

# Financial Services Litigation

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NEWSWIRE

## Court Refuses to Modify \$45 Billion Sale of Lehman Assets to Barclays

By Thomas J. Hall and Emily Abrahams

On February 22, 2011, Judge James M. Peck of the United States Bankruptcy Court for the Southern District of New York issued a decision declining to modify the September 20, 2008 Sale Order that approved the sale to Barclays PLC (“Barclays”) of assets collectively comprising the bulk of the North American investment banking and capital markets business of Lehman Brothers Holdings Inc. (“LBHI”), Lehman Brothers Inc. (“LBI”) and certain of their affiliates (together “Lehman”). Barclays paid \$45 billion for Lehman securities valued at \$49.7 billion in what the court described as “the largest, most expedited and probably the most dramatic asset sale that has ever occurred in bankruptcy history.” Indeed, throughout the 103 page decision, the court repeatedly cited to the unprecedented circumstances of the sale, which occurred during the pinnacle week (dubbed “Lehman Week”) of what the court aptly described as the greatest financial crisis of our lives.

The essence of the challenge by movants LBHI, the Official Committee of Unsecured Creditors (the “Committee”), and the Trustee of Lehman Brothers Inc. under the Securities Protection Act (“SIPA”) (the “SIPA Trustee”) (together, “Movants”)—made pursuant to Federal Rule of Civil Procedure (“FRCP”) 60(b), which provides multiple grounds upon which a court may relieve a party from final judgment—is that Barclays negotiated an alleged secret \$5 billion discount in the final moments of the sale, which was not approved by the court, and did so primarily through a Clarification Letter filed with the court two days after the sale. / continued page 2

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## Lehman

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### The Clarification Letter

The Clarification Letter was drafted to address several complications and list some of the assets moving over from Lehman to Barclays. At the time of the sale, the court was aware that the Clarification Letter was not final, but that the language of the letter would not materially modify the terms of the transaction approved by the Sale Order in a way that would adversely impact Lehman's bankruptcy estate. Two days after the sale, on September 22, 2008, the Clarification Letter was filed with the court but was never submitted for final court approval.

In the two and a half years prior to seeking modification of the Sale Order, which the court described as a "most unusual after the fact challenge to the fairness of a transaction of global significance, a transformative combination in the financial services industry that was accomplished at a time of fear and major

### The Backdrop to the Sale

In its decision, the court repeatedly cited to the unprecedented circumstances of the sale of Lehman's assets to Barclays and the harm that would have ensued had the sale not been consummated, describing the scene as "a war zone," "a catastrophic week," "organized chaos," "a bad situation" in which "coordination was difficult" and in which "everyone was sleep deprived and stressed out" during "marathon negotiating and drafting sessions." Indeed, using the term "fog of Lehman," the court recalled the "confusion, ambiguity and uncertainty" that prevailed during Lehman Week resulting from the enormity of the transaction and the impossible time constraints in completing it. As such, the court explained that everyone involved in the transaction—including the court—expected that there would be errors, omissions and miscommunications and that it would have been impossible to comprehend fully every aspect of the acquisition, including the fair market value of all of the

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dislocation in the markets," the parties very clearly relied on the Clarification Letter as a valid and binding part of the transaction. For example, in a joint submission with Barclays dated September 29, 2008, Movant LBHI described the letter as "clarifying the intention of the Parties with respect to certain provisions of the Purchase Agreement, amend[ing] the Purchase Agreement in certain respects, and . . . binding . . . the Parties." The SIPA Trustee cited and relied on the Clarification Letter in a settlement motion and, just weeks before filing the Rule 60(b) motions, the SIPA Trustee stipulated that the Clarification Letter was part of the approved Purchase Agreement. As such, the court held that "[a]lthough the omission from the Sale hearing of any meaningful discussion of the Disputed Assets may have deviated from the core principles of disclosure underlying section 363 of the Bankruptcy Code, such a failure does not render the Clarification Letter unenforceable in this instance because the parties themselves have acted in reliance upon the Clarification Letter and have treated the document as enforceable."

assets being transferred, including those described in the Clarification Letter.

### The Non-Disclosures Were Not Cause for Rule 60(b) Relief

While the court readily acknowledged that it did not possess "some very basic information regarding the transaction" during Lehman Week, it ultimately held that the failure to disclose that information was not cause for relief under Rule 60(b). While Rule 60(b) motions should be liberally construed when "substantial justice" will be served, they are properly granted only upon a showing of exceptional circumstances. In this case, the Movants relied on the following grounds: (1) mistake, inadvertence, or excusable neglect; (2) newly discovered evidence; (3) innocent or intentional misrepresentation or fraud . . . by an opposing party; and (4) fraud by any other party or fraud on the court.

As the court explained, those claims were all based on the allegation that certain crucial facts about the sale were not disclosed to the court. The court found, however, that the com-

plained of non-disclosures did not affect the fairness of the sale hearing or its outcome and that there was a lack of any substantial evidence to support a finding that the Sale Order was procured by fraud, misrepresentation or wrongdoing of any kind.

The court relied heavily on the testimony of a Barclays' expert who testified that "the book value of the assets being acquired by Barclays was not understated . . . by a significant amount, particularly not by \$5 billion, and that the book value according to Lehman's financial records was approximately \$70 billion or less." Moreover, many of the assets being valued were illiquid, which would have made them difficult to value even under normal circumstances.

Reverting to the unprecedented circumstances of the sale, the court noted that while the disclosure problems were real, they were due to "the 'fog' of Lehman and the emergency of a magnitude unlike any that has ever occurred in any sale hearing" making the disclosure failures understandable and forgivable.

Moreover, as the court repeatedly made clear, the only options on the table were a sale to Barclays or liquidation, the latter not being a viable option as "the disintegration of the [Lehman] enterprise and the liquidation that would have occurred had there been no sale to Barclays would have resulted in far greater harm and losses in the financial markets than actually were experienced in September 2008 and succeeding months of the financial crisis."

While the facts of the sale transaction itself are complex, the holding of this case is ultimately simple; the process was imperfect, but necessary to stave off a worsening of the already devastating financial crisis. ©

## New York Court Dismisses Iceland Financial Crisis Suit on Forum Non Conveniens Grounds

By Jeffrey I. Wasserman and Paige M. Willan

A New York state court recently dismissed, on forum non conveniens grounds, a case filed by the Winding-up Board of Glitnir Banki HF, a major Icelandic bank, and its foreign representative against certain of the bank's former officers and

directors and the bank's auditor, PricewaterhouseCoopers, to recover billions of dollars allegedly fraudulently funneled from the bank's capital raising activities. *Glitnir Banki HF v. Johannesson*, Index No. 601217/10 (N.Y. Co.).

According to plaintiffs, during 2007 and 2008, certain of the bank's former officers, directors and auditors engaged in a fraudulent scheme that included raising funds based on fraudulently misstated financial statements. The former officers and directors allegedly funneled those funds through a series of transactions to corporations controlled by them and certain other defendants, allowing them collectively to loot billions of dollars from Glitnir, which ultimately became insolvent during the world-wide financial crisis. Plaintiffs thus seek to recover the allegedly diverted funds from the individual defendants for the benefit of the Icelandic equivalent of Glitnir's bankruptcy estate.

Defendants moved to dismiss the action on forum non conveniens grounds (in favor of Iceland as a more appropriate forum) and for lack of personal jurisdiction. PricewaterhouseCoopers also moved to dismiss based on a forum selection clause in its engagement letter with Glitnir that provided that Iceland would be the exclusive forum for disputes under that agreement. Plaintiffs opposed the motion, arguing that New York was a proper forum because a significant portion of the alleged fraud took place in New York.

### The Parties' Arguments Regarding New York as a Forum

In determining whether to dismiss an action under the forum non conveniens doctrine, a New York state court must consider and balance relevant public and private interest factors—including, for example: (i) the burden on New York courts, (ii) any hardship for defendants, (iii) the availability of an alternative forum, (iv) the residency of the parties and (v) where the transaction that gave rise to the suit occurred—and ultimately determine whether to retain jurisdiction in "the exercise of its sound discretion." *Islamic Republic of Iran v. Pahlavi*, 62 N.Y.2d 474, 478-79 (1984).

Plaintiffs focused their arguments on the third, fourth and fifth factors. Thus, plaintiffs argued that the courts in Iceland were flooded with cases related to the financial crisis and that the Icelandic judiciary "does not have experience with complex international cases[.]" Plaintiffs further argued that certain of the individual defendants were residents of New York, and that plaintiffs would attempt to enforce the requested judgment against assets maintained in New York. / continued page 4

## Iceland Financial Crisis

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Plaintiffs focused their argument, however, on conduct intended to address the fifth factor. Plaintiffs therefore argued that four specific “buckets” of activity occurred in New York that justified a New York state court as the venue for the dispute: (1) Glitnir needed to access financial markets in New York to effectuate its scheme by raising money in the form of medium term notes; (2) a Glitnir board meeting was held in New York, during which the defendants “took significant steps to advance” their fraud and approved false financial statements; (3) New York served as the “nerve center” for one of the transactions whereby the defendants diverted nearly half a billion dollars from Glitnir to corporations that they controlled; and (4) false financial statements were distributed to investors in the New York financial markets in support of Glitnir’s fundraising activities. Moreover, during the relevant time period, Glitnir had opened an office in New York, which, according to plaintiffs, provided the venue for certain activities undertaken in furtherance of the fraud.

The individual defendants countered plaintiffs’ arguments by setting forth arguments relating to all five relevant factors. The individual defendants argued that, because the plaintiffs were Icelandic citizens, their choice of forum was entitled to no weight. And, moreover, they emphasized how inconvenient—and burdensome on the Court—it would be to try the case in New York: the action involved an Icelandic bank suing its former officers and directors—all Icelandic citizens—as well as the officers and directors of other Icelandic corporations. Indeed, defendants identified forty witnesses who were in Iceland, and asserted that “huge amounts of evidence not only are in Iceland, but will have to be translated” if the case remained in New York. The claims themselves were based on Icelandic banking laws and Icelandic fiduciary duty rules, all under a legal theory that was not even certain in Iceland. Courts in Iceland, they argued, should decide such unsettled issues, not courts in New York. Finally, even if the Court kept the case and rendered a judgment in it, Defendants argued that a judgment rendered by a New York court would not even be enforceable in Iceland, which would make the New York action “just a warm up act to another case.”

Defendants disputed plaintiffs’ contention that New York was a central location of the relevant transactions, and emphasized that the case involves a “critical issue for the country of Iceland.” Finally, Defendants cited a statistic that

revealed that, rather than being flooded with cases, as the plaintiffs argued, the case load maintained by Icelandic judges pales in comparison to that of a Commercial Division judge in New York County.

### New York Is an Inappropriate Forum

As a threshold issue, the judge indicated—although he did not formally decide the issue—that he likely would have concluded that he could exercise jurisdiction over the defendants based on the New York contacts alleged by plaintiffs. The forum non conveniens doctrine, however, permits the court to dismiss an action over which it otherwise has jurisdiction.

The Court addressed plaintiffs’ various arguments. With respect to the plaintiffs’ arguments about judicial resources, the court found that the case “is an unnecessary burden for the State of New York[.]” While the Court appreciated the compliment regarding the quality of the judges of the commercial division, the court contrasted the relative workload of the New York State judiciary with that of Iceland, and concluded that plaintiffs’ arguments regarding the flooding of the Icelandic judiciary were unconvincing given the much larger caseload of the average New York state judge. Significantly, the court determined that the Icelandic judiciary was competent to decide this case, reasoning that the arguments regarding the relative inexperience of the Icelandic judiciary in such matters were not compelling because “the only way the Icelandic courts will learn how to handle cases like this is to handle cases like this.”

With respect to plaintiffs’ arguments regarding the ties to New York, the court concluded that those arguments were relevant to the jurisdictional questions, not the forum non conveniens analysis. Given the strong relationship to Iceland, the court observed, “I don’t think that I can come up with a credible argument that the center of this case belongs anywhere other than Iceland.” Thus, the Court concluded:

“Looking at this as kindly as I can, what I see unfolding is a case that is going to show me that the conspiracy was hatched in Iceland or Denmark or some place, but not necessarily New York. That New York played a role in that it was the marketplace where these notes could be successfully sold to the public. This is where you do things like that. Either New York or London, that’s primarily where these things are done. It doesn’t make us the focus of this conspiracy, if it is [one].”

Interestingly, the court noted that the result may have been different had the suit been filed on behalf of note holders who purchased notes marketed in New York, rather than on behalf of an Icelandic bankruptcy estate. The court also agreed that the claims against PricewaterhouseCoopers would have to be dismissed based on the forum selection clause in its retainer letter.

Finally, as a condition for dismissal, the court required all defendants to consent to the jurisdiction of the courts of Iceland, and to agree not to raise jurisdictional or other similar defenses to any enforcement actions arising from a final judgment in Iceland against assets located in New York.

### The Takeaways

The *Glitner* case provides several important takeaways:

- The existence of personal jurisdiction over defendants in New York does not guarantee that New York is a convenient forum. Indeed, the allegation that certain of the defendants maintained residences in New York was not sufficient to avoid dismissal on forum non conveniens grounds.
- Simply because a financial fraud involves a New York financial market, as most (or, at least, many) do, the use of that market does not guarantee that New York will be deemed an appropriate forum; otherwise, New York would be an appropriate forum for nearly every financial fraud.
- The relative lack of experience of a foreign court with respect to complex financial-based claims does not make that court an inadequate forum.
- New York's overtaxed judiciary will take a serious look at forum non conveniens motions concerning disputes that seemingly have little to do with New York. ☺

## New York Courts Split Over MERS Foreclosure Standing

By Jonathan C. Cross and Stacey Trimmer

Grappling with an unprecedented wave of real property foreclosure actions, New York courts have reached conflicting conclusions regarding the question of whether assignments of mortgages and related notes may validly be made by the Mortgage Electronic Registration System ("MERS"), rather than by the financial institution that holds the relevant note and beneficial interest in the relevant mortgage. The United States

Bankruptcy Court for the Eastern District of New York, applying New York law, has concluded that MERS lacks the authority to assign mortgages and notes, while several New York state courts have reached a contrary conclusion. The unsettled state of the law regarding MERS mortgage assignments in New York is likely to create considerable uncertainty in certain foreclosure actions, at least until the New York appellate courts weigh in on the issue.

### The Role of MERS

MERS was established in the 1990s by the mortgage banking industry to facilitate the computerization of mortgage loan records, and to expedite the assignment and securitization of mortgage loans. It maintains a national mortgage registration database, reflecting information concerning the ownership and assignment of millions of home mortgage loans. Acting as a nominee of the owner of the mortgage note, MERS is recorded in local land records as the "mortgagee of record." Subsequent transfers of the mortgage note occur within the MERS database. MERS estimates that some 50% of the mortgages in the United States utilize the MERS registration system.

Pursuant to its membership agreement, membership rules, and certain provisions of the mortgages for which it serves as mortgagee of record, MERS takes the position that it may lawfully commence foreclosure proceedings on behalf of the owner of the note, as well as effectuate mortgage and note assignments. Parties resisting foreclosure, however, have frequently sought to challenge MERS' standing to foreclose, as well as its standing and authority to effectuate mortgage and note transfers. See Multidistrict Court Dismisses Mortgage Foreclosure Class Actions, *Financial Services Litigation Newswire*, December 2010.

### The Bankruptcy Court's *Agard* Decision

On February 10, 2011, in deciding whether to grant a mortgage servicer's motion for relief from the automatic bankruptcy stay to foreclose on a debtor's real property, the United States Bankruptcy Court for the Eastern District of New York concluded that MERS lacks the authority to assign mortgage notes. *In re Agard*, No. 810-77338-REG, 2011 WL 499959 (E.D.N.Y. 2011). Despite this conclusion, based on a prior state court judgment of foreclosure, the court ultimately held that the *Rooker-Feldman* doctrine (which prohibits the lower federal courts from reviewing state court judgments) and the doctrine of *res judicata* precluded the debtor's standing challenges. Thus, the court granted the mortgage / continued page 6

## MERS

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servicer's motion, permitting it to foreclose.

The court went on, however, to analyze the merits of the mortgage servicer's standing as the agent of the mortgagee, U.S. Bank. Notwithstanding its holding that the standing issue was resolved by the application of *res judicata*, the court stated it "believe[d] this analysis is necessary for the precedential effect it will have on other cases pending before this court." In analyzing the merits, the court noted that to have standing to foreclose, the mortgagee must hold both the note and the mortgage.

The court found there was insufficient proof that U.S. Bank actually held the note. While MERS represented that U.S. Bank was reflected in its database as the owner of the note, the court found that no showing had been made that the note had been validly assigned to U.S. Bank. The court concluded that an

the mortgage. The court also found that MERS' membership rules, to which all MERS member institutions agree, did not grant "clear authority to MERS" to assign the Mortgage, and that the statute of frauds barred the court from finding that MERS had mortgage assignment authority unless such authority was clearly memorialized in writing.

The court rejected MERS' arguments that its "mortgagee of record" status under the terms of the Mortgage gave it "the rights of a mortgagee in its own right." In rejecting this contention, the court noted that MERS had executed the Assignment of Mortgage "as nominee for" the original lender, rather than as mortgagee in MERS' own right. The court wrote that "MERS' position that it can be both the mortgagee and an agent of the mortgagee is absurd, at best."

The court was unmoved by concerns that its analysis could create uncertainty in mortgage litigation and in mortgage credit markets, writing that "this Court does not accept the

**The uncertainty created by the *Agard* decision is likely to dissipate as the New York appellate courts weigh in but as this split in authority in New York demonstrates, it is far from clear how courts in a wide array of jurisdictions, applying state law, will resolve these issues.**

Assignment of Mortgage executed by MERS in favor of U.S. Bank was not sufficient—despite language stating that U.S. Bank was "to have and to hold the said Mortgage and Note"—to effect a transfer of the note. The court reasoned that this language was "vague and insufficient to prove an intent to assign the Note," that MERS was not a party to the note, and that the record did not show that the original noteholder had authorized MERS to assign the note.

Next, the court found that MERS lacked the power to assign the mortgage to U.S. Bank. MERS argued that it had the authority to assign a mortgage because it is the named "mortgagee of record" and a "nominee" for the mortgagee in the mortgage itself. The court found this language insufficient to confer any authority upon MERS to assign the mortgage, absent evidence of specific authority to assign the mortgage. The court concluded that MERS had not shown that it was granted the "specific right to assign the mortgage" in writing, and as such, found that MERS lacked the authority to assign

argument that because MERS may be involved with 50% of all residential mortgages in the country, that is reason enough for this Court to turn a blind eye to the fact that this process does not comply with the law."

While it remains to be seen whether other courts will follow *Agard's* analysis or view it as *dicta*, the *Agard* decision will likely factor prominently in future MERS foreclosure proceedings in New York. In fact, the court expressed an intent to adhere to its own opinion in "dozens" of other pending cases that did not involve a prior state court judgment of foreclosure. The court wrote that "in all future cases which involve MERS, the moving party must show that it validly holds both the mortgage and the underlying note in order to prove standing before this Court."

Finally, the court "le[ft] open the issue as to whether mortgages processed through the MERS system are properly perfected and valid liens," based on the theory that the MERS system impermissibly separates the note and the mortgage.

Such a holding would have far-reaching implications, insofar as it would have the potential, if widely adopted, to invalidate mortgage liens whenever a mortgage is held through the MERS system.

### Recent New York State Court Decisions

A number of New York courts have adopted analyses contrary to the Bankruptcy court's approach in *Agard*. On March 3, 2011, the New York Supreme Court, Bronx County granted summary judgment in a foreclosure action brought by a MERS assignee. See *Bank of New York v. Sachar*, Index No. 0380904/2009 (Bronx Co. 2011). Contrary to the *Agard* court's analysis, the *Sachar* court held that the mortgage instrument "conferred broad powers upon MERS as nominee to act on the original lender's behalf," including by assigning the mortgage. Moreover, because (unlike the situation in *Agard*) evidence had been presented that the assignee had taken physical delivery of the mortgage note, the *Sachar* court held that the note had been validly transferred as well.

The *Sachar* court followed the analysis of the New York Supreme Court, Suffolk County in *U.S. Bank v. Flynn*, 27 Misc. 3d 802 (Suffolk Co. 2010), which upheld a MERS assignment of both a mortgage and note based on language in the mortgage instrument similar to that which the *Agard* court found insufficient. The *Flynn* court held that "a written assignment of the note and mortgage by MERS, in its capacity as nominee, confers good title to the assignee and is not defective for lack of an ownership interest in the note at the time of the assignment," because MERS has the power to "act[] as the nominee of the owner of the note and of the mortgage." Insofar as the *Agard* court's analysis rested in part on a conclusion that MERS had not clearly acted to assign the note, differences in the factual record may partially explain the divergent approaches in *Flynn* and *Agard*.

Notwithstanding *Flynn* and *Sachar*, New York state courts have not uniformly upheld the foreclosure standing of MERS assignees. In *LaSalle Bank National Ass'n v. Lamy*, 12 Misc. 3d 1191(A), 2006 WL 225172 (Suffolk Co. 2006), for example, the court found that a MERS assignment was invalid because MERS lacked an ownership interest in the Note at the time of the assignment. Numerous New York courts, however, have upheld MERS' standing and power of assignment.

### Conclusion

The issue of MERS' standing is a subject of dispute in a variety of jurisdictions nationwide. The uncertainty created by the *Agard* decision is likely to dissipate as the New York appellate courts weigh in but as this split in authority in New York demonstrates, it is far from clear how courts in a wide array of jurisdictions, applying state law, will resolve these issues. While MERS and its assignees have prevailed in a large majority of cases nationwide, any judicial trend to reject MERS' standing, or that of its assignees, has the potential to prolong and complicate the foreclosure process nationwide. Moreover, if the "separation of the mortgage and note" theory left open by the *Agard* court gains traction, it may cast doubt on the enforceability of millions of defaulted mortgages. Lenders with exposure to residential mortgages, or to mortgage-backed securities or other mortgage-related instruments, should continue to monitor developments concerning MERS' foreclosure standing. ☺

## Non-Judicial Mortgage Foreclosures Invalid Without Proof of Assignment in Effect at Notice of Sale

By Benjamin D. Bleiberg

Homeowners won another victory recently against financial institutions that attempt to foreclose on mortgages without evidence of their pre-foreclosure assignment of the mortgage from the original mortgage holders. The Supreme Judicial Court of Massachusetts, the Commonwealth's highest court, upheld a Massachusetts land court decision that invalidated the foreclosure sales conducted by two banks when they failed to prove that they held mortgages on the foreclosed properties on the date the notice of sale was published. *United States Bank Nat'l Ass'n v. Ibanez*, 941 N.E.2d 40 (Mass. 2011). The court found that the foreclosure rights granted by the mortgages' power of sale and under Massachusetts General Law required strict adherence to mortgage-holder / continued page 8

## Mortgage Foreclosures

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requirements and compliance with foreclosure procedural rules.

### Background

In May 2005, Mark and Tammy LaRace (“LaRace”) took out a mortgage loan from Option One Mortgage Corporation (“Option One”), which granted the mortgage holder the power of sale in the event of default. In December 2005, Antonio Ibanez (“Ibanez”) took out a mortgage loan from Rose Mortgage, Inc. (“Rose Mortgage”), which granted the mortgage holder a similar power of sale. With limited exception, Massachusetts law does not require a mortgage holder to obtain judicial authorization to foreclose on a mortgaged property if the mortgage grants its holder the power of sale.

On July 5, 2007, the plaintiffs in this case, U.S. Bank National Association (“U.S. Bank”) and Wells Fargo Bank, N.A. (“Wells Fargo”), acting as trustees for certain mortgage-backed securities, foreclosed on the Ibanez and LaRace mortgages, respectively, without resorting to the courts. The banks then purchased both properties at the foreclosure sales. The banks had published notice of the foreclosure sales during the month prior to the sales.

Over a year after the foreclosure sales, the banks brought separate actions against the Ibanez and LaRace in Massachusetts land court seeking (1) a judgment that the foreclosures had extinguished the mortgagors’ titles, (2) a declaration that the banks were the fee simple owners of the foreclosed properties, and (3) a declaration that there was no cloud over the title arising from the notice of sale. Significantly, the complaints alleged that the banks had become holders of their respective mortgages from assignments made *after* the date of the foreclosure sales. When neither Ibanez nor LaRace responded to their respective complaints, the banks moved for default judgments.

Hearing the banks’ default judgment motions together, the land court ruled that the foreclosure sales were invalid. Based on the banks’ own allegations that they acquired the mortgages by assignment only after the published notice of sale, the land court held that the banks had no interest in the mortgages on the notice publication date or at the time of the foreclosure sales themselves and, therefore, lacked the right to foreclose on the mortgages.

The banks subsequently moved to vacate the judgment, alleging the existence of additional evidence establishing they were assigned the mortgages before the notice of sale. After a review of that newly submitted evidence, however, the land court denied the banks’ motions. The banks then appealed to the Supreme Judicial Court for direct appellate review.

### Arguments on Appeal

On appeal, the banks argued that the evidence established that they were mortgage assignees at the time of publication of notice and, therefore, the owners of the foreclosed properties in fee simple. Specifically, U.S. Bank alleged that in December 2005, Rose Mortgage first assigned the Ibanez mortgage in blank, but subsequently specified Option One as assignee, which recorded the mortgage. After several additional assignments, the mortgage was assigned to the Structured Asset Securities Corporation (“SATC”). SATC pooled it with other mortgages and converted them into a mortgage-backed security. SATC then assigned the Ibanez mortgage to U.S. Bank, as trustee pursuant to a December 2006 trust agreement, a private placement memorandum (“PPM”), and a schedule listing the assigned mortgages. After Ibanez defaulted, U.S. Bank published notice of the foreclosure sale in June 2007, and purchased the Ibanez property at the sale in July 2007. Additionally, in September 2008, a successor-interest to Option One, the record holder of the Ibanez mortgage throughout the purported chain of assignments, executed a written, post-foreclosure assignment of the mortgage to U.S. Bank, which U.S. Bank thereafter recorded.

Similarly, Wells Fargo alleged that after several assignments originating from Option One, the LaRace mortgage was assigned to the Asset Backed Funding Corporation (“ABFC”) in October 2005. ABFC subsequently pooled it with other mortgages and, pursuant to a pooling and servicing agreement (“PSA”), assigned the LaRace mortgage to Wells Fargo, as trustee to an asset-backed security containing the mortgage. After LaRace defaulted, U.S. Bank published notice of the foreclosure sale in June 2007, and purchased the LaRace property at the sale in July 2007. On May 7, 2008, Wells Fargo finally executed a statutory foreclosure affidavit and foreclosure deed. Additionally, Option One, which was still the record holder of the LaRace mortgage, executed an assignment to Wells Fargo, as trustee, which Wells Fargo thereafter recorded. This assignment listed a retroactive effective date of April 18, 2007, a date that preceded the June 2007 publication of the notice of sale.

The banks further argued in the alternative that (1) their financial interests in the mortgage notes should grant them the right to foreclose even without valid assignments, (2) post-sale assignments are industry custom and should be honored, and (3) an adverse ruling, if any, should apply only prospectively to future foreclosures.

### The Court's Decision

Finding the banks' evidence insufficient to meet their burden of proving that they had authority to foreclose under the power of sale and statutory foreclosure requirements, the court affirmed the avoidance of the sales of the Ibanez and LaRice properties. Recognizing that Massachusetts General Law gives the plaintiffs, as holders of mortgages with a power of sale, the "substantial power" to foreclose without immediate judicial oversight, the court ruled that a mortgage sale is void unless the seller acts in strict compliance with the terms of mortgage's power of sale, acts in good faith and uses reasonable diligence to protect the interests of the mortgagor. According to the court, the strict compliance requirement therefore necessitates that only the present holder of the mortgage, including "the mortgagee or his executors, administrators, successors or assigns," may foreclose on a property. Because only the present holder may foreclose on a mortgaged property, a valid notice of sale must identify the then-current holder of the mortgage.

Upon examination of the banks' evidence, the court determined that neither bank had acquired a fee simple title to the foreclosed properties before publishing notice of sale. Although U.S. Bank claimed it was assigned the Ibanez mortgage pursuant to a trust agreement with SATC as indicated by an attached schedule listing the assigned mortgages, the court noted that U.S. Bank failed to submit a copy of either document to the court. U.S. Bank provided the court with a copy of the PPM, but the court declined to rely on the PPM alone as it described the trust agreement as an agreement that would be executed in the future and, accordingly, merely established the parties' intention to assign the mortgages to U.S. Bank at some later time. Finally, the court found that U.S. Bank had failed to provide any evidence of the chain of assignment that indicated how SATC was ultimately assigned the mortgage from the original mortgage holder.

Wells Fargo's claim that ABFC assigned the LaRice mortgage pursuant to a PSA was similarly rejected. Unlike the aspirational language used in U.S. Bank's PPM, the PSA expressly stated that ABFC "does hereby . . . assign" the mortgages listed on an

attached schedule. Like U.S. Bank, however, Wells Fargo also failed to provide the court with the schedule evidencing that the LaRice mortgage was included in the security. Additionally, the court found that Wells Fargo failed to provide proof of the chain of assignment between Option One and ABFC.

Finding that the banks did not act in strict compliance with the mortgages' power of sale and that the remaining two foreclosure requirements were never raised in the land court below, the court did not address whether the banks acted in good faith or exercised reasonable diligence to protect the mortgagors' interests.

The court concluded by briefly addressing and rejecting the banks remaining arguments. First, the court held that an assignment in blank fails to convey title and is therefore void. Second, the court ruled that, although the banks may have held the mortgage notes, a financial interest in the mortgage is insufficient under Massachusetts law without proof of a written assignment. Third, the court declined to adhere to a purported industry custom that permits foreclosures with post-sale assignments, as well as post-foreclosure assignments that include retroactively-applying pre-foreclosure effective dates, because this conduct conflicts with Massachusetts law. Finally, the court rejected the banks' request for the ruling to apply prospectively because prospective rulings are only appropriate where a ruling significantly changes the application of common law, and the court had made no such change here.

### Conclusion

The *U.S. Bank* case further illustrates the increasing trend in judicial rulings requiring financial institutions to ensure that their documentation is accurate, complete and organized before foreclosing. The decision reaffirms the need for financial institutions acting as trustees for mortgages pooled together in a trust and converted into mortgage-backed securities, to verify each individual mortgage's chain of assignment, and to preserve proper documentation establishing proof of their assignments where possible. ☺

# Lender's Federal Foreclosure Action Stayed in Deference to Borrower's State Declaratory Judgment Action

By Thomas J. Hall and Andrea Voelker

A New York federal district court recently stayed a mortgage foreclosure action before it where a prior state court action filed by the borrower, regarding the validity of an acceleration of the mortgage, could have resulted in piecemeal litigation. *Bank of America v. Sharim Inc.*, 10 Civ. 7570 (S.D.N.Y. 2010). Specifically, the court found that, notwithstanding the strong presumption against abstention, a stay of the federal action was warranted where proceeding with both cases potentially would result in duplicative efforts and inconsistent opinions, contested jurisdictional issues in the federal action would require discovery and briefing, and no federal law or policy was implicated in the federal action.

## Background

The mortgage loan at the core of this litigation involved a commercial building located in New York City. In 2007, the borrower, Sharim Inc. ("Sharim"), granted a mortgage on that property to secure a \$22 million refinancing pursuant to a mortgage consolidation agreement (the "Mortgage"). Bank of America, the lender, was the latest in a series of trustees administering the Mortgage.

In 2009, Sharim fell behind in its monthly mortgage payments, and several times requested a voluntary restructuring from the lender and the regular servicer. Sharim contends that the regular servicer was initially receptive to the restructuring but, when CW Capital Asset Management LLP ("CW Capital") stepped in as special servicer, restructuring the loan no longer was an option. Rather, on July 15, 2010, CW Capital issued a default notice and demanded a payment of over \$1.4 million, which included both default interest and late charges dating back to 2009. On July 28, 2010, Sharim paid the full amount under protest. Bank of America accepted the payment, but

refused to return the Mortgage to non-default status unless Sharim paid an additional \$292,837, which included a \$220,000 reinstatement fee and other charges. When Sharim refused to pay on the grounds that the payment of such fees was not required by the loan documents, Bank of America accelerated the loan.

In response, Sharim commenced a state court action against Bank of America seeking a declaratory judgment that (a) Sharim had cured the defaults set forth in the default notice and that the Mortgage should be returned to non-default status without further payment; (b) Bank of America is not entitled to the reinstatement fee; (c) Sharim is not obligated to pay default interest and late charges prior to April 2010 because they had been waived, reversed, and/or never charged; (d) the loan cannot be accelerated; (e) the acceleration notice is not effective; and (f) Bank of America did not have the right to foreclose on the Mortgage due to the improper assignment thereof. In addition, Sharim requested injunctive relief preventing Bank of America from acting on the notice of acceleration and from continuing to charge default interest during the pendency of the action.

On the basis of diversity jurisdiction, on October 4, 2010, Bank of America filed a federal foreclosure action against Sharim. In response, the state court stayed the state court action for 45 days to allow Sharim to file a motion for a stay or abstention of the federal foreclosure action, which the defendants in that action filed on November 16, 2010.

## Applicable Law

A federal court's abstention from exercising jurisdiction is generally disfavored. According to the U.S. Supreme Court, "[a]bstention . . . is the exception, not the rule," and is limited to a few exceptional circumstances where federalism is implicated, or "in situations involving contemporaneous exercise of concurrent jurisdictions, either by federal courts or by state and federal courts." *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800, 813-16 (1976).

When state and federal proceedings are parallel, the *Colorado River* test addresses six factors: "(1) the assumption of jurisdiction by either court over any res or property; (2) the inconvenience of the federal forum; (3) the avoidance of piecemeal litigation; (4) the order in which the jurisdiction was obtained; (5) whether state or federal law supplies the rule of decision; and (6) whether the state court proceeding will adequately protect the rights of the party seeking to invoke federal jurisdiction." According to *Nat'l Union Fire Ins. Co. of*

*Pittsburgh, Pa. v. Karp*, 108 F.3d 17, 22 (2d Cir. 1977), cases are parallel when they “are essentially the same; that is, there is an identity of parties, and the issues and relief sought are the same.” As held by the Supreme Court in *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 21 (1983), a federal court will exercise abstention only when “the parallel state-court litigation will be an adequate vehicle for the complete and prompt resolution of the issues between the parties.”

## The Claims and Defenses

The federal court defendants argued that the state action and the federal foreclosure action are parallel proceedings, and that the six factors weighed in favor of granting a stay because the foreclosure action is governed exclusively by state law and thus implicates no federal policy. Bank of America, the plaintiff in the federal action, argued that the two proceedings were not parallel because the parties and claims in the two suits differed, some interested parties were not named in one of the suits, and Bank of America had not filed a state foreclosure action. Further, Bank of America argued that the federal court must exercise its jurisdiction because the federal case was a foreclosure action, and was thus a proceeding in rem.

## The Court’s Ruling

The federal court found that the state and federal court proceedings were parallel because the “contending parties, underlying facts, and legal issues are essentially the same.” Further, the court found that both proceedings required a finding of “whether there was a default; if so, whether it was cured; [Bank of America’s] right to the reinstatement fee; and [Bank of America’s] right to accelerate the mortgage loan.” The court also found that the absence of any parties or claims in the state court action could easily be remedied simply by adding them to that action.

Regarding the application of the six-factor *Colorado River* test, the court found that the first factor, the assumption of jurisdiction by either court over any res or property, weighed in favor of denying a stay because it was “the first and only court to obtain jurisdiction of the res in this in rem proceeding.” Citing *Moses H. Cone*, 40 U.S. at 15-16, however, the court emphasized that no factor of the test was singularly dispositive and that a flexible analysis of the factors should be espoused.

Turning to the second factor, the inconvenience of the federal forum, the court found that this factor weighed against granting a stay because no inconvenience existed. The court

found that the third factor, however, the avoidance of piecemeal litigation, weighed heavily in favor of granting the stay. The court specifically found that “[a]t best allowing both cases to proceed will result in duplicative and wasted efforts. At worst, doing so will lead to inconsistent decisions, binding on different parties, all of whom have an interest in the matter.” While Bank of America argued that these concerns were the doing of Sharim—for racing to the state courthouse when it could have anticipated the commencement of the foreclosure action—the federal court was not critical of Sharim’s approach, stating that the very purpose of declaratory judgment is to resolve a dispute at the very earliest point in time. Further, the court stated that Sharim had no duty to wait for Bank of America to file a foreclosure action and, moreover, that Sharim had a valid claim for reimbursement of any improper mortgage arrears that was requested by either Bank of America or CW Capital.

The court found that the fourth factor, the order in which jurisdiction was first obtained, also supported granting a stay. The court explained that while no decision on the merits had been rendered in the state court action, a motion for preliminary injunction had been fully briefed, and no progress had been made in the federal foreclosure action. The court, citing *Will v. Calvert Fire Ins. Co.*, 437 U.S. 655, 663 (1978), held that a district court should also consider whether a matter can be resolved in a more expeditious matter in the state court action. Because the defendants challenged Bank of America’s assertion of diversity, and an asserted gap in title might prevent Bank of America from properly asserting standing, the court noted that the federal action would require preliminary discovery and briefing merely on whether subject matter jurisdiction existed.

Considering the fifth and sixth factors, whether state or federal law supplies the rule of decision, and whether the state court proceeding will adequately protect the rights of the party seeking to invoke federal jurisdiction, the court held that these factors also supported the granting of a stay. The court emphasized the fact that the foreclosure action involved property in New York and a mortgage loan that closed in New York and, as such, no federal law or policy was implicated. Citing *Gen. Reins. Corp. v. Ciba-Geigy Corp.*, 853 F.2d 78, 82 (2d Cir. 1988), the court held that “[a]lthough the absence of federal issues does not require the surrender of jurisdiction, it does favor abstention where ‘the bulk of the litigation would necessarily revolve around state-law . . . rights of [numerous] . . . parties.’”

Moreover, the court noted that there / continued page 12

## Foreclosure Action Stayed

*continued from page 11*

were no concerns that the state court would inadequately protect Bank of America's rights. After considering all six factors, the court ultimately held that, despite the presumption against abstention, the factors supported granting a stay of the federal foreclosure action.

### Conclusion

In light of the heavy presumption against abstention in federal court, usually stays are granted only in exceptional circumstances. While generally these circumstances involve questions of federalism, the U.S. Supreme Court has also found that abstention is appropriate for prudential reasons when there is "contemporaneous exercise of concurrent jurisdictions" between federal courts or federal and state courts. Lenders bringing foreclosure actions in federal court should be aware of the potential for a stay being granted where there is a high risk of piecemeal litigation because of a pre-existing pending state court action. To reduce the risk of abstention, lenders should bring foreclosure actions in the federal court at the earliest point in time to escape competing with a previously filed state court action. Let the race to the courthouse begin! ☺

## Risk Disclosure Statements Save Barclays from Securities Fraud Suit

*By Scott S. Balber and Stacey Trimmer*

The United States District Court for the Southern District of New York has dismissed a securities class action case against Barclays Bank PLC arising from its offerings of American Depository Shares. The court found that Barclays' disclosure of the risks associated with those securities was adequate, and thus, plaintiffs had failed to state a claim that defendants misled investors by improperly accounting for risky real estate business. The court further found that the plaintiffs lacked standing and failed to timely file the action. *In re Barclays Bank PLC*, 2011 WL 31548 (S.D.N.Y. 2011).

### The Offerings

The lead plaintiffs in this action were purchasers of securities in one or more of four separate offerings of American Depository Shares (the "Securities") issued by Barclays between April 2006 and April 2008 (the "Offerings") pursuant to two shelf registration statements and several prospectuses (the "Offering Materials"). The defendants included Barclays, several former Barclays' directors, and the investment banks that underwrote the securities offerings. The plaintiffs asserted claims under Sections 11, 12(a)(2), and 15 of the Securities Act of 1933, which included allegations that defendants failed to disclose and write down mortgage-related assets during the Offerings and provided misleading descriptions of risk management practices.

Plaintiffs contended that during the time of the Barclays four securities offerings between April 2006 and April 2008—Series 2 in April 2006, Series 3 in September 2007, Series 4 in November 2007, and Series 5 in April 2008—Barclays "held large amounts of risky mortgage-backed assets," including:

(1) Alt-A mortgages and residential mortgage-backed securities ("RMBS") with par value of over £5 billion; (2) subprime mortgages and subprime RMBS with par value of over £6 billion; (3) gross exposure to risky mortgage-backed collateralized debt obligations ("CDOs") of approximately £5 billion; (4) commercial real estate related assets of approximately £8 billion; and (5) exposure to structural investment vehicles ("SIVs" and "SIV-lites") of £0.9-1.6 billion.

On account of these risky assets, plaintiffs claimed Barclays had total credit market exposure of greater than £36 billion. In addition, in late 2006 specialized indices such as ABX.HE and TABX.HE indicated that the value of RMBSs and CDOs began to decline substantially due to a rise in mortgage loan defaults. Thus, plaintiffs claimed that Barclays reasonably should have known that the value of Barclays' subprime/non-prime-backed RMBS/CDOs had declined significantly before the September 2007 Offering and should have disclosed it.

### Motion to Dismiss

Barclays moved to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6). In support of that motion, Barclays asserted that it had in fact made adequate disclosures. For example, Barclays asserted that on November 15, 2007, it had issued a "Trading Update" in which it disclosed "exposure to the U.S. subprime mortgage and credit markets of approximately £18.4 billion," but also stated that "Barclays' liquidity position remained very

strong, especially in comparison to its competitors' substantial writedowns." In addition, Barclays pointed out that, on February 19, 2008, it publicly announced in its 2007 Annual Report that it had written down £1.6 billion on its CDO and subprime exposure. Then, in July 2008 Barclays released its 2008 interim results, which disclosed Barclays' first-half net income declined 34 percent, "largely owing to a massive write-down of £2.8 billion in credit-related assets." The Series 2 and 3 Offering Materials disclosed that Barclays held over £13 billion and £18.7 billion of mortgage and other asset-backed securities. In addition, the Offering Materials cautioned investors by saying if certain risks were to materialize "Barclays' business, financial condition, and results of operations could suffer."

Plaintiffs opposed the motion by arguing that Barclays had boasted about its risk management practices in the Offering Materials by stating, for example, "the identification and management of risk remains a high priority and underpins all our business activity." The defendants countered that the Offering Materials also warned investors that "Barclays' risk-management system is designed to manage rather than eliminate the risk of failure to achieve business objectives."

### The Court's Analysis

In their complaint, plaintiffs made several allegations based on Barclays' disclosures and alleged non-disclosures, including that (1) defendants failed to disclose and write down mortgage-related assets, (2) defendants failed to itemize mortgage-related assets, (3) defendants violated accounting and SEC requirements, and (4) defendants misleadingly emphasized its risk management practices. The court rejected each of these arguments.

First, as to Barclays' alleged failure to disclose and write down mortgage-backed assets, the court relied on prior case law establishing that "subjective opinions are only actionable under the Securities Act if a complaint alleges that the speaker did not truly have the opinion at the time it was made public." The court held that since the assets at issue here were not traded on an efficient market such as the New York Stock Exchange, the value of such assets is a subjective opinion. Therefore, a proper claim must "allege that Barclays did not truly believe its own valuation." Here, the complaint made no such allegations. Further, Barclays did offer "substantial risk disclosures regarding its valuations, such as: 'if any of these risks occurs, our business, financial condition, and results of operations could suffer . . .' and 'the profitability of Barclays businesses could be adversely affected by a worsening of

general economic conditions.'"

Second, the court held plaintiffs' claim that Barclays was required to itemize its mortgage-related assets into separate subcategories insufficient because the Second Circuit Court of Appeals has specifically found that such itemization is not necessary. In addition, "Securities Act Sections 11 and 12 do not require an offering participant to disclose information merely because a reasonable investor would very much like to know it."

Third, the court found that plaintiffs' claim that defendants violated accounting standards and SEC requirements failed because it contained only general allegations of non-disclosure and not specific allegations of how the accounting practices were improper.

Finally, plaintiffs' claim that Barclays misleadingly emphasized its risk management practices also failed because Barclays only made general statements and also cautioned against risk. Moreover, plaintiffs did not allege that the descriptions of risk management processes were actually false or that those processes were not followed.

### The Procedural Rulings

As an alternative ground for dismissal, the defendants asserted the plaintiffs lacked standing because they merely pled that they "bought securities issued pursuant to or traceable to" the Offering Materials. To have standing, a plaintiff must plead that it purchased directly from the defendant. While the court apparently saw merit in this argument, the court commented that this defect could have been easily cured, had the action not been dismissed on other grounds.

Further, the defendants asserted the plaintiffs' claims were time-barred. The statute of limitations for Section 11 and 12(a) (2) claims is one year, and a claim accrues at the time of discovery or when discovery should have been made by reasonable diligence, which is also called inquiry notice. In this case, the court found that the plaintiffs had inquiry notice for the Series 2 and 3 Offerings on November 12, 2007, the date of the Trading Update that disclosed Barclays' exposure. Even though the Trading Update contained "words of comfort from management," a reasonable investor would have investigated the disclosures anyway. As to the Series 4 Offerings, the plaintiffs had inquiry notice on February 19, 2008, when Barclays released the 2007 annual results. The action thus was untimely because the plaintiffs filed their initial complaint on March 12, 2009, more than one year after the dates of inquiry notice, which provided an alternative ground for dismissal. */ continued page 14*

## The Take-Away

Many commentators continue to be surprised that more criminal and civil liability has not been imposed on financial institutions as a consequence of the economic collapse and resulting deep recession. This case demonstrates the significant hurdles that plaintiffs face in imposing civil liability, as many financial institutions indeed made significant disclosures of risk—disclosures that many frenzied investors apparently failed to heed. This decision suggests that reckless investors were just as much at fault for the economic bubble that burst, as the financial institutions that packaged and sold risky securities. ©

# Court Refuses to Limit Damages to Benefit of the Bargain for Breach of Contract to Sell Distressed Debt

By Robert A. Schwinger and Laura Rowntree

In *Credit Suisse First Boston v. Utrecht-America Fin. Co.*, 914 N.Y.S.2d 600 (N.Y. Co. 2010), a New York trial court rejected the argument of investment bank Utrecht-America Finance Co. (“Utrecht-America”) that its liability for terminating an agreement to sell distressed debt should be limited to the difference between the contract price and market value of the debt on the date of termination. In so doing, the court declined to apply the general rule that damages are determined “by the loss sustained or gain prevented at the time and place of the breach,” without regard to events subsequent to the breach. The court concluded that determining the proper measure of damages in the emerging legal area of distressed debt required a more comprehensive understanding, to be developed at trial, of the type of transaction at issue.

## Agreement to Purchase Distressed Debt

The dispute between plaintiff Credit Suisse First Boston (“Credit Suisse”) and defendant Utrecht-America, a Delaware subsidiary of Dutch investment bank Cooperatieve Centrale

Raiffeisen-Boerenleenbank, B.A., also a defendant, arose from an alleged breach of an agreement to sell distressed debt. According to the complaint, on October 28, 2003, the parties entered into an oral agreement pursuant to which Utrecht-America agreed to sell to Credit Suisse a portion of the \$45 million interest it held in a \$485 million syndicated loan to Choctaw Investors, B.V. (“Choctaw”), which had been a financing vehicle for Enron Corporation.

As is customary in the distressed debt market, the deal structured payment as a percentage of the face value of the claim. Under the terms of that agreement, which was memorialized in a November 5, 2003 confirmation, Credit Suisse was to purchase \$15 million of the face amount of Utrecht-America’s claim against Choctaw for 62.5% of its face value. By January 13, 2004, just a few months after reaching this agreement, the market value of the Choctaw debt had risen to 75% of its face value, at which time Utrecht-America notified Credit Suisse that it planned to terminate their agreement. Utrecht-America memorialized its termination by a written confirmation the next day. The market value of the Choctaw debt continued to rise and, on February 24, 2004—over a month after Utrecht-America terminated—Credit Suisse purchased a comparable amount of Choctaw debt from a third party but was forced to pay a higher price than the amount it had agreed to pay Utrecht-America. Credit Suisse brought suit for breach of contract.

## Questioning the Measure of Damages

In their motion for partial summary judgment, defendants sought an order limiting Credit Suisse’s damages to the difference between the agreed-upon purchase price and the price Credit Suisse paid to the third-party in February. Credit Suisse opposed defendants’ motion, arguing that it was premature to determine the measure of damages prior to trial because New York courts apply different measures of damages to different situations and, to properly determine the measure of damages, the court required a more complete factual record.

Defendants argued that New York law assesses damages at the time and place of the breach and that Credit Suisse had failed to demonstrate that some other measure of damages should apply. The court disagreed.

As a preliminary matter, the court acknowledged the general rule that damages are measured as of the time and place of the breach without regard to “fluctuations in value that occur subsequent to the breach.” More specifically, as a general matter, “[w]here the breach involves the failure to deliver an asset, damages are determined by the difference between the contract

price for the asset and the fair market value of the asset at the time of the breach.” Nevertheless, the court agreed with Credit Suisse’s position that the appropriate measure of damages depends on the circumstances of the particular case, and the full circumstances of the case had not yet been fully presented.

The court analyzed other potential measures of damages that might apply. The court observed that, as one possible exception to the general rule discussed above, a non-breaching party can recover lost profits that might have been realized after the date of the breach, provided that parties had contemplated such a measure of damages at the time they entered into the contract and provided that the lost profits claimed can be accurately measured. Additionally, the court referenced Article 2 of the Uniform Commercial Code (“U.C.C.”), which provides for cover damages as a remedy where the breached contract is for the sale of goods. Under N.Y. U.C.C. Section 2-712, a buyer may, in good faith and without unreasonable delay,

tract. In this case, the court was unable to determine without a more complete record to be developed at trial if this goal could be accomplished under the customary measure of damages. Specifically, the structure and liquidity of the market for Choctaw debt and Credit Suisse’s involvement in that market, as well as the nature of the debt itself, remained unclear to the court at the summary judgment stage.

In particular, the court focused on the open question of whether the Choctaw debt might qualify as an investment security or a good so as to extend the remedies of the U.C.C. The court observed that additional evidence could reveal that the debt was properly characterized as an investment contract. Such a determination would mean that the debt would constitute a security under the Supreme Court decision *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946), which defined an “investment scheme” as one that “involves an investment of money in a common enterprise with profits to come solely from the

**As the court itself recognized, one of the difficulties in resolving the status of the Choctaw debt for the purposes of measuring damages was the court’s own unfamiliarity with the distressed debt market and the dearth of applicable precedent.**

repurchase goods in substitution of those promised for sale under the contract and later recover from the seller the difference between the cost of the cover and the contract price. Despite acknowledging that Article 2 explicitly excludes “investment securities” from the definition of “goods,” the court noted that New York courts have applied the U.C.C. to security transactions by analogy and cited several examples of the same. In one such case, *G.A. Thomson & Co., Inc. v. Wendell J. Miller Mortg. Co., Inc.*, 457 F. Supp. 996, 999 (S.D.N.Y. 1998), a federal court applying New York law awarded plaintiff cover damages where defendant failed to deliver securities under a contract and forced the plaintiff to purchase the same securities from another source.

### Unresolved Factual Concerns

The court observed that the overall approach to damages under New York law is to restore the non-breaching party to the position it would have been in but for the breach of con-

efforts of others.” Alternatively, a complete record might establish that the court should treat the Choctaw debt as a good similar to foreign currency, as the New York Appellate Division did in *Saboundjian v. Bank Audi (USA)*, 157 A.D.2d 278, 284 (1st Dep’t 1990). When dealing with foreign currency, the *Saboundjian* court had measured damages as “the difference between the price at which the plaintiff could have executed the trade at issue, were it not for the failure to carry it out, and the price at which he could have executed the transaction within a reasonable time after he learned that it had not been effected earlier.” Moreover, if the court ultimately concludes that the Choctaw debt is analogous to a good, thereby subjecting defendants to the value of cover damages under the U.C.C., the court observed it would need additional facts to determine whether Credit Suisse’s delay of over one month in purchasing replacement debt following termination was reasonable. The court reasoned that the incomplete record on summary judgment made that inquiry, and the others, impossible. / continued page 16

## Court Refuses to Limit Damages

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### Conclusion

As the court itself recognized, one of the difficulties in resolving the status of the Choctaw debt for the purposes of measuring damages was the court's own unfamiliarity with the distressed debt market and the dearth of applicable precedent. The court cited the need to obtain "a fuller understanding of Choctaw distressed debt and also trading of distressed debt, generally—a subject about which, owing to the relative newness of distressed debt trading, there is a surprising dearth of relevant case law." As more courts have the opportunity to grapple with these issues, and a more unified legal characterization of distressed debt materializes, perhaps the question of damages similar to those presented in *Credit Suisse* can be resolved at the summary judgment stage. Meanwhile, the court concluded that defendants had failed to make out a prima facie showing of entitlement to judgment as a matter of law, and summary judgment was denied. ☺

## Claims for Fraudulent Practices in Mortgage Modification Program Partially Dismissed

By Phoebe Wilkinson and Kimberly Zafran

In *Gustavo Reyes, et al. v. Wells Fargo Bank, N.A.*, Case No. C-10-101667 JCS (N.D. Cal. 2011), the plaintiff homeowners filed a class action lawsuit against Wells Fargo Bank, N.A. ("Wells Fargo") arising from Wells Fargo's alleged mortgage practices relating to distressed residential mortgages. The plaintiffs alleged that Wells Fargo duped them into making six months of monthly payments with promises of a loan modification thereafter. In finding that, in making those payments, the plaintiffs were simply doing what they were otherwise contractually obligated to do under the pre-existing loan agreement, the court dismissed many of plaintiff's claims, while leaving intact several statutory and other claims under California law.

### Background

Plaintiffs Gustavo Reyes and Maria Teresa Guerro purchased a California home in 2003 with a loan from Wells Fargo and, in 2005, Wells Fargo refinanced that loan. By 2009, the value of the home had fallen to less than half of the loan amount and Reyes and Guerro allegedly were no longer able to make mortgage payments. They requested a loan modification, which Wells Fargo denied. In September 2009, Wells Fargo recorded and served a Notice of Default and Election to Sell, choosing to proceed with the foreclosure of the property. Under California Civil Code Section 2924, the recordation and serving of the Notice of Default triggered a three-month cure period.

On December 1, 2009, Wells Fargo sent Reyes and Guerro an "Offer Letter" enclosing a Special Forbearance Agreement by which Wells Fargo offered that, if the borrowers remained current on the next six installment payments at the reduced amount set forth therein, "[a]ny outstanding payments and fees will be reviewed for a loan modification." The Offer Letter stated:

We have good news about the above referenced loan. Our goal is simple. We want to ensure you have every opportunity to retain your home . . . [W]e would like to offer you a Special Forbearance Agreement ("Agreement"). Currently, your loan is due for 6 installments . . . As agreed, you have promised to pay the amounts stated within the Agreement . . . This is not a waiver of the accrued future payments that become due, but a trial period showing you can make regular monthly payments. Please note that investor approval is still pending.

Upon successful completion of the Agreement, your loan will not be contractually current. Since the installments may be less than the total amount due, you may still have outstanding payments and fees. Any outstanding payments and fees will be reviewed for a loan modification. If approved for a loan modification, based on investor guidelines, this will satisfy the remaining past due payments on your loan and we will send you a loan modification agreement. An additional contribution may be required . . .

If your loan is in foreclosure, we will instruct our foreclosure counsel to suspend foreclosure proceedings once the initial installment has been received, and to continue to suspend the action as long as you keep to the terms of the Agreement. Upon full reinstatement, we will instruct our foreclosure counsel to dismiss foreclosure proceedings . . .

The Special Forbearance Agreement enclosed with that Offer Letter included, in the Terms and Conditions section, the following disclaimer:

The lender is under no obligation to enter into any further agreement, and this Agreement shall not constitute a waiver of the lender's right to insist upon strict performance in the future.

... The lender, in its sole discretion and without further notice to you, may terminate this Agreement.

Plaintiffs Reyes and Guerro signed and returned the Agreement and, starting in December 2009 through March 2010, they made their monthly payments as modified in the Special Forbearance Agreement. After Reyes and Guerro made their fourth such payment in March 2010, they learned that their house had been sold in foreclosure in February 2010.

and restitution under Cal. Civ. Code Sections 1688 & 1689, the California Rosenthal Fair Debt Collection Practices Act ("Rosenthal Act"), Cal. Civ. Code Section 1788, et seq; and (3) unfair competition under Cal. Bus. & Prof. Code Sections 17200, et seq.

Plaintiffs' breach of contract claim was based on the allegation that the parties entered into the Agreement whereby, in exchange for six monthly payments (at the modified amount), Wells Fargo agreed to put plaintiffs into a forbearance-to-modification program to give them the opportunity to retain their home, which Wells Fargo subsequently breached. The claims for rescission and restitution were based on the allegation that the plaintiffs' consent to the Agreement, and thereafter the making of monthly payments, was given by mistake or obtained through fraud. Further, Wells Fargo represented that it had reviewed plaintiffs' financial situation before offering them the opportunity to sign the Agreement, and that this

**One of the most interesting aspects of this decision is the ruling that plaintiffs suffered no damages by making monthly payments pursuant to the Special Forbearance Agreement as they were already contractually obligated under the original loan documentation to make those payments, albeit at a higher level.**

## The Claims

The plaintiffs' complaint alleged that their lawsuit "seeks to redress and remedy Wells Fargo's recent practice of extracting payments from defaulted residential mortgage customers by falsely promising them the opportunity to retain their homes through an illusory forbearance-to-modification program." Plaintiffs asserted that Wells Fargo offered such mortgage modification programs to borrowers despite that fact that it was not prepared to modify their mortgages to a payment level the borrowers could reasonably afford. Further, plaintiffs asserted that the Wells Fargo "forbearance-to-modification program was essentially a sham ... designed to generate revenue from non-performing mortgage loans without providing customers with the promised consideration of an opportunity to retain their homes."

Plaintiffs class action suit asserted the following causes of action against Wells Fargo: (1) breach of contract and/or the implied covenant of good faith and fair dealing; (2) rescission

induced the plaintiffs to enter into the Agreement and make the monthly payments when Wells Fargo should have known that the reduced payment it offered to plaintiffs in the Special Forbearance Agreement was not a payment it was willing to accept on a long-term basis. Plaintiffs' claim under the Rosenthal Act relied on the allegation that Wells Fargo was acting as a debt collector and violated the Rosenthal Act by "using false, deceptive, and misleading statements in connection with the collection of Plaintiffs' mortgage debt." Plaintiffs' claims under California's unfair competition law focused on the allegation that defendants forbearance-to-modification offer was intended to and likely did mislead the public. Additionally, plaintiffs contended that Wells Fargo violated laws underlying legislative policies designed to prevent foreclosures.

The complaint requested relief in the form of an order rescinding and/or terminating the Special Forbearance Agreements executed by all class members, / continued page 18

## Claims Dismissed

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awarding restitution of all of the consideration paid under those agreements by the entire class, awarding statutory damages, and awarding attorneys' fees.

### Wells Fargo's Motion to Dismiss

Wells Fargo moved to dismiss the complaint on the grounds that it failed to state a claim. Wells Fargo asserted that the complaint failed to point to any provision of the Agreement that Wells Fargo had breached. Additionally, Wells Fargo asserted that all of the claims based on fraudulent practices failed to allege the circumstances surrounding the fraud with the required particularity. Further, Wells Fargo argued that both rescission and restitution are not stand-alone claims but, rather, are remedies for other claims. Wells Fargo also contended that it is not a "debt collector" under the Rosenthal Act and, therefore, no claim was stated thereunder. Finally, Wells Fargo argued that any claim concerning unfair business practices should be dismissed as the plaintiffs had not suffered any injury in fact and any had not adequately alleged a fraud claim due to the failure to plead with particularity.

### The Court's Analysis

#### The Breach of Contract Claim

The court agreed with Wells Fargo's assertion that no breach of contract claim can exist where the plaintiffs do not and cannot allege damages. The court found that doing or promising to do what one otherwise is legally bound to do is not consideration for a promise and, because the plaintiffs were already legally bound under their original loan agreement to make monthly payment on their mortgage loan, the payments made pursuant to the Special Forbearance Agreement did not constitute legally cognizable damages. Additionally, the court found that plaintiffs could not point to any provision of the Agreement that promised the plaintiffs with any degree of certainty a meaningful opportunity to retain their home.

The court addressed whether Wells Fargo breached its implied duty of good faith and fair dealing by foreclosing on the home when the Agreement was arguably still in effect, without at least refunding a portion of the February payment. The court observed, however, that "where the money paid under an agreement was already owed under a prior agreement, it is not consideration and cannot support a claim for damages." Further, plaintiffs did not dispute that they were

able to remain in their home even after the foreclosure sale and, therefore, could not assert damages in that manner. The court consequently found that plaintiffs failed to state a claim for breach of contract or breach of the implied covenant of good faith and fair dealing.

#### Rescission/Restitution Claim

The court held that plaintiffs' claim for rescission and restitution failed for all payments they made under the Agreement prior to March 2010. The court agreed with Wells Fargo that rescission is not a standalone claim, but the court did find restitution to be a recognized cause of action under California law. To state a claim for restitution, a plaintiff needs to plead the receipt and unjust retention of a benefit of another. Plaintiffs need not establish bad faith, only that the recipient of funds is not entitled to retain such. As to the payments made by plaintiffs to Wells Fargo before the foreclosure, the court found that plaintiffs were not entitled to restitution as Wells Fargo was owed this money under the original loan agreement. The court found, however, that the restitution claim as to the March payment, that was made post-foreclosure, survived Wells Fargo's motion to dismiss, the court recognizing that plaintiffs may be able to prove that (1) the March payment was not required under the Agreement, and (2) because it was made after Wells Fargo foreclosed on the property in February, Wells Fargo was not entitled to it under Cal. Civ. Code § 580d.

#### Rosenthal Act Claim

The court rejected Wells Fargo's argument that it is not a debt collector as defined in California's Rosenthal Act. The Rosenthal Act "is intended to prohibit debt collectors from engaging in unfair or deceptive acts or practices in the collection of consumer debts and to require debtors to act fairly in entering into and honoring such debts." The Rosenthal Act additionally prohibits "any false, deceptive, or misleading representation or means in connection with the collection of any debt." A debt collector is defined as a person who in the usual course of business "regularly, on behalf of himself or others, engages in debt collection." The court found that a mortgage servicer may be a debt collector under California's Rosenthal Act, unlike under the federal Fair Debt Collection Practices Act which excludes creditors collecting on their own debts.

Other California courts have found that "where the claim arises out of debt collection activities 'beyond the scope of the ordinary foreclosure process,' a remedy may be available under

the Rosenthal Act.” In evaluating such a claim, the objective of the Rosenthal Act is to protect the least sophisticated debtor. The court here found, based on the language in the Offer Letter relating to the Special Forbearance Agreement, that it was beyond the scope of the ordinary foreclosure process. The court could not conclude on a motion to dismiss that the letter was not misleading based on: (1) the words “good news” in the Offer Letter, (2) the language indicating that the Agreement was being offered based on a review of the recipient’s financial information, (3) the instruction that counsel would be directed to delay foreclosure proceedings as long as timely payments were made under the Agreement, and (4) the use of the words “trial period” to describe the Agreement. Based on the above, the court found that the complaint stated a claim under the Rosenthal Act.

### Unfair Competition Claims

The court found that plaintiffs had standing to bring claims under the California Unfair Competition Law and that they had stated a claim thereunder based on their allegations of unfair, unlawful and fraudulent business practices. To state a claim under that law, plaintiffs must allege an injury in fact, in the form of lost money or property, as a result of unfair competition. Only money or property that is subject to restitution satisfies this requirement. Because the plaintiffs here allegedly made payments to Wells Fargo as a result of Wells Fargo’s business practices, the plaintiffs had standing to bring this claim. To establish this claim, a plaintiff must further show a violation of an underlying law. Here, plaintiffs had stated a claim under the Rosenthal Act, which is sufficient to support a claim for unlawful business practices. Additionally, the court stated that a fraudulent business practice is one in which the public is likely to be deceived. At the motion to dismiss stage, the court could not conclude that the Offer Letter and Special Forbearance Agreement from Wells Fargo would be insufficient to show deceptive practices and to prevail on this claim.

### Conclusion and Implications

One of the most interesting aspects of this decision is the ruling that plaintiffs suffered no damages by making monthly payments pursuant to the Special Forbearance Agreement as they were already contractually obligated under the original loan documentation to make those payments, albeit at a higher level. Lenders should be careful, of course, to ensure that modified mortgage payments are not procured through misleading statements. Though lenders are clearly entitled to

payments due under loan agreements, entering into special mortgage forbearance agreements may expose lenders to liability that they might not otherwise have. ©

## Action Against Trust Special Servicer Dismissed for Failure to Comply with No Action Clause

By Thomas J. McCormack and Caroline Pignatelli

A New York federal district court recently granted summary judgment to a special servicer of a trust on the grounds that the plaintiff investors failed to comply with the no action clause of the Pooling and Services Agreement (“PSA”). The special servicer, CRIIMI MAE Services Limited Partnership (“CMSLP”), asserted that plaintiffs had failed to satisfy the no action clause as they were not authorized by more than 25% of the holders of Class A-1 certificates to bring suit. While the plaintiff argued that it did not need the authorization of the Class A-1 holders as that class was not adversely affected by the transaction complained of, the court disagreed, finding that plaintiff had failed to carry its burden of establishing that the Class A-1 certificate holders were unaffected. *Teachers Insurance and Annuity Association of America v. CRIIMI MAE Services Limited Partnership*, No. 06 Civ. 0392, 2011 WL 403428 (S.D.N.Y. 2011).

### The Trust

In October 1995, plaintiffs allegedly invested in a trust comprised of nine fixed-rate mortgage loans with an aggregate principal balance of \$967 million created pursuant to the PSA. The trust issued several classes of certificates with different interests in the trust. The PSA established a distribution priority on the borrowers’ principal payments whereby the senior class with an outstanding principal balance was to be paid in full prior to the next class receiving principal payments. As the time of the relevant events, Class A-1 was the most senior class with an outstanding balance. Plaintiffs owned more than 25% of the interest-receiving Class A-CS2 certificates, a class lower than Class A-1. / continued page 20

## Action Against Servicer Dismissed

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### The Hardage Loan

One of the nine loans in the trust was a fixed-rate mortgage loan owed by Hardage Hotels I, Inc. (“Hardage”). At the time it was transferred to the trust, that loan’s balance was \$91 million with a fixed interest rate of 9.54 percent and a maturity date of July 11, 2017. In late 2002, Hardage ran into financial difficulties. In July 2003, CMSLP sold that loan’s \$80.7 million principal balance for \$74.4 million. As Class A-1 was the most senior class with an outstanding principal balance, it received all of the proceeds of that sale. Class A-1 had an original principal balance of \$652.7 million on which the certificate holders were paid an interest rate of 7.1 percent. The Hardage loan proceeds reduced this principal balance and, accordingly, reduced the future interest payments to the Class A-1 certificate holders.

of at least 25% of each affected Class of Certificates shall have made written request upon the Trustee to institute such action, suit or proceeding in its own name as Trustee hereunder and shall have offered to the Trustee such reasonable indemnity as it may require against the costs, expenses and liabilities to be incurred therein or thereby, and the Trustee, for 30 days after its receipt of such notice, request and offer of indemnity, shall have neglected or refused to institute any such action, suit or proceeding.

The court explained that, in its earlier decision *Teachers Ins. & Annuity Ass’n of Am. v. CRIIMI MAE Svcs. Ltd. P’ship*, 681 F. Supp. 2d 501 (S.D.N.Y. 2010), it concluded that “this language means that plaintiffs may sue only if they represent 25 percent in interest of every class of certificates that was affected adversely by the sale of the Hardage loan.” Accordingly, “[a]s plaintiffs represent only Class A-CS2, the question is whether any other class

## No action clauses in trust agreements can impose substantial bars to an investor’s standing to bring a suit.

### The Lawsuit

In December 2005, the Class A-CS2 holder plaintiffs brought suit contending that the special servicer breached the PSA by modifying and selling the Hardage loan. Plaintiffs contended that the special servicer did so to advance its own personal interests as the special servicer’s parent owned lower-priority principal-receiving certificates. The plaintiff asserted that such sale harmed them financially.

In its defense, the special servicer relied on a “no action clause” in the PSA which provided that a certificate holder could bring suit only if at least 25% of the certificate holders of each affected class first made a demand on the trustee. It provided, in relevant part:

No Certificateholder shall have any right to institute any suit, action or proceeding in equity or at law upon or under or with respect to this Agreement, unless . . . the Holders of Certificates representing Percentage Interests

was affected adversely” in December 2005 when plaintiffs initiated this action. The court noted that “[t]he focus of this motion is whether plaintiffs complied that a ‘no action clause’ contained in the PSA in bringing this action.”

In moving for summary judgment, the special servicer argued that the sale of the Hardage loan adversely affected the holders of all Class A-1 Certificates. While that motion was originally denied, following additional factual development the special servicer sought and was granted leave to renew their motion for summary judgment.

### Discussion

To defeat the special servicer’s motion, the plaintiffs were required to “adduc[e] admissible evidence that, if believed, would create a genuine issue of fact as to whether Class A-1 was affected adversely by the sale of the Hardage loan.” Both parties submitted evidence to support their views of the effect of the Hardage loan sale on Class A-1. The plaintiffs argued that

the sale benefited Class A-1 and submitted a spreadsheet showing that when a discount rate of 7.1 or greater was used Class A-1 benefited from the sale. For its part, the special servicer pointed to an expert declaration that expressed the view that the sale harmed Class A-1 because Class A-1 would have earned an interest rate of between 2 and 3.5 percent on the Hardage loan sale proceeds—assuming the proceeds were invested in a vehicle that was comparable in rating and maturity to the Class A-1 certificates—which is substantially less than the 7.1 percent interest Class A-1 was earning on the principal balance.

Before reaching the issue of whether Class A-1 was adversely affected, the court concluded that the effects of the sale of the Hardage loan were (i) Class A-1 received an accelerated principal disbursement and (ii) as a result of the accelerated disbursement, Class A-1's principal balance was decreased which reduced the amount of interest disbursed to Class A-1. Therefore, to determine the sale's "net effect," the *benefits* of the accelerated principal disbursement need to be compared to the *costs* to Class A-1 of reduction in interest. As the costs and benefits were realized at different times—the benefit being received upon the principal paydown in July 2003, and the interest reduction being felt over time through the maturity date of the certificates in 2017—a discount rate needed to be applied to reflect the "time value of money and the risks associated with any investment." The court concluded that, whether Class A-1 benefited from the sale of the Hardage loan or were adversely affected by that sale, turned on the discount rate used to measure the effects of the sale.

The court explained that "[d]etermining a discount rate is an issue of fact on which the parties may adduce evidence." The special servicer contended—based upon comparables investments—that the appropriate discount rate is between 2 and 3.5 percent. Although plaintiffs challenged the appropriateness of the comparable investments used by the special servicer, the court observed that, under plaintiff's approach, the comparable investments of the sale did not harm Class A-1 only if a discount rate of 7.1 or higher was applied. Although the court conceded and provided examples of when, theoretically plaintiffs' assertion is possible, the court explained that plaintiffs cannot carry their burden "with a theoretical illustration that the sale *might not* have harmed Class A-1." Instead, to survive summary judgment plaintiffs were required to put forth "admissible evidence that, if believed, would support the use of a discount rate of 7.1 percent or greater in these circumstances." The court concluded that plaintiffs had failed to put forth that evidence. Instead, the evidence plaintiffs pointed to with respect to the determination of a "discount rate" was the 2003 ten-year Treasury notes, that

were paying between 4 and 4.5 percent after the loan was sold, the court noted, was "far short of the 7.1 percent that plaintiffs need to prove."

## Conclusion

No action clauses in trust agreements can impose substantial bars to an investor's standing to bring a suit. As this case amply demonstrates, courts enforce such clauses as written, and hold plaintiff holders to their burden of proving compliance with restrictions in no action clause. ☺

# Borrower's Inaction Ratifies Unauthorized Corporate Loan

By Francesca J. Perkins

The United States District Court for the Southern District of New York has recently ruled that, where an individual lacks actual or apparent authority to execute a loan agreement on behalf of a corporate entity, that entity will be deemed to have ratified the transaction when it fails to object or attempt to undo the transaction upon learning of it. In addition, the court found that ratification of an unauthorized transaction occurs when the entity accepts the benefits of the transaction. *In re Vargas Realty Enterprises, Inc.*, 440 B.R. 224 (S.D.N.Y. 2010).

## The Facts

Vargas Realty Enterprises, Inc., Noble Realty Corp., V & R Realty Corp., and E.R. Properties Inc. (collectively "Borrowers") allegedly are corporations that own real property in New York City. Victor Vargas is the sole shareholder and president of each Borrower. On at least five separate occasions since 2001, Victor Vargas' then spouse, Rosa, and his son, Henry, allegedly held themselves out as Borrowers' agents. Borrowers maintained, however, that neither Rosa nor Henry were ever officers, directors, shareholders, managers, agents, or employees of Borrowers and, therefore, were not authorized to act for them. On each of these five occasions, Rosa or Henry allegedly carried out loan transactions with financial institutions purporting to be Borrowers' agent, and granted liens against Borrowers' properties to secure those loans. These transactions allegedly were carried out without Victor Vargas's prior / *continued page 22*

## Borrower's Inaction

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knowledge or consent. When Victor subsequently learned of these unauthorized transactions, he allegedly took no steps to invalidate them or to unwind the transactions.

Turning to the loan at issue in this litigation, on August 28, 2007, Henry, holding himself out as Borrowers' agent, borrowed \$8 million from CFA W. 111 Street, L.L.C. ("CFA"), obligated Borrowers on an \$8 million promissory note, and granted liens on Borrowers' real properties to secure that loan. At that time, Borrowers did not need additional funds for operations.

On April 8, 2008, Borrowers defaulted on their repayment obligations to CFA. Thereafter, in the Summer of 2008, CFA commenced a foreclosure action in New York state court. Borrowers and CFA entered into a Pre-Negotiation Agreement in an effort to reach a settlement or restructuring of the note and mortgage. In that Agreement, Borrowers acknowledged their "legal and enforceable obligations" to CFA under the CFA note and mortgage "without any defenses, counterclaims or offsets." When those efforts were unsuccessful, in January 2009, Borrowers voluntarily filed a Chapter 11 petition in the United States Bankruptcy Court for the Southern District of New York.

On May 25, 2009, Borrowers commenced adversary proceedings against CFA in the Borrowers' bankruptcy case. Borrowers' amended complaints filed in June 2009 requested that: (1) the CFA note and mortgage be declared invalid because Henry lacked authority to execute the deal and CFA failed to perform due diligence on this authority, (2) the Pre-Negotiation Agreement be nullified, and/or (3) CFA's claims be equitably subordinated to all other creditors because CFA procured the deal through fraud or misconduct. CFA moved to dismiss on the grounds that, to the extent Henry may have lacked authority, Borrowers ratified the CFA note and mortgage when they failed to take steps to nullify the transaction and when they executed the Pre-Negotiation Agreement.

In an August 3, 2009 Order, the Bankruptcy Court dismissed the consolidated adversary action against CFA concluding that: (1) Borrowers ratified the note and mortgage when they executed the Pre-Negotiation Agreement and when Borrowers accepted at least a partial benefit of the transaction, (2) the Pre-Negotiation Agreement was not a fraudulent conveyance because it was not a transfer and Borrowers could not satisfy the requisite elements necessary to make a fraudulent conveyance claim, (3) Borrowers failed to plead all of the elements of

an unlawful preference claim, (4) CFA's use of its position to drive a harder bargain was not wrongful conduct warranting equitable subordination, and (5) the Pre-Negotiation Agreement was neither a product of coercion or duress because Borrowers had other alternatives to signing it. The Borrowers appealed.

## The District Court's Ruling

On appeal, the district court affirmed the complaint's dismissal. The court began its analysis by noting that the district court evaluates a bankruptcy court's findings of fact for clear error and its conclusions of law de novo.

The court held that, regardless of whether Henry lacked actual or apparent authority to execute a loan on behalf of Borrowers, Borrowers thereafter ratified the note and mortgage when they failed to object or attempt to undo the transaction upon learning of it and executed the Pre-Negotiation Settlement Agreement, rendering the note and mortgage valid and enforceable against Borrowers. Moreover, rather than object to the CFA note and mortgage, Borrowers accepted the benefits of the transaction, using at least \$5 million of the CFA loan proceeds to satisfy a prior debt owed to Sovereign Bank. In addition, at least \$400,000 was used to make interest payments on behalf of Borrowers.

The court then held that the Pre-Negotiation Agreement was not a contract of adhesion or coercion. In so ruling, the court wrote that the fact that a form of contract is offered on a take-it-or-leave-it basis, standing alone, is insufficient to make it one of adhesion. Nor is mere disparity in bargaining power sufficient to show that a contract of adhesion exists. In addition, the record did not show that the disparity in the instant action was such that CFA coerced Victor Vargas into signing the Pre-Negotiation Agreement under duress.

Borrowers had alleged that the Pre-Negotiation Agreement, along with the underlying CFA note and mortgage, were part of CFA's criminal scheme to take over Borrowers' properties. This claim was similarly found to be without merit, as they failed to point to a single case or fact that would support such claims. Moreover, the court noted that Borrowers' claim of a criminal enterprise was merely derivative of their other, failed, theories.

The court rejected the Borrowers' fraudulent conveyance claim. Because the Pre-Negotiation Agreement constituted a contract through which Borrowers ratified a prior transaction, Borrowers' claim failed because a ratification of a former transaction is not a transfer within the meaning of the fraudu-

lent conveyance statutes.

On the claim for equitable subordination, the court held that, because an ordinary creditor, like CFA, does not owe a fiduciary duty to a debtor, it is rare for a court to subordinate claims arising out of such arms length dealings. In the case of non-insider creditors, “unless the claimant controls the debtor, and exercises that control to gain an unfair advantage,” the proponent of such a claim must show “wrongful conduct involving fraud, illegality or some other breach of a legally recognized duty.” The court wrote that, aside from making bare allegations, Borrowers failed to show how CFA committed fraud and failed to ground their allegations in fact or law.

The court then briefly remarked on the Borrowers’ claim that the Pre-Negotiation Agreement was an unlawful preference, noting that, other than a cursory mention of the claim, Borrowers did not raise the issue until their reply brief (and even there, they devoted “a total of three sentences to this claim”) and it would therefore be deemed waived for purposes of their appeal. The court went on to note that, even if the preference claim were properly raised, it would still fail where Borrowers had not pleaded all of the necessary elements in their complaint.

The court also analyzed Borrowers’ usury claim. The court highlighted the fact that Borrowers alleged for the first time on appeal that the CFA note and mortgage were criminally usurious. Nevertheless, the court easily disposed of this claim, holding that New York’s usury laws (New York Penal Law § 190.40, New York General Obligations Law §§ 5-511, 5-501-1 and 5-501-6-a) do not apply to loans over \$2.5 million. While the CFA note imposed a default interest rate above the 25% usury threshold, because the loan amount was above \$2.5 million dollars, the usury laws did not apply.

Finally, the court noted that it saw no reason to reverse the Bankruptcy Court’s decision on grounds of public policy. The court found that the Pre-Negotiation Agreement was not inconsistent with New York’s public policy encouraging settlements, nor was it inadmissible as a settlement discussion pursuant to Federal Rule of Evidence Rule 408. In addition, Borrowers could not cite a single applicable precedent in which a court found that such an agreement was found to be invalid on public policy grounds.

## Conclusion

While it addressed a number of claims and issues, the District Court’s holding in *In re Vargas Realty* stands for the very basic proposition that an unauthorized corporate loan transaction

will be enforced where the corporation thereafter ratifies it by failing to object or attempting to undo the transaction upon learning of it or by returning its benefits. ☺

# Option Agreement Enforceable Despite Breach of Related Loan Agreement

By Nicolas Stebinger

In another decision that demonstrates the importance of clear drafting, a New York trial court recently held that a party having the option to acquire units in a limited liability company could do so notwithstanding the fact that it had allegedly breached its obligation to lend \$100 million to the optionee. In so ruling, the court found that, although the loan agreement and option agreement were executed at the same time as part of the same transaction, they were independent agreements to be read and enforced individually. *Schron v. Grunstein*, No. 650702/10 (N.Y. Co. 2011).

## A Complex Acquisition of Assets

This saga begins with the purchase by the plaintiff real estate investors of the assets of Mariner Health Care, a large nursing home company, for approximately \$1.3 billion. The structuring of the transaction was allegedly complicated by the plaintiffs’ desire to purchase the real estate assets while segregating the management and operations portion of the business to a separate entity.

To that end, two agreements, among others, were executed. The first, a Loan Agreement, obligated one of the plaintiffs, Cammeby’s Funding III LLC (“Cammeby’s”), to loan \$100 million (the “Loan”) to defendant SVCARE Holdings LLC (“SVCARE”). Separately, the parties executed a Limit Purchase Option Agreement by which plaintiff Cammeby’s had the option (the “Option”) to purchase 99.9997% of the membership units in defendant SVCARE for \$100 million.

Cammeby’s exercised its option under the Option Agreement to purchase the SVCARE membership units. The defendants refused to honor that Option exercise on the ground that the plaintiffs had failed to fund the Loan. The plaintiffs sued, alleging a breach of the Option Agreement. In response, the defendants contended that / continued page 24

## Option Agreement Enforceable

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plaintiff's funding of the \$100 million Loan was necessary to the viability of its exercise of the Option.

The central issue in dispute before the court therefore became whether the Option Agreement and Term Agreement were independent agreements, or constituted a single agreement that should be read jointly. The defendants offered three justifications for reading the agreements together: (1) the parties had intended the two agreements to be read together, (2) funding of the Loan was the consideration for the Option granted in the Option Agreement, and thus its funding was essential to the effectiveness of the Option, and (3) even if funding of the Loan was not consideration for the Option, the funding of the Loan was a condition precedent to the exercise of the Option. The court relied on basic contract principles in rejecting each argument.

### General Principles of Contract Interpretation

The court began by noting that contracts are presumed separate “unless their history and subject matter show them to be unified,” which is determined by examining the parties’ intent as manifested at the time of the formation of the contracts “viewed in light of the surrounding circumstances.” Unless evidence of the parties’ intent demonstrates otherwise, the Option Agreement and the Loan Agreement constitute independent agreements, and the plaintiff’s failure to fund the Loan would not relieve the defendants of their obligation to sell under the Option Agreement. The court proceeded to consider several aspects of the Option Agreement form to assess the intent of the parties.

The court first noted that the Option Agreement and the Loan Agreement were “separate written agreements with separate assents,” and lacked complete identity of parties. Further, the agreements did not explicitly incorporate or cross-reference one another, even where the opportunity was presented. For example, the Option Agreement referenced a “credit facility” to be funded by one of the plaintiffs, but it neither identified the Loan Agreement as the facility nor stated that the loan’s funding was consideration or a condition of the agreement. The court noted that the agreements were executed and amended on the same dates and the parties, as sophisticated business people, easily could have written the two documents to incorporate one another had they so desired. That the parties did not integrate the documents given the oppor-

tunity to do so was a strong indication to the court of their intent that the documents were independent agreements, to be read and enforced separately.

### The Merger Clause

The defendants pointed to the fact that the Loan amount and the Option price were identical at \$100 million, arguing this was evidence of their interdependence, thereby creating an ambiguity that would allow the court to reach outside the four corners of the Option Agreement and read the agreements together to resolve the ambiguity. The court rejoined that the Option Agreement on its face was clear and contained a merger clause, thus precluding the defendants from referring to the Loan Agreement to interpret the Option Agreement.

Merger clauses are generally viewed as demonstrating the intent of the parties that the parol evidence rule should apply to preclude the use of parol evidence—in other words, that an agreement should be interpreted without reference to extrinsic evidence, such as the terms of other agreements. The court qualified its assessment of the merger clause by noting that extrinsic evidence may be introduced despite the existence of such a clause where a contract is ambiguous. A contract is not ambiguous, however, “if the language it uses has a definite and precise meaning, unattended by danger of misconception.” In the face of an unambiguous contract, the “mere assertion” by a party that language in the agreement has some other meaning is insufficient to create ambiguity. The parol evidence rule thus precludes the need for discovery in interpreting a clear and integrated agreement, because a court need not look beyond the four corners of the contract at issue.

Because the Option Agreement contained a strongly worded merger clause, the court held that the parol evidence rule barred the use of extrinsic evidence to create ambiguity in the contract which was otherwise “complete and clear.” The defendants could not use the Loan Agreement to attempt to inject uncertainty into the interpretation of the Option Agreement and upset the court’s conclusion that the parties intended the agreements to remain separate.

### Lack of Consideration

The defendants next contended that the Loan Agreement constituted the consideration for the Option Agreement, and the loan’s funding therefore was a condition precedent to the exercise of the Option. The Option Agreement stated that the consideration therefor was the exchange of “mutually beneficial covenants” contained within the Option Agreement itself—the

“option to repurchase the company at a set price,” in exchange for the defendants’ right to profit from the upside of a subsequent sale by the plaintiffs. The court acknowledged that under applicable precedent, the receipt of consideration named in a contract can be disputed with extrinsic evidence. Nevertheless, such an exception applies only where an agreement merely names the consideration to be exchanged outside of the contract. Where, as here, the consideration was provided for in the Option Agreement itself, and the Agreement did not recite Loan funding as part of its consideration, the court rejected the suggestion that the funding of the Loan had any impact on whether valid consideration was exchanged for the Option Agreement.

### Conditions Precedent

Finally, the court rejected the defendants’ argument that funding of the Loan constituted a condition precedent to the enforceability of the Option Agreement. The court observed that, to create a condition precedent, clear contractual language must exist demonstrating that the parties intended such. As no such clear conditional language appeared in the Option Agreement, the court rejected the defendants’ argument that funding of the Loan was a condition precedent to the enforceability of the Option Agreement.

### Conclusion

The parties here very well may have intended that the Option Agreement and the Loan Agreement be read in tandem. That would make perfect business sense. But they did not take the opportunity to make that clear in the documents themselves. Because the terms of the agreements failed to establish any intent that the Option Agreement and the Loan Agreement constituted a single agreement, that the funding of the Loan was consideration for the Option Agreement, or that the funding of the Loan was a condition precedent to the exercise of the Option, the court dismissed the defendants’ claim to void the Option Agreement based on the plaintiff’s alleged failure to fund the Loan. ☺

## Narrowly Drafted Default Provision Dooms Lender’s Recourse Under Guaranty

By C. Jonathan Wood

A New York federal district court recently ruled that a lender could not recover under a guaranty of a multi-million dollar mezzanine loan where the alleged actions giving rise to the breach were committed by an escrow agent who was not mentioned in the underlying default provision. *Madeleine L.L.C. v. Street*, No. 08 Civ. 10520, 2010 U.S. Dist. LEXIS 136070 (S.D.N.Y. 2010). The decision turned on tightly drafted sections of the Pledge Agreement, Loan Agreement and Guaranty (“Guaranty”) that limited defaults to the acts and omissions of specifically named parties.

### Background

Madeleine L.L.C. provided a mezzanine loan for up to \$275 million for the construction of several condominium projects. Each project and associated property was owned by a separate corporate Property Owner. Through Pledge Agreements for each of the projects, the borrowers pledged their interests in the Property Owners as collateral. Two principals, Brian Street and James Cohen, issued a Guaranty of the loan. The Pledge Agreements set forth eight events that constituted defaults thereunder, which were incorporated into the Guaranty. Thus, to trigger the recourse provision of the Guaranty, an enumerated event of default must have occurred under a Pledge Agreement.

In 2007, the lender became convinced that of one the Property Owners, BLIA Developers, had caused an event of default to occur. Specifically, BLIA had allegedly deposited in an interest bearing account the down payments made by condominium purchasers, and the lender alleged that BLIA violated the Pledge Agreement by transferring the interest earned in that account to a management company that administered all of the properties. The transfers allegedly were done at the direction of the guarantors Street and Cohen, but were physically accomplished by an escrow agent, and the funds were allegedly used to pay expenses on other properties.

Madeleine asserted that these transfers constituted events of default under the Pledge Agreement, and demanded payment of the outstanding loan amount / continued page 26

## Default Provision

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from Street and Cohen under the Guaranty. When the guarantors refused to pay, the lender brought suit.

### Lender's Arguments

The court began its analysis by noting that the dispute centered on a basic point of contract interpretation. The court examined the Pledge Agreement applicable to the property at issue, Biscayne Landing, to determine whose actions could constitute a breach of that agreement, thereby triggering the Guaranty. One of the events of default in that Pledge Agreement was as follows: "Pledgor transfers or encumbers any portion of the Collateral in violation hereof or of the Loan Agreement." As the court noted, this event of default only covers actions taken by "Pledgor." The Pledge Agreement identified only one party as the Pledgor: North Miami Land Holdings, Limited ("NMLH"), which was the Property Owner. Thus, the court found, only NMLH was capable of committing an event of default thereunder. But, as the court noted, NMLH was not the party that actually made the challenged transfers. It was BLIA Developers, not NMLH, that owned the account in which the funds were held. While it was alleged that Street and Cohen, not NMLH, directed the funds be transferred, it was the escrow agent, not NMLH, that carried out that transfer. The court thus found that the "plain language . . . [of the Pledge Agreement] identifies only one entity as the Pledgor: North Miami Land Holdings, Ltd. ('NMLH'). Therefore, only NMLH is capable of committing an Event of Default under Section 9(a)(i) of the applicable pledge agreement."

The lender attempted to overcome this plain language by arguing that any distinction between the entities should be ignored. To support this theory, the lender argued that NMLH held nearly all of the equity in BLIA, making any transfer by BLIA effectively a transfer by NMLH. The court rejected this argument as BLIA was not included in the definition of "Pledgor." Further, BLIA was included in the definition of "Issuer." The court noted that, while several events of default covered both Issuers and Pledgors, the event of default on which the lender premised its action did not apply to Issuers. The court concluded that "[t]he selective use of the term 'Issuer' indicates a deliberate distinction between Events of Default that an Issuer is not capable of triggering."

### Alternative Arguments

The lender next argued that BLIA violated other provisions of the Loan Agreement, thereby triggering a default. The Loan Agreement contained a catchall provision stating that any failure of the entities, including BLIA, to perform under that agreement would constitute a default. The lender argued that BLIA violated two sections of the loan agreement, and should therefore be considered in default. The court found this argument unpersuasive writing that "[a]n event of default under the Loan Agreement is defined differently from an Event of Default under the Pledge Agreement . . . They should not be conflated. As a result, an Event of Default under the Loan Agreement is irrelevant except to the extent that its occurrence somehow triggers an Event of Default under the Pledge Agreement."

In an attempt to bolster its position, the lender pointed to a provision of the Pledge Agreement that provided that a "Loan Document Event of Default" shall constitute an event of default under the Pledge Agreement. Since the Loan Agreement was a Loan Document, the lender argued that BLIA's default under the Loan Agreement constituted default under the Pledge Agreement, thereby triggering the Guaranty. The court similarly rejected this argument by looking to the definition of "Loan Document Event of Default" which clearly stated that the default must be committed by a Pledgor—and BLIA was not within the definition of Pledgor.

### Conclusion

This decision demonstrates the importance of thoughtful drafting of loan documents based on a full understanding of the inter-relationship of various parties in complicated commercial transactions. By using language here—whether intentional or not—that only the acts or omissions of specifically named entities could constitute defaults under the Pledge Agreement, the lender effectively agreed that defaults caused by other parties, here the escrow agent at the direction of the guarantors, would not trigger the Guaranty. ☉

# Borrower's President Not Liable on Corporate Agreement and Note

By Christopher Cusmano

A New York state trial court has granted a corporate president's motion to dismiss a case against him personally for payments due under his corporation's purchase agreement (the "Agreement") and promissory note (the "Note"). The plaintiffs, Robert Brown and RG Group LLC ("plaintiffs"), filed suit against both Noble, Inc. ("Noble") and its President, Thomas Caruso, after Noble allegedly failed to make payments due under the Agreement and Note. Caruso moved to dismiss the action against him individually arguing that, although he was a party to the Agreement and signed it in his personal capacity, he did not personally undertake therein the contractual obligation to pay, as supported by the fact that he had signed the Note only in his corporate capacity. The court agreed, finding that the contractual obligation to pay was solely on the corporation, not Caruso. *Brown v. Noble*, No. 600876/10, 2010 WL 4941999 (N.Y. Co. 2010).

## Background

In mid-2009, plaintiffs entered into the Agreement with Noble and Caruso by which Noble purchased accounts receivable from plaintiffs. Caruso was a named party in that Agreement in his personal capacity and also was a personal signatory to that Agreement. Noble, too, was a party to that agreement. As to the Note, Caruso was not named as a party and signed it only in his capacity as Noble's President.

Noble allegedly failed to make the payments due under the Agreement and Note, and plaintiffs filed suit on April 7, 2010. In the complaint, plaintiffs asserted six causes against both Noble and Caruso (1) breach of contract, (2) unjust enrichment, (3) breach of implied covenant of good faith and fair dealing, (4) promissory estoppel, (5) fraud and misrepresentation and (6) indemnity. Caruso moved to dismiss, arguing that, although he was named as a party in the Agreement and signed it in his personal capacity, the terms of that Agreement imposed no payment or other obligations on him. Rather, the Agreement and Note imposed the payment obligation solely on the corporation. Since the complaint was based on the premise that a contractual relationship existed with Caruso personally, he argued that plaintiffs failed to state a claim for relief against him individually.

## The Merits of the Motion to Dismiss

On Caruso's motion to dismiss, the court reviewed the complaint to determine whether any of the six causes asserted against Caruso individually stated a claim for relief. Even under New York law's liberal pleading standards, the court found that all of plaintiffs' causes of action against Caruso must be dismissed.

The court found that there was no actual contractual relationship formed between Caruso and the plaintiffs because, although named individually as a party to the Agreement and a signatory to that Agreement, he received no consideration in his personal capacity for executing it, an essential element for the formation of a contract under New York law. As Caruso neither received any personal benefits nor incurred any personal obligations under the Agreement or Note, and as there were no other allegations in the complaint establishing his personal liability for the payments, plaintiffs failed to establish a contractual relationship with Caruso individually, and failed to state a claim for breach of contract. The court noted that, to bring a claim against Caruso individually, plaintiffs would effectively need to "pierce the corporate veil," but the complaint contained no factual allegations in this regard.

The court summarily dismissed the remaining claims, finding the complaint plainly insufficient to assert any cause of action against Caruso individually. The court noted, for example, that throughout the complaint plaintiffs "appear to attempt to assign upon the defendants equal liability for the alleged breaches of the Note and the Agreement, simply by grouping Noble and Caruso together." Without specific factual allegations against him individually, the court found, there was no theory under which Caruso could be held liable to plaintiffs.

## Conclusion

This case presents a rather typical fact pattern regarding an officer of a corporation signing a corporate contract in his individual capacity. Attorneys drafting such agreements need to take care that an individual officer is not signing in this individual capacity, unless, of course, the deal is that the officer is assuming personal responsibility and potential liability. As this decision makes clear, under New York law, even where a corporate officer signs a corporate contract in his individual capacity, he may avoid personal liability where he did not personally undertake the contractual obligations that were allegedly breached. Moreover, unless the individual obtains some personal benefit under the agreement, the court may find an absence of the consideration needed to form a binding contract. ☺

# Saving the Best for the Footnotes

Footnote 1 of the Massachusetts' Land Court's decision in *Kubie v. Audette*, 2100 Mass. LCR Lexis 98 (2010), reads:

1. Although referred to locally as Webster Lake or Lake Webster, it is also known by its Algonquian name "Chargoggagoggmanchauggauggagoggchaubunagungamaugg"—which is said to mean, "You fish on your side; I fish on my side; nobody fishes in the middle," although "Fishing place at the boundaries, neutral meeting grounds" may be a more accurate translation. See *Encyclopedia Britannica*, e.b.com (search for "Webster Lake"); see also *Massachusetts: A Guide to the Pilgrim State* (2nd Ed., 1971) at 436.

## New York Court of Appeals Honors Chadbourne Partner George Bundy Smith

Chadbourne partner George Bundy Smith was honored by former colleagues at the New York State Court of Appeals' 2011 Diversity Program.

The February 18 event in Albany, New York honored Judge Smith for his 14 years of service on New York's highest court. He retired in 2006 as an Associate Judge on the Court and, a few months later, joined Chadbourne as a litigation partner. Honoring Judge Smith were current and past judges on the Court, including Judge Theodore Jones and Chief Judge Jonathan Lippman. The event also featured a screening of a video tribute to Judge Smith, "George Bundy Smith: The Wind Beneath Our Wings."

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