

LEWIS RICE *Bank Law Update*

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Stress Test Results to be Released

As we go to press, federal banking regulators have delivered their initial “stress test” (known as the Supervisory Capital Assessment Program) assessment results. Ten of the nation’s nineteen largest bank holding companies were identified as needing to raise additional capital. Although limited to the largest financial institutions, the stress test results could affect the market’s views on the health of the banking industry generally, impacting financial institution stock prices and the ability of those institutions to raise capital.

The regulators prepared two macro-economic scenarios (the “baseline” scenario and the “more adverse scenario”) and evaluated the participants’ projected performance in the context of those scenarios. The regulators asked the participants to project, in the context of the two scenarios, their losses and revenues for 2009 and for 2010 and the level of reserves that the participants would need at the end of 2010 for the purpose of covering losses expected in 2011.

The regulators directed the participants to project their losses on their entire portfolio – including off-balance sheet commitments and contingent liabilities – and to assess those losses across twelve separate categories of loans. The regulators provided each participant a template for response setting forth the categories of loans and securities included in the review, but each participant also was encouraged to report projected losses arising from other positions not reflected on the template. Each participant also was asked to adjust the balance sheet values of

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HUD Enacts Changes to Real Estate Settlement Procedures Act

On November 17, 2008, the Department of Housing and Urban Development (HUD) issued a new rule regarding disclosure requirements for mortgage settlement costs under the Real Estate Settlement Procedures Act (RESPA). The new rule aims to simplify and improve the process of obtaining mortgages and to reduce consumer settlement costs by (1) standardizing the Good Faith Estimate (GFE) form to make it easier for consumers to shop among service providers, (2) adopting a standardized application process which requires loan originators to collect the borrower’s name, social security number and gross monthly income in addition to other information, and limiting the fees originators may impose on consumers for the GFE, (3) limiting the circumstances under which the GFE can be revised, (4) modifying the HUD-1/1A Settlement Statement (HUD-1) to allow easy comparison with the GFE, and (5) requiring a clear summary of loan terms and total settlement charges, including yield spread premiums, in the GFE and HUD-1. The new rule requires clearer disclosure of settlement costs, which could allow consumers to more easily compare the terms offered by loan originators. Consequently, lenders may face stronger competition and pressure to adjust the rates they charge for settlement services.

The Good Faith Estimate Form. Prior to the new rule, RESPA regulations required loan originators to provide a GFE of the borrower’s settlement costs, but they did not prescribe a standard form. Because originators often listed different categories of charges or identified specific charges by different names, it was relatively difficult for consumers to compare the charges of various loan originators. Moreover, the prior regulations did not require GFEs to contain any loan terms or explanatory information to assist consumers in comparing charges. The new rule creates a standardized GFE form designed to clarify charges and enable simpler comparisons between originators. The new GFE form will require loan originators to disclose a summary of the key terms of a loan, including the initial loan amount, the loan term, the initial interest rate, the initial monthly payment owed for principal, interest and any mortgage insurance, origination charges and other settlement service charges. The form also discloses whether the interest rate or loan balance may increase, whether the loan has a prepayment penalty or a balloon payment, and whether the loan includes a monthly escrow payment for property taxes and other obligations. The rule also fixes certain actual charges at settlement to those disclosed in the GFE, and restricts certain others to a 10% increase.

Disclosure of Lender Payments to Mortgage Brokers – Yield Spread Premiums. Prior to the new rule, RESPA required disclosure of yield spread premiums only as a “payment outside closing;” this term generally meant little to consumers. Consequently, many consumers objected to yield spread premiums as unnecessary costs of which they were frequently unaware. Although some consumer advocates argued that yield spread premiums should be illegal, HUD maintains that they are an essential option for mortgage borrowers with limited available cash to pay some or all of their closing costs at a higher interest rate. The rule continues to permit yield spread premiums, but requires loan originators to disclose them on both the GFE and HUD-1. The rule also streamlines the current regulatory definition of “mortgage broker” in an attempt to clarify that all persons who perform mortgage broker services will be subject to the same disclosure requirements under the proposed rule.

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assets to reflect its expectations regarding customer drawdowns on unused credit commitments and other changes on the balance sheet appropriate in a “stressed economic environment” or due to pending accounting changes. Regulators asked participants with at least \$100 billion in trading assets to also estimate their potential trading-related losses (including counter-party credit losses) under a market stress scenario provided by the regulators. In addition to providing projections of certain losses, participants were asked to project the resources available to absorb losses over the two-year time period described in the two macroeconomic scenarios.

In addition to reviewing the above participant information, the regulators also used the collective responses of all the participants to develop a series of benchmarks that provided a common background against which to evaluate each participant’s projections. The regulators focused on past performance, portfolio composition, origination vintage, borrower characteristics, geographic distribution, international operations, and business mix when deriving these benchmarks.

If the result of the stress test evaluation is a determination that a participant should raise its capital or improve the quality of its capital for the purpose of withstanding losses that might occur in one or both of the macroeconomic scenarios, the participant is expected to increase or to improve its capital to create a “buffer.” However, the regulators stressed that the determination that a participant should so augment its capital “is not a measure of the current solvency or viability” of that participant.

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Court Decides Commercial Tort Claims Security Interest Case

A recent decision in the Seventh Circuit Court of Appeals underscores the necessity of continued diligence with regard to commercial tort claims as loan collateral. In *Helms v. Certified Packaging Corporation*, decided in December, 2008, the court held that the failure of a lender to specifically identify commercial tort claims in its security agreement caused its purported security interest in such claims to be ineffective against a judgment lien held by a bankruptcy trustee.

Certified Packaging Corporation (Certified) was brought in as an adversary party to the bankruptcy proceeding of a customer when the bankruptcy trustee sought to avoid payments made by the customer to Certified. On this claim, the trustee was awarded a \$2 million default judgment. During collection, CPC Acquisition

Inc. (CPC), the parent company of Certified and an assignee of a loan to Certified (under which CPC claimed a security interest in Certified’s assets), intervened to assert the priority of its lien over that of the trustee. At issue was priority in the proceeds of certain commercial tort claims arising from a fire at one of Certified’s plants that damaged equipment. Two suits were filed by Certified after the fire: one against an insurance broker alleging negligence in failing to list the plant on a business-loss insurance policy, and another against a utility company alleging negligence in the maintenance of its power lines. Because business losses from the fire greatly exceeded the value of the equipment damages, these claims were of primary importance to CPC.

The parties agreed that the loan agreement granted a security interest in the equipment damaged in the fire, and that the security interest covered proceeds of such equipment including any portion of the claims that would constitute damages for its replacement. However, while the lender contended that settlement money from the claim for failure to obtain business-loss insurance constituted proceeds of the equipment, the court disagreed. Focusing on the fact that the business losses from the fire exceeded the impairment of the lender’s collateral ninefold, the court held that there was no necessary relationship between the value of damaged collateral and the business loss resulting from its damage. Because the claim was paid to compensate business loss, not collateral, the lender’s security interest did not cover the settlement money.

Turning to whether the lender would be entitled to the business-loss portion of the claim against the utility company, the court analyzed language in the loan agreement which apparently granted a security interest in commercial tort claims. The definition of collateral in the agreement included “Commercial Tort Claims listed on Schedule B,” and, while the agreement authorized the lender to amend Schedule B to add any claims Certified might acquire, it expressly stated that Certified had no commercial tort claims other than those set forth on Schedule B. Additionally, despite the fact that the agreement was amended after the fire, Schedule B was never amended to add any claims and remained blank. CPC, the lender, claimed that it possessed a valid security interest in the business-loss claim itself, because its filed financing statement claimed collateral in all of Certified’s assets and expressly included “Commercial Tort Claims,” and its failure to add a specific reference to the claims in the loan agreement was an harmless mistake.

The court disagreed, concluding that the description of the collateral in the financing statement did not satisfy UCC requirements. The UCC provides that a security interest is only enforceable to the degree that the underlying security agreement provides a description of the collateral. Because the UCC requires that an agreement creating a security interest in commercial tort claims contain a descriptive component beyond the “type” alone

(i.e., a simple reference to “all commercial tort claims” is an insufficient description), neither a reference in the financing statement nor a general reference in the loan agreement, if one had been present, were adequate to create a valid security interest in the claims filed by Certified. The court reasoned that a “prudent potential creditor” would have requested a copy of the security agreement, and upon seeing the blank Schedule B, such creditor would have concluded that the lender had no security interest in Certified’s tort claims.

This case serves as a reminder that because commercial tort claims must be specifically described in a security agreement, lenders should take care to provide as much identifying information as possible in any security agreement as to then-existing claims they wish to include as collateral. Furthermore, a claim that has not yet come into being when the security agreement is drafted cannot be described at all. In this sense, the lender in *Helms* took the correct approach by including a schedule to its security agreement and by expressly providing for its amendment for any after-acquired claims. Nevertheless, because the lender failed to amend the schedule when the borrower provided notice of its pending tort claims, it lost any priority in such claims it might otherwise have had. If a creditor wishes to perfect a security interest in commercial tort claims, it must adequately describe such claims, by including at least some reference as to their subject matter, or better, specific references to information sufficient to identify individual claims. Finally, if a creditor wishes to perfect a security interest in claims that postdate its security agreement, it must take care that the agreement itself allows for such claims to be added to the definition of secured collateral in the agreement as they arise.

The text of the 7th Circuit’s decision is available at:
<http://www.ca7.uscourts.gov/tmp/MH0LNKQQ.pdf>.

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Treasury Calls for New Resolution Authority

On March 23, 2009, Treasury Secretary Timothy Geithner announced the need for a unified federal scheme that grants Treasury broad resolution authority over “systemically significant” financial companies currently outside the scope of the FDIC’s resolution regime. Accordingly, Treasury submitted its proposed “Resolution Authority for Systemically Significant Financial Companies Act of 2009” to Congress. The proposed legislation, which is largely a reworking of the current Federal Deposit Insurance Act (FDIA), would fill in some regulatory gaps and override the Bankruptcy Code under certain circumstances.

Currently, when a non-bank financial firm is in severe distress, it has one of two options: (1) to seek outside capital or federal funding, or (2) to file for bankruptcy. According to Treasury, neither option gives the federal government sufficient power to effectively manage the situation in a way that limits systemic risk while imposing a minimal cost on taxpayers.

Under the proposed legislation, the federal government would have authority to put such firms into conservatorship or receivership and then, respectively, to reorganize or liquidate the firm. In its current form, the Resolution Authority would apply to financial institutions deemed to pose potential systemic risk to the economy but which are not yet subject to the FDIC’s resolution authority. This includes bank and thrift holding companies and holding companies that control broker-dealers, insurance companies, and futures commission merchants.

Before exercising any powers granted under the proposed resolution, the Secretary, with the recommendation of both the Federal Reserve Board and the “appropriate federal regulatory agency” (the FDIC, SEC, or CFTC) and in consultation with the President, would need to make a determination that (1) the company is in danger of becoming insolvent; (2) its insolvency would have serious adverse effects on the economy or systemic financial stability; and (3) taking emergency action under the Resolution Authority would avoid or lessen those adverse effects. The Secretary and the FDIC would then make the decision of whether to provide financial assistance to the firm or to put it into conservator- or receivership.

As either conservator or receiver, the government would be granted broad powers over an at-risk firm, including the power to: (1) sell or transfer the assets or liabilities of the firm, (2) renegotiate or repudiate the firm’s existing contracts (including employment contracts), (3) merge the firm with another company, and (4) replace the firm’s board of directors and senior officers. In the case of receivership, the government could organize and operate a temporary “bridge financial company” which would have the power to assume some or all of the firm’s assets, and would eventually operate independently after the original firm was liquidated. Similarly to the FDIA, the proposed legislation would provide liability protection for the firm’s board of directors for allowing the appointment of a government conservator or receiver. The Resolution Authority would also allow the government to administer the claims process. Furthermore, in the event a conservator or receiver chooses to repudiate any of the firm’s contracts, the proposed legislation would place strict limits on the ability of parties to those contracts to seek damages. Additionally, the Resolution Authority would grant the government power to make loans to the firm at issue, purchase its obligations or assets, assume or guarantee its liabilities, or purchase an equity interest in the firm.

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HUD Enacts Changes ... *continued from page 1*

Modification of the HUD-1/1A Settlement Statements. In accordance with the modifications of the GFE form, the rule modifies the HUD-1 to facilitate borrowers' comparison of specific charges at closing with the estimated charges listed on the GFE. Furthermore, an addendum is added to the HUD-1 that will allow comparison of loan terms and settlement charges estimated on the GFE to the final charges on the HUD-1. Accordingly, loan originators may face increased scrutiny for any discrepancies between settlement costs quoted at the GFE stage and those imposed at settlement.

Permissibility of Average Cost Pricing and Negotiated Discounts. The final rule changes the term "average cost pricing" to "average charge," and clarifies that an average charge may be used by any settlement service provider that obtains a service from a third party on behalf of a borrower or a seller, not just by loan originators. The final rule also allows flexibility in calculating average charges while requiring the maintenance of certain records to ensure that regulators and borrowers are able to determine the basis on which the average charges were calculated.

While the new rule was effective as of January 16, 2009, compliance with the new requirements pertaining to the GFE and HUD-1 is not required until January 1, 2010. Financial institutions should ensure that they are prepared to implement the disclosure requirements that the new rule has introduced. The full text of the new rule, including the new GFE and the modified HUD-1 are available online at:

<http://www.hud.gov/utilities/intercept.cfm?/offices/hsg/ramh/res/finalrule.pdf>.

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The Resolution Authority would be funded either through appropriations from the Treasury's general fund or through a system of special assessments on all potentially covered financial companies. The existing deposit insurance fund would not be used to support any actions taken under the Resolution Authority. The full text of the proposed legislation is available at:

<http://www.treas.gov/press/releases/reports/032509%20legislation.pdf>.

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