

## Litigation

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BY THOMAS J. HALL  
AND THOMAS J. McCORMACK

**W**E LIVE in turbulent financial times—a global recession, trillions of dollars of equity market losses, gaping holes in pension plans and personal retirement accounts, massive job layoffs, a worldwide credit market collapse, unprecedented home mortgage default rates and booming home foreclosures. In this environment, it is not surprising that the litigation train has already left the station and is gathering steam as it proceeds down a multi-year track. Indeed, the bubble of mortgage defaults is expected to rise dramatically over the next two years, as borrowers move off the interest-only phase of their repayment obligations. We address below some of the more ripe areas for litigation.

### Collateralized Debt Obligations

The last decade has seen an explosion of the use and issuance of collateralized debt obligations (CDOs). Lenders and other mortgage originators packaged mortgages (frequently subprime) into mortgage-backed securities which were sold to third-party investors, thereby shifting the risk of non-payment from the lenders to the third-party investors. These mortgage-backed securities were themselves packaged into CDOs, which were rated by credit agencies. CDOs were issued in tranches, with the tranche rated as the least risky receiving the lowest interest rate and the more risky tranches receiving higher interest rates. When home prices began to fall in the past couple of years, mortgage delinquencies rose causing increasing losses to the third-party CDO investors.

In litigation to date, the investors have focused

THOMAS J. HALL and THOMAS J. McCORMACK are litigation partners with Chadbourne & Parke and head its banking litigation practice group. They can be reached at [thall@chadbourne.com](mailto:thall@chadbourne.com) and [tmccormack@chadbourne.com](mailto:tmccormack@chadbourne.com). Firm associates JASON PARK, JONATHAN NOBLE and FRANCESCA PERKINS assisted in the preparation of this article.



attention on the originators of the CDOs and the underlying mortgage-backed securities. Allegations have been made that the originators misrepresented the risks associated with these financings or failed to warn them adequately of these risks. For instance, in *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.*, 2005 WL 2148919 (SDNY Sept. 6, 2005), an early harbinger of the present wave of litigation, purchasers of securities backed by pools of mobile home loans brought securities fraud claims against the issuers and underwriters of those securities, alleging that the defendants falsely stated in offering documents that “strict and prudent” standards (such as credit score requirements) were used in originating the underlying loans.

Plaintiffs alleged that defendants disregarded those standards by generating a large volume of underlying loans to applicants with “no assets, no evidence of employment, debt exceeding income, and poor FICO scores.” Though the court refused to dismiss the claims against all defendants, the court found that scienter was not adequately pled as to the corporate parent because those allegations were vague and conclusory and, unlike the allegations against other defendants, were not supported by

the detailed reports of confidential sources.

In addition, claims have been brought against the rating agencies that rated the risks.<sup>1</sup> Whether rating agencies will be exposed to liability is unclear. Rating agencies have traditionally defended such claims by asserting that they are immune from liability under §11 of the Securities Act of 1933, and that their published rating opinions are protected free speech under the First Amendment of the U.S. Constitution.

### Funding Suspension Litigation

With the tightening of (or, some would say, evaporation of) credit markets, lenders are increasingly looking for ways to avoid lending obligations. Real estate developers are claiming with increasing frequency in litigation that their lenders have improperly refused to release construction funds, causing many to halt construction work and consider bankruptcy. Several have gone to court demanding that their lenders release funds so that development work can continue.

Back in the 1990s real estate recession, lender liability suits were prevalent. At that time, in an effort to improve the prospects of repayment, many

lenders aggressively stepped in and took effective control of construction projects, oftentimes dictating management decisions. This control exposed lenders to liability where the borrower could establish that such control was exercised improvidently leading to otherwise preventable losses.

The memory of those legal battles, along with the recent added pressure from shareholders who want financial institutions to cut back on their real estate financing exposure, has caused many lenders to operate with increased caution when dealing with similar projects. These days, instead of stepping in and assuming control of a project, lenders seem more inclined to cut their losses and suspend funding.

For example, in *Wachovia Bank v. Promenade at Doral II, LLC*,<sup>2</sup> a real estate developer financed the development and construction of a project with a loan from Wachovia Bank. The loan was structured so that the developer would present draw requests to Wachovia as needed to pay invoices presented by suppliers and contractors. The developer claims that because Wachovia made unwarranted setoffs from draw requests, including unearned interest charges and other unwarranted holdbacks, the project was unable to pay its subcontractors and suppliers. In the suit, the developer alleges that the bank took these steps as a ruse, its real intention being to kill the project so it could suspend funding. The developer asserts that the bank breached its contract and engaged in bad faith and unfair dealing.

In response to increasing instances of lenders cutting off construction financing in California, a group of 30 California builders reportedly has been meeting to examine ways to defend themselves against what they feel are increasingly unscrupulous practices by lenders. The group has been considering a number of possible tactics, including reaching out to state and national lawmakers. One such group member has been reported to have said: "If banks want to get out of residential lending, that's fine," but he notes, "that isn't being done. The rug is literally being pulled out from under us and games are being played."<sup>3</sup>

In addition to funding suspension cases, lawsuits have been filed alleging that lenders have refused to comply with their obligation to syndicate loans. For example, in November 2008, Relativity Media, a film company, brought suit in the Southern District of New York against Citigroup alleging that Citigroup refused to syndicate a loan in breach of the parties' contract and, instead, demanded changes to the financing agreement prior to proceeding with the syndication.<sup>4</sup> The plaintiff alleges damages of over \$50 million contending that the financing was intended to be used to invest in films of Sony Pictures. Citigroup denies these allegations.

### Securities Fraud Claims

The implosion of the subprime mortgage industry has resulted in a dramatic increase in the number of private actions brought under the federal securities laws. Many of these actions involve securities fraud claims brought by shareholders of large commercial and investment banks, who have asserted that the banks misrepresented the value and quality of their mortgage-based holdings. While these actions are certain to give

rise to novel legal issues, it is equally clear that traditional obstacles to recovery in securities fraud cases, such as demonstrating scienter, reliance and loss causation, will impose significant obstacles for shareholder plaintiffs asserting such claims against financial institutions.

The most ubiquitous conventional stumbling block for plaintiffs alleging securities fraud is the requirement, set forth in the Private Securities Litigation Reform Act of 1995 (PSLRA), that such plaintiffs plead facts evidencing scienter, i.e., an intent to deceive or defraud. Specifically, the PSLRA requires that plaintiffs plead "with particularity" facts giving rise to a "strong inference" that the defendant acted with an intent to deceive or defraud. 15 USC §78u-4(b)(2). The difficulty in cases arising out of the subprime meltdown derives

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The most ubiquitous conventional stumbling block for plaintiffs alleging securities fraud is the requirement, set forth in the Private Securities Litigation Reform Act of 1995, that such plaintiffs plead facts evidencing scienter, i.e., an intent to deceive or defraud. The difficulty in cases arising out of the subprime meltdown derives in large part from the fact that until the dramatic collapse of the subprime market, mortgage-backed securities appear to have been widely accepted as reasonable investment opportunities.

in large part from the fact that until the dramatic collapse of the subprime market, mortgage-backed securities appear to have been widely accepted as reasonable investment opportunities.<sup>5</sup> Thus, plaintiffs must plead with particularity facts showing that defendants deliberately misled investors regarding the quality of their mortgage-based holdings, despite the widespread belief in the investment community that such holdings were reasonably safe investments.

There is also reason to suspect that demonstrating reliance will pose a significant obstacle in securities fraud actions brought against financial institutions based on statements regarding their mortgage-based holdings. First, sophisticated institutional shareholders of large commercial and investment banks face a heightened burden of demonstrating actual reliance on fraudulent statements made by defendants, given that their understanding of the marketplace and access to information often rivals that of the defendants. Put differently, the sophistication of the plaintiff is a critical factor in determining whether the alleged reliance on the fraudulent statement was reasonable.<sup>6</sup>

Even if plaintiffs are able to demonstrate scienter and reliance, the general market downturn that has accompanied the collapse of the subprime market may significantly complicate efforts to establish loss causation and damages. For instance, in *Lucia v. Prospect Street High Income Portfolio Inc.*, 769 F.Supp.

410 (D. Mass. 1991), investors sued a junk bond fund, alleging that the defendants misrepresented the risks of the high-yield bond market, and did not disclose other material information, such as the default rate of bonds in the defendants' portfolio. The court required the plaintiffs to amend their complaint to seek recovery only for those damages caused by the fund's alleged misrepresentations, as distinguished from losses caused by the collapse of the market for high-yield bonds.

### Claims Against Officers, Directors

Another likely place for litigation flowing from the financial crisis involves shareholder derivative actions against corporate officers and directors. Shareholders are claiming that their directors and officers breached their fiduciary duties to the company when they failed to control the risks associated with subprime investments. For instance, in *JP Morgan Chase & Co. Shareholder Derivative Litigation*, 2008 WL 4298588 (SDNY Sept. 19, 2008), plaintiffs alleged that certain officers and directors of the bank had "recklessly acquired and maintained billions of dollars worth of subprime mortgage related assets," despite rising delinquencies among homeowners and analysis of the risks in the bank's research reports.<sup>7</sup> In those companies where some shareholder ownership has been conveyed to the federal government in exchange for bailout funds, the dilution of the shareholders' equity interests will likely be a factor in the damage analysis.

### Mortgage Lending Claims

In an agreement announced in early October 2008, Bank of America settled claims arising out of the mortgage lending practices of Countrywide Financial, which Bank of America acquired in July. While this settlement ends claims by state attorneys general, it has given rise to civil litigation.

The lawsuits filed by state attorneys general earlier this year alleged that Countrywide's mortgage origination and servicing businesses violated state consumer protection laws. In their complaints, the states focused on Countrywide's marketing of payment option adjustable rate mortgage (ARM) products, hybrid ARMs, no-interest ARMs, and home equity lines of credit, alleging that Countrywide lowered its underwriting and origination standards. Additionally, they alleged that Countrywide's marketing practices included emphasizing low initial payments and concealing later higher payment levels, misrepresenting the term of initial payment periods, and misrepresenting prepayment penalties.

Relying chiefly on state unfair and deceptive acts and practices statutes, the states argued that Countrywide's lending operations illegally misrepresented the true costs of the loans. The statutes vary by state, but generally prohibit deceptive statements or omissions of material facts, without requiring proof of actual inducement.

When Bank of America acquired Countrywide, it announced that Countrywide would cease certain lending practices. These commitments have been formalized as part of the settlement. As part of its agreement with the states, Countrywide agreed not to offer subprime mortgages, mortgages with negative amortization and, with certain exceptions, "no-documentation" or "low-documentation" loans. Countrywide also agreed to maintain

programs to identify and contact homeowners in danger of delinquency.

The settlement further provides for a loan modification program. Depending on the form of loan, modifications may include writing down the principal balance to 95 percent of the current value of the property, converting to fixed-rate mortgages, cutting variable interest rates to as low as 2.5 percent, with limits on future rate increases, and extending interest-only or introductory-rate payment periods. Countrywide also agreed to waive prepayment penalties and fees for late payments, delinquency and loan modifications.

While this settlement resolves the claims of the attorneys general, in early December 2008, the holder of securities backed by Countrywide mortgages filed suit seeking damages allegedly arising out of the modification to the loan terms.<sup>8</sup> The plaintiff contends that Countrywide's settlement with the state attorneys general, in which it modified loan terms, will cause it damages. The plaintiff contends that Countrywide simply had no right to modify the terms of the mortgages and that, under the applicable contracts, Countrywide is obligated to purchase at face value any mortgage that it modifies.

### Class Actions by Borrowers

Another category of recent litigation has included claims by borrowers who claim either inadequate disclosure or misrepresentation as to the terms of their mortgage financing. Federal law obligates that certain disclosures be made to homeowners engaging in mortgage financing, and with increasing frequency borrowers are contending that the appropriate disclosures were not made. A significant issue in these cases is whether such claims can be brought on a class action basis. While common law claims may be subject to class action consideration, the availability of class actions for statutory claims is less clear.

In *Andrews v. Chevy Chase Bank*, 2008 U.S. App. LEXIS 20153 (7th Cir. Sept. 24, 2008), Susan and Bryan Andrews alleged they obtained a loan from Chevy Chase Bank, F.S.B. to refinance their home. The bank offered them an unusual "cashflow payment option" loan, that enabled them to vary their payments based on their monthly cash flow. This flexible mortgage option allowed them to pay a monthly minimum payment at a low interest rate for an initial term. While their interest rate was to adjust monthly, the minimum payments remained fixed at the low rate until the initial term expired or the outstanding balance exceeded 110 percent of the original loan (through negative amortization). After a time, the Andrews' minimum monthly payment

became insufficient to cover the accrued interest, and the negative amortization feature (adding the unpaid interest to the principal) commenced.

In 2005, the couple filed a class action lawsuit against Chevy Chase Bank, alleging violations of the Truth in Lending Act (TILA), 15 USC §1635, and seeking damages under §1640(a)(2) and rescission under §1635. TILA is the federal law developed to protect consumers engaging in credit transactions by assuring "meaningful disclosure of credit terms" to the consumer. §1601(a). TILA's most significant requirements concern information that must be disclosed to a borrower before extending credit, such as the term of the loan, annual percentage rate and total costs to the borrower. The plaintiffs claimed that several of Chevy Chase's disclosures were misleading, particularly regarding whether the initial interest rate was fixed. Additionally, the couple claimed that the stamp used by the bank on its disclosure forms, which referred to the note as a "WS Cashflow 5-Year Fixed Note Interest Rate 1.950%," was similarly deceptive because the document could be understood to identify the note as having a fixed rate.

The district court in the Eastern District of Wisconsin granted summary judgment in plaintiffs' favor, authorizing rescission and awarding attorney's fees.<sup>9</sup> The district court granted class certification under Rule 23(b)(2) of the Federal Rules of Civil Procedure, allowing all class members the right to rescind their mortgages. The court held that the certified class would include any person who had obtained an adjustable-rate mortgage from Chevy Chase on a primary residence between April 2004 and January 2007, and who had received a Truth in Lending Disclosure Statement from Chevy Chase bank containing any of the language the court found deficient under TILA.

On appeal, the U.S. Court of Appeals for the Seventh Circuit noted that while this was a matter of first impression in that circuit, the First and Fifth Circuits, in addition to California's Court of Appeals, have held that rescission class actions are unavailable under TILA as a matter of law.<sup>10</sup> The court ruled that because the TILA rescission remedy requires the return of borrowers to the position they occupied before the loan was signed, it is a purely personal remedy to be fashioned by individual creditors and debtors. Moreover, the court indicated that the personal nature of the rescission remedy makes it both procedurally and substantively unsuitable for class certification.

The court remarked that while the statute does not explicitly prohibit the use of a class action for rescission purposes, the lack of an explicit instruction in this area is not dispositive. In fact, the court wrote that TILA's rescission remedy "is

written with the goal of making the rescission process a private one."<sup>11</sup>

Finally, the court pointed out that the TILA damage provision has a cap of the lesser of \$500,000 or 1 percent of the creditor's net worth for the total recovery in class actions. In contrast, the court ruled that because recoveries could possibly reach the hundreds of millions in this case and similar ones on a class basis, the notable absence of a similar provision in the TILA rescission provision suggests Congress did not intend to include class actions for rescissions.

### Conclusion

There is no question that a tremendous wave of litigation is flowing from the unprecedented collapse of the subprime mortgage industry and related credit crunch. While the outcomes to some of these cases may appear to some to be predictable, the nature of the claims and magnitude of the losses will likely lead courts and litigants into uncharted legal territory.

1. See, e.g., *Teamsters Local 282 Pension Trust Fund v. Moody's Corp.*, No. 07 Civ. 8375 (SDNY) (alleging that Moody's misrepresented or failed to disclose that it assigned "excessively high ratings" to subprime MBSs and CDOs and thereby misled investors about the quality and relative risk of those investments).

2. See Counterclaim, *Wachovia Bank v. Promenade at Doral LLC II*, 08-13745CA02 (11th Cir. July 21, 2008); see also Complaint, *Urbana Holdings, LLLP v. Bank of America*, No. 08-47824CA27 (11th Cir. Aug. 20, 2008); Complaint, *Regent Hotel, LLC v. First Bank*, No. 00009879 (Cal. Super. Ct. May 1, 2008); Cross-Complaint, *J.P. Eliopoulos Enter. Inc. v. IndyMac Bank F.S.B.*, No. GC040588 (Cal. Super. Ct. May 20, 2008).

3. Michael Corkery, "Builders Sue Banks That Pull Financing as Construction Projects Lie Unfinished," Wall St. J., July 23, 2008, at C1.

4. *Relativity Media v. Citigroup*, 08 Civ. 9721 (SDNY 2008).

5. See *Tripp v. IndyMac Financial Inc.*, 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007) (court dismissed complaint for failure to plead scienter noting that while the restatement of the bank's financials was some indication that defendants were aware of inaccuracies in those records, "an even stronger inference is that the Defendants were simply unable to shield themselves as effectively as they anticipated from the drastic change in the housing and mortgage markets and, once that inability became evident, IndyMac's financials were changed accordingly").

6. See *Banca Cremi, S.A. v. Alex Brown & Sons Inc.*, 132 F.3d 1017 (4th Cir. 1997), (court upheld dismissal of claims against a broker who sold collateralized mortgage obligations to the plaintiff, a foreign bank, finding that the plaintiff bank was a sophisticated investor, held \$5 billion in assets, had "extraordinary" investment experience, and had employees with business expertise and background in the industry); *In re Apple Computer Securities Litig.*, 886 F.2d 1109, 1115 (9th Cir. 1989) ("We conclude that in a fraud on the market case, the defendant's failure to disclose material information may

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