

DON'T BLAME THIS MESS ON TITLE 11

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"So, I say to myself, Self, things could be worse. And, sure enough!"

Don't blame the home mortgage mess on the Bankruptcy Code.

Section 11 USC 109 excludes insurance companies and "lending institutions" from title 11. Why? Because it is regulated under some other state and/or federal law.

Let's go back to 1968 and the Senate floor debate on the soon-to-be federal programs: the Mortgage-Backed Securities Program of the Government National Mortgage Association (GNMA) and the Home Loan Guarantee Program of the Veteran's Administration. Both programs were to encourage the investment of money to make home loans. The thought, at the time, was that money from such home loans would flood in if the investor's money was backed by the full faith and credit of the United States, (*New York Guardian Mortgage Corp. v. Cleland*, 473 F.Supp. 422, 424 (D.C.N.Y. 1979)).

How was it designed to work? A mortgage banker (the issuer) originates a mortgage loan. An issuer qualifies to enter into a guarantee agreement with GNMA with regard to pools of mortgages put together by the issuer or its securities dealer. A separate guarantee agreement is executed by GNMA, a government-owned company operated by HUD. The issuer provides to each investor in a mortgage pool a GNMA-issued certificate providing that the federal government will pay the certificate holder, if the issuer fails to make the monthly payment to that investor, payments of borrowers from loans in the pool to which that investor belongs. To become an issuer, the mortgage banker had to make various promises to GNMA. Those promises include, but are not limited to: (1) providing GNMA with unrecorded assignments of the mortgage pools; (2) the deposit of all mortgage pool payments into a custodial bank account; (3) payment by the issuer of a guarantee fee to GNMA; (4) maintenance of a minimum net worth by the issuer; (5) if the pool borrower fails to make the monthly payment, the issuer must immediately take personal funds and pay



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them into the segregated pool account as servicer of the mortgage pool. If all goes as agreed, the issuer gets a servicing fee. *GNMA v. Adana Mortgage Bankers Inc.*, 12 B.R. 977, 979-983 (Bankr. N.D. Ga. 1980).

It worked! And then it didn't work. It worked in creating huge investments in government-backed mortgage loans. Within 10 years of the program's inception, \$100 billion of government-guaranteed mortgage loans were generated. 12 B.R. at 987. Presently, with many more home mortgage loans outstanding than \$100 billion, it doesn't work so hot. Many of the issuers were thinly capitalized to begin with. This is, in part, a reason for our present financial crisis.

What's the problem? Got me! I'm not smart enough to answer that question. Hopefully, someone will read this and tell us. The list of sources for our problem include greed, mismanagement of the federal programs, mismanagement of the mortgage bankers, too little regulation and supervision, too much regulation and supervision and failure to weed out the approved issuers who were poorly capitalized in the first place. Please add your own to my list and also please feel free to disagree.

The one thing that doesn't seem to be the cause is the Bankruptcy Code's limitation on who may be a debtor under title 11. Private-mortgage lending companies and bank holding companies can seek relief under title 11. But they can hardly be

called unregulated. Various laws that appeared to "trump" title 11 include:

1. The National Housing Act (NHA), 12 USC §1721(g), 1723(a);
2. 24 CFR 390.1, which implements the NHA;
3. The Federal Reserve Act (FRA), 12 USC 371c;
4. Financial Institutions Supervisory Act (FISA), 12 USC §1818;
5. 12 CFR 225.4(a)(1), implementing FISA;
6. Bank Holding Company Act of 1956 (BHCA);
7. The Investment Company Act of 1940;
8. Investment Advisor's Act of 1940; and
9. The Gramm-Leach-Bliley Act (GLB Act).

Yes, I know that's not a complete list; I am only scratching the surface. We have the Financials Institution's Reform, Recovery and Enforcement Act of 1989 (FIRREA), which oversaw the savings and loan industry, among others.

There appears to be plenty of regulation for those "persons" who don't qualify for relief under title 11. 11 USC §109(b)(2), (d). Even for those who do qualify, the laws governing lending do not go away. Let's look at private mortgage lending companies.

In *In re Whitcomb and Keller Mortgage Company*, 8 B.R. 83 (Bankr. N.D. Ind. 1980), the bankruptcy court held that the Bankruptcy Code did not prevent GNMA from terminating the issuer's status and the debtor's guarantee agreement and taking control of the Issuer's pooled assets. The court's focus was on 24 CFR 390.3(c), and the GNMA requirement that the issuer maintain a minimum net worth to insure that it has sufficient assets to make up shortfalls in collection of pooled mortgages. The National Housing Act, 12 U.S.C. §1721(g), provides that upon default by the issuer under the guarantee agreement, GNMA can terminate the issuer and declare the pooled assets its absolute property, despite §362 of the Bankruptcy Code. Throw in the anti-injunction provision of 12 U.S.C. §723(a) to keep bankruptcy judges from meddling with regulatory action taken or to be taken.

In *In re Adana Mortgage Bankers*, 12 B.R. 977 (Bankr. N.D. Ga. 1980), the bankruptcy court held that the guarantee agreement is

a nonassignable executory contract. However, the court did hold that the servicing revenues of the issuer debtor belonged to the debtor's estate. Again, the bankruptcy court looked at the NHA and its implementing regulations, 24CFR 390.1, as controlling. The court did not indicate, however, that the bankruptcy court could not intervene if GNMA acted unreasonably in not allowing the debtor's servicing portfolio to be transferred to a new issuer to preserve the debtor's servicing fees or assets of the estate.

Other nonbankruptcy cases also demonstrate how non-title 11 laws "trump" the Bankruptcy Code. In *New York Guardian Mortgage Corp. v. V.A. and GNMA*, 473 F. Supp. 422 (D.C.N.Y. 1979) the assignee of an issuer mortgage lender who could qualify for relief under title 11 sued to recover assets of the issuer for distribution to investors in the issuer. The district court held that the issuer's book of assets belonged to GNMA for the benefit of the pooled investors. The court also held the V.A. has no set-off rights to pooled assets based on its claims against the issuer. Under title 11, given the holding in *New York Guardian Mortgage Corp.*, there may be little property of the estate for reorganization or liquidation purposes under 11 U.S.C. §541(d).

Bank holding companies also qualify for relief under title 11. They are treated no differently.

In *People's Bankshares v. Department of Banking*, 68 B.R. 536 (Bankr. N.D. Iowa 1986), the bank holding company as the shareholder of a state bank filed for chapter 11. The debtor sought to impose the stay of §362 and/or injunctive relief under §105 to prevent state regulators from taking over five state-chartered banks mostly owned by the debtor. The court held that neither section prevented the superintendent of banking from taking over the assets of the banks.

In *In re Delta Corporation Inc. v. OTS*, 111 B.R. 419 (Bankr. S.D. N.Y. 1990), the subsidiary of the chapter 11 debtor was the owner of stock of a federal savings and loan. Federal and state banking agencies sought to place the federal savings and loan (S&L) in receivership. The chapter 11

debtor sought injunctive relief to stop that from happening and the bankruptcy court denied the debtor's motion. The debtor holding company was relying on *In re MCORP*, 101 B.R. 483 (Bankr. S.D. Tex. 1989), where the Bankruptcy Court stopped the Federal Reserve Board from exercising its powers under title 12 to take control over the debtor holder company's assets as a result of the debtor's failure to comply with the "financial strength" requirements for bank holding companies under federal regulations. The bankruptcy court in *Delta Corp.* distinguished *MCORP*.

In the *Delta Corp.* case, FIRREA was implicated. The OTS had taken control of the assets of Colonial (S&L), which could not be a debtor under §109. Although the bankruptcy court denied the debtor's request for injunctive relief, the district court also denied the OTS motion to dismiss or abstain in the holding company bankruptcy case. The moral of the story appears to be that the title 11 qualifying debtor's assets are subject to state and federal financial institution regulation irrespective of chapter 11.

The Supreme Court later got the *MCORP* case. In *Board of Governors of the Federal Reserve v. MCORP Financial*, 502 U.S. 32 (1991), the Supreme Court affirmed the appeals court reversal of the district court's decision. The district court had granted injunctive relief under §105 preventing receivership control over the debtor's assets. The Supreme Court held that the violations of the Federal Reserve Act, 12 USC §371c, and the Federal Deposit's Insurance Act, 12 U.S.C. 1818(i)(1), and implementing regulations of 12 CFR 225.4(a)(1) "trump" any bankruptcy jurisdictional effort under §105 of the Code.

In *In re Imperial Credit Industries Inc.*, 527 F.3d 959 (9th Cir. 2008), we see one of the more recent examples of the interrelation between title 11 and existing federal regulations of lending institutions. Imperial was the holding company owner of Southern Pacific Bank (SPB). SPB was found by the FDIC to be undercapitalized and to submit a capital restoration plan. The FDIC told Imperial to guarantee performance of the SPB capital restoration

plan. When the \$18.3 million capital infusion didn't happen, the California Department of Finance pronounced SPB as insolvent. It appointed the FDIC as receiver and called on Imperial to honor its guarantee but Imperial filed for relief under chapter 11. The FDIC then relied on 11 U.S.C. §365(o). Section 365(o) is one example of how title 11 and federal law regulating the lending institutions attempt to meld the respective policy concerns of each federal law. Another example of this is, of course, found in the language of §109 dealing with who may and may not be a debtor under title 11. The bankruptcy court in Imperial ruled that Imperial must pay the guarantee obligation to remain in chapter 11 and caused Imperial to convert to chapter 7. In the chapter 7 case, the issue *de jure* was the level of priority attributed to the guaranteed amount called for by the FDIC to be paid. As to that aspect of the chapter 7 case, the Ninth Circuit Court of Appeals, relying on title 11, called the guaranteed amount the FDIC required for infusion into the SPB from Imperial a ninth priority administrative expense.

There was a more touchy area of the clash between title 11 and federal banking law that was at issue in *Imperial Credit*, 12 U.S.C. 1828(u), which prohibits any person from having a claim against any federal banking agency for the return of assets transferred to a federal insured bank by virtue of a "recapitalization demand" made by the federal agency. The trustee brought a fraudulent conveyance claim against the FDIC. The FDIC moved for summary judgment relying on §1828(u). The appeals court denied the FDIC motion. The holding was narrowly limited to the court's conclusion that no transfer had yet been made.

Let me end where I started. Don't blame title 11 for this mess.

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