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Mortgage-Backed Securities Litigation in the Wake of COVID-19

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Ropes & Gray's litigation & enforcement practice group is actively monitoring developments in mortgage-backed securities ("MBS") litigation in the wake of COVID-19. The global public health crisis has impacted nearly every industry and market sector in the United States. But with non-essential businesses shuttered across most of the country and millions of people experiencing joblessness, furloughs, and income reductions, the pandemic has caused a particular squeeze in commercial and residential mortgage payments. Mortgage servicers and MBS-holders alike are likely to feel the effects of the crisis.

In the 2008 financial crisis, residential mortgage-backed securities ("RMBS") were at the epicenter of the economic crisis. Though mortgages are collateral damage—rather than the driving force—of this crisis, we expect RMBS disputes to arise and litigation to follow on the heels of the coronavirus epidemic. One area where this may be particularly likely is disputes between MBS-holders and the entities that service the underlying mortgages. As the situation unfolds, below are some key issues for MBS-holders to watch:

- Unlike in 2008, when losses were weighted in sub-prime loans and among lower-income borrowers, COVID-19 is causing borrowers to be unable to pay mortgages across all income levels. Congress has passed legislation requiring servicers to allow borrowers to delay payments on federally backed mortgage loans for up to one year. Homeowners have been quick to avail themselves of this relief, with substantial increases in forbearance requests to servicers in the last few months.

- Servicers generally are contractually obligated to continue to advance payments to RMBS investors when borrowers stop paying, at least for a defined period of time. Until recently, the government had not yet acted to backstop the substantial outflows of cash by servicers in meeting their continued loan payment obligations during this extended period of broad-based borrower relief.

    - As a result of these increasing pressures, mortgage industry groups urged the Federal Housing Finance Agency to implement such a backstop to ensure that mortgage servicing firms do not go bankrupt during the mandated borrower forbearance. On April 21, 2020, the regulator announced a plan requiring servicing firms to advance only four months of cash payouts to bond investors, after which Fannie Mae and Freddie Mac will assume the obligation to advance payments on federally backed loans for up to eight months.

    - No such relief, however, has appeared for servicers in non-agency RMBS or other asset-backed securities, which may give rise to disputes about the servicers' continued obligations to make advancements to investors, and the extent and exercise of their discretion in determining if loans are seriously delinquent and not recoverable.

- In light of the current state of the market and evolving nature of the relief provided, RMBS investors should thoroughly familiarize themselves with the terms of the operative Pooling and Servicing Agreement or other documents governing the securities, which should include the following:

  - Understanding the agreement's provisions on the servicer's advancement obligations and reimbursement to better monitor the servicer's performance.

  - Evaluating whether recent legislation has impacted the servicer's obligations, and whether and to what extent the servicer retains and is exercising judgment in the servicing of delinquent loans.

  - Reviewing monthly remittance reports to determine whether servicers are recouping the cash advanced from payments made into the loan pool *before* the remittance payments are paid to investors through the trust's waterfall distribution, and to determine whether and where funds are missing from the waterfall. Disputes may arise about which funds the servicers are able to capture and which tranches of investors are impacted by the servicers' actions.

- Issues may likewise arise in connection with the servicing of commercial mortgage-backed securities ("CMBS"), particularly where the assets are concentrated in hard-hit geographies.

  - Many U.S. CMBS borrowers have inquired about relief relating to COVID-19. Fitch Ratings reports that, as of last week, more than 5,000 borrowers had contacted master servicers for relief since the pandemic began. These requests are heavily concentrated in the hotel, retail, and multi-family sectors. Coronavirus-related transfers to special servicing so far total $8.5 billion, and that number may well continue to rise while impacted industries recover.

  - Conflicts and disputes between and among borrowers, investors, and special servicers may be especially likely to arise in the wake of the pandemic, in light of special servicers' active role in managing the subject properties during default.

  - As with RMBS-holders, CMBS investors should pay close attention to loan performance and the details of the operative deal documents.