, 2009).

subordinated to other, subsequent debt;[11] it is a promise of legal priority, which functions much like a negative pledge clause that prohibits the granting of security to other creditors.[12] Accordingly, as traditionally understood, *pari passu* does not prohibit states from creating *de facto* priority by paying some creditors first; indeed, this is what has been done from time immemorial, as states do not pay all of their creditors simultaneously.[13]

In the current litigation, however, some holdout Argentine creditors have advanced a relatively novel argument that the *pari passu* clause requires that if Argentina makes *any payment* on its unsecured unsubordinated foreign debt, then it must pay all foreign creditors with a *pari passu* clause ratably.[14] To illustrate, under the holdout creditors' interpretation, if Argentina paid on one bond series, it would have to pay simultaneously on *all* bond series with *pari passu* clauses.

In the instant litigation, the United States District Court for the Southern District of New York ruled in favor of the holdout creditors and issued injunctions against Argentina paying the exchange bonds without paying the holdout creditors in full and against third parties from assisting Argentina in making payments on the exchange bonds without ensuring that full payment to the holdout creditors was also made.[15] The case has been appealed to the United States Court of Appeals for the Second Circuit, and the United States submitted an *amicus curiae* brief urging reversal of the District Court's *pari passu* holding.[16] The United States as *amicus curiae* argues that the District Court misinterpreted the *pari passu* clause, that even if the holdout creditors' interpretation is correct it does not give rise to an injunctive remedy, and that injunctive remedies of the type issued by the District Court are inappropriate under the Foreign Sovereign Immunities Act (FSIA).

The United States' actions in the Argentine debt litigation are neither unusual nor unwarranted nor anti-investor. The United States has filed *amicus curiae* briefs in sovereign debt litigation in the past, including a brief filed on this very issue in 2004 by the Bush Administration.[17] Moreover, the Obama Administration has taken significant action against Argentina related to its default; the Obama Administration imposed trade sanctions on Argentina

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[11] *See, e.g.,* Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 870 (2004).

[12] One might reasonably ask why there would be *pari passu* clauses at all, if they have little effect. For a review of the complicated history of these clauses, *see* Mark C. Weidemaier, Robert E. Scott & Mitu G. Gulati, *Origin Myths, Contracts, and the Hunt for Pari Passu*, UNC Legal Studies Research Paper No. 1633439 (Mar. 25, 2011), *at* http://ssrn.com/abstract=1633439.

[13] *See, e.g.,* Lee C. Bucheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 497 (1988).

[14] The creditors proceed on the basis of a single favorable decision from a Belgian court. *See* Elliot Assocs., L.P. v. Banco de la Nacion, General Docket No. 2000/QR/92 at 3 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000) (holding without citation to authority "the various creditors benefit from a *pari passu* clause that in effect provides that the debt be repaid pro rata among all creditors."). The decision was functionally overruled by a subsequent Belgian statute that precludes creditors from obtaining orders blocking payments through bank settlement systems. See Belgium Law 4765 [C-2004/03482].

[15] Order, NML Capital, Ltd. v. Republic of Argentina, 08-cv-06978 (TPG) (S.D.N.Y. Dec. 7, 2011); Order, NML Capital, Ltd. v. Republic of Argentina, 08-cv-06978 (TPG) (S.D.N.Y. Feb. 23, 2012).

[16] Brief for the United States of America as *Amicus Curiae* in Support of Reversal, NML Capital, Ltd. et al. v. Republic of Argentina, 12-105-cv(L) (2d Cir. April 4, 2012).

[17] Statement of Interest of the United States, Macrotechnic Int'l Corp. v. Republic of Argentina, 02-CV5932 (TPG); EM Ltd. v. Republic of Argentina, 03-CV-2507 (TPG), (S.D.N.Y. Jan. 12, 2004).

following Argentina's refusal to pay an International Centre for the Settlement of Investment Dispute (ICSID) award.[18] There is simply no basis for interpreting the Obama Administration's actions in regard to Argentine debt as "anti-investor."

In the current *amicus curiae* brief, as in the Bush Administration's *amicus curiae* 2004 brief, the United States makes clear its interest in this issue: preserving global financial market stability and protecting the foreign relations interests of the United States. The United States is not looking to further the interests of any particular party in the litigation; rather it is concerned that a ruling that disturbs settled expectations about sovereign debt would roil global financial markets with widespread domestic effects, that a ruling in favor of the plaintiff investors in this litigation would make it impossible to restructure sovereign debt, and that the granting of injunctive relief endangers the foreign relations of the United States and exposes the United States and its property to foreign judgments.

The United States has a great interest in global financial market stability; global financial markets are interconnected, and financial events abroad reverberate at home. Sovereign debt is an important category of financial instruments; many sovereigns, including the United States, borrow to fund government operations.

Sometimes sovereigns find themselves overleveraged and need to restructure their debts. We have all seen the on-going global economic turmoil stemming from Greece's inability to do so. As things currently stand, the only way to restructure sovereign debt is through consensual negotiations; there is no sovereign bankruptcy. In sovereign debt restructurings, like Argentina's old debt is typically exchanged for new debt with some combination of lower interest rates, longer maturities, reduced principal, or with payment obligations tied to the debtor's economic growth (capitalization bonds).

A major problem with such exchanges is the existence of holdout creditors who refuse the exchange offer of new debt for old debt. These creditors are still looking to recovery 100 cents on the dollar on the old debt (even if they bought it at a steep discount in the secondary market). If holdouts are able to successfully realize 100 cents on the dollar, there is a strong disincentive for any creditor to accept the exchange offer. If not enough creditors take exchange offers, then sovereign debt restructuring attempts fail. It bears strong emphasis that failure of a sovereign debt restructuring does *not* mean that creditors receive 100 cents on the dollar per their original contract. Instead, it typically means more negotiations, further delay in any payment, and more domestic and international financial turmoil.

Interpreting *pari passu* clauses as the holdout creditors do would make it impossible to restructure sovereign debt. Under the holdout creditors' interpretation, if sovereigns paid any of the exchange bonds, then it would trigger an obligation to repay the holdouts as well. In such a world, there is no incentive to tender the old debt in an exchange offer. Everyone will be a holdout and economic crisis will metastasize. The holdout creditors' interpretation would require governments to completely suspend *all* payments in order to restructure their debts, which is something that no bankrupt company does and no country can. It is not only reasonable, but also appropriate in a globally interconnected financial world for the United States to urge a court to uphold the traditional understanding of a sovereign debt contract clause when the alternative is an interpretation that would make it impossible for sovereigns to restructure their

[18] Doug Palmer, *Obama Says to Suspend Trade Benefits for Argentina*, REUTERS (MAR. 26, 2012).

debts and would exacerbate global economic crises.[19]

The other main concern of the United States in this case is stems from the issuance of injunctive relief, which the United States argues goes beyond the scope of the court's jurisdiction and which complicates the United States foreign relations. As a general matter, foreign governments are immune from suit in the United States and their property immune from attachment, arrest, or execution under the Foreign Sovereign Immunities Act of 1976 (FSIA).[20] There is an exception, however, for when foreign government engage in commercial activity.[21] An earlier case involving a prior Argentine debt default held that Argentina was subject to suit in the United States because it fell within the commercial activity exception because payment on the bonds was to be made in New York.[22] Subsequently issued Argentine debt, such as the bonds at issue here, has a different payment arrangement, with payments made outside of the United States. Accordingly, the holdout creditors in this case have sought an injunction, rather than a money judgment because a money judgment would be unenforceable under FSIA because the funds in question are located outside of the United States.[23]

The injunction the holdout creditors obtained is against a foreign state prohibiting any payment on its unsecured, unsubordinated external debt without payment in full to the holdout creditors. Thus, a payment by Argentina to a Swiss creditor made through a Thai bank in Bhatt without payment to the holdouts would violate the injunction. Such a broad injunction would allow the holdout creditors to restrain Argentina from using funds that the holdout creditors cannot attach directly. The United States is reasonably concerned that an expansive reading of the commercial activity exception to the FSIA would have adverse consequences for the United States, as enforcement of the injunction would effectively be dictating domestic policy to foreign states and taken as an affront. Moreover, some states own sovereign immunity law is based on reciprocity. Accordingly, the injunction against Argentina could encourage foreign courts to issue similar injunctions against the United States and its property abroad in the future.

The United States *amicus curiae* brief in no wise condones Argentina's default or seeks to prevent investors from collecting on their debts as a general matter.[24] Instead, it is concerned about larger issues than those of a particular investment fund that purchased distressed debt with full knowledge of the risks it was running and discounted its purchase price accordingly. The United States filed its *amicus curiae* brief because it was appropriately looking out for the larger

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[19] Critically, this is not a sanctity of contract issue. Contracts are written against a backdrop of enforceability. In the United States, this means they are written against a backdrop of bankruptcy law. In the sovereign context, this means they are written against a backdrop of functional and legal sovereign immunity—the sovereign only pays when it wishes to. This makes sovereign debt fundamentally different from other debt, and presumably it is priced to reflect this risk.

[20] 28 U.S.C. §§ 1604, 1609.

[21] 28 U.S.C. § 1605(a)(2).

[22] Republic of Argentina v. Weltover, 504 U.S. 607 (1992).

[23] It is not clear that a violation of a *pari passu* covenant triggers injunctive relief, at least in this case. The Argentine debt documentation provides that if covenants are not upheld, then the bondholders can accelerate the debt and demand payment for the entire bond principal. If that payment demand is not met, then there is a default. In this case, the holdout creditors have not accelerated the debt and declared a default because they do not want a money judgment on the debt, as they would then be subject to the application of the merger doctrine, meaning that their rights under the debt contract would be replaced by their rights under the judgment, and those rights would not include *pari passu.*

[24] Again, though, as with Chrysler and GM, the United States' position is adverse to that of some investors, but supportive of that of other investors, namely the vast majority who accepted the exchange bonds.

interests of society, including global economic stability and maintaining the foreign relations of the United States.

MORTGAGE SERVICING SETTLEMENT

On February 9, 2012, the federal government, 49 state attorneys' general,[25] and five major mortgage servicers agreed to enter into a settlement (the "federal-state settlement") over various frauds alleged to have been committed by the servicers.[26] This followed on the heels of the April 11, 2011 consent orders entered into by the Office of Comptroller of the Currency and the Federal Reserve Board with sixteen servicers and holding companies.[27]

There are numerous substantive problems with the mortgage servicing settlement. The settlement provides too little relief for too few homeowners. It will not clear housing markets. It will not deter future consumer fraud by too-big-to-fail banks, and does not even force the banks to disgorge the wrongful profits from their misbehavior. Despite the settlement's unprecedented size, it is a slap on the wrist for one of the most pervasive violations of procedural rights in history.[28]

That said, the settlement is still not a completely free pass; it has a $25 billion price tag, a record for any consumer fraud settlement.[29] The catch, however, is that most of that price tag will not be paid by the defendants. The defendant banks only have to pay $5 billion in hard cash under the settlement.[30] Another $10 billion is to come in the form of principal reductions on mortgages, a further $3 billion from refinancing underwater mortgages, and another $7 billion in other forms of relief such as short sales and forbearance.[31] The settlement does not specify which mortgages must be restructured or refinanced other than in terms of broad category requirements.

Critically for the purposes of this hearing, the settlement permits the banks to receive credit under the settlement by reducing principal or refinancing on mortgages that they service, but do not own.[32] The Obama Administration does not dispute this, but instead contends that "this settlement will not force investors to incur losses. That's because any loan modification tied to this settlement will result in more of a financial return for an investor than a foreclosure

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[25] I have served as a consultant for the New York Attorney General in regard to mortgage servicing issues and as a Volunteer Deputy Attorney General for the State of Delaware in regard to another related mortgage servicing litigation. The views I express here are my own, and not necessarily those of the New York Attorney General or Delaware Attorney General.

[26] Press Release, U.S. Dept. of Justice, *Federal Government and State Attorneys General Reach $25 Billion Agreement with Five Largest Mortgage Servicers to Address Mortgage Loan Servicing and Foreclosure Abuses*, Feb. 9, 2012, *at* http://www.justice.gov/opa/pr/2012/February/12-ag-186.html.

[27] *See, e.g.,* http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html.

[28] *See, e.g.*, Adam Levitin, *The Servicing Settlement: Banks 1, Public 0*, CREDITSLIPS.ORG, Fed. 9, 2012, *at* http://www.creditslips.org/creditslips/2012/02/the-servicing-settlement-banks-1-public-0.html.

[29] Dept. of Housing and Urban Development, *Fact Sheet: Mortgage Servicing Settlement*, *at* http://portal.hud.gov/hudportal/HUD?src=/mortgageservicingsettlement/fact-sheet.

[30] *Id.*

[31] *Id.*

[32] Dept. of Housing and Urban Development, *Myth vs. Fact: Setting the Record Straight about Historic Mortgage Servicing Settlement*, Mar. 12, 2012, *at* http://blog.hud.gov/index.php/2012/03/12/myth-vs-fact-setting-the-record-straight-about-historic-mortgage-servicing-settlement/ ("The settlement could affect some investor-owned loans, depending on existing agreements servicers have with those investors.").

would."[33] The Obama Administration claims to anticipate that servicers will first modify loans they hold on balance sheet and only then look to modify securitized loans.[34]

Unfortunately, some of the Obama Administration's predictions about the impact of the settlement belie the contention that it will not affect mortgage investors. HUD Secretary Shaun Donovan has stated that the non-cash portion of the settlement might result in as much as $32 billion in relief for homeowners, rather than $20 billion.[35] How does $20 billion become $32 billion?

The settlement credits servicers with $1 of settlement credit for every $1 of principal they write down on loans owned by servicers. The settlement gives 45 cents of credit, however, for every dollar in principal reduction on loans owned by investors.[36] Thus, for the servicers to get $10 billion in principal reduction credit under the settlement, they would have to write down principal on $22 billion in investor-owned loans. The Obama Administration's prediction of $32 billion in relief assumes that servicers will engage in principal write-downs *solely* of investor-owned loans. This is entirely inconsistent with the Administration's claim that servicers will modify the loans on their balance sheets first.

It is hard to know if the Administration's $32 billion claim is merely wildly optimistic spin of a grossly inadequate settlement or evidence of connivance with the too-big-to-fail banks to pass the costs of the settlement on to investors. We know, however, that servicers have strong incentives not to engage in principal write-downs on loans they own, lest they be forced to recognize losses and raise capital. Indeed, were it otherwise, the servicers would have written down loans they own already. Instead, it appears likely that most of the principal reductions will come from investor-owned mortgages. Procedurally, this raises serious concerns, as investors were not at the table during the settlement discussions nor are they party to the settlement, and the Obama Administration is clearly cognizant that some investor-owned loans might be modified under the settlement.

It is not clear, however, whether investors will suffer any harm from the settlement. The Obama Administration insists (rightly) that defendant banks are still obligated to comply with the terms of their servicing contracts, known as pooling and servicing agreements or PSAs.[37] PSAs typically restrict the ability of servicers to modify loan terms unless the loan is in default or default is imminent or reasonably foreseeable.[38] PSAs will often impose further restrictions

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[33] *Id.*

[34] *Id.*

[35] Ben Hallman, *Shaun Donovan, HUD Chief, Hopes Fannie Mae and Freddie Mac Will Write Down Mortgages,* Feb. 16, 2012, *at* http://www.huffingtonpost.com/2012/02/16/shaun-donovan-fannie-mae-freddie-mac-mortgage-write-down_n_1283020.html.

[36] *See e.g.*, Consent Judgment, United States v. Bank of America Corp., et al., 12-cv-00361 (D.D.C. filed Apr. 4, 2012), Exhibit D-1, *at* https://d9klfgibkcquc.cloudfront.net/Consent_Judgment_BoA-4-11-12.pdf.

[37] Dept. of Housing and Urban Development, *Myth vs. Fact: Setting the Record Straight about Historic Mortgage Servicing Settlement*, Mar. 12, 2012, *at* http://blog.hud.gov/index.php/2012/03/12/myth-vs-fact-setting-the-record-straight-about-historic-mortgage-servicing-settlement/ ("First and foremost, the settlement in no way overrides any existing contractual agreements or requirements between the servicer and the investors. If investors do not allow for principal reduction in a specific securitization, then the servicers will not be able to utilize on loans underlying the securities.").

[38] Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 32-33 (2011).

on loan modification.[39] If servicers violate these provisions, they should be sued for breach of contract; nothing in the federal-state settlement prevents this.[40] PSAs also often require servicers to maximize the net present value (NPV) of loans.[41]

Taken all together, this suggests that *if servicers are complying with PSAs*, then there are no additional principal modifications that they should undertake *because* of the settlement. In other words, if servicers are complying with PSAs, then servicers will get credit under the settlement for loan modifications that they would have done anyhow. If so, then the price tag of the settlement isn't being borne by investors. Instead, it is just a sham settlement in which the banks settle by agreeing to do what they were already required to do.

On the other hand, *if servicers have not been complying with PSAs*, but not start performing loan modifications because of the settlement, investors may be harmed by the settlement. If the servicers are not performing the loan modifications they were supposed to perform, there is no investor harm. Yet if the servicers are performing loan modifications under the settlement that they are not permitted to perform by contract, then there is likely investor harm, and investors should sue servicers over this.

Herein lies the problem: we do not know if the servicing settlement is a sham settlement in terms of only obligating servicers to do what they were already obligated to do, whether it will bring servicers into compliance with their PSAs or induce them to breach their PSAs. (The settlement, like the OCC and Fed consent orders is undoubtedly inadequate in terms of providing proper sanction for the largest consumer fraud in history.) Depending on the answer, the servicing settlement may or may not harm investors. My own intuition is that the settlement is a combination thereof. Some of the loan modifications for which servicers will receive credit will be loan modifications they were already obligated to do either under PSAs or under HAMP. In other words, the $20 billion or $32 billion price tag is at least partially a sham. At the same time, I would expect servicers to perform some modifications that violate PSAs in order to get additional settlement credit. If I am correct, then the settlement is the worst of both worlds—in part a sham and in part its costs are pushed onto mortgage investors.

Irrespective of the substantive harm involved the settlement, the settlement procedure was problematic. Regardless of how one believes that the cost of principal reduction—and thus ultimately responsibility for the housing bubble—should be allocated, if at all, the *process* of allocating the costs must be done fairly. That means it must be done either through a political process, through consensual negotiations with all parties, or a judicial proceeding in which *all* parties are represented. It is, however, manifestly unfair to have that principal reduction be paid by MBS investors when they were not even at the table.

While this settlement appears to be a one-off, unique event,[42] one can envisage similar

[39] Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1089-91 (2009).

[40] Other issues, such as the disinterest in RMBS trustees in enforcing investor rights exist without the federal-state settlement. *See* Levitin & Twomey, *supra* note 38, at 58-63.

[41] *Id.* at 30.

[42] It bears noting, however, that an earlier settlement between the California and Illinois Attorneys General and Countrywide/Bank of America involved promises by Countrywide/Bank of America to modify loans that it serviced, but did not own as compensation for mortgage origination fraud. *See* Order, Greenwich Fin. Serv. Distressed Mortgage Fund 3, LLC v. Countrywide Fin., No 650474/2008 (N.Y. Sup. Ct. Oct. 7, 2010) (dismissing

conflicts arising in the future. In the servicing settlement, the Obama Administration found itself forced to do something about robosigning—the evidence of widespread fraud was too great to ignore—but the administration also decided it was far better to have the costs diffused among investors—such as pension plans and mutual funds—rather than be concentrated on a handful of too-big-to-fail banks. Rather than being somehow "anti-investor" the Obama Administration was held hostage because it tolerated the continued existence of too-big-to-fail banks, and as a result, its scope for policy action through the settlement was limited.

CONCLUSION

There is no dispute that American investors need better protections, but it is not from the government, but rather from financial institutions that have become too-big-to-fail. Serious steps toward investor protection would be to increase the SEC and CFTC budgets and to facilitate securities fraud litigation. I recognize that those are steps unlikely to be even contemplated by the current Congress, but that is what real investor protection would entail and doing so would strengthen investor confidence in US capital markets.

As far as the specific cases examined by this hearing, the Chrysler bankruptcy and the Argentine debt amicus brief are in no way evidence of anti-investor bias from the Obama Administration, but rather examples of responsible stewardship of state. The mortgage servicing settlement, on the other hand, was deeply flawed in many ways, including its unfair treatment of mortgage investors who may have to shoulder most of the cost of the settlement without having engaged in any wrongdoing themselves and without having had a seat at the negotiating table. That said, it is not an example of anti-investor bias, but rather the inevitable result of the existence of too-big-to-fail banks. The Obama Administration's hands were tied because of its toleration of the too-big-to-fail banks; there was little it could do but allow a settlement that enables the banks to put the costs of the servicing fraud settlement on investors.

We should recognize the deep costs the continued existence of too-big-to-fail will have in a range of policy contexts. As long as too-big-to-fail banks continue to exist, they will continue to externalize the costs of their behavior on other parties. In 2008 the costs were externalized to taxpayers. In 2012, they were externalized to investors. Taking investor—and taxpayer—protection seriously means eliminating too-big-to-fail. Otherwise, when push comes to shove, costs of bank misbehavior will again be shunted onto investors and taxpayers.

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investor suit over Countrywide's actions on the basis of plaintiffs not having achieved the PSA's collective action threshold for suit). In other words, investors paid for Countrywide's fraud.