Lender-Liability Issues in Securitized Mortgage Loans

By John C. Murray
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Introduction

There are relatively few lender-liability cases dealing directly with the special issues involved in originating and servicing securitized mortgage loans. The cases that have been decided are fact-specific (as in most lender-liability cases), but there are some valuable lessons that can be gleaned from these cases that should be instructive to both lenders and borrowers (as well as to loan originators, servicers, and other participants in commercial mortgage loan securitizations). For example, purchasers of mortgage-backed securities sometimes assert negligence actions against the seller for alleged breaches of a "duty of care" regarding specific representations and warranties contained in the securitization agreements. As one commentator has noted:

> Litigation has arisen where a mortgagor is in default on its mortgage, thereby affecting the value of the pooled assets, or is otherwise out of compliance with the terms of the mortgage. The purchaser of the pooled assets (i.e., the financial institution investing in the mortgage-backed securities) or the mortgage servicer may sue the seller (i.e., the investment bank offering the mortgage-backed securities) for breach of contract. The purchaser of the pooled assets may also sue the seller for breach of the representations and warranties under the PSA [Pooling and Servicing Agreement]. The causes of action for a breach of a securitization agreement claim mirror those for breach of contract[.]

Robert M. Abrahams, *Securitization Disputes – Breach of Securitization Agreement*, 8 BUS. & COMM. LITIG. FED. CTS. § 90:12 (2d ed.) (2007).

This article will examine the case law in this area, which is still evolving. Given the current state of the real estate market and the economy in general, and increased governmental and private scrutiny of securitized mortgage transactions (especially subprime securitized mortgage transactions), as well as the dramatic increase in investments in mortgage-backed securities by individual and institutional investors over the past few years, litigation in this area is certain to increase.

Ruling in Favor of Lender – the *Blue Hills Office Park* Decision

A Massachusetts U.S. district court case, *Blue Hills Office Park LLC v. J.P Morgan Chase Bank*, 477 F.Supp.2d 366 (D. Mass. 2007), dealt with lender-liability issues regarding a securitized mortgage loan. This case is a significant victory for lenders, and contains more than a few lessons for borrowers to learn from. The lender's lawyers did a great job for their client on this case (and the firm was awarded all of its attorney's fees as part of the judgment against the borrower!).

The district court rejected virtually all of the borrower's lender-liability claims and upheld virtually all of the lender's claims for "borrower liability." As the court noted, "This high stakes, winner-takes-all, quintessentially complex commercial case involves a $33 million dollar nonrecourse loan, multiple sophisticated parties, and an abundance of loan documents." *Id.* at 368. The plaintiff, Blue Hills Office Park LLC ("Blue Hills") alleged that the defendants (all participants in the origination and securitization of the loan): 1) breached the mortgage contract; 2) breached the case management agreement; 3) breached the implied covenant of good faith and fair dealing, and; 4) violated a specific Massachusetts consumer-protection statute (MASSACHUSETTS GENERAL LAWS chapter 93A) by making intentional misrepresentations. The lender defended these accusations by raising several counterclaims, alleging that Blue Hills had itself breached both the loan contract and the implied covenant of good faith and fair dealing. The lender also "raised the stakes" by alleging that the loan's individual guarantors themselves made intentional representations in violation of MASSACHUSETTS GENERAL LAWS chapter 93A.

The district court, after hearing all the evidence at a bench trial and based on the clear language of the loan documents, ruled that: 1) the lender was not required to give 30 days' notice before declaring the borrower in default for missing a tax payment; 2) the lender did not violate the mortgage agreement by declaring the borrower in default; 3) the lender did not breach the covenant of good faith and fair dealing; 4) the lender did not violate the Massachusetts Consumer Protection Act; 5) the borrower defaulted by settling a zoning claim for $2 million against an adjoining landowner without the lender's approval; 6) the guarantors were liable for the excess of the remaining debt over the amount received through foreclosure; 7) the borrowers' actions had not risen to the level of outright fraud because there was no affirmative misrepresentation or affirmative attempt to mislead the lender; and 8) prejudgment interest began to accrue from the date of default, rather than the date payment was demanded. Also, the court permitted the lender to recover its actual attorneys' fees (in excess of $2 million) against both the borrower and the guarantors because one of the mortgage provisions specifically provided that the lender could recover all attorneys' fees actually incurred "to protect its interest in the Mortgaged Property," and another mortgage provision provided that the lender could recover "all costs and expenses of Mortgagee in exercising its rights and remedies" under the default provision in the mortgage; furthermore, the guaranty specified that the guarantors were jointly and severally liable for the amount of the debt, "which encompasses attorneys' fees and expenses." *Id*. at 3.

This case is very instructive and interesting reading and is one of the few reported cases nationwide on this particular subject.

See also Steed Finance LDC v. Nomura Securities Intern., Inc., 148 Fed. Appx. 66 (C.A.2 N.Y., 2005). In this case the investor in mortgage-backed securities brought a securities fraud action against the originator of the mortgage loans. The United States District Court for the Southern District of New York entered summary judgment in favor of the originator, and the investor appealed. The Court of Appeals held that: (1) the investor had access to all of the critical disclosure documents and was sufficiently apprised of the potential risks associated with the loan to a hospital, and could not show that it justifiably relied on any of the alleged misrepresentations or omissions; (2) the originator did not act with scienter required to support a securities fraud claim when it allegedly misrepresented to the investor that the hospital loan qualified as a Real Estate Mortgage Investment Conduit loan and, (3) the originator was not liable to the investor on a negligent misrepresentation theory under New York law.

Ruling in Favor of Borrower – the *1601 McCarthy Boulevard* Decision

A 2005 California case, *1601 McCarthy Boulevard LLC v. GMAC Commercial Mortgage Corp.*, Case No. CGC-03-425848, California Superior Court (March 21, 2005) (unreported trial court decision) -- albeit a lower-court decision that apparently was not appealed -- concerned the actions of GMAC Commercial Mortgage Corp. ("GMAC"), as special servicer for a securitized loan. This case contains an interesting discussion on the use of "material adverse change" clauses, as well as loan-workout planning and conflicts of interest. Unlike the situation in the *Blue Hills Office Park* decision, *supra*, the special servicer was "slammed" in this case. The following is an excellent analysis of this case by Prof. Dale Whitman (as the "Daily Development" on the DIRT listserv for March 30, 2005, Dirt@listserv.umkc.edu; the DIRT listserv, a superb resource for real estate lawyers, was created by, and is monitored and edited by, Professor Patrick A. Randolph of the University of Missouri -- Kansas City School of Law):

> LENDER LIABILITY; SPECIAL SERVICERS: Special servicer loses suit by borrower for return of lease termination fee, plus big punitive damages judgment.
>
> *1601 McCarthy Blvd. v. GMAC Commercial Mortgage Corp.*, Case No. CGC-03-425848, California Superior Court, Mar. 21, 2005 (Unreported trial court decision)
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> When commercial mortgage loans are securitized, it is common to have at least two servicers appointed: a primary or master servicer, who will service the loans in the securitized pool so long as they are current, and a special servicer who will take over servicing of defaulted loans. The special servicer is typically designated by the

holder of the securities having the lowest priority (commonly termed the "B piece"). Indeed, in some cases the purchaser of the "B piece" will directly serve as special servicer. This close relationship is usually justified on the ground that, since the holder of the "B piece" will sustain the first losses in the event of loan delinquency, it should have a strong voice in resolving delinquencies.

In the present case the special servicer was GMAC Commercial Mortgage Corp., which serves as primary servicer or special servicer on a very large number of mortgage loan pools. The borrower on the loan in question, 1601 McCarthy, owned an office building in Milpitas, California. Its anchor tenant requested and received a release from its lease, in return for a payment of a $7.2 million lease termination fee. The fee was deposited in a trust account held by GMAC, with the apparent intention that it was to be released to 1601 McCarthy when it found a replacement tenant.

When a new tenant was found, however, GMAC refused to release the fee to 1601 McCarthy. Initially, GMAC attempted to renegotiate the language of the loan agreement as a way of establishing its right to pay the termination fee down on the loan balance. When this was unsuccessful, GMAC then claimed that the lease termination had resulted in a "material adverse change" in 1601 McCarthy's financial condition, and hence that the borrower was in technical default. (Apparently there was no monetary default by 1601 McCarthy.)

The borrower's lawyers claimed that GMAC had refused to refund the fee as a device for forcing the borrower into foreclosure. The jury found that GMAC had violated the loan agreement by withholding the funds. It assessed a punitive damage award of $33 million on top of the return of the $7.2 million fee!

Reporter's Comment: The description above was pieced together from news reports, since the case is not officially reported. 1601 McCarthy was represented in the judicial action against GMAC by Keker & Van Nest. On its face, there is nothing terribly unusual about the substantive decision After all, a mortgagee, or the servicer for a mortgagee, is bound by the loan documents. Of course, the "material adverse change" language sometimes found in

loan agreements as a basis for declaring a default is "squishy" language; all borrowers' financial positions fluctuate to some extent, and a mortgagee or servicer who relies on this as the sole basis for a default had better have strong evidence of a very serious financial problem. In the present case, the jury was apparently convinced that the "material adverse change" was a subterfuge, and that GMAC was trying to "steal" the building.

Editor's Comment 1: Also based upon rumor and hearsay, the editor understands that GMAC was the "B Piece" holder (or partial holder) as well as the special servicer here. [Author's note: This is true. The author has a copy of the case, which confirms, at p. 4 of the opinion, that GMAC was the special servicer as well as the holder of the "unrated – or 'junk' bond – tranche of [the mortgage loan pool]. Because the losses in the [mortgage loan pool] first flow to the unrated tranche, GMAC would be hurt significantly by any losses in the [mortgage loan] pool."] This complicated things for GMAC. The jury seems to have seen GMAC's conduct as an attempt to convert a high-risk, high-return investment into a windfall profit.

There is a distinct danger for "B Piece" holders when mortgage borrowers weaken. These investors don't really make out unless and until the loan is paid to maturity or prepaid in such a way that prepayment premium pays off in the same way that a payment to maturity would. Thus, even though the borrower's security still exceeds the amount owed on the loan, a default and foreclosure for the loan amount is a disaster for the "B Piece" holder. Hence, as special servicer, it will look at long term borrower viability issues very differently. Borrowers are going to have to get used to this if they are going to seek the price benefits of securitized lending.

Editor's Comment 2: If, as Reporter Dale Whitman suggests, the borrower was not in [monetary] default, then it is of some interest that the "special servicer" was involved in the deal at all. Perhaps the loss of a major tenant was an event triggering GMAC's involvement.

The Reporter for this item was Dale Whitman of the Missouri/Columbia Law School.

S*ee also Wells Fargo Bank Minnesota v. Wachovia Bank*, 196 Fed. Appx. 246 (5th Cir. 2006). In this case, the court held that the destruction of loan origination and other loan documents constituted a breach of the seller's contractual representations and warranties under the purchase agreement; i.e., that it had delivered those documents to the trustee holding the mortgages; but the court ruled further that the buyers could not prove any damages caused by such breach. The court stated that, "On this record, we find that the presence or absence of the origination documents did not affect [the buyer's] decision to purchase the certificates. Moreover, the record contains testimony that the market value of the loans increased after the absence of the origination documents became public knowledge. This undermines the claim that the documents had significant value." *Id*. at 250.

In *First Alliance Mortgage Co. v. Lehman Commercial Paper, Inc.*, 471 F.3d 977 (Ca. 2008), causes of action were filed in the bankrupt subprime lender's Chapter 11 bankruptcy case, first by borrowers who were allegedly defrauded by the subprime lender to recover from other lenders that financed the subprime lender's operation on an aiding and abetting theory, and secondly by the trustee appointed to liquidate the subprime lender to set aside payments to these other lenders as fraudulent transfers and to equitably subordinate proof of claim filed by these other lenders. The District Court entered an order denying the trustee relief on his fraudulent transfer and equitable subordination claims, and appeal was taken. The appellate court consolidated the appeal with a separate judgment for the borrowers on their aiding and abetting claim. The lender argued that reliance was not satisfied because the borrowers signed documents that contradicted the oral misrepresentations made by the lender. *Id.* at 992. The Ninth Circuit rejected that argument because "it was by design that [plaintiffs] did not understand that the loan documents told a different story," *Id.*, and that California law did not impose a presumption of reliance; instead, it required that the misrepresentation be a "substantial factor" in inducing plaintiff's action. *Id.* The court ruled that the jury's finding of class-wide fraud was supported by the evidence, and could not be disturbed on a motion for new trial or judgment as a matter of law in class litigation to recover from lenders that allegedly aided and abetted the bankrupt subprime mortgage lender's fraud, given evidence of the bankrupt subprime lender's use of a standardized training program for its sales agents, which included a script that the agents were required to memorize and strict adherence to a specific method of hiding information and of misleading borrowers.

In *F.D.I.C. v. Bakkebo*, 506 F.3d 286 (4th Cir. (W.Va., Oct. 25, 2007), the Federal Deposit Insurance Corporation ("FDIC"), as receiver for a failed local bank in West Virginia, the First National Bank of Keystone ("Keystone"), brought a civil action for fraud and conspiracy to commit fraud against, *inter alia*, the principal for the mortgage company and the loan-servicing company used in the alleged fraudulent scheme. Following a jury trial, the District Court for the Southern District of West Virginia entered a $161 million judgment against the principal and denied his post-trial motion for judgment as a matter of law, a new trial, or remittitur. The principal then appealed to the Fourth Circuit Court of Appeals, which affirmed the findings of the District Court.

According to the Court of Appeals, "In the mid 1990s, the principal and several co-conspirators induced Keystone to invest hundreds of millions of dollars in a financial enterprise known as loan securitization, in which Keystone purchased thousands of subprime home loans from the lenders that had originally made the loans (or from other entities that had previously acquired the loans), then resold the rights to most of the loans' proceeds in the form of special mortgage-backed securities." *Id.* at 289. The Court of Appeals noted that the principal's co-conspirator "effectively exercised sole control over the securitization program in which Keystone engaged." *Id*. at 290.

The Court of Appeals held that the evidence supported the jury's finding that the principal's co-conspirator made fraudulent misrepresentations to Keystone regarding the following: the co-conspirator's receipt of kickbacks from the principal for which he performed no work; the underwriter's warning that the loan securitization program undertaken by Keystone on advice of the co-conspirator was a money-losing venture plagued by low-quality loans and sloppy administration, which permitted the conclusion that the co-conspirator's representations to Keystone regarding the program's future performance were not made in the honest belief that they would prove correct; and that the co-conspirator misrepresented past and existing material facts, such as the low quality of loans bought from the mortgage company and the present value of Keystone's residual interests in the program. The court further ruled that Keystone, as a small local bank unfamiliar with securitization, was justified in relying on the false representations made by the principal and co-conspirator and that the amount of the award was justified by the evidence. (As noted by the court in *Gariety v. Vorono*, 2008 WL 110906, C.A.4 (W.Va.), Jan. 8, 2004, at *1, "Until the early 1990s, Keystone was a community bank in the small town of Keystone, West Virginia (population less than 1,000) with assets of around $17 million. The town of Keystone itself "looks like a movie set left over from Coal Miner's Daughter." Timothy Roche, *Poor Town, Rich Bank,* Time Magazine, November 1, 1999.")

See generally Helen Davis Chaitman, *Fifth Circuit Affirms Denial of Damages to Mortgage Pool Trustee Based on Lack of Evidence that the Destruction of Loan Origination Documents Diminished the Value of the Pool*, 03-07 LENDER LIAB. LAW REP. 1 (discussing court's holding in *Wells Fargo* case).

Mixed Ruling – the *LaSalle Bank National Association* Decision

In *LaSalle Bank Nat'l Ass'n v. Nomura Asset Capital Corp*., 424 F.3d 195 (2nd Cir. 2005), there were two contracts, a Mortgage Loan Purchase Agreement ("MLPA") and a Pooling and Servicing Agreement ("PSA"), governing commercial mortgage loans either originated or acquired by Nomura Asset Capital Corporation ("Nomura") and in turn sold through its affiliate, Asset Securitization Corp. ("ASC"), to LaSalle Bank National Association ("LaSalle"), as trustee of a $1.8 billion commercial backed securities trust. (LaSalle purchased each of the 156 mortgage loans in the fund.) LaSalle alleged that Nomura and ASC breached several standard warranties contained in the aforementioned contracts for the sale and securitization of the commercial mortgage loans -- including that each loan was secured by a mortgage on real property with a fair

market value at least equal to 80 percent of the principal loan amount as of a certain date (the court determined that in fact the loans were only 60% secured), and that each mortgage was qualified for inclusion in the real estate mortgage investment conduit ("REMIC") for federal income-tax purposes. The Second Circuit noted that, "[a]lthough this dispute implicates the multi-billion dollar market for a complex and often risky class of investments known as commercial mortgage-backed securities, it revolves around a single, ill-fated mortgage on a now-defunct Chicago Hospital." *Id.* at 199. The Second Circuit described the mortgage-securitization process as follows:

> The Doctors Hospital Loan was underwritten by Nomura, a major participant in the mortgage-backed securities market, which in October 1997 sold it, along with 155 other commercial mortgages, to an affiliate, ASC. ASC, in turn, packaged the mortgages into a single, $1.8 billion fund, the Series 1997-D5 Trust (the "D5 Trust"), appointed LaSalle as the fund's trustee, and sold stakes in the fund to investors. It is these stakes – the "bonds" or "certificates" – that are ordinarily referred to as commercial mortgage-backed securities ("CMBS").

Id. at 200.

The Second Circuit ruled that it could not rely on extrinsic evidence of the parties' intent, such as their course of dealing, to interpret the unambiguous contract warranties, and agreed with the district court's finding that there was insufficient evidence that Nomura and ASC breached the origination warranty. But the Second Circuit disagreed with the district court's finding that the eighty-percent warranty and the qualified-mortgage warranty were redundant, and ruled that the applicable REMIC "safe harbor" provision was expressly negated by the terms of the MLPA and did not in any event apply to or cover mortgage originators. (The REMIC safe-harbor provision provides that an obligation is "deemed" to be "principally secured by an interest in real property" if the "sponsor" of the REMIC "reasonably believes" that the obligation is so secured "at the time the sponsor contributes [the] obligation to [the] REMIC." 26 C.F.R. sec. 1.860G-2(a)(1)(i).) The Second Circuit found that the 80% loan-to-value guaranty applied to the collateral position of the loans and not the tax consequences of each loan. The Second Circuit further determined that Nomura and ASC had not properly cured any breach by providing a legal-opinion "comfort letter" opining that the mortgage qualified for inclusion in a REMIC. The Second Circuit therefore affirmed the district court's holding with respect to the origination warranty but vacated its judgment with respect to the defendants' satisfaction of the eighty percent warranty and the qualified mortgage warranty, and remanded the case for further proceedings.

See generally Gregg J. Loubier, *Securitized Commercial Mortgage Loans, Modifications and Workouts*, 22 CAL. R. PROP. J. 31 (2004) (discussing mortgage defaults and loan modifications under REMIC rules); William G. Murray, Jr., *Workouts in the Twenty First Century*, 17 CAL. R. PROP. J. 1 (1999) (discussing structure and workouts of

securitized loans, including REMICs); *Securitization: Second Circuit Holds for Bank Trustee in Dispute Over Terms in Securitization Pact*, BANKING DAILY HIGHLIGHTS (BNA, Sept. 22, 2005) (discussing *LaSalle Bank* case, *supra*); Geoffrey K. Milne and Denis R. Caron, *Secondary Market – Reliance and Sale of Loans in Secondary Market*, 4 L. DISTRESSED REAL EST. § 44A:10 (2007) (discussing *LaSalle Bank* case, *supra*, and other recent securitization cases); Helen Davis Chaitman, *Massachusetts Federal Court Enters Judgment in Favor of Lender on Contract Despite Non-Recourse Nature of Loan*, 11-07 LENDER LIAB. LAW REP. 2. (discussing *LaSalle Bank* case, *supra*); Kenneth G. Lore and Cameron L. Cowan, Chapter 2, *The Public and Private Sectors in an Expanding Secondary Mortgage, Mortgage-Backed Securities* (Thomson/West and Westlaw MORTSEC) (providing detailed description of secondary market); Anthony Lin, *Suit Reflects Risks of Practice in Mortgage-Backed Securities*, 238 N.Y.L.J. 1 (col. 3) (2007) (discussing *LaSalle Bank* case, *supra*); Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. _____ (Issue No. 4, February/March 2008); this paper can currently be downloaded free of charge at: http://papers.ssrn.com/sol3/papers.cfm?abstract id=1012937.

Subprime Mortgage Securitizations

In *Chase Manhattan Corp. v. Advanta Corp.*, 2005 WL 2234608 (D.Del., Sept. 8, 2005), the federal district court awarded Chase Manhattan Bank ("Chase") $17,516,000 based on Advanta Corporation's ("Advanta") breach of an MLPA between the parties involving subprime mortgage loans originated by Advanta and sold to Chase. (Advanta was both the servicer and the residual interest holder in the securitizations it sponsored.) Chase alleged that Advanta engaged in federal securities fraud (under applicable federal and Delaware statutes), negligent representation, and breach of contract, based on Advanta's failure to accurately disclose delinquent interest advances as required by the Agreement. (In general, there are several types of advances that a servicer may be required to make, namely "servicing" or "escrow" advances, "delinquent interest advances," and "corporate advances.") But the award by the court was made only under the breach-of-contract claim; the court rejected Chase's claims based on common law fraud, federal securities law fraud, and negligent misrepresentation, finding that Chase, as a party "sophisticated in investor accounting," was derelict in its own due diligence regarding the loans it purchased based on the evidence presented and the totality of the circumstances, and that its reliance on the information supplied by Advanta was not reasonable, especially since there was an integration clause in the Agreement. The court stated that:

> Among the information Advanta provided to Chase were several disclosures which, upon a reasonable examination, would have alerted Chase that its loss assumptions, and hence its valuations of Advanta's Securitizations, were inconsistent with the historical and likely future performance of the Securitizations, or at least would have

> caused Chase to ask more questions about Advanta's reporting of losses.

Id. at *20.

The court also noted that there was no fiduciary relationship between the parties and that they had engaged in a longstanding business relationship, thereby negating any liability under tort theories. (Securitization agreements do not always contain express indemnification clauses, and so the existence of a "special relationship" between the parties may need to be implied by a court as a matter of law in order for a party to prevail on a claim of indemnity.)

One commentator has cogently summarized the holding of the federal district court in the *Chase Manhattan* case as follows:

> When lenders allege that they sustained losses because of the conduct of originators, the courts will examine the station of the parties in the transaction; if agreements exist that define the parties' relationship, reliance may be difficult to prove. Although not directly on point, the trial court opinion in *Chase Manhattan Corp. v. Advanta Corp*. demonstrates the difficulty of proving reliance on loan information when two commercial parties have negotiated an agreement with an integration clause. In that case, Chase alleged that Advanta engaged in federal securities law violations, common law fraud, negligent misrepresentation and breach of contract in connection with the purchase of sub-prime mortgage securitizations. The claims in this case did not stem from collateral valuation issues, but rather from the manner by which liquidated losses were reported, which did not include delinquency advances. What is particularly important is the court's treatment of the purchase and sale agreement; it concluded that, based upon an integration clause, the absence of a fiduciary relationship, the ability of Chase to detect fraud, the sophistication of the plaintiff, its access to relevant information and the existence of a long standing business or personal relationship, that no tort liability would be imposed. The court cited *AES Corp. v. Dow Chem. Co.* [325 F.3d 174 (3rd Cir. 2003)]. Although the Court awarded Chase more than $17 million on the breach of contract claim, it failed to find in Chase's favor on the fraud, securities law and negligent misrepresentation claims. Specifically, the court stated that "no Chase witness testified to reviewing the loss information contained in the Prospectus Supplements." Apparently, the court concluded

that more thorough due diligence would have disclosed the loss potential within the Advanta securitizations. This analysis is especially instructive, as a court faced with similar claims involving collateral overvaluation may simply rely upon the agreements at issue, particularly when valuation information may be obtained through public records and automated valuation models.

> Automated valuation models are speedy; also, they are objective and they reduce costs. They are based, however, on public data which, if stale or based upon certain market conditions, may reflect inaccurate valuations. Most notably, AVMs cannot be used to determine the physical condition and marketability of a property. Finally, an AVM cannot employ the breadth of knowledge and judgment of a skilled appraiser. Nevertheless, an AVM may still be a valid tool for lenders in assessing collateral value, in addition to a traditional appraisal and a review of the title.

Milne and Caron, *supra*, 4 L. DISTRESSED REAL EST. at § 44A:10.

See also Chase Nets $16.7 Million in Suit Over Mortgage Pools, 11 No. 10 ANDREWS' BANK & LENDER LIAB. LITIG. REP. 8 (2005) (discussing court's ruling in *Chase Manhattan* case); *Repurchases Stinging Subprime Sector*, MORTGAGEDAILY.COM, January 8, 2007 (noting that "[b]uybacks are exacting a toll on subprime lenders – even forcing some out of business").

There have been a growing number of claims asserting federal and state securities fraud involving the purchase and sale of mortgage-backed securities. But, according to one commentator, "courts normally will not attribute either duty or reliance by the parties to a securitization contract, due to the arm's length nature of the transaction and sophistication of the respective parties which . . . are almost always both financial institutions." Robert M. Abrams, *Securitization Disputes – Negligence/Fraud/Negligent Misrepresentation*, *supra*, 8 BUS. & COMM. LITG. FED. CTS. § 90:13 (2d ed.) (2007). The author cites and summarizes the following cases (in addition to the *Chase Manhattan* case, *supra*,) in support of this conclusion:

> *In re American Business Financial Services, Inc. Securities Litigation*, 413 F. Supp. 2d 378, 398-403 (E.D. Pa. 2005) (federal securities fraud class action in which investors claimed that mortgage lenders officials fraudulently altered its loan delinquency ratios to strengthen sales of its securitized loan pools. The court granted summary judgment on the grounds that investors did not provide the level of detail required under the heightened pleading standards for such claims, and did not demonstrate

> materiality of the alleged misstatements or scienter on the part of the defendants, among other evidentiary deficiencies); *In re New York Community Bancorp, Inc., Securities Litigation*, 448 F. Supp. 2d 466, 478–80 (E.D.N.Y. 2006) (court granted motion to dismiss where securities fraud class action plaintiffs claim misrepresentations under the securities laws for strategy statements that allegedly contradicted defendant's higher risk strategy of investing in mortgage-backed securities, as company had disclosed its investments in such securities in numerous public documents); *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 2006 WL 2161887 at *12 (S.D. N.Y. 2006) (court denies motion for class certification in securities fraud class action, holding that plaintiffs did not meet predominance requirement, where plaintiffs wished to show reliance on misstatements regarding defendant's packaging of loans for issuance as asset-backed securities through the fraud-on -the-market theory and court held that the market for asset-backed securities is not efficient as required for use of that theory). *But see Fraternity Fund Ltd. v. Beacon Hill Asset Management LLC.*, 376 F. Supp. 2d 385 (S.D. N.Y. 2005), *as amended* (July 6, 2005) (court denied motion to dismiss federal and state securities fraud and negligent misrepresentation claims in suits against investors in hedge funds specializing in mortgage-backed and related securities, where investors claimed that the funds overstated the net asset values of the securities).

Abrahams, *supra*, at fn. 4.

The Abrahams article also contains an excellent description of PSAs and the warranties and representations contained therein:

> PSAs typically contain many different representations with respect to the underlying mortgages and the administration of the mortgage pool. Common examples include representations that: there are no material defaults in the mortgage notes; the real estate is free of liens, encumbrances and realty tax indebtedness; the mortgage instruments are duly executed and fully enforceable; each mortgage is a valid first lien on the property; and all property taxes have been paid.

Id. at fn. 1.

The *Chase Manhattan* case also contains the following discussion and description of subprime mortgage securitizations in general (which are in such financial difficulty today):

> A. General Background on Subprime Mortgage Securitizations
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> 1. Central to this case are residual interests in subprime mortgage securitizations. A subprime mortgage loan is a mortgage loan to a borrower with sub-standard credit. In a subprime mortgage securitization, a number of mortgage loans are pooled together and sold into a trust by an "originator." Interests in the trust are in turn sold to investors, known in this case as certificateholders. The cash from the certificateholders goes to the originator, and the originator can then use that cash to originate more loans. The certificateholders receive monthly payments, constituting a paydown of their principal investment and interest on that investment.
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> 2. When a subprime mortgage securitization is formed, a number of complex, interrelated contracts are executed. Typically a Pooling and Servicing Agreement ("PSA") is among them. In general, the PSA sets forth the rights and obligations of the participants in the securitization.
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> 3. Subprime mortgage securitizations generally have a trustee that is responsible for, among other things, reporting information about the trust activities to the certificateholders and distributing cash to the participants in the securitizations. Such securitizations also typically have a servicer who is responsible for receiving payments from mortgage borrowers, depositing those payments into a custodial account (known as a "P & I account"), handling collections and foreclosure matters, and providing information to the trustee. In addition, the servicer generally must preserve the trust's interest in the collateral, which could include making tax payments, paying for maintenance, or paying attorneys' fees related to foreclosure actions. These payments are generally known as "servicing advances" or "escrow advances." A servicer may also be required to advance to the trust the amount of unpaid interest and principal due from a delinquent borrower. Advances of interest are known as "delinquent interest advances," "delinquency Advances," or "interest advances." When the servicer makes servicing or

> interest advances as a result of delinquent loans, the PSA generally provides that the servicer is entitled to be reimbursed for those advances. Advanta also sometimes refers to property preservation expenses as "corporate advances."
>
> 4. As cash comes in from payments collected from the mortgage borrowers, it is used to reimburse servicing advances, to repay interest and principal owed, and to provide a monthly payment to the certificateholders; any remaining money goes into what is called the "residual account" or "residual interest." The result of this structure is that the residual interest holder either suffers the effect of any losses or benefits from the gains.

Chase Manhattan Corp. v. Advanta Corp., 2005 WL 2234608 at *1-2 (internal citations omitted).

Note that in the *Chase Manhattan* case, Chase, as the purchaser of the subprime mortgage loans under the Purchase and Sale Agreement, alleged that Advanta engaged in securities fraud under both federal and Delaware statutes (the express terms of the Agreement specified that all contract claims were governed by Delaware law), but that these claims were rejected by the court. *See also Skinner v. Preferred Credit*, 361 N.C. 114 (2006), *reh'g denied*, 361 N.C 371 (2007). In this case, the mortgagors instituted a class action against a nonresident trust which, as assignee of the mortgages, received payments for benefit of the trust's mortgage pass-through certificate holders. The mortgagors alleged violations of North Carolina's usury statutes and Unfair and Deceptive Trade Practices Act (UDTPA) and North Carolina usury statutes, relating to allegedly "excessive and illegal origination fees" and "unfair and deceptive acts associated with the making and collection of the loans." *Id*. at 412. The lower court dismissed the action based on lack of personal jurisdiction and failure to state a claim, and the mortgagors appealed. The Court of Appeals affirmed the lower court's holding, at 172 N.C.App. 407 (2005), and the North Carolina Supreme Court subsequently granted certiorari. The North Carolina Supreme Court held that personal jurisdiction did not exist pursuant to North Carolina's long-arm statute, and even assuming the long-arm statute provided a basis for personal jurisdiction, exercising such jurisdiction would violate due process. The court noted that less than three percent of the mortgage loans held by the trust, including the loan at issue (a subprime loan to the named defendant that had been sold into the securitized trust) had passed into the trust after it was originated by third parties. The court also noted that the trust in this case "is a New York common law trust with back offices in New York and California. It has no employees. Its servicer of the mortgage notes is an independent contractor located in California." *Id.* The court also ruled that the Trust's status as the beneficiary of the deed of trust securing the loan did not render it the holder of "local property" sufficient to make it subject to North Carolina's jurisdiction. Therefore, the court concluded, these tenuous connections were insufficient to satisfy North Carolina's long-arm statute.

The North Carolina Attorney General was extremely upset by this decision and sought a rehearing, but the North Carolina Supreme Court denied the request. A Memorandum from the North Carolina Attorney General pointed out that although the North Carolina loans totaled only three percent of the entire loan pool (i.e., those loans in the trustee's portfolio), there were 114 North Carolina loans in the pool with an aggregate dollar value of $4 million. This raises an interesting question: At what percentage (or dollar amount or number of loans) would there be enough "minimum contacts" or "substantial activity" with North Carolina upon which to predicate a claim of jurisdiction?

Environmental Issues in Securitized Loans

A few cases have dealt with the issue of the existence of undisclosed environmental contamination in a securitized loan transaction as constituting a material breach of warranty under the MLPA or an environmental indemnity agreement ("EIA"). In *LaSalle Bank Nat'l Ass'n v. Lehman Bros Holdings*, 237 F.Supp.2d 618 (D. Md. 2002), the federal district court held that a warranty provision in the MLPA was breached by the seller, Lehman Brothers Holding Company, Inc. ("Lehman") where a $9 million commercial mortgage loan (one of 429 mortgage loans in a $2.2 billion pool of loans) sold pursuant to the MPLA was in material default as of the date when the sale closed, because of multiple misrepresentations made by the mortgagor and the principal to conceal environmental contamination at the property. The court found that the origination and underwriting practices of Lehman were not prudent and did not meet customary industry standards, noting that Lehman had failed to obtain updated environmental reports prior to the closing of the underlying transaction as required by its own guidelines. (The property was environmentally contaminated as the result of the presence of metals and organic compounds in the ground water.) Lehman argued that it had not known about the contamination and that the parties who had originated the underlying transaction had concealed the truth, but the court held that ignorance was no defense. The court also ruled that LaSalle Bank National Association ("LaSalle"), as the trustee of the trust that purchased the loans from Lehman, had standing to bring the breach-of-contract action against Lehman under the MLPA and the PSA that created the trust. The court further held that Lehman had been given proper and timely notice of the breach under New York law, because the special servicer under the PSA gave such notice within two months after LaSalle learned of the significant environmental contamination at the property. Finally, the court ruled that because of the pending bankruptcy proceedings against the mortgagor and its principal (as guarantor), the loan could not be repurchased by Lehman and LaSalle therefore was entitled to recover traditional contract damages for Lehman's warranty breaches in the amount of the principal balance of the loan, plus ordinary and default interest and servicing advances, less sums already collected during the bankruptcy proceedings.

As one commentator has noted regarding the holding of the court in the *LaSalle Bank* case, *supra*:

> In the context of mortgage pooling agreements, it is not uncommon for the assignees to bring warranty claims against the assignors; but it is unusual, I think, to see such an action resolved on summary judgment in favor of the plaintiff. That is especially true concerning the claim for breach of the warranty of "prudence and due diligence," which usually involves numerous triable issues of fact. Here, even though there were competing declarations regarding the conduct of the assignor, the court still found on summary judgment that the assignor had behaved imprudently.
> The court's harsh description of the behavior of the assignor should be mandatory reading for anyone considering buying or selling mortgages on the secondary market.

Professor Dan Schechter, *Assignor of Commercial Mortgages Breached Warranties When it Sold Mortgage Secured by Environmentally Contaminated Property*, 2003 COMM. FIN. NEWS. 13.

In *In re Hurley*, 285 B.R. 871 (Bankr. D.N.J. 2002), the indenture trustee for the loan servicer, as successor-in-interest to the original lender, brought an adversary nondischargeability proceeding in the mortgagor-debtor's ("Hurley") Chapter 11 bankruptcy proceeding, seeking to except the mortgage debt from discharge because of alleged misrepresentations made by Hurley in an EIA executed by Hurley in connection with the loan. This case involved a $9 million dollar mortgage loan to WDH Howell, LLC (of which Hurley was the principal owner) from Holliday Fenoglio, L.P. ("Holliday Fenoglio"). Hurley personally guaranteed the loan, and the loan documents included the EIA executed by Hurley. The loan was subsequently purchased from Holliday Fenoglio by Lehman Brothers Holding, Inc. ("Lehman"), which had created a trust fund in which the subject loan would be included. After the loan closing, Lehman sold the loan to First Union Commercial Mortgages as the trustee for the trust. Plaintiff Criimi Mae was designated as the special servicer for the trust. Criimi Mae brought an action for summary judgment in the bankruptcy court, based on alleged misrepresentations made by Hurley in the EIA in procuring the loan secured by the property, alleging that "Hurley knew the property was environmentally contaminated and misrepresented the extent of the contamination in obtaining the loan." *Id.* at 874. Hurley claimed that he did not misrepresent the contamination on the property, and that Criimi Mae could not have relied on the EIA in connection with the loan because it was not the original lender. The court, after listening to the testimony and reviewing the evidence, found that, assuming for the sake of argument that Crimmi Mae even had the Phase I environmental report (allegedly attached to the EIA), the evidence presented by Criimi Mae (if proven true) would establish that Hurley knew of further contamination at the property and failed to disclose it in violation of the EIA. But the court stated that it could not make a definitive factual finding on whether Hurley made a material misrepresentation based on a summary judgment motion. Furthermore, the court stated that it also could not make a definitive final factual finding at this stage of the proceedings as to whether Criimi Mae

"justifiably relied on the alleged misrepresentations.'" *Id.* at 875. The court noted that even though the alleged false statement was not initially made to Criimi Mae, Criimi Mae could, in accordance with other bankruptcy court holdings on the issue, establish "justifiable reliance" by showing that "each successor in interest to the original lender, Holliday Fenoglio, justifiably relied on the alleged misrepresentations in the EIA." *Id.* at 876. The court noted that because discovery had not yet concluded on this issue, it was premature to determine if such justifiable reliance had been established. Finally, the court rejected Hurley's argument that the bankruptcy doctrine of "claim preclusion" (requiring that a litigant assert all related claims against all parties in one action or be barred from bringing a claim in a second action) applied to collaterally estop Criimi Mae from bringing its action. The court stated that "Criimi Mae alleges fraudulent conduct not in connection with the execution or enforcement of the loan, but rather in the ability to discharge the loan . . . . There is no claim preclusion or issue preclusion." *Id.* at 877.

For an excellent discussion of lender liability risk under current environmental laws, including potential liability of lenders in securitized mortgage transactions, *see* Lawrence P. Schnapf, *Lender Liability Today Under Environmental Laws*, 60 CONSUMER FIN. L.Q. REP. 147, 161-164 (2006) (containing in-depth discussion and analysis of *LaSalle Bank* and *Hurley* cases, *supra*, as well as broad discussion and analysis of environmental risks to creditors and compliance issues with respect to existing federal and state environmental statutes and case law).

Prompt and Timely Notice of Breach

Note that in the *LaSalle Bank* case, *supra*, prompt and timely notice to the loan seller by the loan purchaser of the alleged breach of the warranty regarding the environmental condition of the property was a crucial issue. Proper compliance with contractual provisions, and documentation of notice of any defaults, are critically important in actions involving securitized loans. As noted by the Robert M. Abrahams, in *Securitization Disputes – Breach of Securitization Agreement*, *supra,* 8 BUS. & COMM LTIG. FED. CTS. § 90:12 (2d ed. 2007):

> The most common defenses in this area [breach of securitization agreement] involve failure of notice of a mortgage default. If a mortgagor is in default, the PSA normally requires the seller of the mortgage-backed securities either to cure the default or repurchase the underlying mortgage. However, the purchaser and loan servicer, under the terms of the PSA, also have an obligation to first notify the seller to give it the opportunity to cure. Litigation has arisen when there is a dispute as to the timing of the notice.

As further noted by Mr. Abrahams:

> The major purchaser of shares in a particular REMIC trust is often an institutional investor that serves as trustee and administrator of the trust. It is therefore possible that the purchaser/trustee will have notice of a default on an underlying mortgage before the seller.

Id. at fn. 2.

As also noted by another commentator, Andrew L. Liput, in *The Hidden and Emerging Battle Between Investors and Servicers* (THE MORTGAGE PRESS, 2007):

> Servicers, the initial and most direct link to borrowers, are failing to take immediate, effective steps to control losses before they spiral out of control. Lenders are then facing repurchase demands where significant time has passed after a default, with little or no steps taken to control losses.
>
> . . . .
>
> Furthermore, the failure of servicers to act properly, or in concert with their investor clients, sometimes means that foreclosures occur before a notice of defect or default is even given to a lender.
>
> . . . .
>
> Lenders would be interested to know that typical servicing agreements executed by investors contain extremely detailed schedules of servicing tasks and time frames within which they are to be performed. These include timely reporting of consumer servicing problems and disputes, defaults, escrow problems, insurance issues (such as cancellation), property issues (such as abandonment and damage), property valuation, foreclosure, REO acquisition, and the details of post foreclosure property listing and sales.
>
> Left to their own devices, without proper reporting (or investor inquiry), some servicers are ignoring early warnings of borrower issues, failing to manage and control abandoned properties, failing to properly conduct market valuations to determine post REO sales, and most important to lenders, failing to provide timely notice to defaults so that loss mitigation can be conducted in a global manner, involving not only the servicer, but the investor and the lender as well.

See, e.g., LaSalle Bank Nat'l Ass'n v. Citicorp Real Estate, Inc., 2003 WL 22047891 (S.D.N.Y., Aug. 29, 2003). As the court stated at the beginning of its decision, "this case involves a mortgage loan that was sold to a securitized pool of mortgage loans and then went bad. Several million dollars are at stake." *Id.* at *1. Plaintiff LaSalle Bank National Association ("LaSalle"), defendant and third-party plaintiff Citicorp Real Estate, Inc. ("Citicorp"), third-party defendant Criimi Mae, and several other entities not involved in this lawsuit signed a PSA for the purchase by LaSalle of $1.3 billion worth of mortgage loans that were included in a REMIC trust, of which LaSalle was Trustee and Administrator. Citicorp was the mortgage loan seller. LaSalle, as the purchaser of the mortgages under the PSA, sued Citicorp for breach of agreement and related torts after one of the mortgage loans sold into the securitized pool went into default. The court denied a summary judgment motion, holding that a fact issue existed as to when LaSalle realized that the mortgagor's breach meant that Citicorp had breached its representations and warranties in the PSA regarding timely notice of the default. The PSA imposed a duty on all parties to the PSA to give all other parties prompt written notice upon the discovery of "a breach of any of the representations and warranties set forth in [§ 2.05(d) of the PSA] which materially and adversely affects the value of any Mortgage Loan or the interests therein of the Certificateholders." The court noted that:

> [T]here is a distinction between a default under the franchise agreement and a breach by Citicorp of its representations and warranties in the PSA. That is, if [the mortgagor] was in default *before* the Closing Date of the PSA, Citicorp necessarily breached its representations and warranties about the [the mortgagor's] loan; however, if [the mortgagor] was in default *after* the Closing Date, it does not automatically follow that Citicorp breached its representations and warranties. Citicorp does not cite any evidence that shows when LaSalle knew that [the mortgagor's] default occurred while Citicorp still owned the loan.

Id. at *5. (Emphasis in text.)

See also Lehman Bros. Holdings, Inc. v. Laureate Realty Services, Inc. 2007 WL 2904591 (S.D. Ind., Sept. 28, 2007) at *12-13 (purchaser of mortgages under MLPA argued that seller breached MLPA by not informing purchaser that certain loan origination and underwriting representations and warranties with respect to particular loan were false and known to be false by seller at time of loan; court rejected seller's argument that purchaser failed to give it prompt written notice under MLPA where notice was given less than two months after purchaser's receipt of letter from special servicer notifying it of alleged breaches; court stated that "under New York law, notice given within two months of discovery of an alleged breach of contract is deemed reasonable"); *LaSalle Bank Nat'l Ass'n v. Citicorp Real Estate, Inc.*, 2003 WL 21671812 (S.D.N.Y., July 16, 2003), at *3 (mortgage seller, being sued by buyer for breach of warranty for failure to notify seller of mortgagor's loan default, asserted third-party claims against

mortgagor's franchisor and buyer's loan servicers for failure to timely notify it of such default, thus exposing seller to liability; court held that complaint properly stated claim against servicers for breach of contract but not for implied warranty, and properly stated claim against franchisor for promissory estoppel but not for negligence or indemnity); *LaSalle Bank Nat'l Ass'n v. Capco American Securitization Corp.*, 2005 WL 3046292 (S.D.N.Y., Nov. 14, 2005) (court held that warranty in PSA, by purchaser of $1.2 billion worth of mortgage loans to be included in REMIC Trust, that it would provide UCC financing statements on all personal property, was material and was breached with respect to failure to do as to subject loan because of defective filing, and purchaser gave "prompt notice" of defect by providing seller with notice two months after default).

But see Trust for Certificate Holders of Merrill Lynch Mortg. Passthrough Certificates Series 1999-C1 v. Love Funding Corp., 2005 WL 2582177 (S.D.N.Y., Oct. 11, 2005), at *7 (holding that notice requirement was not a condition precedent with respect to seller's obligation to cure breach or repurchase loan under MLPA; according to the court, "[the seller's] obligation is independent of its receipt of prompt written notice because, under the terms of the contract, the obligation can also arise upon its own discovery of a breach. Consequently, [the buyer's] breach of the prompt written notice provision at most gives rise to a setoff against its assignee, the Trust").

Conclusion

Mortgage loan securitization, in its various formats, has increased exponentially during the past few years. For example, on March 29, 2007, Moody's Investor Services ("Moody's," which is one of the major rating agencies), issued a report entitled *US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans* (hereinafter the "Moody's Report"). The Moody's Report states, at Page 1, that "just in the last two years, mezzanine loan issuance included in commercial real estate CDOs (CRE CDOs) has skyrocketed from a few score million dollars annually to over $3 billion per year." In financial markets, collateralized debt obligations (CDOs) are a type of asset-backed security and structured credit product. CDOs gain exposure to the credit of a portfolio of fixed-income assets and divide the credit risk among different tranches: senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). Losses are applied in reverse order of seniority and so junior tranches offer higher coupons (interest rates) to compensate for the added risk. CDOs serve as an important funding vehicle for portfolio investments in credit-risky fixed income assets. *See* John C. Kelly, *An Introduction to Commercial Real Estate CDOs (Part 1)*, 21 PROB. & PROP. 38 (2007).

As can be seen from the cases described in this article (and more that are sure to come), the courts are beginning to understand the loan-securitization process more clearly, as well as the nature and scope of the involvement of the various parties to such transactions. Because there are more parties involved in a mortgage loan securitization, as well as more documents to comply with, there are more chances for "slip-ups" by one or more of these parties, which may result in a lender-liability claim against one or more of

the participants. But, as noted clearly in the *Blue Hills Office Park* case, *supra* – and in many of the other cases discussed in this article -- the courts still will generally utilize traditional notions of contractual liability and what actually constitutes lender liability, and will not tolerate frivolous borrower claims or claims that are unsupported by the facts or the provisions of the applicable transaction documents – and will even award damages to lenders for "borrower liability" under the proper circumstances.