

# Financial Services Litigation

NEWSWIRE

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## Securities Suit Against Rating Agencies Dismissed

By Thomas J. Hall and Robert E. Grossman

In a February 1, 2010 decision, Judge Lewis A. Kaplan of the United States District Court for the Southern District of New York dismissed in their entirety the claims against two rating agencies, Moody's and Standard & Poor's, arising from their involvement in mortgage pass-through certificates underwritten by Lehman Brothers, Inc. That dismissal turned, in large part, on the court's determination that the rating agencies had not acted as the "underwriters" or "sellers" of securities under the Securities Act of 1933. While the court

found that the rating agencies "quite likely" contributed to the collapse of the mortgage-backed securities market, it found that the allegations of the complaint nevertheless failed to state a claim under the legal theories advanced by the plaintiffs. *In Re: Lehman Bros. Mortgage-Backed Securities Litigation*, No. 08 Civ. 6762 (LAK) (S.D.N.Y. Feb. 1, 2010).

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### The Claims

This putative class action arose in connection with the issuance, distribution and sale of over \$90 billion of mortgage pass-through certificates underwritten by Lehman Brothers, Inc. in over 90 offerings between September 2005 and July 2007. In mortgage securitizations such as at issue here, mortgage loans are sold to a trust which issues certificates to purchasers who receive distributions from the cash flow generated from the mortgage pool. The two rating agencies allegedly assigned high investment grade ratings to these certificates.

The complaint alleged that the offering documents were materially false and misleading in a variety of respects, including that the underlying loans failed to comply with the loan underwriting guidelines set forth in the registration statements, that the rating agencies, and not Lehman, determined the composition of the securitization pool, that there

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## Securities Suit Dismissed

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was a failure to disclose conflicts of interest between Lehman and the rating agencies, and that the credit enhancements provided to the certificates were inadequate to support the investment grade ratings given.

The complaint asserted various claims against the rating agencies based on these alleged misstatements and omissions. Specifically, the plaintiffs alleged that, in addition to rating the certificates, the rating agencies controlled which mortgages were purchased and securitized and at what prices and directed the structure of the certificates, all in violation of Section 11(a)(5) of the 1933 Act. Second, the complaint alleged that the rating agencies were involved in the solicitation of sales of the certificates by virtue of the fact that they

plaintiffs' argument that the term "underwriter" is not limited to those who have purchased securities from an issuer with a view towards the resale, but extends to those who have "engaged in steps necessary to the distribution." While the court observed that the rating agencies' alleged activities may have had a "good deal to do with" the composition and characteristics of the mortgage pools and credit enhancements, there was nothing in the complaint to indicate that they participated in the purchase of the securities at issue with a view towards their resale, as required by Section 11.

Next, the court dismissed the plaintiffs' Section 12(a)(2) claim. This claim rested on the allegations that the rating agencies assisted in the drafting of prospectus supplements, collaborated on credit enhancements and used their models to structure particular deals to suit the credit ratings desired.

**In its conclusion, the district court noted that the collapse of the mortgage-backed securities market "has been a national disaster," and that many actors "quite likely including the Credit Agencies" contributed to this catastrophe.**

were a "substantial factor" in those sales, in violation of Section 12(a)(2) of the 1933 Act. Lastly, the complaint alleged that the rating agencies were control persons in connection with the sale of securities as they largely determined which loans would be included in the securitizations, and the amount and form of credit enhancements for each certificate, in violation of Section 15 of the 1933 Act.

### The Dismissal

The district court dismissed all three claims against the rating agencies.

As to the Section 11 claim, the court found that the rating agencies did not fall within the definition of "underwriter" subject to liability under that Section. The court noted that the plaintiffs conceded that the rating agencies did not purchase the certificates from the issuer. The court rejected the

The court pointed to the U.S. Supreme Court decision in *Pinter v. Dahl*, 486 U.S. 622 (1988), which held that Section 12(a)(2) seller liability is limited to those who either pass title or "successfully solicited the purchase, motivated at least in part by a desire to serve his own financial interest or those of the securities owner." As the plaintiffs conceded that the rating agencies here had no direct contact with the plaintiffs or any other sales prospects, the Section 12 claim was dismissed.

Lastly, the court dismissed the Section 15 claim under which the plaintiffs alleged that the rating agencies controlled others involved in the sale of the securities who violated Section 11 or 12 of the 1933 Act. To that end, the plaintiffs had alleged that the rating agencies were involved in determining which loans were to be included in the securitizations, the amounts and forms of credit enhancements, and the like. While the court found that these allegations may reflect the "power to

influence or persuade,” that does not amount to control under Section 15. What is required for Section 15 liability is “the practical ability to *direct* the actions of people who issue or sell securities,” something absent here.

### Another Recent Decision Regarding Rating Agency Liability

In the December 2009 edition of this *NewsWire*, we reported on a decision in *Abu Dhabi Commercial Bank and King County, Washington v. Morgan Stanley & Co., et al.*, No. 08 Civ. 7508, 2009 U.S. Dist. Lexis 79607 (S.D.N.Y. Sept. 2, 2009), in which the court refused to dismiss fraud claims asserted against ratings agencies that had likewise allegedly issued misleading ratings and assisted in the compilation of mortgage-backed securities. In *Abu Dhabi*, the court recognized that the First Amendment of the U.S. Constitution, which protects freedom of speech, shields ratings agencies “from liability arising out of their issuance of ratings and reports [where] their ratings are considered matters of public record.”

However, the *Abu Dhabi* court found that the rating agencies’ ratings and reports should not be afforded such protections because they were “disseminated . . . to a select group of investors, rather than the public at large.”

Unlike in *Abu Dhabi*, the ratings at issue in the *Lehman* lawsuit could be considered “matters of public record” meriting First Amendment protection because they were presented in registration statements filed publicly with the SEC. Accordingly, the plaintiffs in this case may have determined that they could not assert a fraud claim against the ratings agencies and instead relied on the aforementioned securities claims.

### Conclusion

In its conclusion, the district court noted that the collapse of the mortgage-backed securities market “has been a national disaster,” and that many actors “quite likely including the Credit Agencies” contributed to this catastrophe.

Nevertheless, the court found that, even if the plaintiffs were able to prove every word of their complaint at trial, such proof would still not satisfy the legal standards for the claims alleged. ©

## Court Narrows Champerty Doctrine in Victory for Distressed Debt Investors

By Scott S. Balber and Robert E. Grossman

The New York Court of Appeals, New York’s highest court, has issued a ruling clarifying New York’s champerty statute, which forbids the assignment of promissory notes and other financial instruments “for the purpose of bringing an action or proceeding thereon.” *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates v. Love Funding Corp.*, N.Y. slip op. 07323, 2009 WL 3294928 (Oct. 15, 2009) (“*Love Funding*”). In *Love Funding*, the Court of Appeals upheld a financial institution’s acquisition and subsequent exercise of rights under a loan purchase agreement — including the right to assert litigation claims arising from a breach of that agreement — because the institution had a preexisting interest in the defaulted loan at issue.

Although this holding dealt with the narrow issue of the applicability of a defense of champerty where the plaintiff has a preexisting interest in the underlying debt that predated the assignment of claim, the Court of Appeals went further and clarified that New York’s champerty statute has a limited scope and “does not apply when the purpose of an assignment is the collection of a legitimate claim.” Thus, *Love Funding* suggests that purchasers of debt instruments in the secondary market — who often require an assignment of potential litigation claims from the original lender — can be confident that their acquisitions include the right to pursue legitimate claims against defaulted borrowers.

### Factual Background

Love Funding Corp. (“*Love Funding*”), an originator of commercial mortgage loans, entered a mortgage loan purchase agreement (the “*Love MLPA*”) with UBS Real Securities, Inc. (“*UBS*,” the successor-in-interest to Paine Webber Real Estate Securities Inc.). In the *Love MLPA*, Love Funding represented that the mortgage loans it was selling were not in default and that, if it breached such representation, it would either cure its breach or repurchase the defaulted mortgage loan(s).

The mortgage loans encompassed by the *Love MLPA* were subsequently sold by UBS to Merrill Lynch / *continued page 4*

## Champerty

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Investors, Inc., which in turn placed those mortgages into a trust (the “Merrill Trust”). At the time of this sale, UBS warranted in a new mortgage loan purchase agreement (the “Merrill MLPA”) that the mortgage loans at issue were not in default.

Several years later, the Merrill Trust discovered that one of the mortgage loans originally sold by Love Funding, and subsequently sold to the Merrill Trust by UBS, had been procured by fraud and was therefore in default at the time it was consummated. Accordingly, both Love Funding and UBS appeared to have breached their representations that the mortgage loans they had sold were not in default.

The Merrill Trust sued UBS for a breach of the representa-

law that seeks to prevent the buying and selling of lawsuits. New York’s champerty statute, N.Y. Jud. Law § 489(1), forbids the assignment of promissory notes and other financial instruments “for the purpose of bringing an action or proceeding thereon.” If a court determines that an assignment violates this statute, it can void that assignment such that the assignee cannot seek to enforce any rights granted thereunder.

The Second Circuit Court of Appeals has held that claims arising from acquired defaulted sovereign debt are not champertous under this statute because “where the debt instrument is acquired for the primary purpose of enforcing it, with intent to resort to litigation to the extent necessary to accomplish the enforcement, the intent to litigate is merely incidental and contingent and does not violate the

Although the *Love Funding* decision involved a narrow set of facts where an assignee of a claim had a “preexisting proprietary interest” in the underlying debt instrument, purchasers of distressed debt will likely find comfort in the Court’s restrictive description of the champerty defense.

tions in the Merrill MLPA, but could not sue Love Funding because it was not a party to the original Love MLPA. After protracted litigation, the Merrill Trust settled its claims against UBS. As part of that settlement, UBS assigned to the Merrill Trust all of its rights under the Love MLPA, including the right to assert claims against Love Funding for breaching its representations under that agreement.

The Merrill Trust then brought suit against Love Funding in New York federal district court for breaching its representations in the Love MLPA. Love Funding sought dismissal of the Merrill Trust’s claims because, it maintained, UBS’s assignment of the right to sue Love Funding violated New York’s champerty statute.

### The Champerty Statute

The champerty doctrine is derived from centuries-old English

statute.” *Elliot Assoc. LP v. Banco de la Nacion*, 194 F.3d 363, 378 (2d Cir 1999). The trial court decision in *Love Funding*, however, seemed to call this holding into question and cast doubt on the propriety of assigning claims in connection with distressed debt investments.

### Prior History

In *Love Funding*, the trial court dismissed the complaint, ruling that the Merrill Trust’s claim was barred by the champerty doctrine because the Trust’s “primary purpose” in accepting UBS’s assignment of rights under the Love MLPA was to bring a lawsuit against Love Funding. On appeal, the Merrill Trust argued that, even if it intended to sue Love Funding at the time of the assignment, the assignment would not be barred by New York’s champerty statute. The Second Circuit Court of Appeals acknowledged that New

York's champerty law was unclear and certified several questions to the New York Court of Appeals relating to the scope and applicability of that statute where, as here, the assignee of the right to sue had a preexisting proprietary interest in the underlying debt.

### The New York Court of Appeals' Decision

Apparently recognizing that New York's champerty statute is often misinterpreted, the New York Court of Appeals focused on "the difference between one who acquires a right in order to make money from litigating it and one who acquires a right in order to enforce it."

The former category, which is barred by the champerty statute, has a "narrow scope" and historically has "been . . . largely directed toward preventing attorneys from filing suit as a vehicle for obtaining costs." In contrast, a party that "acquires a right in order to enforce it" engages in conduct that is not (or is not necessarily) champertous. Relying on this distinction, the Court of Appeals held that if the Merrill Trust's purpose in taking the assignment of the right to sue Love Funding "was to enforce its rights, then, as a matter of law, given that the Trust had a preexisting proprietary interest in the loan, it did not violate" New York's champerty statute.

The Court also disagreed with the trial court's finding that the Merrill Trust's acquisition of rights constituted champerty because the Trust intended to make a profit from the *Love Funding* litigation in excess of its losses as a result of the loan default. In particular, the Court found that this argument was not supported by any case law and, in any event, it would not be possible "in many cases to assess whether [litigation] rights are likely to yield a larger recovery than earlier demanded."

### Implications for Distressed Debt Investors

Although the *Love Funding* decision involved a narrow set of facts where an assignee of a claim had a "preexisting proprietary interest" in the underlying debt instrument, purchasers of distressed debt will likely find comfort in the Court's restrictive description of the champerty defense. Significantly, the Court affirmed "that if a party acquires a debt instrument for the purpose of enforcing it, that is not champerty simply because the party intends to do so by litigation." The Court elucidated the doctrine further by describing cases in which courts found that an assignment was not champertous because the assignee brought its subsequent claim to pursue its contractual claim, not to harass or injure

the defendant. In other words, New York's champerty statute "does not apply when the purpose of an assignment is the collection of a legitimate claim." ☺

## Court Preliminarily Enjoins Lender From Suspending Loan Funding

By Thomas J. McCormack and Emily Abrahams

In *Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.*, 889 N.Y.S.2d 793 (4th Dep't 2009), the Appellate Division of the New York Supreme Court, New York's intermediate appellate court, upheld a lower court preliminary injunction ordering Citigroup to continue funding a construction loan that Citigroup had determined to be in default. The November 13, 2009 decision, which some have viewed as a clear departure from established precedent, was based primarily on the court's determination that it would be extremely difficult for plaintiff Destiny USA Holdings, LLC ("Destiny Holdings") to find replacement financing in the current economic climate and because of the unique "green economic" aspects of the project. The court's decision, and the reasoning behind it, raise significant issues for lenders, particularly as green economic development continues to evolve and until economic conditions improve.

### Background

This lawsuit arose out of a 2005 agreement by which Citigroup agreed to provide construction financing to Destiny Holdings for the construction of a shopping center and tourist destination in Syracuse, New York. The project, referred to as "Destiny USA," was to be funded using a "unique financing model for green economic development," described as a "new financing paradigm for green economic development," which was "visionary" and "revolutionary." *Destiny*, 889 N.Y.S.2d at 796, 801. In addition to the unique financing model, the project itself "was designed to serve as a 'living laboratory' and showcase for the use of state-of-the-art green technology, renewable energy resources and sustainable design for both its construction and operations." Complaint ¶ 1, *Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.*, 2009 WL 384479 / continued page 6

## Destiny Holdings

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(Onondaga Co. 2009) (No. 2009-4517). Indeed, the project allegedly was part of the bank's plan to "direct \$50 billion over the next 10 years to address global climate change through investments, financings and related activities to support the commercialization and growth of alternative energy and clean technology among the clients and markets it serves." *Id.* ¶ 2. In addition to the approximately \$155 million loan from Citigroup, the financing model included funding from Destiny Holdings itself and from proceeds of a bond issuance by the City of Syracuse Industrial Development Agency ("SIDA"). Citigroup, as agent, was charged with approving (or denying) all advances of funds, regardless of the source.

Calculations for the 20th through 26th draw requests, an agreement that was limited to those seven draw requests. In connection with the 27th draw request, however, the dispute over the inclusion of TI Costs re-emerged when Citigroup sent Destiny Holdings a Deficiency notice. The alleged Deficiency of over \$15 million was the direct result of Citigroup's inclusion of TI Costs in the Deficiency Calculation. Destiny Holdings allegedly did not cure the Deficiency in the proscribed ten day period and thus Citigroup determined the loan to be in default and did not fund any subsequent draw requests.

In response, Destiny Holdings commenced this lawsuit asserting, among others, a cause of action for breach of contract, and simultaneously filed a motion for a preliminary injunction ordering Citigroup "to fund the pending loan

**At a time in which green development is evolving each day, along with the prolonged depressed economy, it would seem that the exceptions advanced by this decision have the potential to swallow the general rule.**

As set forth in the governing Amended and Restated Building Loan, Project Loan and Security Agreement (the "Agreement"), Citigroup would fund draw requests made by Destiny Holdings so long as certain conditions precedent were met and unless Citigroup determined the existence of a "Deficiency," which occurred when the money required to complete construction of the "Required Improvements" exceeded the money yet to be advanced and other available funds.

In connection with the 20th through 26th draw requests, a dispute arose between Destiny Holdings and Citigroup as to whether Tenant Improvement Costs ("TI Costs") were to be included in calculating a Deficiency. (TI Costs are changes to the interior of a building to accommodate its tenants, for example, floor coverings, partitions, heating and cooling systems, and other customized finishings.) Ultimately, the parties agreed to exclude TI Costs from the Deficiency

advances . . . or, alternatively, enjoining Citigroup from refusing to fund such pending advances." Destiny Holdings further sought an injunction ordering Citigroup "to comply with the procedural requirements of the construction loan agreement when approving future loan advances — in particular, the contractually-mandated calculation of a 'Deficiency' under that agreement."

### Legal Standard for Obtaining Preliminary Injunctive Relief

To obtain preliminary injunctive relief under New York law, the movant must, among other things, establish that without an injunction it will suffer irreparable harm. Generally, "irreparable injury cannot be established where any damages sustained are calculable, because the plaintiff in such a case would have an adequate remedy in the form of mone-

tary damages.” *Destiny*, 889 N.Y.S.2d at 800 (citations omitted). For example, a party generally cannot show irreparable harm “in a pure contract money action.” *Id.* at 799 (citations omitted). Similarly, as a general rule “specific performance will not be ordered when money damages ‘would be adequate to protect the expectation interest of the injured party.’” *Id.* (citations omitted).

### The Trial Court’s Decision

Although *Destiny Holdings* was seeking a preliminary injunction in what could be described as a “pure contract money action,” the trial court nevertheless granted *Destiny Holdings’* motion for a preliminary injunction. The trial court’s Order, in relevant part, (1) declared the Notice of Deficiency and Notice of Default null and void and vacated them both; (2) determined that the term “Deficiency” was not a budget-based term and that TI Costs could not be used in calculating whether a Deficiency existed; (3) determined that Citigroup had breached the Agreement; (4) ordered Citigroup to fund the 27th draw request, as well as the subsequent 28th and 29th draw requests; and (5) ordered Citigroup to “pay all future sums due as draws or advances under the [Agreement] as they come due without further delay or interference.” *Destiny*, 889 N.Y.S.2d at 797. It was from this Order that Citigroup appealed to the Appellate Division.

### The Appellate Decision and Dissent

On appeal, the Appellate Division affirmed the decision of the trial court granting the preliminary injunction. The court determined that *Destiny Holdings* had demonstrated a likelihood of success on the merits based on evidence that TI Costs should not be included in Deficiency calculations, and further determined that *Destiny Holdings* had demonstrated that it would suffer irreparable harm if the injunction did not issue.

The thrust of the court’s decision was based on two so-called exceptions to the general rule that a party cannot obtain preliminary injunctive relief in a pure money damages contract action. First, although there apparently was no evidence in the record that *Destiny Holdings* even attempted to obtain replacement funds to mitigate its damages, the court in essence determined that such a showing was not necessary as the court could take judicial notice of “the economic conditions that prevailed when Citigroup ceased making the loan advances.” *Destiny*, 889 N.Y.S.2d at 801. If *Destiny Holdings* was able to find replacement financing, that fact

would likely have precluded any claim of irreparable harm. Defying conventional wisdom, however, the court’s holding has left wide open the argument by borrowers that they need not even attempt to mitigate damages in times of economic duress when it would be difficult to do so. Second, the court determined that because of the unique “green economic” financing, for which there was apparently no precedent, it would be impossible to quantify damages. The dissent, however, argued that “[w]hile the scope of the Project may be unique to the region in both its size and impact, the record clearly establishes that the Agreement itself is simply one to loan money in order to finance construction.” *Destiny*, 889 N.Y.S.2d at 806.

Citigroup is taking steps to appeal this decision to the New York Court of Appeals, New York’s highest court.

### Conclusion

Although the *Destiny Holdings* decision is limited in its unique facts, counsel drafting loan agreements — in particular for construction loans — should be mindful of this decision. Indeed, at a time in which green development is evolving each day, along with the prolonged depressed economy, it would seem that the exceptions advanced by this decision have the potential to swallow the general rule. ☉

## Mortgage Discharged Where Bank Failed to Negotiate in Good Faith

By Kimberly Zafran

In *IndyMac Bank F.S.B. v. Yano-Horoski*, 890 N.Y.S.2d 313 (Nassau Co. 2009), the court found that a mortgage lender failed to negotiate new loan terms with its borrower in good faith, and otherwise proceeded with “unclean hands” and exercised “insufferable temerity” in seeking to foreclose. As a result, not only was the lender prevented from foreclosing, but the court went so far as to cancel the indebtedness and discharge the mortgage.

### Background and Procedure

In 2005, plaintiff *IndyMac Bank* brought a foreclosure action on property owned by defendant *Yano-* / continued page 8

## IndyMac Bank

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Horoski. The mortgage at issue, dated August 4, 2004, was in the original principal amount of \$292,500 with an adjustable interest rate of 10.375%. IndyMac serviced the loan at issue for the benefit of Deutsche Bank, the owner and holder of the note and mortgage.

On January 12, 2009, the court entered a Judgment of Foreclosure and Sale. Because the loan was considered to be high interest and sub-prime, prior to the foreclosure sale the defendant requested that the court hold a settlement conference so that the parties could attempt to compromise, potentially allowing IndyMac to continue to recover on its mortgage loan and Yano-Horoski and her family to remain in their home. The court agreed and a conference was com-

IndyMac additionally claimed that it had offered the defendant homeowner a forbearance agreement to resolve the action, it admitted at the conference that its proposal was sent to defendant after the due date of the first payment set forth in that agreement. Defendant thus would have been in default of the proposed forbearance agreement even before receiving it.

The court observed that the defendant repeatedly proposed solutions to avoid foreclosure. As one such proposal, defendant's grown daughter who lived in the house with her parents offered to buy the house for its fair market value with third-party financing, but IndyMac would not agree. The court was clearly displeased with the bank's rigid stance, as it noted that many subprime loans across the country have been successfully modified relying on the income of non-obligors who

**Courts can and will look beyond contractual rights to the conduct of the parties in litigation, and while a bank may have every contractual right to foreclose upon a mortgage, it may not always be the most balanced option available.**

menced on February 24, 2009. The court continued that settlement conference, however, five times due to what it called its unsuccessful attempts "to obtain meaningful cooperation from plaintiff." Ultimately, due to bank's lack of cooperation in the settlement process, the court ordered that the plaintiff produce a business representative at a conference on September 22, 2009.

### Court-Ordered Conference and Hearing

At that court-ordered conference, IndyMac's Regional Manager of Loss Mitigation appeared. The bank made clear at this conference that it had no intention of resolving this matter other than by the "complete and forcible devolution of title from defendant." IndyMac claimed that it was owed over \$525,000 on this loan and acknowledged that the property securing the loan was worth less than \$275,000. While

reside in the subject premises. It was obvious to the court that, despite defendant's and her family's attempts to find a way to repay the loan, the bank was single-minded in seeking to foreclose and eject the family.

On the court's own motion, a hearing was held November 18, 2009. IndyMac's representative claimed at that hearing that a balance of \$527,437 was due on the loan as of September 22, 2009, though it was unable to advise the court what portion of that amount constituted principal. Defendant asserted that as of August 10, 2009, the principal balance owed was only \$283,992. An earlier June 30, 2008 Referee's report had found that the total amount due and owing on the loan as of that time was only \$392,983. The court appeared to grow frustrated with the apparent inconsistencies of the amount owed under the loan and the bank's inability to calculate the current principal balance owed.

## The Court's Decision

Based on the foregoing, “[t]he Court [wa]s greatly disturbed by plaintiff’s assertions of the amount claimed to be due from defendant.” *Id.* at 316. The court stated that “[i]t is the province and indeed the obligation of the trial court to assess and determine issues regarding credibility. In the matter before the court, the pendulum of credibility swings heavily in favor of defendant.” *Id.* at 317 (citation omitted). The court stated that it did not believe that the plaintiff was acting with any good faith throughout this entire, drawn-out saga and that “Plaintiff comes before this court with unclean hands yet has the insufferable temerity to demand equitable relief against defendant.” *Id.* at 317.

The court noted that the defendant and her husband suffered from numerous medical conditions but both, along with their adult daughter, were willing to commit their income to paying the loan at issue. And, despite their physical challenges, they, unlike the bank, appeared at every scheduled court conference. At each conference, defendant, along with her family, made good faith efforts to come to an amicable resolution of the issue of payment of the mortgage. The bank, however, did not make any effort to resolve the issue despite defendant’s good faith suggestions to modify the loan and the court’s attempts to broker a settlement.

While the court recognized that home foreclosures are inevitable and frequently appropriate, it did not find this to be such a case. Defendant, her husband, and her daughter were all willing to make sacrifices to use their respective incomes to make payments to plaintiff. To allow these payments to be made would result in an ultimate gain to plaintiff who would retain a steady income stream and would not suffer a loss by taking the house that was not worth the outstanding mortgage. Additionally, the neighborhood would remain untarnished. The court believed that a loan modification would have resulted in a win-win for all of the parties involved. To reach any other result, the court found, would essentially be to banish defendant and her family to navigate homelessness while dealing with severe physical issues.

A foreclosure action sounds in equity, and therefore invokes the court’s equity jurisdiction. While contracts are not to be undermined by “judicial sympathy,” equity cannot always “blindly follow the law.” *Id.* at 318 (citations omitted). Moreover, an individual’s legal rights should not advance injustice or oppression. “[W]here a party acts in a manner that is offensive to good conscience and justice, he will be completely without recourse in a court of equity, regardless of

what his legal rights may be.” *Id.* at 319 (citation omitted). The court found the bank’s conduct since the initiation of this action to be unconscionable and lacking any good faith. Because of this, the court concluded that equity would not be used to vindicate plaintiff’s rights. The court held that cancellation of the indebtedness and a discharge of the mortgage in its entirety was appropriate in this instance based on “the unique facts and circumstances presented herein.” *Id.* at 319.

## Conclusion and Relevance

While this decision arose from a unique set of circumstances, as the court acknowledged, it is important for banks to realize the ramifications of taking a no-settlement position in home mortgage foreclosures, particularly because such actions are equitable in nature. Working cooperatively with courts and with mortgage holders to make modifications so that all parties can come to be in a winning position may frequently be in the best interests of both homeowners and lenders. Courts can and will look beyond contractual rights to the conduct of the parties in litigation, and while a bank may have every contractual right to foreclose upon a mortgage, it may not always be the most balanced option available. ☺

# City’s Suit Against Subprime Lender for Widespread Foreclosures Dismissed

By Scott S. Balber and Laura Rowntree

The latest battleground of the mortgage crisis is the attempt by several U.S. cities to hold subprime lenders responsible for widespread mortgage foreclosures. This effort suffered a major blow last month when a U.S. District Court in Maryland dismissed a suit by the City of Baltimore against Wells Fargo for alleged “predatory and discriminatory lending practices.” *Mayor and City Council of Baltimore v. Wells Fargo Bank, N.A. and Wells Fargo Financial Leasing, Inc.*, No. 1:08 CV-00062, 2010 U.S. Dist. LEXIS 834 (D. Md. Jan. 6, 2010).

Baltimore’s suit alleged that Wells Fargo had targeted minority and underprivileged neighborhoods through a process known as “reverse redlining,” thereby / *continued page 10*

## Foreclosures

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causing a high number of foreclosures in a city already struggling with a depressed economy. In dismissing the action, U.S. District Judge J. Frederick Motz determined that, based on the allegations of the complaint, the City would be unable to establish that the bank's conduct had caused the broad injuries the City attributed to it. Although the decision did leave open the possibility that Baltimore could file an amended complaint, and even suggested the facts that the City would need to plead for its amended complaint to be viable, it marked a growing trend of federal courts dismissing municipalities' lawsuits against lenders for claims related to subprime mortgages.

The City also cited the financial drain of foreclosed property that owners had abandoned, specifically the costs to acquire and maintain the abandoned property, and to provide added police and fire protection to combat the criminal activity festering there. Estimates of vacant homes in the City range from 16,000 to 30,000.

### A Problem of Causation

In granting Wells Fargo's motion to dismiss, the court initially recognized that Wells Fargo had indeed engaged in discriminatory lending practices. The court found, however, that the complaint failed to set forth allegations sufficient to satisfy the standing requirements to bring a claim under the Fair Housing Act. The court determined that the alleged causal link between the practice of reverse redlining and the harm the City suffered

**The City contended that Wells Fargo had violated the Fair Housing Act by engaging in a practice known as “reverse redlining,” whereby lenders offer credit at unfair terms to borrowers based on the racial or ethnic composition of their neighborhoods.**

### Grounds for Suit

In its complaint filed in January 2008, the City contended that Wells Fargo had violated the Fair Housing Act by engaging in a practice known as “reverse redlining,” whereby lenders offer credit at unfair terms to borrowers based on the racial or ethnic composition of their neighborhoods. The practice stands in contrast to “redlining,” by which lenders deny prime credit to certain borrowers based on the racial or ethnic composition of their communities. Baltimore alleged that Wells Fargo's practice of reverse redlining led to a disproportionately high rate of foreclosures in the City's African-American communities. According to the suit, more than 33,000 homes in the City have been subject to foreclosure since 2000.

The City alleged a broad range of damages caused by the widespread foreclosures, including a decline in the value of nearby homes, which in turn decreased property tax revenue.

was too attenuated. Applying the U.S. Supreme Court's recent decisions in *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), the court determined that the City's claims failed to demonstrate the plausibility of a causal relationship between the City's “generalized type of damages” and Wells Fargo's practices.

The decision pointed to two major flaws in the City's causation allegations. First, the facts alleged indicated that Wells Fargo was “responsible for only a negligible portion of the City's vacant housing stock.” The City's own statistics demonstrated that only 401 properties on which the bank made loans were foreclosed upon between 2005 and 2008. And only 163 of such properties were both located in minority neighborhoods and became vacant after Wells Fargo made its loans. Moreover, only 80 of the properties on which Wells Fargo had foreclosed were vacant.

Second, the court noted that, despite the tens of thousands of foreclosures citywide, myriad other factors could have led to the City's financial distress, "such as extensive unemployment, lack of educational opportunity and choice, irresponsible parenting, disrespect for the law, widespread drug use, and violence." Without the ability to establish a causal chain between Wells Fargo's lending practices and the blight of foreclosures, the City lacked a viable claim.

### A Possible Amended Complaint

In a footnote, Judge Motz noted that an action for improper lending practices in an economically depressed community could perhaps succeed if there was "a significant amount of improper lending activity in a particular neighborhood [that] caused then ongoing rehabilitation efforts by other home owners in that neighborhood to fail or caused a deteriorating neighborhood to become dramatically worse." Additionally, the court noted the City could pursue an amended claim for "specific damages allegedly suffered by the City in regard to specific houses that became vacant allegedly because of Wells Fargo's lending activities," or "for damages allegedly caused to a specific neighborhood in which Wells Fargo made enough allegedly improper loans that its activities bear a plausible causal relationship to the destruction of that neighborhood."

### A Growing Trend

The *Baltimore* opinion relied on other recent decisions dismissing municipal suits against entities involved with subprime lending. Last August, for example, a federal district court in Alabama dismissed a suit by the City of Birmingham against a number of lenders, in which the City alleged similar claims of reverse redlining. *City of Birmingham v. Citigroup, Inc. et al.*, No. CV-09-BE-467-S, 2009 U.S. Dist. LEXIS 123123 (N.D. Ala. Aug. 19, 2009). Notably, the complaint there alleged that the defendants had encouraged minority borrowers to obtain higher interest subprime mortgages even though they would have otherwise qualified for prime mortgages. As a result of the unfavorable terms of subprime mortgages, Birmingham alleged, these minority borrowers defaulted on their mortgages at an increased rate, resulting in widespread foreclosures. That suit alleged that the foreclosures had spurred a decrease in property values in minority neighborhoods and led to lost property tax revenue along with the added costs for administration of the foreclosed properties, and for crime and fire prevention.

The *Birmingham* court found the practice of reverse redlin-

ing too tenuously connected to Birmingham's alleged injuries, particularly in light of the many other factors that could have caused individual owners to default or the City's economy to suffer. It ruled that the injuries were therefore not traceable to the harm alleged as required to establish standing.

The City of Cleveland also met an unsuccessful result in its lawsuit asserting a slightly different theory of recovery. *City of Cleveland v. Ameriquest Mortgage Securities, Inc., et al.*, 621 F. Supp. 2d (D. Ohio 2009). Rather than suing for a violation of the Fair Housing Act, Cleveland based its action on a single cause of action, public nuisance. Cleveland did not sue the lenders themselves, but sued entities that were involved in securitizing subprime loans into mortgage-backed securities, either through the process of bundling together subprime loans or providing the funding to purchase the underlying loans. The City claimed that "subprime lending was categorically inappropriate for Cleveland due to its 'unique' economic situation, characterized by a high poverty rate, sluggish economy, limited employment opportunities, and stable but not booming property values."

Applying Ohio's public nuisance law, the court found for the defendants because there was no direct connection between the conduct of the defendants and the City's harm, and thus no proximate cause, given the many independent events and potential intervening causes between them. In that decision, the court noted that the federal government had condoned subprime lending by encouraging "lending to traditionally underserved segments of the population."

On December 30, 2009, the City of Memphis filed suit against Wells Fargo also asserting claims under the Fair Housing Act, based on wrongdoing similar to that alleged by Baltimore. The Western District of Tennessee will now have to determine whether Memphis has met or can meet the standing requirements, or if that suit will become yet another in a growing line of dismissals.

### What the Decision Means for Cities and Banks

This recent decision from the Maryland federal district court, together with the similar results in the last year in other districts, strongly undermines the ability of municipalities to prevail in such suits, and suggests they will have to adopt new strategies to attempt to hold subprime lenders accountable for increased foreclosures in their communities and the adverse consequences thereof. ☹

# Credit Suisse Not Liable for Structuring Risky Financial Transactions

By Gerald D. Silver and Bernadette Galiano

The United States Court of Appeals for the Third Circuit recently affirmed a decision dismissing claims by a bankrupt company seeking to hold its bank responsible for risky financing transactions the bank had structured but which were approved by the company's board of directors. *OHC Liquidation Trust v. Credit Suisse et al. (In re Oakwood Homes Corp.)*, No. 08-4445, 2009 WL 4829835 (3d Cir. Dec. 16, 2009). The court found the claims were barred under New York's *in pari delicto* doctrine because, "to the extent the financing decisions were blameworthy, Oakwood was at least as culpable as Credit Suisse." *Id.* at \*3.

## Background

Oakwood Homes Corporation ("Oakwood") produced and sold manufactured homes. Its client base consisted mostly of low-income individuals with poor credit. Oakwood later expanded its business to include mortgage financing for its clients. To obtain liquidity to fund these operations, Oakwood would securitize the payment streams on the mortgage loans it had financed.

In 1994, Oakwood retained Credit Suisse to perform future securitizations. At this time, Oakwood did not engage Credit Suisse as its financial advisor; Credit Suisse did not control Oakwood or "tell it what to do." *Id.* at \*2. Oakwood's board of directors — comprised of legal and business professionals from real estate development companies, law firms and investment banks — approved the securitization transactions, which had increased annual revenues to nearly \$1 billion by the late 1990s.

In 1999, however, the market for manufactured housing collapsed and purchasers began to default on their loans. Oakwood reported operating losses in its SEC filings and press releases. Credit rating agencies then downgraded Oakwood's credit ratings.

As its liquidity dried up, Oakwood began to consider various options for stop-gap financing. First, Oakwood proposed that Credit Suisse structure a transaction that would provide immediate liquidity to the company. An internal memoran-

dum prepared by Credit Suisse recommended against the transaction due to deteriorating market conditions and the company's risk of bankruptcy. Credit Suisse did not provide a copy of that memorandum to Oakwood. In any event, Oakwood did not move forward with this transaction.

Instead, in 2000, Oakwood developed a different financing package with Credit Suisse that would allow Oakwood to continue its periodic securitizations. Oakwood's board of directors "was fully aware of how the securitization program operated, how it was doing and at no time undertook to mandate the discontinuance of it." *Id.* at \*1. In fact, one Oakwood officer stated that this financing package "was in Oakwood's best interests." *Id.*

In 2001, Credit Suisse again provided short term financing to Oakwood and then negotiated a different transaction to re-securitize and sell the most subordinated securities at a fraction of their value. Even with this financing in place, Oakwood continued to face significant adverse liquidity effects.

## Bankruptcy

On November 15, 2002, Oakwood filed for bankruptcy in Delaware citing "the continued poor performance of loans originated, the extremely weak conditions in the manufactured housing industry and deteriorating financial terms in the asset-backed securitization market." *Id.* at \*2.

Once before the bankruptcy court, Oakwood requested permission to continue its securitization and other financing transactions with Credit Suisse because "securitization transactions have provided the most effective and least expensive financing technique for satisfying Oakwood's tremendous liquidity needs." *Id.* Based on Oakwood's representations, the court granted the motion.

## The Lawsuit

On November 13, 2004, Oakwood's successor-in-interest, OHC Liquidation Trust (the "Trust"), objected to the proofs of claim filed by Credit Suisse in the bankruptcy case and asserted counterclaims of negligence, breach of implied contract and breach of fiduciary duties under New York law on the grounds that "Credit Suisse knew the transactions it was structuring were value-destroying and would eventually drive Oakwood into bankruptcy, and that Credit Suisse never bothered to undertake further due diligence about the effects of those transactions, never conveyed its superior understanding of the transactions to Oakwood, and never behaved in accordance with the fiduciary position it

had assumed by refusing to participate in further value destruction.” *Id.*

The bankruptcy court sent the case to the district court to be tried before a jury. Before the trial began, the district court granted Credit Suisse summary judgment dismissing the claims. The Trust appealed that dismissal to the Third Circuit Court of Appeals.

### Unclean Hands

On appeal, the Third Circuit first addressed the Trust’s claims of negligence and breach of implied contract, which the district court had dismissed based upon the doctrine of *in pari delicto*. This doctrine, also called the doctrine of unclean hands, “refers to the principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing.” *Id.* at \*3.

Suisse to do.” *Id.* Therefore, “Oakwood was at least as culpable as Credit Suisse” because “Oakwood routinely approved the ‘value-destroying’ transactions as an appropriate way to raise liquidity when the company was in financial turmoil.” *Id.*

The Trust argued that Credit Suisse could not avail itself of the *in pari delicto* doctrine because it was an “insider” of Oakwood. Generally, the doctrine of unclean hands will not apply when one party controls the other. The court rejected this argument because Credit Suisse did not control Oakwood. On the contrary, the undisputed evidence demonstrated that Oakwood “retained total control over its decisions.” *Id.* at \*4.

### No Proximate Cause

The court then addressed the breach of fiduciary duty claim, to which the defense of *in pari delicto* does not apply under New York law. The Trust alleged that Credit Suisse breached its fidu-

**Under New York law, the *in pari delicto* defense may bar a company’s claims against its bank for damages arising from the company’s own financial decisions, especially when those decisions are approved by a board of sophisticated legal and business professionals.**

The court agreed that these claims “do not survive summary judgment under New York’s *in pari delicto* doctrine” because Oakwood’s board of directors and managers — all sophisticated business and legal professionals — had authorized and directed the securitization transactions as a way to bolster liquidity. Indeed, even after filing for bankruptcy, Oakwood moved the court for permission to continue the transactions “as the most effective and least expensive financing technique for satisfying Oakwood’s tremendous liquidity needs.” *Id.*

The court further found that Credit Suisse had “merely assisted Oakwood’s implementation of its flawed business plan by structuring and executing these transactions, transactions which provided the liquidity necessary for Oakwood’s continued operation, exactly what Oakwood employed Credit

ciary duty by failing to provide its opinion about the securitization transactions. To succeed on a breach of fiduciary duty under New York law, the plaintiff must prove that the defendant’s actions proximately caused the plaintiff’s injury.

The court agreed that affirmance of the summary judgment dismissal was warranted due to lack of causation. Oakwood’s directors were “fully aware of the securitizations and how they operated as an integral part of Oakwood’s operation, and the Board at no time undertook to mandate the discontinuance of the transactions.” *Id.*

Indeed, Oakwood’s own filings in the bankruptcy court belied the claim that Credit Suisse caused its bankruptcy: “Oakwood attributed its bankruptcy to extremely weak market conditions — not to any supposed ‘value-destroying’ transactions.” *Id.*

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## Oakwood Homes

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### Conclusion

Under New York law, the *in pari delicto* defense may bar a company's claims against its bank for damages arising from the company's own financial decisions, especially when those decisions are approved by a board of sophisticated legal and business professionals. For this reason, among others, banks should strive to remain independent from their client's decision-making process when facilitating financial transactions. ©

## Court Imposes New Loan Terms in Foreclosure Action

By Robert A. Schwinger and Paige M. Willan

Reflecting a new era of judicial activism in dealing with the onslaught of home mortgage foreclosures, a New York state trial court has invoked the court's equity powers to impose a settlement on a mortgage company, a settlement that effectively re-writes the terms of the loan. *Aames Funding Corp. v. Dudley*, No. 29781/06, 2009 N.Y. slip op. 52410U (Kings Co. Nov. 30, 2009).

### Foreclosure Action

Aames Funding Corp. had extended a loan secured by a mortgage on the home of one Everton Dudley. After the loan went into default in 2007, Aames commenced a foreclosure action. In early 2008, a preliminary settlement was reached whereby Aames agreed to forebear in prosecuting the action so long as Dudley made a \$10,000 down payment and specified monthly payments thereafter. After Dudley failed to live up to that settlement, a second round of settlement negotiations began in October 2008, when a second defendant in the action, who lived in the property but was neither an owner of the property nor a party to the mortgage, averred that she had the ability and desire to make payments on the mortgage. This second round of negotiations lasted nearly a year, but resulted in an impasse, with the parties' positions diverging by \$1,000 a month.

### Power To Impose Equitable Settlement

The threshold issue considered by the court was whether, as a court of equity, it had the power to intervene in the parties' negotiations and impose an equitable settlement on them. In deciding that it did have such power, the court noted that "[w]hen confronted with [a] seemingly un-breachable gap, a law court would discontinue the negotiations and leave the parties to their remedies[, but] a court sitting in equity has other resources at its disposal." *Aames Funding Corp.*, 2009 N.Y. slip op. 52410U at 2.

In this case, the "plaintiff purposely sought the benefits of an action in equity" by bringing a foreclosure action, which arises under equity rather than law. *Id.* Citing to a 1975 decision that allowed a mortgagor to raise equitable defenses to a foreclosure action, the court observed that "a cardinal principle of equity jurisprudence" is that "a plaintiff is equitably bound to do equity as a condition precedent to obtaining equitable relief." *Id.* at 2 (citing *Fed. Nat'l Mortgage Ass'n v. Ricks*, 83 Misc. 2d 814, 821-22 (Kings Co. 1975)) (internal quotations omitted). Thus, given the equitable remedy sought of foreclosure, the court concluded it had the power to review the equitable nature of the parties' conduct and fashion and impose an equitable remedy.

### Equitable Considerations In Fashioning A Settlement

Having determined that its powers in equity were broad enough for the court to impose a settlement upon the parties, the court turned to a determination of the equitable considerations that should inform its crafting of that settlement. The court concluded that these equitable considerations included public policy and overall fairness. *See, e.g., Fed. Nat'l Mortgage Ass'n*, 83 Misc. 2d at 822 (refusing to "[m]erely rubber-stamp[] mortgagees' foreclosure actions, when they have acted barely within the formal legal bounds of [] loosely defined [federal] housing programs").

The court initially observed that judicial intervention to speed the resolution of this case was necessary due to the public policy considerations it raised. Reasoning that delays in reaching resolutions in foreclosure actions have detrimental effects on both a societal and an individual level — such as the removal of homeowners from homes and vacant houses leading to urban blight and decreased property values — the court confirmed its determination to craft a resolution to the parties' settlement impasse.

Second, the court addressed the concern that the mort-

gage at issue might have been the result of discriminatory lending practices. The court cited a 2008 decision, *M&T Mortgage Corp. v. Foy*, 20 Misc. 3d 274 (Kings Co. 2008), that found a “rebuttable presumption of discriminatory practice” where a mortgage loan with a fixed interest rate above 9% was granted to a home buyer in a minority community.

In *M&T Mortgage*, the court had looked to the Home Mortgage Disclosure Act (“HMDA”), 12 U.S.C. § 2801, *et seq.*, which mandates that citizens and public officials have access to “sufficient information . . . to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located” and also provides authority to the Board of Governors of the Federal Reserve to promulgate regulations to enforce this mandate. The court also considered the Act’s

ally increased on various change dates up to a cap of 12.4%. By June 2007, the rate had increased to “as much as 9.4%.” Further, the mortgage was “granted to a minority buyer for the purchase of a property in a minority area.” Considering the criteria set out in *M&T Mortgage*, the court determined that the adjustable rate mortgage at issue “will eventually call for an interest rate that exceeds nine percent” and thus the rebuttable presumption of unlawful discrimination applied. To overcome this presumption, the lender was required either: (1) to prove at a hearing, by a fair preponderance of the evidence, that the mortgage rate did not result from unlawful discrimination, or (2) to freeze the maximum rate chargeable on the mortgage at 9%.

Without holding a hearing at which the lender could rebut the presumption of unlawful discrimination, the court deter-

*Aames Funding demonstrates the power of a court sitting in equity, such as in a foreclosure action, to disregard a loan agreement and impose a settlement on the parties that supersedes or modifies the contractual terms.*

implementing regulations for the definition of a “higher priced loan,” which would indicate possible discrimination in lending. The proposed regulations implementing the HMDA defined “higher priced loan” as one in which the rate spread was three percentage points above “the Treasury security of comparable maturity” (*citing* Proposed Rules: Regulation Z, 73 Fed. Reg. 1672, 1673 (Jan. 9, 2008)). Using these criteria, the court in *M&T Mortgage* determined that the 9.5% fixed rate mortgage at issue there, “and indeed most 30-year mortgages written after the year 2000,” would constitute “higher priced loans.” Given this analysis, the court held “that an interest rate exceeding nine percent evidences the existence of a higher priced loan and creates a rebuttable presumption of discrimination.”

In *Aames Funding*, the loan at issue was a 2005 adjustable rate mortgage with an initial rate of 6.4%, which automati-

mined that a more appropriate outcome was its imposition of a settlement on the parties. In attempting to balance the remedy to be imposed, the court noted the “checkered history” of this case and determined that “the plaintiff is entitled to assurances that the defendant is . . . ready[,] willing and able to maintain the payments.” Given these equitable considerations, the court ordered that the defendant deposit \$10,000 with the county clerk and make payments of \$2,500 a month — an amount halfway between the negotiating positions of the two parties. The court further provided that that any delinquency in payment would allow the plaintiff to immediately enter a judgment of foreclosure and sale.

### Conclusion

*Aames Funding* demonstrates the power of a court sitting in equity, such as in a foreclosure action, to / *continued page 16*

## Aames Funding

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disregard a loan agreement and impose a settlement on the parties that supersedes or modifies the contractual terms. A mortgagee considering whether to initiate a foreclosure action may first need to consider the extent to which it has “done equity,” or acted in a fair and upright matter in its dealings with the mortgagor. If the mortgagee fails to act equitably, it should be prepared for the possibility that the foreclosure court will impose new loan terms without regard to the existing terms and the potential detriment to the mortgagee. ©

# Bank to Pay \$536 Million Forfeiture for Transferring Funds From U.S. Sanctioned Countries

*By Karl H. Buch and J. Carson Pulley*

Swiss banking giant Credit Suisse AG recently reached an agreement to pay a record \$536 million forfeiture in connection with violations of the International Emergency Economics Powers Act (“IEEPA”) and New York state law. Credit Suisse admitted that between 1995 and 2006, it assisted foreign banks and persons in countries sanctioned in programs administered by the U.S. Department of Treasury’s Office of Foreign Assets Control (“OFAC”), including Iran and Sudan, to move hundreds of millions of dollars through U.S. financial institutions by altering or hiding wire transfer information. The settlement will be split evenly between the United States and the New York County District Attorney’s Office.

## The International Emergency Economics Powers Act

The IEEPA (50 U.S.C. §§ 1701-06) makes it a crime to willfully violate or attempt to violate any regulations issued under the Act. Those regulations include the OFAC sanctions programs relating to Iran, Sudan, Burma, Cuba and Libya, all of which were implicated in Credit Suisse’s illegal conduct. The Federal Register states in the background to the OFAC Economic Sanctions Enforcement Guidelines, 31 C.F.R. Part 501, that

[t]he primary mission of OFAC is to administer and enforce economic sanctions against targeted foreign countries and regimes, terrorist and terrorist organizations, weapons of mass destruction proliferators, narcotic traffickers, and others, in furtherance of U.S. national security, foreign policy, and economic objectives. OFAC acts under Presidential national emergency powers, as well as specific legislation, to prohibit transactions and block (or “freeze”) assets subject to U.S. jurisdiction.

Pursuant to the Economic Sanctions Enforcement Guidelines, one major consideration in evaluating whether penalties for violations will be imposed is whether the individual or company has made a voluntary self-disclosure. According to the Guidelines, voluntary self-disclosure means

self-initiated notification to OFAC of an apparent violation by a Subject Person that has committed, or otherwise participated in, an apparent violation of a statute, Executive Order, or regulation administered or enforced by OFAC, prior to or at the same time that OFAC, or any other federal, state, or local government agency or official, discovers the apparent violation or another substantially similar apparent violation.

Pursuant to this definition, such disclosure will have mitigating effect only if it is done before or at the same time that the violation is discovered by a government authority.

## Credit Suisse’s Voluntary Self-Disclosure

In April 2006, Credit Suisse notified OFAC about potential violations it had discovered in an internal investigation related to U.S. securities transactions its personnel had executed on behalf of an entity that was subject to U.S. sanctions. In early 2007, Credit Suisse advised OFAC of a separate internal investigation related to its conduct as a U.S. dollar correspondent for OFAC sanctioned countries, including Iran. Because the New York County District Attorney’s office had already been investigating several suspicious wire transfers, however, this second voluntary self-disclosure did not fall within the safe harbor provisions of the OFAC’s Economic Sanctions Enforcement Guidelines. Credit Suisse’s illicit wire transfer activity, described in more detail below, formed the basis for the charges that lead to this historic forfeiture.

## The Illegal Conduct

From early 1995 through 2006, Credit Suisse personnel

assisted clients in wire transferring funds from U.S.-sanctioned countries, and thereafter altered the wire transfer documentation by deliberately deleting material information, including customer names, bank names and addresses. This allowed transfers by customers in U.S.-sanctioned nations to pass undetected through existing filters in the U.S. financial system. In the settlement agreement, Credit Suisse acknowledges that it

had a standard procedure of structuring payments to avoid disclosing the sanctions nexus of transactions passed through the United States, deleting or omitting certain information when transactions were to be processed through the United States, and providing incorrect information in wire transfer instructions executed through the United States on behalf of U.S. sanctioned individuals and entities.

customers in the U.S.-sanctioned countries, including by closing its Tehran office. But by then, it was too late to avoid massive penalties.

### The Record Settlement

On December 16, 2009, the Department of Justice filed a criminal information in the U.S. District Court for the District of Columbia charging Credit Suisse with one count of violating the IEEPA. Credit Suisse waived indictment, and accepted responsibility for its criminal conduct. In the settlement reached with the U.S. Department of the Treasury's OFAC, Credit Suisse agreed to forfeit \$536 million pursuant to the terms of deferred prosecution agreements it reached with the Department of Justice and the New York County District Attorney's Office and to settle OFAC's civil claims arising from the IEEPA violations.

## Financial institutions should operate with extreme caution when they conduct business with customers located in U.S.-sanctioned nations.

In the case of its Iranian customers, for example, Credit Suisse personnel would hand check every payment message to ensure that any information that would trigger a filter had been scrubbed there. Credit Suisse even provided its Iranian clients with a pamphlet entitled "How to transfer USD payments," a detailed instruction manual advising such clients on methods to avoid detection.

The global economic and political significance of this conduct is palpable. Indeed, the Credit Suisse settlement agreement states that "[t]he apparent violations by Credit Suisse . . . provided substantial economic benefit to Iran, Burma, Sudan, Cuba, Libya . . . , thereby undermining the U.S. national security, foreign policy, and other objectives of the related sanctions programs."

By 2006, Credit Suisse had put an end to such activity with

### Implications for International Banks

The U.S. and New York governments' aggressive pursuit of Credit Suisse for violations of the IEEPA and for dealing with customers operating in OFAC sanctioned nations illustrates the importance of maintaining strict compliance with U.S. financial business regulations and making early voluntary self-disclosure promptly once violations are detected. Financial institutions should operate with extreme caution when they conduct business with customers located in U.S.-sanctioned nations. If they provide services that violate U.S. laws, the bank serves the customer at its own financial and reputational peril. ☹

# Lender's Failure to Satisfy Pre-Loan Counseling Requirements Voids Reverse Mortgage

By Thomas J. Hall and Maureen K. Schad

A New York trial court recently voided a reverse mortgage arrangement entered into by an elderly woman suffering from paranoid schizophrenia, holding that the mortgage company failed to prove it had adequately counseled the woman prior to closing, as required by the National Housing Act, 12 U.S.C. § 1701, *et seq.* In the guardianship proceeding *Matter of Doar*, No. 31393/07 (Sup. Ct. Queens Co. Dec. 18, 2009), the court held that, even absent any showing that the lender knew of the borrower's incapacity, the mortgage would be voided given the Act's purpose of protecting elderly loan applicants and the lender's failure to ensure that the woman understood the implications of the reverse mortgage agreement.

## Background

Ms. Brunson purchased a home in Queens, New York in 1974, and held the property in her name until 2001, when she transferred title to herself and her brother as joint tenants. In 2001, she and her brother entered into a \$300,000 reverse mortgage agreement with Financial Freedom Senior Funding Corp. ("Financial Freedom"), and in 2003 they entered into a second \$375,000 reverse mortgage transaction with Financial Freedom, paying off the 2001 mortgage. A reverse mortgage allows older homeowners to access equity in their homes while retaining the property and does not require repayment until the borrower moves out or sells the mortgaged property.

In 2007, the New York City Commissioner of Social Services petitioned the court to appoint a guardian for Ms. Brunson pursuant to Article 81 of the Mental Hygiene Law on the grounds of incapacity. The petition was granted, and the court appointed a guardian to look after Ms. Brunson's affairs. The guardian then sought to vacate the reverse mortgage, alleging that Ms. Brunson lacked the capacity to enter into the mortgage agreement, that she signed under physical and emotional duress from her brother, and that the proceeds were used exclusively for her brother's benefit. Financial

Freedom denied these assertions, contending that Ms. Brunson had sufficient capacity to enter into the contract and that, even if she did not, the proceeds of the mortgage were used for her benefit and thus it was entitled to repayment.

## The Guardianship Proceeding

At trial, Ms. Brunson's psychiatrist testified that he began treating her when she was hospitalized in 2000, and that he continued to see her on a monthly basis until 2006. Her diagnosis was chronic schizophrenia, paranoid type. The psychiatrist explained that toward the end of 2001, Ms. Brunson began suffering from a cognitive impairment that involved a loss of memory and inability to function. She also suffered delusions centered on the loss of her home, including a fear that her neighbor, who was recently released from prison, was trying to take her house away from her, and a belief that she no longer had the deed to her home. In addition, she began expressing severe anxiety and fear of her brother, who she claimed was not feeding her. After observing several of Ms. Brunson's interactions with her brother, her psychiatrist concluded that her brother was mistreating her, and he referred the matter to Adult Protective Services.

Based on this testimony, as well as that of Ms. Brunson's sister, the court found that Ms. Brunson was incapacitated at least from the time of her hospitalization in 2000. It held that her mental illness, including psychosis and delusions, rendered her incapable of handling her financial affairs and from understanding the nature and long-term implications of reverse mortgages.

## The State Law Analysis

Having found that Ms. Brunson was incapacitated at the time of the 2003 reverse mortgage, the court addressed whether, under New York state law, the incapacity of the mortgagor renders the mortgage voidable.

The court reviewed the history of New York law on voiding contracts for incapacity. Prior to the enactment of Article 81 of the Mental Hygiene Law, New York law required that a mortgagee have actual knowledge of the mortgagor's incapacity for the mortgage to be voided. In *Ortelere v. Teachers' Retirement Bd.*, 25 N.Y.2d 196, 205 (1969), the New York Court of Appeals held that "there should be relief only if the other party knew or was put on notice as to the contractor's mental illness."

When Article 81 was enacted in 1992, it included no requirement of knowledge of the contracting party's incapacity.

Rather, Article 81 provides that a court may modify, amend or revoke any contract made prior to the appointment of a guardian if the court finds that it was made while an individual was incapacitated. Notwithstanding the statutory language, the court noted that, even after the statute's adoption, the New York appellate courts continued to require that a mortgagee have knowledge of the mortgagor's incapacity before a contract could be voided. As no evidence was presented that Financial Freedom was aware of Ms. Brunson's incapacity at the time of the reverse mortgage agreement, no clear basis existed under state law to invalidate it.

### The Federal Statutory Analysis

The court then turned to an analysis of the National Housing Act, which legislated the concept of reverse mortgages aimed

signed it, and it did not provide any evidence as to the counselor's qualifications or the specific content of the counseling provided. The Certificate stated only that the counseling took place in a forty-five minute phone conversation. The court explained that it could not ascertain from that Certificate whether the counselor actually spoke with Ms. Brunson, or with just her brother who appeared to dominate his sister's actions. Nor could the court determine whether Ms. Brunson asked any questions and, if she did, whether those questions were answered. There was no evidence, the court concluded, that Ms. Brunson understood the terms of the mortgage, and thus Financial Freedom had failed to meet its burden under the Act. "Under the circumstances of this case any responsible counselor would have unearthed Ms. Brunson's mental illness and her delusions

**This decision demonstrates that courts take seriously the obligation imposed by the National Housing Act that lenders provide counseling to elderly applicants and ensure that they adequately understand the implications of reverse mortgages.**

at providing the elderly access to the equity in their home. In connection with the adoption of that Act, the Department of Housing and Urban Development underscored the need to ensure that elderly individuals fully understand the intricacies of reverse mortgages. To that end, the statute requires pre-loan counseling of all prospective mortgagors. See 12 U.S.C. § 1715z-20(f). The court noted that the regulations accompanying the Act, 26 C.F.R. Section 206.41, reiterate and codify Congress's concern for elderly recipients of reverse mortgages by expanding the counseling obligation and requiring the submission of a certificate attesting that the counseling requirement was satisfied.

Although Financial Freedom produced a Certificate of Counseling at trial, certifying that Ms. Brunson and her brother received counseling prior to entering into the mortgages, it failed to produce as a witness the counselor who

regarding her house and determined that Hermina Brunson lacked the capacity to enter into the mortgage, or at the very least, that further counseling was needed." *Matter of Doar* at \* 3.

The court stressed that the "very nature of the intended recipients of these mortgages render such transactions suspect and thus a greater obligation is appropriately placed on the mortgagee than in an otherwise arms length transaction." Thus, the court held, in dealing with a reverse mortgage, the burden of knowledge must be shifted to the mortgagee. It is sufficient that a lender could have known of a borrower's incapacity "by the reasonable fulfillment of its statutory obligations." To rule otherwise, the court held, would render the protections of the National Housing Act meaningless.

Under the Act, the court concluded, lenders are charged with the responsibility of determining / continued page 20

## Matter of Doar

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whether a potential borrower is capable of understanding the nature and implications of a reverse mortgage. The court emphasized that this counseling requirement was “not meant to be perfunctory or a mere rubber stamp for the banking and mortgage industry.” Rather, it was intended to ensure that the rights of elderly homeowners are protected, and that such borrowers fully understand the terms and significance of reverse mortgage agreements.

Here, Financial Freedom was in a position to know of Ms. Brunson’s incapacity, and it failed to conduct an adequate inquiry as to her understanding of the mortgage agreement. The court explained that the fact that Financial Freedom produced a signed Certificate of Counseling may indicate that information was provided to Ms. Brunson, but it was not dispositive of the issue of her knowledge and understanding of the details of the reverse mortgage. As such, the court voided the mortgage. Recognizing that Ms. Brunson used a portion of the funds to protect her ownership rights in the property, the court required the guardian to reimburse Financial Freedom for certain payments made at closing, including real estate taxes, water charges and New York City Department of Social Services liens.

### Conclusion

This decision demonstrates that courts take seriously the obligation imposed by the National Housing Act that lenders provide counseling to elderly applicants and ensure that they adequately understand the implications of reverse mortgages. Lenders must be mindful that a signed Counseling Certificate, without more, may not be enough to satisfy their burden of proof. Particularly in the context of a guardianship proceeding, courts may be willing to void mortgages even absent proof that a lender knew of a borrower’s incapacity, if it finds that the lender failed to satisfy its counseling obligation under the Act. ☺

## Claims May Arise From Partial Assignment of Interrelated Loans

*By Benjamin D. Bleiberg*

The *Lehman* bankruptcy court has recently ruled that a borrower on a series of interrelated real estate loans, one used to acquire real property and the others used to maintain the real estate and fund interest payments, may have claims arising from the assignment of the Acquisition Loan alone without the assignment of the related loans. *LH 1440 L.L.C. v. Lehman Commer. Paper, Inc. (In re Lehman Bros. Holdings, Inc.)*, 416 B.R. 392 (Bankr. S.D.N.Y. 2009). The court held that the borrower had potential claims against both the assignee of the Acquisition Loan, if it was on notice of the interrelated nature of the loans, as well as the assignor of that loan, the original lender.

### Background

In June 2007, plaintiff LH 1440 L.L.C. (“LH 1440”) entered into loan agreements with Lehman Brothers Holding, Inc. (“LBHI”) for the acquisition and improvement of certain commercial real estate in the Bronx, New York. Pursuant to those agreements, LBHI extended three separate loans to LH 1440, an Acquisition Loan for the acquisition of the real estate, and Project and Building Loans under which LBHI advanced funds for LH 1440 to maintain and improve the property and to fund interest payments on the Acquisition Loan. The loans were secured by three separate promissory notes, but a single participation fee and interest rate cap applied to all three loans. Lehman Brothers Commercial Paper, Inc. (“LCPI”) then acquired these loans from LBHI.

In May 2007, LCPI entered into a master repurchase agreement (“MRA”) with State Street Bank and Trust Company (“State Street”). Under the MRA, State Street paid approximately \$1 billion to buy from LCPI a pool of assets consisting mainly of commercial loans. LCPI agreed in the MRA to repurchase these assets at a later date. One of the loans that LCPI eventually included in the State Street asset pool was the LH 1440 Acquisition Loan. LCPI did not also assign to the State Street pool the LH 1440 Project and Building Loans, under which LCPI had ongoing funding obligations.

LCPI subsequently filed for Chapter 11 bankruptcy protec-

tion and defaulted on the MRA by failing to repurchase the MRA assets from State Street. Also as a result of LCPI's bankruptcy, LCPI defaulted on its continuing funding obligations to LH 1440 under the Project and Building Loans. LCPI's failure to advance funds under the Project and Building Loans put LH 1440 at risk of default and foreclosure under its Acquisition Loan, now held by State Street, as funds under the Project and Building Loans were no longer available to pay interest on the Acquisition Loan.

### The Suit

LH 1440 brought suit against State Street, LCPI and LBHI seeking a declaratory judgment that the three loans were "integrated" and intended to function as a unified financing package. LH 1440 claimed that, because the loans were integrated, (1) LCPI and LBHI had improperly split the loans when

### The Claims Against State Street

In ruling on the motion to dismiss, the Bankruptcy Court agreed with the defendants that the express terms of the loan agreements permitted their individual assignments. The court stressed that the repurchase market is necessarily "fueled by the unfettered transferability of financial assets" where "[c]ash and financial assets are exchanged between financial institutions in the ordinary course of business based on standard documentation with the understanding that the assets being sold are otherwise unrestricted and may be converted to cash without the overhang and delay of litigation risk." An unnecessary restraint on this transferability would, therefore, adversely affect the market's ability to function efficiently.

But this was not the end of the Court's analysis. The court

**Because the transfer of the Acquisition Loan exposed the plaintiff to "unanticipated transactional risks," the court denied LBHI and LCPI's motion to dismiss, and gave the plaintiff opportunity to conduct discovery on the issue of the parties' intended characterization and treatment of the loans.**

it transferred only the Acquisition Loan to State Street, and (2) State Street, as owner of the pool of assets that included the Acquisition Loan, should be required to fund the lender's ongoing obligations under the Project and Building Loans, even though those loans were not acquired by State Street.

The defendants moved to dismiss the complaint for failure to state a claim. State Street argued that it could not be forced to act as lender on the Project and Building Loans that it never acquired under the MRA. LBHI and LCPI argued that express and unambiguous language of the loan agreements established that the loans were individually transferable and that, accordingly, the Acquisition Loan was properly transferred to State Street pursuant to the MRA.

suggested that the "only conceivable exception" to this general proposition would be if LH 1440 pled sufficient circumstances that placed State Street on actual or inquiry notice of the interrelated nature of the Project and Building Loans.

The court found that the complaint failed to allege that State Street had either actual notice that the loans were not to be separated, or inquiry notice that State Street knew of any facts that would induce a reasonable actor in the same position to investigate the matter further. Without alleging either actual or inquiry notice, the court found that public policy concerns favoring the easy execution of transactions involving sophisticated financial institutions, and the orderly exchange of financial assets between market participants, weighed

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against requiring counterparties such as State Street to conduct a detailed investigation into the underwriting of a note or the authority of the seller to freely transfer that note. The court reasoned that a counterparty to the repurchase agreement would be indifferent to the expectations of the parties at the time of origination with respect to a particular loan within a diverse pool of assets, particularly where other assets often can be substituted, a counterparty's focus being on the aggregate value of the assets, and not specific assets within the pool.

While the court dismissed the complaint against State Street, it granted the plaintiff an opportunity to amend the complaint to plead facts demonstrating that State Street was on either actual or inquiry notice, at the time of the assignment of the Acquisition Loan, of its interrelationship with the Project and Building Loans.

### The Claims Against LBHI and LCPI

As to the claims against LBHI and LCPI, the court denied their motion to dismiss finding that, despite the express language in the loan agreements providing for the individual transferability of the loans, the plaintiff had sufficiently stated a claim that the parties considered the loans as interrelated and that LBHI and LCPI should not have transferred them separately.

Despite its finding that each loan by its terms was individually transferable, the court still held that the “underlying documents” indicated that the parties may have intended for the loans to function as a single loan transaction and, therefore, should not have been split to LH 1440's detriment. In reaching this conclusion, the court was persuaded by the single participation fee and interest rate cap for all three loans, as well as the fact that the loans were designed to be used in tandem to purchase and improve a single real estate investment and fund interest charges. Because the transfer of the Acquisition Loan exposed the plaintiff to “unanticipated transactional risks,” the court denied LBHI and LCPI's motion to dismiss, and gave the plaintiff opportunity to conduct discovery on the issue of the parties' intended characterization and treatment of the loans.

### Conclusion

While the loan agreements contained language providing for their individual transferability, the bankruptcy court refused to dismiss the claims against LBHI and LCPI. Perhaps more

explicit contractual language would have resulted in dismissal. As to the claims against State Street, although the court clearly found that a repurchase agreement counterparty has no duty to investigate the assets within a pool, the ruling kept the door open for the plaintiff to plead that State Street knew or should have known that other loans were interrelated with the Acquisition Loan assigned to the MRA asset pool. ☺

## Court Allows Mortgage Assignee to Resurrect Dismissed Foreclosure Action

*By Francesca J. Perkins*

In *Beltway Capital, LLC v. Soleil*, 22244/07 (N.Y. Sup. Nov. 23, 2009), a New York state court granted a motion by the assignee of a mortgage to vacate the dismissal of a foreclosure action that had been brought by the original mortgagee. The court held that, as the assignee stood in the shoes of the assignor, it was entitled to bring any claims belonging to the assignor, and thus was entitled to seek vacature of the dismissal order granted on default against the original mortgagee on the same grounds as would have been available to the original mortgagee.

### The Facts

Asset Management Holdings, LLC (“Asset”) commenced suit in June 2007 to foreclose on a mortgage recorded against real property located in Brooklyn, New York. The mortgage had been executed by the owner of the property, Soleil, to secure a \$652,000 note.

Soleil moved to dismiss the action. When plaintiff Asset failed to oppose that motion and failed to appear at two hearings on that motion, the court granted the motion on default dismissing the action and discharging the mortgage. Land records revealed that the Order discharging the mortgage was recorded against the property on August 5, 2008. Six months earlier, however, Asset had sold the mortgage to Beltway Capital, LLC (“Beltway”), which recorded that assignment on July 21, 2008.

To complicate matters further, Soleil subsequently sold the property to Deborah Hughes (“Hughes”) by deed recorded on October 14, 2008. Hughes then mortgaged the property to HB Baron Family Associates (“HB Baron”), apparently without knowledge of the Asset/Beltway mortgage.

### The Suit

Beltway, as assignee of Asset and the current holder of the mortgage, filed a motion with the court for an order substituting it as plaintiff, in the place of Asset, and vacating the dismissal and discharge order against Asset, thereby restoring the mortgage as a lien against the property. Claiming that Asset’s counsel had never received notice of the defendant’s motion to dismiss, it argued that Asset had a reasonable excuse for its default. Beltway claimed that Asset failed to

vene alleging that intervention was warranted to determine her rights in the property. Hughes argued that she was protected as a bona fide purchaser for value without notice or knowledge of any claim by Beltway and held title to the subject property free and clear of Beltway’s mortgage. Hughes alternatively claimed that Beltway’s mortgage should be subordinated to her existing mortgage and her equitable lien for the improvements she made to the property as of the date of the reinstatement of the original mortgage.

### The Holding

While saving many of the knotty procedural and substantive issues for another day, the court granted Beltway’s motion to be substituted as plaintiff. The court held that, pursuant to Section 13-105 of the New York General Obligations Law and

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appear on either hearing date because Asset filed for bankruptcy in early 2008. Beltway further claimed that the Order discharging the Mortgage was improper because (1) the scope of relief exceeded what was requested and (2) the court did not have jurisdiction to grant such relief.

In response, Soleil argued that Beltway failed to present a reasonable excuse for why Asset did not appear at the hearing on the dismissal motion. Soleil further argued that Beltway had no standing to bring claims against Soleil, as Soleil no longer owned the subject property, which had been purchased by Hughes who, he asserted, was a bona fide purchaser for value. In addition, Soleil argued that the action should be dismissed for failure to join as parties Hughes and HB Baron, the current owner and her mortgagee.

To add to the procedural confusion, Hughes moved to inter-

established state case law, it is “well established” that an assignee may bring an action to enforce an assigned claim in the same manner as the assignor might have done. While an assignee may pursue the same remedies as would have been available to the assignor, an assignee’s claims are also subject to the same “infirmities, equities, and defenses that could have been asserted [by the obligor] against the assignor at the time of the assignment,” the court quoting *Trans-Resources, Inc. v. Nausch Hogan & Murray*, 298 A.D.2d 27, 30 (2002), and citing *National Commercial Bank & Trust Co. v. Malik*, 72 Misc. 2d 865, 867 (1973).

The court held that Section 5105(a) of the New York Civil Practice Law and Rules makes clear that a party seeking to vacate an order granted on default, here Asset’s default on the defendant’s motion to dismiss, must / continued page 24

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establish both a reasonable excuse for the default and a meritorious defense or claim. Noting that the determination as to whether there is a reasonable excuse for a default is discretionary, the court accepted Beltway's assertion that Asset was not properly served with Soleil's motion to dismiss, and thus the reasonable excuse requirement was satisfied. As to the second prong, the court concluded that Beltway had, by virtue of its position as the assignee of the mortgage, a meritorious claim, and vacated the dismissal order and reinstated the mortgage.

## Conclusion

As an assignee of the original mortgage, Beltway stood in the shoes of Asset. As such, it was entitled to continue the foreclosure proceedings in its own name. Beltway's right to continue that action, however, was subject to any defenses that existed against Asset, here Asset's default on the motion to dismiss, which Beltway was able to overcome. ☺

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### FOR MORE INFORMATION, CONTACT:

#### New York

Oliver J. Armas  
Scott S. Balber  
Thomas E. Butler  
Thomas J. Hall  
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Robert A. Schwinger  
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Marcin Boruc

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Edited by Thomas Hall at +1 (212) 408-5487 ([thall@chadbourne.com](mailto:thall@chadbourne.com)) and Thomas McCormack at +1 (212) 408-5182 ([tmccormack@chadbourne.com](mailto:tmccormack@chadbourne.com)). Visit us at [www.chadbourne.com](http://www.chadbourne.com).

#### Chadbourne & Parke LLP

##### New York

30 Rockefeller Plaza  
New York, NY 10112  
+1 (212) 408-5100

##### Washington

1200 New Hampshire Ave., NW  
Washington, DC 20036  
+1 (202) 974-5600

##### Los Angeles

350 South Grand Ave., 32nd Floor  
Los Angeles, CA 90071  
+1 (213) 892-1000

##### Mexico City

Chadbourne & Parke SC  
Paseo de Tamarindos, No. 400-B Piso 22  
Col. Bosques de las Lomas  
05120 México, D.F., México  
+52 (55) 3000-0600

##### London

Chadbourne & Parke (London) LLP  
an affiliated partnership  
Regis House, 45 King William Street  
London EC4R 9AN, UK  
+44 (0)20 7337-8000

##### Moscow

Riverside Towers  
52/5 Kosmodamianskaya Nab.  
Moscow 115054 Russian Federation  
+7 (495) 974-2424  
Direct line from outside C.I.S.:  
(212) 408-1190

##### St. Petersburg

Stroganovskiy Business Centre  
19A Nevskiy Prospect  
St. Petersburg 191186 Russian Federation  
+7 (812) 332-9300

##### Warsaw

Chadbourne & Parke  
Radzikowski, Szubielska and Partners LLP  
ul. Emilii Plater 53  
00-113 Warsaw, Poland  
+48 (22) 520-5000

##### Kyiv

25B Sahaydachnoho Street  
Kyiv 04070, Ukraine  
+380 (44) 461-7575

##### Almaty

Dostyk Business Center  
43 Dostyk Avenue, 4th floor  
Almaty 050010, Republic of Kazakhstan  
+7 (727) 258-5088

##### Dubai

Chadbourne & Parke LLC  
City Tower I, Sheikh Zayed Road  
P.O. Box 23927, Dubai, United Arab Emirates  
+971 (4) 331-6123

##### Beijing

Beijing Representative Office  
Room 902, Tower A, Beijing Fortune Centre  
7 Dongsanhuan Zhonglu, Chaoyang District  
Beijing 100020, China  
+86 (10) 6530-8846

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