

# CLASS ACTION WATCH

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## Mortgage-Backed Securities Litigation: Hedge Funds vs. Banks

Countrywide Home Loans, Inc. became the largest mortgage originator in the nation, originating more than \$400 billion in mortgages in both 2006 and 2007.<sup>1</sup> The value of its originations exceeded those of Chase and Bank of America combined.<sup>2</sup> But approximately 40% of those loans were “non-conforming,” meaning they did not qualify to be purchased by Fannie Mae or Freddie Mac.<sup>3</sup>

### The Subprime Fallout

These non-conforming loans included subprime mortgages, “exotic” negative amortizing mortgages, interest-only loans, and “teaser rate” adjustable-rate mortgages. Origination fees on these non-conforming loans were high—providing quick profits. They were then packaged into mortgage backed securities (“MBS”) which were sold to investment Trusts. Securitization shifted the credit risk of the securitized loans from Countrywide to the MBS investors.

In 2008, Countrywide, now owned by Bank of America, was the target of suits brought by various state attorneys general alleging that the corporation had issued thousands of mortgages that it knew the borrowers could

by Charles M. Miller

not service.<sup>4</sup> The lawsuits also claimed that it had misled many consumers by misinforming them about the workings of the non-conforming loans. To settle those cases, Countrywide agreed to no longer issue subprime and negative amortizing mortgages, to reduce issuance of no-documentation mortgages (colloquially, “liar loans”), and to limit broker origination commissions. Most importantly, it agreed to modify up to \$8.4 billion dollars worth of securitized mortgages. Countrywide has since stated that it may modify as much as \$91 billion worth of mortgages—88% of which have been securitized. These modifications arguably impact the ability of the MBS investors to realize the contracted rate of return on the mortgages in which they invested. This, unsurprisingly, has led to class action litigation.

### The Litigation

On December 1, 2008, *Greenwich Financial Services Distressed Mortgage Fund 3, LLC, v. Countrywide Financial Corporation* was filed in New York state court. The plaintiffs seek to represent a class of investors in 373 tranches of

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## FIFTH CIRCUIT APPLIES CAFA TO LA AG ACTION

by Christopher K. Ralston & Bryan Edward Bowdler

When Hurricane Katrina made landfall in Southeast Louisiana on August 29, 2005, it caused severe damage along the entire Gulf Coast of the United States. It also resulted in a tremendous number of lawsuits.

With this deluge of litigation, the Louisiana Attorney General filed a state court lawsuit against numerous insurance providers and companies that provided consulting or software to these insurers. The case, styled as a *parens patriae* action, and based on Louisiana’s anti-trust statute, was removed to federal court under the Class Action Fairness Act of 2005 (CAFA). Eventually, the United States Court of Appeals for the Fifth Circuit was asked to see whether

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Countrywide-issued MBSs. The complaint alleges that the Pooling and Servicing Agreements (“PSA”) governing the MBSs require Countrywide to repurchase every mortgage that it modifies by paying the current principal balance plus outstanding interest to the securitization Trust.

Countrywide removed the case to the U.S. District Court, Southern District of New York, where it is currently pending before Judge Richard Holwell.<sup>5</sup> As its basis for removal, Countrywide argues that the case is removable as a federal question<sup>6</sup> and, alternatively, as a minimally diverse class action.<sup>7</sup> The federal question is said to hinge upon interpreting 15 U.S.C. §1639a.

## The Truth in Lending Act

Congress enacted §1639a as part of the Truth in Lending Act in 2008 to create a safe harbor for servicers of securitized mortgages to modify the loans “to maximize the net present value” of the MBSs. The statute reads, in part:

(a) Except as may be established in any investment contract between a servicer of pooled residential mortgages and an investor, a servicer of pooled residential mortgages:

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(2) shall be deemed to act in the best interests of all such investors and parties if the servicer agrees to or implements a modification or workout plan, ... for a residential mortgage or a class of residential mortgages [provided that:]

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(C) The anticipated recovery on the principal outstanding obligation of the mortgage under the modification or workout plan exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.<sup>8</sup>

The *Greenwich* plaintiffs contend that §1639a does not apply to their case because the introductory language of the statute expressly excludes breach of contract claims. They argue that the PSAs are investment contracts that prevent Countrywide from modifying mortgages subject to the PSA unless those mortgages are repurchased. They also argue that §1639a does not create a right for the servicer to modify the underlying mortgages, but merely

provides an objective standard by which to measure modifications that are permitted by other PSAs.

For its part, Countrywide argues that the PSA authorizes it to modify mortgages when prudent and when necessary to protect the interest of the Trust. Accordingly, Countrywide argues that §1639a shields it from liability to the MBS investors.

Congress may have the last word on the meaning of §1639a. Representative Barney Frank has introduced legislation to shield loan servicers from liability “notwithstanding any investment contract.”<sup>9</sup> The legislation has received bipartisan support in the Financial Services Committee. In fact, the Republicans on the committee are advocating for an amendment to include a provision requiring an investor whose suit is rebuffed by §1639a to pay the servicer’s attorney fees.<sup>10</sup>

To avoid being barred by §1639a, the plaintiffs contend that whether Countrywide is permitted to modify mortgages under §1639a is immaterial to their case. They state that they take no position on whether the mortgages should be modified. Instead, they insist that their claims are focused upon the provision of the PSA which they claim requires Countrywide to repurchase any modified loan, and that these claims are not impacted by §1639a. Countrywide counters that that interpretation of the PSA should be informed by §1639a.

The primary issue in *Greenwich* is whether the PSA requires the risk of loss to shift to Countrywide when a non-performing loan is modified. Thus, unless H.B. 788 (or something similar) passes, this case will be won or lost based upon the language of the 160+ page PSA.

## The Pooling and Servicing Agreement

The *Greenwich* plaintiffs argue that §3.12 of the PSA permits Countrywide to modify mortgages, but requires Countrywide to “purchase[] the Modified Mortgage Loan from the Trust Fund immediately following the modification as described below.”<sup>11</sup> Notably, the PSA does not require Countrywide to repurchase the mortgage until after it is modified. Assuming for the moment that this section controls any loan modification, then the question becomes, “At what price?”

The answer will be reached through analyzing various defined terms in the PSA.<sup>12</sup> “Purchase Price” is defined for relevant purposes as the “Stated Principal Balance,” which, in turn, is defined as the unpaid principal balance prior to any adjustments less any “Realized Loss.” The term “Realized Loss” has two components. First, it means amounts unrecovered through a foreclosure sale or other liquidation. Alternatively, “Realized Loss” means the

amount a court determined that the loan exceeds the value of the property combined with the amount to which the principal balance has been reduced below the reduced value of the house.

At first blush, the definition of “Realized Loss” appears to open the window for Countrywide to voluntarily modify the mortgages while maintaining the risk of loss with the MBS investors. This conclusion, however, is contradicted by the definition of “Deficient Valuation,” which appears to require a court determination of the value of the property before a modification can be a “Realized Loss.” Thus, §3.12 appears to require Countrywide to shoulder the loss of any modified mortgage.

This reading is supported by §3.12’s requirement that “[f]or federal income tax purposes, the Trustee shall account for such purchases as a prepayment in full of the Modified Mortgage Loan.” This statement appears to contemplate that the MBS investors will not suffer any loss as the result of Countrywide’s voluntary mortgage modification. There is some room for argument that because the sentence reads that the Modified Mortgage Loan is paid in full, that the Trust should have realized the loss of the modification before the repurchase by Countrywide, and only the reduced amount is treated as paid in full.

Countrywide points to §3.01, which permits it to service and administer the loans in a prudent manner; the section provides that Countrywide’s authority extends to cancelling and fully or partially releasing or discharging the loans, and unquestionably grants Countrywide the power to modify the mortgages, which Countrywide argues triggers the protections of §1639a.

PSA §3.01 also provides that Countrywide is responsible for any “shortfall in any collection ... is attributable to adjustments to Mortgage Rates, Scheduled Payments or Stated Principal Balances.” This provision, however, might not be as restrictive as it appears. It holds Countrywide responsible for shortfalls *caused* by mortgage modifications. Countrywide will argue that collection shortfalls are inevitable for loans in default. The modifications are not causing the losses, but instead are designed to reduce losses. Moreover, §1639a requires the court to presume that the modifications reduce losses. Therefore, this provision is not activated.

In addition to the above provisions, PSA §3.05 will likely impact the disposition of *Greenwich*. That section expressly permits Countrywide to make certain specific adjustments to mortgages without triggering the §3.12 obligation to repurchase. The §3.05 adjustments are

limited to waiving late fees, penalty interest, prepayment fees, and extending a loan for no more than 270 days. Importantly, §3.05 shifts the risk of loss to Countrywide by requiring Countrywide to advance payments to the Trust in accordance with the original amortization schedule in these instances.

Finally, §3.12 limits Countrywide to modifying no more than 5% of the mortgages underlying any tranche. The agreement, however, does not necessarily impose any liability upon Countrywide for exceeding this threshold, but merely permits the Trust to declare a default and remove Countrywide as servicer. This will not necessarily solve the Trust’s problems because it will have to either service the loans itself, or negotiate a servicing agreement with a new servicer, who will not be likely to accept any risk of loss.

Once the procedural wrangling over the proper forum for the litigation, and whether the plaintiffs have standing to assert claims under the PSA are resolved, the litigation will focus upon interpreting PSA provisions discussed above.

### Public Policy Arguments

Notably, the claims asserted by the Greenwich plaintiffs have been limited to declaratory judgment claims regarding the respective rights and obligations under the PSA. The complaint does not allege any fraud, bad faith or malfeasance on the part of Countrywide in originating or securitizing the underlying mortgages. The absence of these claims is noteworthy. The plaintiffs have apparently elected to avoid public policy arguments over the propriety of the mortgages. There are no allegations that Countrywide knew that that mortgages could not perform or were overvalued at the time of securitization. As of this time, there have been no public policy arguments that Countrywide, as the originator of these “toxic assets,” should shoulder the losses. The litigation does not appear designed to smear Countrywide. The litigation is poised purely as a contract case.

This, of course, does not mean that public policy arguments will not ultimately be raised. The plaintiffs will likely make these arguments in some form. The plaintiffs can certainly argue that the TARP funds Bank of America has received should be used to modify the mortgages.

For its part, Countrywide could argue that the entire purpose of an MBS is to transfer both the potential for profit and the risk of loss to the investors. The typical investor in MBSs are hedge funds, mutual funds, pension plans, and other institutional investors that understood the risk that they were assuming. The investors were willing to

accept that risk to achieve returns that they thought would be slightly higher than investing in bonds. Moreover, the Trust hedged against this risk by participating in interest rate swaps with entities such as Swiss Reinsurance Co.<sup>13</sup> When the investors purchased the MBSs, they accepted the down-side risk along with the up-side returns.

The plaintiffs' argument regarding the correct interpretation of the PSA potentially creates a prisoner's dilemma, by punishing cooperation. If one ignores the question of why the loans are underperforming and who is to blame, this dilemma becomes clear.

Assume a loan has entered default. For whatever reason, the borrower is not in a position to continue servicing the loan at the contracted rate. The borrower's options are to either walk away or work with the lender to arrange a payment plan that the borrower can service. In most scenarios, the borrower would prefer to work something out to stay in the house. In the current market, the lender should have an equal incentive to return the loan to a performing status. The losses associated with a foreclosure will far outpace the losses associated with a successful modification. Thus there is an incentive for both parties to cooperate.

The mutual cooperation incentive disappears, however, when the risk of loan losses in a foreclosure are not borne by the same party that bears the risk of loss in a modification. If the MBS investor can receive the full return on its investment if the mortgages are modified, but lose up to 50% of the overall return in foreclosure, the MBS investor will obviously prefer modification. Countrywide, however, will have the exact opposite incentive. If a loan is in default, Countrywide, as the servicer, can choose to either foreclose at little risk to itself, or to modify the mortgage and bear the cost of the modification and of repurchasing the note. Countrywide will have every incentive to minimize its risk by foreclosing on the mortgage. Overall, this will create a less than optimal result by maximizing losses for the mortgagor and for the MBS investor.

Of course, these public policy arguments are best left on the courthouse step. The systemic questions of how to address the subprime mortgage crisis, as well as the troubles of the broader financial world, are better answered by Congress, regulators, the states, and the financial industry than by a loan judge.

## CONCLUSION

The PSA involved in *Greenwich* was the result of arms-length negotiations between sophisticated parties. Despite what those of us not involved in the transactions

think the PSA should have provided, it reads the way the parties chose. The plaintiffs' reading of the PSA is certainly plausible, even though it may not conform with the risk-shifting that one would think should occur through securitization. So long as the court determines that the plaintiffs have overcome the procedural obstacles the PSA places in front of them, including making a demand upon the Trustee, and obtaining the support of 25% of the investors in certain circumstances, then the court should reach the merits of the matter. The language of the PSA should decide whether the hedge fund plaintiffs and other investors must accept the losses associated with their investments, or whether Countrywide is contractually bound to pay full value for any loan it agrees to modify.

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## Endnotes

1 <http://www.thetruthaboutmortgage.com/countrywide-finishes-top-in-loan-originations/>.

2 *Id.*

3 <http://query.nytimes.com/gst/fullpage.html?res=9E06EFDA1F3DF935A1575BC0A9619C8B63&sec=&spon=&pagewanted=2>.

4 The states involved in the settlement were Arizona, California, Connecticut, Florida, Iowa, Michigan, North Carolina, Ohio, Texas, and Washington.

5 Case No 1:08-cv-11343-RJH.

6 28 U.S.C. § 1331.

7 28 U.S.C. § 1332(d).

8 15 U.S.C 1639a(a) (emphasis added).

9 111 H.B. 788.

10 [http://republicans.financialservices.house.gov/index.php?option=com\\_content&task=view&id=360](http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=360).

11 PSA, §3.12(A).

12 PSA, §1.01.

13 PSA, §3.21.