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MORTGAGE BORROWERS WIN OFFICIAL COMMITTEE STATUS IN AMERICAN HOME MORTGAGE HOLDINGS, INC. CHAPTER 11 CASE AND OBTAIN MAJOR REVISIONS TO DEBTORS' PLAN

By Stephen A. Weisbrod and W. Hunter Winstead

Late last year, in a chapter 11 bankruptcy case filed by American Home Mortgage Holdings, Inc. and several of its subsidiaries (collectively, "AHM"),¹ several individual mortgage borrowers with consumer protection claims against AHM successfully petitioned the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") for an order establishing an Official Committee of Borrowers (a "Borrowers Committee"). The borrowers contended, and the Bankruptcy Court agreed, that because of the borrowers' unique financial relationships with AHM and AHM's financial institution creditors, the Official Committee of Unsecured Creditors (the "Unsecured Creditors Committee") could not adequately represent borrowers' interests. Most of AHM's other creditors were warehouse lenders, securitizers, or institutional investors that loaned money to AHM or had directly or indirectly acquired mortgages originated by AHM. Once appointed, the Borrowers Committee successfully negotiated with the Debtors and the Unsecured Creditors Committee for substantial modifications to the Debtors' proposed plan. The borrowers' success in *AHM* may serve as a model not only for other borrowers in other cases but for all chapter 11 bankruptcy creditors with interests that conflict with those of the financial institutions that typically dominate official committees of unsecured creditors.

As recently as 2006, AHM was one of the ten largest mortgage originators in the country. AHM focused on the "Alt-A" mortgage market and was not primarily a subprime lender, but it nevertheless engaged in a variety of controversial lending practices. Most significantly, in the three years before its bankruptcy filing, AHM

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¹ *In re American Home Mortgage Holdings, Inc., et al.*, Chapter 11 Case No. 07-11047 (CSS).

had originated almost 90,000 “payment option” adjustable rate mortgages (“ARMs”). Many consumer advocates contend that payment option ARMs are extraordinarily complex and confusing products that are likely to result in borrower foreclosures and consumer protection claims.² According to nationwide statistics recently published in the *Wall Street Journal*, over fifty percent of homeowners with payment option ARMs are likely to default.³

Hundreds of borrowers filed claims in the Bankruptcy Court against AHM, alleging violations of various federal and state consumer protection laws, including:

- violations of the Truth in Lending Act, 15 U.S.C. § 1601 et seq.
- violations of the Home Ownership and Equity Protection Act, 15 U.S.C. § 1639
- violations of the Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 et seq.
- common law fraud
- deceptive and unfair practices, predatory lending, and usury in violation of state statutes

One such claim was filed by Mr. Tilton Jack of Brooklyn, New York. Mr. Jack purchased his house in 1985 and raised eight children there. Now in his eighties, he lives on a fixed income (pension and social security) totaling \$2400 per month. When he received marketing materials from AHM, he already had a mortgage from another lender with a fixed interest rate of 7.4% and monthly payments of \$1,800. He alleges that AHM’s broker told him that he would qualify for a loan with only a 1% interest rate. In fact, the 1% interest rate was a “teaser” rate that remained in effect for only one day before jumping to 8.132%. Yet, according to Mr. Jack, the minimum monthly payment quoted to him by the broker was calculated based on the 1% rate. Soon after he had refinanced his home with AHM, Mr. Jack began receiving monthly statements that gave him multiple payment options. The lowest payment option was the amount quoted to him by the broker, \$1385.30 per month, which did not even cover the full amount of accrued interest. Another payment option, \$2651.54 per month, would cover the accrued interest. Another payment option, \$2,872.03 per month, was fully amortizing.

² A “payment option” adjustable rate mortgage is a mortgage loan for which the interest rate on the note is periodically adjusted based on a variety of indices and that initially offers the borrower several monthly payment options, such as (a) a specified minimum payment that does not even cover the accruing interest, (b) an interest-only payment, or (c) a traditional 15-, 30-, or 40-year fully amortizing payment. Consumer advocates regard payment option ARMs as extremely risky, and inappropriate for most homeowners, because they can result in negative amortization, meaning that the principal amount owed by borrowers will increase rather than decrease over time, even if the borrower is never late on a single payment. Typically, once the amount owed reaches a particular level, the mortgages are “recast,” thereby eliminating the lower and more affordable payment options, and the borrower is required to make significantly larger monthly payments. Often, steep prepayment penalties make refinancing extremely expensive, trapping borrowers in the loans even after the interest rates rise to unaffordable levels.

³ Ruth Simon, *Option ARMs See Rising Defaults*, Wall St. J., January 30, 2009.

The latter two options both exceeded his monthly income. Mr. Jack chose the lowest option, but because it did not cover the accruing interest, the shortfall was added to the outstanding principal, causing the loan to negatively amortize. By the time Mr. Jack filed his claim with the Bankruptcy Court, he was at risk of losing his home, and, unless his loan was modified, he was going to owe \$34,000 more than he originally had borrowed.

Although many borrowers had filed “predatory lending” claims similar to Mr. Jack’s during the first few months following AHM’s bankruptcy filing, borrowers rarely if ever participated in most aspects of AHM’s chapter 11 case. With virtually no input from borrowers, AHM and the Official Committee of Unsecured Creditors – which was dominated by large financial institutions that loaned money to AHM or had invested in AHM mortgages – negotiated a plan of liquidation. Under the proposed plan, AHM would be wound down through a process overseen by a post-bankruptcy trustee, who would be chosen by the creditors serving on the Unsecured Creditors Committee.

On September 9, 2008, several individual borrowers filed their motion for the appointment of an official borrowers committee. (The individual borrowers were represented on the motion *pro bono* by Gilbert Oshinsky LLP and Zuckerman Spaeder LLP.) Section 1102(a)(2) of the Bankruptcy Code allows a bankruptcy court to appoint additional official committees if necessary to “assure adequate representation of creditors.” Although the Bankruptcy Code does not define “adequate representation,” it requires the bankruptcy judge to determine whether a creditor constituency has a meaningful voice on the creditors’ committee after considering: (1) the size and complexity of the case; (2) the competing interests of the various constituencies purportedly represented by the existing official creditors’ committee; and (3) whether the existing creditors’ committee is so dominated by one group that other groups have virtually no say in the decision-making process.⁴ Arguing that the interests of the borrowers diverged from the interests of other financial institution creditors, the movant borrowers contended that the Unsecured Creditors Committee could not adequately represent borrowers’ interests. The borrowers argued that most of the other unsecured creditors – including warehouse lenders, securitizers, and current mortgage holders – had sought to maximize the value of the loans for which borrowers are liable, whereas borrowers had interests other than merely maximizing AHM’s assets. Most notably, borrowers did not want to lose their homes or to have their claims against third parties or their rights with respect to their loans adversely affected by AHM’s chapter 11 case.

Unlike most of the other unsecured creditors, the borrowers’ claims all involved alleged injury as a result of AHM’s improper conduct in the origination and servicing of mortgage loans. As the movant borrowers explained, in important respects, this predicate to their claims could put them at odds with the Unsecured Creditors Committee and other unsecured creditors. For example, borrowers may want to establish that their mortgage terms were illegal, while other creditors may want to establish that they were legal. Borrowers may want to establish that that warehouse lenders, securitizers, and third-party servicers are jointly liable with

⁴ See *In re Dow Corning*, 194 B.R. 121, 141-42 (Bankr. E.D. Mich. 1996).

American Home, while other creditors generally want to establish just the opposite. Borrowers may wish to establish their right to rescind certain mortgage contracts, while other creditors may want the mortgage contracts enforced. Borrowers may want the claims of warehouse lenders, securitizers, and third-party servicers to be equitably subordinated, while those creditors naturally would oppose such treatment.

AHM and the Unsecured Creditors Committee strongly opposed the motion for appointment of an official borrowers committee. They contended that all unsecured creditors were aligned in wanting to maximize the value of estate assets while minimizing estate liabilities. They also contended that, in practice, the Unsecured Creditors Committee had represented the borrowers adequately. But on October 22, 2008, the Bankruptcy Court granted the borrowers' motion after concluding that the Unsecured Creditors' Committee had not adequately represented borrowers and their interests in AHM's chapter 11 cases.

After the Borrowers Committee was appointed, it spent six months negotiating with AHM and the Unsecured Creditors Committee regarding the terms of AHM's proposed plan. (The Borrowers Committee retained Gilbert Oshinsky LLP and Zuckerman Spaeder LLP to represent it.) The Borrowers Committee obtained numerous revisions to AHM's proposed plan that will benefit many borrowers.

For example, the Borrowers Committee obtained strong language preserving borrower claims, rights, and defenses against non-AHM entities, such as brokers, securitizers, servicers, and current mortgage holders. The plan also provides explicitly that borrowers' equitable subordination claims against other creditors are preserved.

Over the past several years, a growing concern among consumer advocates has been that mortgage originators in bankruptcy will use the bankruptcy process to "cleanse" their loans of borrower claims.⁵ To address this problem, Congress amended the Bankruptcy Code in 2005 to provide in section 363(o) that if a consumer credit transaction that is subject to the Truth In Lending Act, such as a mortgage, is purchased through a sale in bankruptcy, that asset remains subject to all claims and defenses; the purchaser does not acquire the asset "free and clear" of liens and encumbrances. (By contrast, pursuant to section 363(f) of the Bankruptcy Code, sales of other types of assets often can be made "free and clear" of liens or encumbrances, such that the purchaser need not worry about third-party claims relating to the purchased property.) Section 363(o) gives borrowers very valuable protection, but it arguably left certain loopholes in place. For example, section 363(o) does not explicitly address post-bankruptcy sales by post-bankruptcy trustees. Nor does it explicitly address loans that are simply abandoned by the originator pursuant to section 554 of the Bankruptcy Code. The AHM plan now includes language that closes these potential loopholes.

⁵ Cf. *In re Mayer-Myers*, No. 05-12466, 2007 Bankr. LEXIS 908 (Bankr. D. Vt. March 14, 2007) (rejecting borrower claims because the borrower's mortgage had been sold by a bankrupt mortgage originator to the current mortgage holder "free and clear" of all claims).

The preservation of borrower claims, rights, and defenses in the revised AHM plan is bolstered by borrower specific carve-outs to the plan's injunction and stay provisions. Under the plan as amended, borrowers will be able to assert claims, counterclaims, and defenses in foreclosure proceedings without seeking permission from the Bankruptcy Court. Borrowers also will be able to name AHM in litigation pending in the borrowers' home courts, as long as the borrowers do not seek damages from AHM in those proceedings, again without seeking permission from the Bankruptcy Court. This is important because borrowers seeking rescission or damages from non-AHM parties will be able to obtain "party" discovery from AHM and will not be limited to cumbersome and expensive third-party discovery procedures when trying to obtain AHM documents. Such documents may include original underwriting materials, recent complaints by the current mortgage holders about the quality of AHM's underwriting and loan origination practices, and details about the contractual relationships among the various parties involved in the securitization process. AHM's plan also requires the appointment of a paid "ombudsman" to respond to borrower requests for copies of their loan files and other information.

AHM itself does not appear to have much money left, so the value of damages claims against AHM itself is limited. But to the extent that a borrower seeks to recover damages from AHM itself, the amended plan also includes a streamlined process for borrowers to seek to file late claims against AHM under an "excusable neglect" standard. In a victory for AHM and the Unsecured Creditors Committee, the Bankruptcy Court held that AHM's plan could be confirmed even though AHM had not given direct notice of the claims bar date to any borrowers and had not published plain-language newspaper advertisements notifying borrowers of the bar date.

Borrowers, others asserting consumer protection claims, and other non-traditional creditors in other chapter 11 bankruptcy cases may wish to employ a strategy similar to that of the AHM borrowers. With several companies that sell consumer products or provide consumer services in bankruptcy, and new bankruptcy filings by such companies occurring on a regular basis, bankruptcy courts may see more aggressive participation by consumers and other non-financial institution creditors.

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