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A legal update from Dechert's Finance and Real Estate Group

RMBS Litigation Update

In this issue, we survey judicial decisions, complaints, and news items that have occurred in the months since the subprime mortgage crisis came to dominate the financial landscape. Our findings suggest that RMBS industry participants are facing greater exposure to litigation; thus it is increasingly important to keep abreast of current legal proceedings across the industry.

October 18, 2007

Luminent Mortgage Capital, Inc. ("Luminent") and two of its subsidiaries, Minerva Mortgage Finance Corporation ("Minerva") and Mercury Mortgage Finance Statutory Trust ("Mercury"), filed suit against HSBC Securities (USA) Inc. ("HSBC") in the U.S. District Court for the Southern District of New York.[1] The complaint alleges that HSBC wrongfully appropriated certain securities backed by subprime collateral (valued by plaintiffs at approximately $38 million) that Minerva and Mercury had posted with HSBC as collateral under several repurchase agreements. Luminent accuses HSBC of having issued premature margin calls (requiring approximately $6 million in posted collateral) on the securities in the wake of the initial outbreak of the August 2007 subprime crisis, declaring plaintiffs to be in default for not meeting said margin calls and holding a mock bidding process under which HSBC purchased the securities at drastically discounted prices. Compensatory and punitive damages are sought; as of the date of this update, the parties continue to amend their pleadings regarding various counterclaims and defenses.

November 12, 2007

Luminent and two of its subsidiaries, Minerva and Saturn Portfolio Management, Inc. ("Saturn"), filed suit against Barclays Capital, Inc. ("Barclays") in the U.S. District Court for the Southern District of New York.[2] Plaintiffs' claims against Barclays are similar to those in the October 18, 2007, complaint above and involve Barclays' alleged breach of repurchase agreements and the implied covenant of good faith and fair dealing. In August 2007, Barclays made margin calls on certain securities pursuant to the relevant repurchase agreements. Luminent refused to submit to Barclays' demands, which prompted Barclays to sell the securities. Luminent accuses Barclays of selling the securities to unidentified buyers at unreasonably low prices as well as assigning unreasonably low values to such securities before crediting plaintiffs' accounts upon completion of such sales. Luminent also claims that Barclays refused to honor a repurchase trade regarding a particular security it had issued and made misrepresentations regarding its reasons for refusal, which forced Saturn to ultimately sell the security back to Barclays at an artificial discount. Compensatory and punitive damages are sought; as of the date of this update, the parties were still filing motions in support of the pleadings.

October-November 2007

Several well-publicized recent decisions in the federal district courts of Ohio suggest that parties seeking to foreclose upon securitized mortgage loans may find themselves subjected to heightened

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1 *Luminent Mortgage Cap., Inc. v. HSBC Sec. (USA) Inc.*, No. 07 Civ. 9340, 2007 WL 3092976 (S.D.N.Y. Oct. 18, 2007).

2 *Luminent Mortgage Cap., Inc., et al. v. Barclays Cap. Inc.*, No. 07 CV 10275 (S.D.N.Y. filed Nov. 13, 2007).

scrutiny in the wake of the subprime mortgage crisis. Without directly addressing the ability of Mortgage Electronic Registration Systems, Inc. ("MERS") to foreclose on a mortgage loan, these cases stand for the principle that courts are unwilling to condone shortcuts in the mortgage assignment process that have become commonplace within the securitization industry.

For example, the U.S. District Court for the Northern District of Ohio dismissed 14 foreclosure actions ruling that the plaintiff-lenders had failed to demonstrate that they were the actual holders and owners of the mortgage notes. In reaching this conclusion, Judge Christopher A. Boyko cited the fact that each of the proffered mortgage notes reflected an original lending institution—rather than the current plaintiff-lender—as the mortgagee. In addition, none of the assignments named a plaintiff-lender as owner of the mortgage as of the date that the foreclosure actions had been brought. Based upon these findings, Judge Boyko determined that the plaintiff-lenders did not have standing to bring their foreclosure actions.

Importantly, the court rejected the plaintiffs' argument that the lender-plaintiffs had simply followed common industry practice, stating: "The institutions seem to adopt the attitude that since they have been doing this for so long, unchallenged, this practice equates with legal compliance. Finally put to the test, their weak legal arguments compel the Court to stop them at the gate."[3] In two subsequent cases, other federal judges in Ohio reached similar conclusions with respect to scores of additional foreclosure actions.[4]

January 8, 2008

The City of Baltimore filed a complaint in the U.S. District Court for the District of Maryland against Wells Fargo Bank, N.A. and Wells Fargo Financial Leasing.[5] The complaint alleges that Wells Fargo Bank engaged in "reverse redlining," the practice of targeting residents in certain geographical areas for unfair credit terms based on the racial or ethnic composition of the area, resulting in a disproportionate number of foreclosures in African-American neighborhoods. Reverse redlining is a violation of the Fair Housing Act of 1968. In the complaint, the City argues that the increase in foreclosures has taken a toll on the city's finances, citing a study that estimates total increases to administrative costs associated with a foreclosure to be as high as $34,199 per foreclosure. Baltimore is seeking a declaratory judgment, injunctive relief, compensatory damages, punitive damages, and attorneys' fees.

January 10, 2008

The City of Cleveland filed suit against 21 financial institutions, alleging that the defendants, which it describes as "the predominant 'securitizers' of sub-prime mortgages," are responsible for a subprime mortgage crisis that has caused thousands of foreclosures in the Cleveland area.[6] In a complaint filed in the Court of Common Pleas in Cuyahoga County, OH, the city argues that the various banks and mortgage lenders (including Goldman, Merrill, Bear Stearns, JPMorgan, and Lehman Brothers) are liable for "public nuisance," having caused the city to suffer damages including "(a) the cost of monitoring, maintaining and demolishing foreclosed properties and (b) decreased tax revenues resulting from the depreciated value of the affected homes and surrounding real estate." Notably, while only several of the defendants, or their subsidiaries, actually made mortgage loans directly to borrowers in the Cleveland area, the complaint alleges that all of the defendants could have and should have foreseen that the proliferation of subprime lending resulting from their activities in issuing or underwriting mortgage-backed securities would inevitably lead to mass foreclosures in areas such as Cleveland.

January 16, 2008

A class action lawsuit was filed against Fidelity National Information Services ("Fidelity") in the U.S

3 *In Re Foreclosure Cases*, No. 1:07-cv-02282-CAB, 2007 WL 3232430 (N.D. Ohio Oct. 31, 2007).

4 *In Re Foreclosure Actions*, No. 07 CV 1007, 2007 WL 4034554 (N.D. Ohio, Nov. 14, 2007)); *In Re Foreclosure Cases*, 521 F. Supp. 2d 650 (N.D. Ohio 2007).

5 *Mayor and City Council of Balt. v. Wells Fargo Bank, N.A.*, No. L08 CV 062, 2008 WL 117894 (D.Md. Jan. 8, 2008).

6 *City of Cleveland v. Deutsche Bank Trust*, No. CV 08 646970, 2008 WL 192123 (Ohio Com.Pl. filed Jan. 10, 2008).

Bankruptcy Court for the Southern District of Texas, alleging that Fidelity, a large default servicer, regularly takes kickbacks on the fees it charges to client mortgage servicers for legal services rendered by third party attorneys.[7] The complaint stems from an ongoing Chapter 13 bankruptcy proceeding in which mortgage servicer Saxon Mortgage Services, Inc. ("Saxon") is a creditor of the debtor plaintiffs. Saxon employs Fidelity to act as its default servicer. Plaintiffs argue that Fidelity is in the practice of keeping approximately half of the legal premiums paid by client servicers and passing the other half on to the third party law firms that Fidelity engages to work on behalf of the servicers. Plaintiffs allege that Fidelity's practice violates bankruptcy law in that it impairs a bankruptcy court's ability to assess and approve the disposition of a debtor's assets. The complaint also charges that Fidelity's practice runs afoul of the bankruptcy prohibition on fixing fees.

February 7, 2008

An investment adviser who had invested in subordinate tranches of RMBS filed suit against Washington Mutual Bank ("WAMU"), a servicer on the transaction, arguing that a breach by WAMU of its servicing obligations led to an improper reallocation of proceeds from subordinate to senior bond holders.[8] The claim relates to securitized mortgage loans that were serviced by WAMU, insured by the Federal Housing Administration ("FHA"), and guaranteed by the Department of Veterans' Affairs ("VA"). In a complaint filed in the U.S. District Court for the District of Colorado, plaintiffs contend that WAMU advanced too much money on delinquent mortgage loans to senior bondholders for too long a period of time. When proceeds from the mortgage loans were not available to reimburse WAMU for these advances, plaintiffs allege that, rather than properly collecting insurance amounts from FHA or VA or attempting to recover amounts from subsequent distributions to senior bond holders, WAMU reimbursed itself by imposing realized losses on the subordinate classes of bonds. The complaint charges breach of contract, promissory estoppel, and unjust enrichment.

7 *Harris v. Fidelity Nat'l Info. Servs. (In re Harris)*, No. 03-44826-H4-13, Adv. No. 08-AP-03014 (Bankr. S.D. Tex. filed Jan. 16, 2008).

8 *Braddock Fin. Corp., on behalf of Galena S. Fund, L.P. v. Washington Mut. Bank*, No. 08-cv-00265-WDM-MEH, 2008 WL 628423 (D. Colo. Feb. 7, 2008)

Other Developments:

February 12, 2008

On February 12, 2008, a group of six HOPE NOW alliance members—Bank of America, Chase, Citigroup, Countrywide, Washington Mutual, and Wells Fargo—announced the launch of Project Lifeline.[9]

Project Lifeline is an outreach program specifically aimed at homeowners who are 90 or more days delinquent. Notably, it will encompass all mortgage types—sub-prime, Alt-A, and Prime—as well as second liens and home equity lines. Qualifying loans can receive a thirty-day "pause" of foreclosure while the lender and the homeowner evaluate modification options. Loans can be disqualified if:

(i) they are in active bankruptcy;

(ii) they are in active foreclosure with a sale date less than 30 days away;

(iii) the homeowner indicates a desire to give up the home;

(iv) the property in question is an investment property; or

(v) the property is vacant.

In order to obtain a 30-day pause, homeowners must notify their servicer within 10 days of receiving notice, tell the servicer that they want to stay in the home, and provide updated financial information so that the servicer can explore the appropriate solution.[10]

Henry Paulson, Secretary of the Treasury, lauded the plan as an "important new initiative" in a speech coinciding with the announcement.[11] Within a week, the HOPE NOW alliance had announced that all of its

9 Project Lifeline – Overview, February 12, 2008, available at http://www.fsround.org/hope_now/pdfs/February12-ProjectLifelineOverview.pdf (hereafter "Project Lifeline Announcement").

10 Project Lifeline Announcement, supra at 9.

11 Statement by Secretary Henry M. Paulson, Jr. on New Private Sector Effort to Rach Homeowners Facing Foreclosure, February 12, 2008, available at http://www.treas.gov/press/releases/hp820.htm.

members will officially adopt Project Lifeline by the end of March 2008.[12]

February 20, 2008

Ohio Attorney General Marc Dann announced that he will issue approximately 15 new subpoenas to "household-name" mortgage companies, targeting industry players who may have knowingly made loans to inappropriate customers or passed risk-laden loans on to investors. Dann claims that the number of subpoenas could rise to the hundreds over the next several years. Approximately 15 subpoenas were issued by Dann last year targeting a broad range of mortgage industry participants. Ohio has suffered from a foreclosure rate that is historically higher than most other states. To date, Dann has already filed a securities fraud suit against Freddie Mac on behalf of the Ohio Public Employees Retirement System in January 2008 and plans to go after Fannie Mae over its failure to fully disclose its subprime holdings.[13]

March 4, 2008

The Office of Thrift Supervision ("OTS") has developed the beginnings of a new approach to prevent foreclosures in the U.S. residential mortgage market.[14] The OTS proposal focuses on instances where a borrower is unable to refinance a previously-securitized loan because the fair market value of the underlying property is less than the outstanding amount of the loan. In these situations, the OTS proposes that the FHA would provide a new loan up to the FHA-maximum of 97 percent of the fair market value of the property and that the proceeds of the FHA loan would be used to repay the original loan.

Investors in the securitization transaction holding the initial loan would also receive a "negative equity interest," evidenced by a certificate representing an interest in the negative equity, for the amount of the shortfall between the FHA loan and the amount outstanding on the original loan. As initially structured, in the event of a subsequent sale of the property, holders of the negative equity interest would be entitled to all excess of the sale price of the house above the initial repayment received from the FHA loan proceeds. Payments to negative equity interest holders would be capped at the full value of the negative equity interest, and any excess above that amount would be payable back to the borrower.

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This update was authored by Eric Iversen (+1 212 698 3538; eric.iversen@dechert.com), Andrew Pontano (+1 212 698 3505; andrew.pontano@dechert.com), Ryan McNaughton (+1 212 698 3848; ryan.mcnaughton@dechert.com), and Eirik Tellefsen (+1 215 994 2172; eirik.tellefsen@dechert.com).

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12 HOPE NOW: Project Lifeline Adopted by All Alliance Members, Press Release, February 19, 2008, available at http://www.fsround.org/hope_now/pdfs/13-19FebruaryRelease.pdf.

13 Joseph A. Giannone, *Ohio expands mortgage industry probe*, Reuters, Feb. 21, 2008, *available at* http://www.reuters.com/article/Housing08/idUSN2064104120080220?sp=true.

14 Statement of John M. Reich Concerning The Condition of the Thrift Industry before the Committee on Banking, Housing and Urban Affairs of the United States Senate, March 4, 2008, at 24, available at http://www.ots.treas.gov/docs/8/87158.pdf (outlining the OTS proposal as well as variations thereof to address specific equity concerns).

Practice group contacts

If you have questions regarding the information in this legal update, please contact the authors or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/finance&realestate.

Eric P. Iversen
New York
+1 212 698 3538
eric.iversen@dechert.com

Steven J. Molitor
Philadelphia
+1 215 994 2777
steven.molitor@dechert.com

Joseph V. Gatti
Washington, D.C.
+1 202 261 3436
joseph.gatti@dechert.com

Ralph R. Mazzeo
Philadelphia
+1 215 994 2417
ralph.mazzeo@dechert.com

www.dechert.com

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