

The eMagazine for the Coalition for Mortgage Industry Solutions (“CMIS”)



# CMIS

## focus

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“Zone of Insolvency” Meets the “Zone of Coverage” in the Mortgage Meltdown”– By Richard Ivar Rydstrom, Esq., Chairman, Coalition for Mortgage Industry Solutions

#### Conference & Webinar Corner:

The American Legal & Financial Network (AFN): On behalf of the members of the AFN we invite you to attend its 7th Annual Leadership Conference. The theme of this year’s event is “New Growth for a New Beginning.” The conference dates are July 21, 22, 23, and 24. For more information go to: [www.e-afn.org](http://www.e-afn.org)

**Highlights in our next issue of CMIS Focus:** Insurance Coverage Traps; Operating in the Insolvency Zone, Home Affordable Modifications; Home Affordable Refinances; Principal Reduction Mods, B.K. Cram Downs and more.



## The AFN Bankruptcy, Foreclosure & REO Legal Watch

*AFN key legal and practice updates*

Bankruptcy Watch - Carolyn A. Taylor, Esq.  
Foreclosure Watch – Cynthia Nierer, Esq.  
REO Property Preservation Watch – Robert Klein, CEO Safeguard Properties

## Tidbits, Facts, & Updates

**REO Property Preservation:** Lack of communication between servicers and municipalities can result in substantial fines and an order to make expensive repairs says **Robert Klein**, CEO of **Safeguard Properties**, Brooklyn Heights, Ohio. Mr. Klein is quoted in detail in an MBA News Link article on this topic entitled: REO Properties a Sticking Point for Servicers, Municipalities located at: <http://www.mortgagebankers.org/tools/FullStory.aspx?ArticleId=1690>

**Principal Reduction & Re-Default Rates:** Re-default rates are rising for most, however American Home Mortgage (AHM) with its aggressive principal reduction program has seen a lowering of its re-default rates to some 20% while the industry average is hovering around 45-55% (OCC, OTS). AHM has proven that its leader, **Wilbur Ross**, expressed viable principal reduction modification remedies in his keynote discussion with Chairman Richard Rydstrom at the CMIS Executive Summit in DC (2008). The next step would be to activate the “liquidity creating” portion of the remedy by selling insured pieces, and/or add a reduction or quarantined device that does not result in capital ratio impairment write-offs ([www.qbiesam.com](http://www.qbiesam.com)). **Litton Servicing** reports use of principal reduction modifications in 33% of its modifications to reach 31% DTI (long before the new guidance on same). **Ocwen** is also reportedly using principal reductions with regularity. The FDIC/IndyMac principal forbearance modification model implemented by **Chairman, Sheila Bair** is hopeful as a national model but the FDIC projects that 30% of the restructured loans will re-default. More than 50% of the “modified” loans in 2008 will re-default within 6 months (Office of the Comptroller of the Currency). “There should be national standards for servicers to follow, but it’s not by itself the answer,” says Economy.com’s **Mark Zandi**. He thinks the FDIC is on the right track but needs to change much of the program to make it suitable for wider use. “Mortgage lenders and homeowners won’t take advantage of the program unless principal write-downs are shouldered at least in part by taxpayers.” (Forbes, Desmond, Feb 10, 2009). **First American Loan Performance** data shows that principal reduction itself is not the determining factor in reducing the re-default rate. However, lowering the monthly “payment” sufficiently by whatever means (i.e.: Interest Rate, 40 year term extensions, Principal Reductions, etc.) will greatly reduce the re-default rate. Both modifications with principal reductions of some 10 or 20% had re-default rates of 30% or 28% within 6 months, respectively. **However, when payments decreased by 20% or more the re-default rate was only 21%.** When payments were lowered only 10-20% the re-default rate was 49%. Fitch Ratings reports that servicers are expanding their loan modification programs to include principal reductions. **Diane Pendley** (Fitch) is quoted as saying “*Some combination of payment reduction and either principal forbearance or forgiveness may be the most effective approach to mortgage modifications, as it may increase borrower ability and willingness to repay the modified amounts*” (quoting Servicing Management March 2009). Guest speaker at the

CMIS Executive Summit in DC (June, 2008), **Richard H. Neiman**, Superintendent of Banks for the State of New York, was a signatory to a joint letter sent to **John Dugan** (U.S. comptroller of the currency), and **John Reich** (Director OTS) along with The State Foreclosure Prevention Working Group (12 state attorneys general, headed by **Attorney General Tom Miller**), **Sarah Bloom Raskin** (Maryland Commissioner), and **Mark Pearce** (Deputy Commissioner of Banks, North Carolina). In a nutshell the letter stated that the industry has done too little to modify unaffordable loans, as reported by Servicing Management March 2009.

**GSE Litigation Waivers:** The Streamlined Loan Modification program brought with it homeowner waivers buried in its requirements. These litigation waivers required homeowners to sign away their rights to sue including predatory lending rights, in return for an acceptance into the program. **Rep. Barney Frank** (D-Mass.) has objected to such practices. Frank was quoted as saying: “I can pretty much guarantee you that we will have put an end to that within a few days.” Fannie Mae and Freddie Mac have discontinued the waivers. This situation only emphasizes the great and ripe need for a voluntary opt in settlement program ([www.optinsettlement.com](http://www.optinsettlement.com)) wherein all parties to the mortgage transaction can receive adequate consideration for reaching true borrower (monthly) affordability in return for mitigation of lawsuit exposure and risks ([www.litigationfreezone.com](http://www.litigationfreezone.com)).

**Streamlined Modification Program:** Treasury Guidance on March 4, 2009 of the *Home Affordable Modification Program* (HAMP) ([www.financialstability.gov](http://www.financialstability.gov)) effectively discontinued the streamlined modification program. Freddie Mac announced that HAMP replaced the streamlined modification program. Freddie Mac announced on March 4, 2009 in its Single Family Advisory, that HAMP: Reduces the monthly mortgage payment to no greater than 31 percent of the borrower's gross monthly household income; Requires free HUD-approved counseling for borrowers with monthly total debt-to-income ratios equal to or greater than 55 percent; Provides incentives to borrowers and Servicers for successful modifications and ongoing timely payments.

**Hope for Homeowners (H4H) Short Refinance Program:** The initial H4H program is widely regarded as a failure. “Less than two months after the program’s unveiling, however, application totals for H4H were dismal – fewer than 100, according to reports.” Efforts to revise it are under way including H.R. 384. (Servicing Management Feb. 2009 “Reinventing H4H: Can Further Tweaks Encourage Participation?”)

**Law or Case Cites to Remember:** “This Court further holds that the lender who has brought this proceeding to foreclose the mortgage must demonstrate by a fair preponderance of the evidence that the mortgage was not the product of unlawful discrimination. [Since it is the lender-plaintiff who seeks equitable relief from this Court, the onus is upon the lender to satisfy the requisites of equity and come to this Court with “clean hands.” *Junkersfeld v. Bank of Manhattan Co.*, 250

A.D.646 (1st Dept. 1937). This is a threshold action is of no moment."

"The judge further held that the foreclosure plaintiff "must demonstrate by a fair preponderance of the evidence that the mortgage was not the product of unlawful discrimination," and that "[i]f the lender is unable to do so, the foreclosure proceeding will be dismissed and the lender left to its remedies at law."

Interestingly, the judge also cited to *EquiCredit Corp. v. Turcois*, 300 A.D.2d 344 (2d Dept. 2002), noting the ruling in that case as "counterclaims alleging reverse redlining practices in claimed violation of the Equal Credit Opportunity Act and the Fair Housing Act dismissed for failure to show that the mortgagors qualified for the loans in question as required pursuant to these statutes."

Richard Rydstrom, Chairman

## The CMIS/AFN June 2008 Executive Leadership Summit Webinar is Available for Viewing



The AFN filmed the Executive Leadership Summit on June 17, 2008 for the Coalition for Mortgage Industry Solutions ("CMIS"), hosted by Dickstein Shapiro in DC. The AFN developed a Webinar of the Summit which aired over three days on September 24-26, 2008. If you are interested in viewing this webinar, send an email to Matt Bartel, Chief Operating Officer, American Legal & Financial Network (AFN) located at 12400 Olive Blvd., STE 555 St. Louis, MO 63141 Phone: 314-878-2360 Fax: 314-878-2236 [mbartel@e-afn.org](mailto:mbartel@e-afn.org).

### The breakdown for CMIS Webcast was as follows:

1. Introduction/ Welcome - (30min) Overview of the Crisis and State of the Marketplace
  - Michael E. Nannes, Chairman, Dickstein Shapiro, LLP
  - Richard Rydstrom, Esq., CMIS
  - Andrew Sherman, General Counsel, CMIS
2. Keynote: w/Richard Rydstrom moderating (30min)
  - Wilbur L. Ross, Jr., Chairman & CEO, WL Ross & Co. LLC
3. Panel One: Impact on Capital Markets, Financial Institutions, Consumer and Communities (1hr)
  - Moderator: David W. Dworkin, CEO and Founder, Affiniti Network Strategies, LLC
  - Douglas G. Duncan, Vice President and Chief Economist, Fannie Mae
  - Richard H Neiman, Superintendent of Banks, New York State Banking Department

- Rick Sharga, Vice President Marketing, RealtyTrac, Inc.
4. Luncheon Keynote Speaker (45 min)
    - Marc H. Morial, President and CEO, National Urban League, former Mayor, City of New Orleans, Former President of the U.S. Conference of Mayors
  5. Panel Two: Loss Mitigation- Workouts that Work (and Those that Don't) (1hr)
    - Moderator: Richard Rydstrom, Esq., CMIS
    - Bruce Dorpalen, Co-Founder, Director of Housing Counseling, ACORN Housing Corporation
    - Arnold Gulkowitz, Partner, Bankruptcy Practice, Dickstein Shapiro, LLP
    - Patricia A. Hasson, President, Consumer Credit Counseling Services of Delaware
    - Steve Horne, President, Wingspan Portfolio Advisors, LLC
    - Andrew Jakabovics, Associate Director for the Economic Mobility Program, Center for American Progress
    - Laurie Maggiano, Deputy Director, Office of Single family Asset management, U.S. Department of Housing and Urban Development
  6. Panel Three: Charting a Future Course- The Case for Self-Regulation (1hr 15min)
    - Moderator: William LeRoy, CEO, American Legal and Financial Network (AFN)
    - R.K. Arnold, President and CEO MERSCORP, Inc.
    - Francis P. Creighton, Vice President of Legislative Affairs, Mortgage Bankers Association
    - Henry E. "Hank" Hildebrand, Chapter 13 Trustee
    - Robert Klein, Chief Executive Officer, Safeguard Properties
    - Hon. Raymond T. Lyons, U.S. Bankruptcy Court, District of New Jersey
    - Debra L. Miller, Chapter 13 Trustee
    - George W. Stevenson, Chapter 13 and 7 Trustee
    - Carolyn A. Taylor, Partner, Hughes, Watters & Askanase
  7. Closing Keynote (15 min)
    - Congressman Thaddeus McCotter (MI-11)

We express our gratitude to the support of our Panelists, Guest Speakers, Keynote Speakers Wilbur Ross, Congressman McCotter, Marc H. Morial (CEO NUL), our summit quests, and participants, the CMIS Summit Executive Team, MortgageOrb and John Clapp, and contributing SPONSORS:

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## New AFN Webinar Hidden Gems: Reconciling New Laws, Rules & Best Practices Guidance is Online



*AFN Webinar*

### Webinar Now Online –

Join the AFN for a SPECIAL BROADCAST entitled **“Hidden Gems: Reconciling New Laws, Rules & Best Practices Guidance”** recorded on October 22, 2008, as Richard Ivar Rydstrom delivers his 2<sup>nd</sup> update of the current changes in law, rules, regulations, and best practices guidance including new principal forgiveness solutions such as QBieSam™ Modifications, which is receiving widespread industry support.

CRITICAL ISSUES for discussion include:

- 1) \$700B Plus Rescue Law: HR 1424
- 2) \$300B Voluntary Short Payoff Refinance Law: HR 3221
- 3) SEC & FASB New Guidance: FAS 157 Fair Value
- 4) Wilbur Ross Solutions: Principal Forgiveness and New Insurance Guarantees
- 5) New Principal Forgiveness Modifications without Loss Write-Offs!

If you are interested in viewing this webinar, please click on the clip from the Summit or send an email to Matt Bartel, Chief Operating Officer, American Legal & Financial Network (AFN) located at 12400 Olive Blvd., STE 555 St. Louis, MO 63141 Phone: 314-878-2360 Fax: 314-878-2236 [mbartel@e-afn.org](mailto:mbartel@e-afn.org).

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## Feature Articles

### REO Property Preservation Watch – Robert Klein, CEO Safeguard Properties

#### Addressing copper theft to combat urban blight

By Robert Klein, CEO Safeguard Properties

Across the country, in cities large and small, our company has witnessed what newspapers and police blotters have reported -- significant increases in metal theft from vacant properties, with copper as a prime target.

The rise in thefts is fueled by scrap metal prices that have doubled and even tripled in some markets during the past three years because of growing demand.

The opportunity to make money stealing and selling scrap metals has been so compelling that thieves have risked death, serious injury and jail time to strip metals from city streets, cemeteries, new construction sites and, where it impacts our industry the most, vacant homes.

Metal thefts not only are dangerous for criminals, they create serious hazards for entire neighborhoods when thieves break working water and gas lines and cut live electrical wires to reach copper components.

Theft of copper and other metals in vacant houses contributes significantly to urban blight. While metals stripped from one home in less than an hour can bring hundreds of dollars through a scrap dealer, the cost to repair the damages left behind can run into the thousands.

Especially in struggling neighborhoods, when homes are stripped of their metals, they are also stripped of any value after thieves tear up floors and punch man-sized holes into walls to gain access to copper pipes. Stolen plumbing often causes severe water and flood damage, and the theft of electrical wiring increases the risk of fire.

In fact, metal-stripped properties often end up with negative value because demolition costs can range from \$5,000 to \$10,000, depending on the market and the size and condition of the property. Many property owners simply abandon these homes, leaving neighbors and cities to deal with the resulting nuisance and eyesore.

#### Deterring thieves and protecting properties

Cities, neighborhood groups and the mortgage industry have tried many ways to deter metal thieves because of the devastation they leave behind. Increasingly, cities and states have begun to consider and enact legislation requiring scrap dealers to obtain proof of ownership for certain high-theft metal items, and to increase their record-keeping and reporting.

Community and block organizations have strengthened neighborhood watch groups and stepped up efforts to educate neighbors and encourage them to be more vigilant in watching for and quickly reporting suspicious behavior at vacant homes in their neighborhoods.

Likewise, the mortgage and field services industries have routinely taken steps to deter metal thieves and better protect properties from the devastating damages they wreak.

First and most obvious, the simple fact that lenders and servicers utilize field service companies to inspect, maintain and secure vacant properties is a strong deterrent. Thieves are less likely to target properties that appear to receive regular attention, and that have been secured by field service professionals.

## Vacant property registration ordinances

Field servicers are always seeking better ways to secure and protect properties on behalf of their clients. For example, Safeguard Properties recently announced a Good Neighbor Door Hanger program to combat thefts and other problems at vacant properties under management.

Under this program, once a property has been secured, in addition to placing a sticker on the front door of the property with emergency contact information, as is standard in the industry, Safeguard will visit neighbors to let them know that the company is managing the property. A door hanger with 24-hour emergency contact information is provided so neighbors can alert Safeguard if an issue arises. It is hoped that this program will encourage neighbors to be more vigilant in watching vacant properties and providing an early alert to report suspicious activities and deter thefts and vandalism.

One of the best ways to protect a vacant property is to give the appearance that it is occupied. While plywood boarding placed over doors and windows that have been breached is effective in keeping properties secure, it is not aesthetically appealing and makes it more obvious that a property is vacant.

Among the initiatives being tested in the industry is artistic boarding, in which plywood boards are covered or painted to give the appearance of actual window panes and doors so that vacant homes are not as obvious and offer a more attractive appearance among other homes in the neighborhood.

Similarly, the industry is upgrading the service packages on post-foreclosure REO properties, as they languish longer on the market and compete increasingly with traditional market homes. For servicers and investors, these homes are even more important to protect from the destruction caused by metal thieves because additional dollars have been invested in them to prepare them for market.

Upgraded services to REO properties include maintaining the exteriors to a neighborhood standard to make them appear occupied, thus deterring theft and vandalism.

The industry also has increased outreach efforts to open lines of communications nationwide with code enforcement officials. An important component in this initiative has been to provide an easy way for code enforcers to obtain contact information for mortgage lenders and servicers. An updated listing for the majority of lenders and servicers is now available through the Mortgage Bankers Association Web site, under its Property Preservation Resource Center ([www.mortgagebankers.org/propertypreservation](http://www.mortgagebankers.org/propertypreservation)).

As a result, when properties experience problems, code enforcers can more quickly identify the person responsible for maintaining a vacant property on behalf of the mortgage lender or servicer. This assures that issues can be addressed quickly and that properties remain safe and secure.

A recent and growing effort by cities has been to enact vacant property registration ordinances, largely in response to increased vandalism and the blight that results when these properties remain unattended. The ordinances allow city officials to reach responsible parties and hold them accountable when code violations occur.

While the industry supports the concept of the ordinances and understands the need for cities to take action, based on our experiences in the field, we believe many of the provisions in ordinances enacted around the country actually have the potential to create consequences that are more severe than the problems they are attempting to address.

This is why mortgage servicers and field servicers have formed a National Vacant Property Registration Committee under the Mortgage Bankers Association to offer our expertise to assure that cities enact the most effective ordinances possible.

With respect to thefts of copper pipe and other metals, the committee has attempted to discourage cities from enacting provisions that draw more attention to the fact that a property is vacant, or that require the installation of materials that are particularly attractive to thieves.

For example, some ordinances require that a large sign be posted in front of a vacant property, readable from the street, identifying a point of contact in case of emergency. The sign itself is more likely to draw criminal behavior, as it identifies the property as vacant. Better alternatives already are in place to identify contacts in a timely manner.

Other provisions under consideration have called for responsible parties to install exterior lighting to vacant properties, or to install metal panels as a more attractive alternative to plywood on doors and windows. In both cases, the lighting and the panels themselves are desirable items for thieves to steal for their scrap value. Artistic boarding, as an example, may be a better option to address the aesthetics and security concerns at the same time.

It is unfortunate but true that even vacant properties under management by field service professionals will become targets of thieves looking to score large quantities of scrap metal for fast profit.

However, working together as an industry, and by reaching out to cities to address the challenge in a spirit of cooperation, our hope is to help deter criminals and minimize damages so that vacant properties can remain viable and return to family homeownership as quickly as possible. There is no better way to combat vacant blight and preserve and maintain the integrity of neighborhoods across the country.

*Robert Klein is CEO of Safeguard Properties, the largest privately held mortgage field services company in the U.S.*

## Bankruptcy Watch – Carolyn A. Taylor, Attorney

The First Circuit Court of Appeals reversed the bankruptcy court's award (affirmed by the district court) of \$250,000 for emotional distress and \$ 500,000 in punitive damages against Ameriquest in the Nosek case, concluding that the alleged failure to "account for and properly distinguish between pre-petition and post-petition payments" and "...[its] inability to promptly credit (Nosek's) account from the suspense account.. " neither violated Bankruptcy Code § 1322(b) nor the debtor's confirmed chapter 13 plan. A copy of the opinion is attached.

The Massachusetts Bankruptcy Court relied upon its authority under Bankruptcy Code § 105(a) to enforce the Code and court orders and to prevent abuse of the bankruptcy process stating that a significant damage award was necessary to gain the attention of this national mortgage company that uses the "same accounting system is servicing all of its Chapter 13 debtors, which shows how widespread the problem could potentially be."

In vacating the lower court judgments, the First Circuit held that (i) the plain language of § 1322(b) is permissive not mandatory and offers the debtor flexibility in forming a plan by listing elements that may be included, but does not impose obligations on any party, including the lender; and (ii) while the confirmed plan provided that the debtor "continue to make the regular monthly payments in accordance with the contract with the Mortgage," and pay the pre-petition arrearage through the plan over sixty months, it did not place any specific accounting or payment allocation obligations on Ameriquest; and (iii) the debtor failed to demonstrate that Ameriquest's accounting practices precluded a financially advantageous refinance or caused her any economic harm such as the imposition of late fees or finance charges or threatened the right to cure a pre-petition default; and (iv) absent specificity in the plan relative to payment application, the Court 's legitimate concerns did not justify its the remedy it invoked under § 105.

Indeed, the harsh sanctions award\* entered by the bankruptcy court may have been excessive in view of the specific facts in Nosek: this was the third bankruptcy case filed by the debtor in a two year period; the two prior bankruptcy cases were dismissed on the Trustee's motion for failure to provide requested information; the debtor defaulted under an Agreed Stay Relief Order in the third case and a notice of stay termination was filed with the court; Ameriquest maintained two accounting systems, one through a computer program that tracked only contractual due dates regardless of whether a payment was pre-petition or post-petition and the second done manually by a bankruptcy specialist who accounted only for post-petition due dates; the servicer's "suspense" account served as a "collection bucket" to accept and hold partial payments that would otherwise be returned to the borrower.; and the third amended plan filed while the appeal was pending provided that the "Court

ordered payment by Ameriquest Mortgage in the amount of \$ 250,000 (would) fund 100% (of) this Chapter 13 plan."

Clearly, the reversal in the Nosek case is a welcome change for lenders and servicers confronted with an increasing number of bankruptcy judges who have not only expanded their oversight role to proactively change mortgage servicing practices but also extended their involvement through conclusion of the bankruptcy case (notwithstanding earlier stay termination). [\*originator/servicer-\$250,000; foreclosure law firm-\$ 25,000; partner, foreclosure law firm-\$ 25,000; national outsourcing law firm-\$ 100,000; current servicer-\$ 250,000; 2 associate attorneys in foreclosure law firm and associate attorney in new law firm-warning.]

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Bankruptcy Law (1985); Business Bankruptcy Law (1989)*

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## Foreclosure Watch – Cynthia Nierer, Attorney

Standing - The issue de jour.

Whether you call it the sub-prime implosion or the bursting of the bubble—it all equates to the same thing. Trouble for the economy...trouble for the mortgage industry. For over a year now, the country and the mortgage industry have been dealing with the repercussions of the housing boom and bust. As mentioned earlier, all levels of government have heeded the call of their constituents and have (in one fashion or another) attempted to right the “wrong” that has been done. Whether you agree with it or not, well, that’s not the issue. The reality is, government has become involved in the mortgage plight and that is the reality those in the mortgage industry must accept in order to move forward.

Judicial scrutiny by the courts has been on an ever increasing rise this past year. Unopposed motions are no longer just accepted as accurate. Judges are raising issues sua sponte (on their own)...raising defenses not raised by the borrowers. And, in some cases, changing the “rules” in the middle of the inning. One needs to look no further than the issue of standing to see the truth behind this. Across the country, standing has become one of the “hottest” issues focused on.

Simply put, standing is the legal right to bring a lawsuit. There are 3 basic requirements: 1) there must be an injury, 2) the injury must be reasonably connected to the defendant’s conduct and 3) there must be a likelihood of success. It is important to note at this juncture that a party may only bring a suit based upon his/her own rights. One cannot bring suit

based upon the rights of another.

So, with the above being said—what has that got to do with foreclosures? Well, plenty. Loan transfers between lenders/servicers—whether it is one loan or 100—are not an anomaly in this industry. It is a regular practice. Along with loan transfers, it is no secret that not all lenders/servicers will have a complete chain of mortgage assignments upon the receipt of a loan(s) or even upon referring same out to a foreclosure attorney. An assignment of mortgage is evidence of the transfer of interest from one bank to another.

It is this assignment of mortgage that proves that the lender/servicer now owns loan “A”. And, it is this assignment of mortgage that proves that the lender/servicer has standing—the right to bring suit against a defaulting borrower. Take this example: Bank A gives a loan to borrower. The loan is sold to Bank C. Borrower defaults. Bank C refers the matter to their attorney for foreclosure. Attorney commences the action in the name of Bank C. In order to prove to the court that Bank C is the owner of the mortgage and is the proper party plaintiff, the assignment of mortgage evidencing the transfer must be provided to the court.

Depending upon the jurisdiction, how and when a copy of the assignment of mortgage must be provided to the court will vary. Many times, same is not needed at the commencement of the foreclosure action. The typical course of action has been for the foreclosure to be initiated and, when required, the assignment provided to counsel who then provides same to the court. In many instances, the assignment of mortgage would be dated sometime after the date of the actual transfer of interest and the date the foreclosure action was commenced. However, same usually contain an “effective date”. This date was a date prior to the commencement of the foreclosure action and was generally associated with the date of the loan transfer.

It is important to remember that the assignment of mortgage is proof positive to a judge that the party who initiated the lawsuit had the right to do so and, as such, has standing. If the plaintiff in the foreclosure action doesn’t match the entity in the assignment of mortgage—well, there is a real problem. Yet, that is not the only situation that the mortgage industry is running up against in courts across the nation. The issue is generally not one of who is listed in the assignment (though that is very important!) but when the assignment was executed. And, in some cases, it goes a step further. Not only is the question when was the assignment executed, but when was it recorded.

Across the nation we are seeing a plethora of decisions being handed down and actions being filed claiming that the lender/plaintiff initiating the foreclosure action lacked standing to do so. Below is just a sampling of same—examples of what has been happening and an precursor to what is yet to come.

Take, for instance, one of the first cases in New York State to rock the mortgage industry on the issue of standing. In

*Countrywide Home Loans, Inc. v. Taylor* (NY Supreme Court, Suffolk County, 843 N.Y.S.2d 495) the borrower defaulted and the bank proceeded to move forward with a foreclosure action. The borrower failed to appear in the action and the bank moved forward with an application for an Order of Reference. The judge, on this unopposed motion, denied same as the plaintiff lacked standing.

In denying the motion, the judge noted that the assignment of mortgage was dated after the commencement of the foreclosure action but had an effective date prior to commencement. He stated that the effective date within the assignment of mortgage was insufficient to establish the plaintiff’s ownership interest at the time the action was commenced. As such, the assignment needed to be fully executed prior to the commencement of the foreclosure action.

While the legal issue of standing is of great import, it is also important to realize what else happened here. Standing is typically an affirmative defense raised by the defendant—there was no answer filed by the defendant in this case. The court itself raised this issue.

It is worth mentioning at this point that there is no statute in New York which requires an assignment be dated prior to the date the foreclosure is commenced. Moreover, there is an Appellate Division case which actually holds the contrary. In *Bankers Trust Company v. Hoovis*, 263 A.D.2d 937, the Appellate Division specifically held that without proof showing otherwise, the effective date within the assignment of mortgage (which was a date prior to the commencement of the foreclosure action) is proper and plaintiff was found to have standing. Yet, despite this, judges in the Supreme Courts of New York continue to hold otherwise.

The level of judicial scrutiny and the relevance to the issue of standing can be further seen in the case of *Aurora Loan Services, LLC v. Sattar*, 17 Misc.3d 1109(A), Kings Co 2007. Abdul Sattar gave a mortgage naming Mortgage Electronic Registration Systems Inc. as mortgagee of record and as nominee for First Magnus Financial Corporation. The borrower defaulted and a foreclosure action was commenced. The complaint stated that the note and mortgage had been assigned to Aurora. Plaintiff made an application for an order allowing service by publication as the borrower could not be located.

Upon reviewing plaintiff’s application, the judge conducted his own investigation. He viewed the website for the recording office and ascertained that there was no assignment of mortgage on record to Aurora or any other entity. His decision stated that in a foreclosure, the plaintiff must not only establish the existence of the note and mortgage but ownership of same. Here the court found that Aurora lacked standing to bring the lawsuit as there was no documentary evidence before the court supporting the claim that the mortgage had been assigned to Aurora. The judge also found that commencing an action by the “wrong” plaintiff was frivolous and a waste of judicial resources. He cautioned that any such waste in the future would result in sanctions being

imposed against the attorney and the named plaintiff.

Cases such as the above, have definitely affected the handling of foreclosure actions in jurisdictions where such holdings have been handed down. Having a complete assignment chain prior to the commencement of a foreclosure action is becoming the norm in many jurisdictions. In some, having a complete and recorded assignment chain is becoming the standard. In the above cases, the courts raised the standing issue on behalf of borrowers. However, the issue of standing is by no means being ignored by borrowers and/or their attorneys. Within the past year we have seen the filing of several class action lawsuits directly dealing with the issue of standing and assignments of mortgage.

Take the class action lawsuit, *Whittiker v. Deutsche Bank National Trust Company, et al.* (US District Court, Northern District of Ohio, Eastern Division; Docket# 1:08-cv-00300-DDD). The borrower/plaintiffs allege that the defendants (bank and foreclosure attorneys) filed foreclosure actions without the benefit of valid, recorded assignments of mortgage (the borrower/plaintiffs claim that recording of the assignment is required). The main contentions in the complaint are that: 1) defendants violated the Federal Fair Debt Collection Practices Act, 15 U.S.C. Section 1692e by making misleading representations concerning defendants' ability to sue and interest in the debt, and 2) that same is in violation of the Ohio RICO (R.C. Section 2923.32) in that by knowingly filing complaints where they did not own the note and mortgage, defendants conduct equates to a pattern of corrupt activity.

This case is still pending and at the time of this writing it is still in the discovery stages. The ultimate outcome is extremely important to the mortgage industry. The borrowers are not just looking for a motion to be denied or a case dismissed. They are seeking actual and statutory damages, including treble damages. In addition, they are requesting the appointment of a receiver to recover from the bank the charges collected from the borrowers, any interests in real property it acquired "illegally", reimbursement of any fees paid to the law firms and to determine the allocation of the funds and property interests.

Similarly, *Graham v. Kochalski, LLC, et al.* (United States District Court, Southern District of Ohio, Eastern Division; Docket# 2:08-cv-00120-GCS-TPK) is another pending class action lawsuit of great concern to the mortgage default industry. This class action lawsuit began with a foreclosure action commenced against Graham. While the bank and its attorney represented that the bank was the holder of the note and mortgage (and had standing to sue) borrower/plaintiffs allege that the bank did not have a valid, recorded assignment of mortgage. The suit alleges violation of the Ohio Consumer Sales Practices Act (Ohio Rev. Code Section 1345.01) and the Fair Debt Collection Practices Act (15 U.S.C. Section 1692).

Similar to *Whittiker*, above, this case is still pending. The outcome can have a major impact on the mortgage industry as

well as the individual defendants. As above, the borrower/plaintiffs are seeking actual and statutory damages. No discussion of standing would be complete without including MERS. In the class action lawsuit, *Jackson, et al. v. Mortgage Electronic Registration Systems, Inc., et al.* (U.S. District Court Minnesota, Docket# 0:08-cv-00305-JNE-JJG), the borrower/plaintiffs alleged that MERS violated state law by failing to record all assignments of mortgage prior to commencing a non-judicial foreclosure as per Minn. Stat. Section 580.02 (2006). Additionally, the plaintiffs claim to have been served with a Notice of Foreclosure Sale naming MERS as the mortgagee. They allege that said Notice failed to list all assignments of mortgage as required by statute (Minn. Stat. Section 580.04).

The District Court certified the following question to be resolved by the Supreme Court: "When MERS serves as mortgagee of record as nominee for a lender and that lender's successors and assigns, and the original lender subsequently sells, assigns, or transfers its rights under the mortgage, has there been an assignment of the mortgage that must be recorded pursuant to Minn. Stat. Section 580.02 (2006) before MERS can commence a foreclosure by advertisement?" Oral argument before the Supreme Court is currently scheduled for September 10, 2008. Not only is the concern about foreclosures going forward—but what about all the foreclosure sales already held and the properties that were transferred?

It is extremely important to realize exactly what the above represents. Standing is a legal requirement and must be complied with. Yet, more than a legal issue—the above cases represent and signify the judicial mindset across the nation.

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## **SUB-PRIME MORTGAGE CRISIS: THE LEGAL**

### **BUSINESS FALLOUT**

#### ***PINK SLIPS, ATTRITION & REDEPLOYMENT***

**By Andrew J. Sherman and  
Dickstein Shapiro LLP**

Michael Milken, the director of low-grade bond research at Drexel, Burnham and Lambert, once remarked that investment in the corporate debt markets often reflected a "herd instinct" i.e. investors stuck solely to investment grade securities. This herd instinct, according to him, was flawed in several ways. His attribution to the instinct of investors as herd-

like was made while he advocated the use of “junk bonds”<sup>1</sup> as a debt instrument. Encouraging investors to look at qualitative considerations such as management’s ability and its vision of the future rather than sticking to the size, historical record and industry position of the company, he was successful in “fueling the growth of the junk bond market.”<sup>2</sup> A similar event occurred in the early part of the 21<sup>st</sup> century when the “housing boom”<sup>3</sup> encouraged a heavy spiraling in sub-prime mortgage lending<sup>4</sup>. This increase saw a parallel increase in the securities offered through a pooling of such sub-prime mortgage loans through the process of “securitization”.<sup>5</sup> Investors moved from buying pooled mortgage loans securitized and sold on the backing of full faith and credit of government<sup>6</sup> and quasi-government agencies<sup>7</sup> to what is referred to as “non-agency transactions” i.e. one where the willing investor undertakes the risk of the underlying mortgage loan.<sup>8</sup> Such a transaction consisted of

issuance of securities out of a pool of mortgage loans without any backing of governmental funds. The “contagion gripped the financial markets”<sup>9</sup> and the herd instinct manifested itself in a situation where investors jumped in significant numbers to take advantage of the booming housing market that prevailed in the early years of the new millennium. Capital markets engaged in technological innovations for the riskier category of investors;<sup>10</sup> something like a “diverse maturity mortgage product”<sup>11</sup> which led to pooling of mortgage loans with varied credit rating into securities. Many conditions conducive to sub-prime lending and securitization of such loans induced investors to take the risk of investing in such loans. The expectations contained in these risks did not materialize and fears of a looming economic crisis that might result from numerous delinquencies for such loans lay large not just in the United States, but all over the world.

A sub-prime borrower has been defined by the 2001 *Interagency Expanded Guidance for Subprime Lending*

*Programs* as one who displays a range of credit risk characteristics on a general basis which includes, *inter alia*, two or more 30-day delinquencies in the last 12 months, judgment, foreclosure, repossession or charge-off in the prior 24 months, bankruptcy in the last 5 years or a debt service-to-income ratio of 50% or greater<sup>12</sup>. The reasons for an increase in lending to

<sup>1</sup> Junk bonds are essentially high yielding bonds rated below investment grade; usually having a lower credit rating of BB+ or less according to the rating of Standard & Poor

<sup>2</sup> Mitchell, Cunningham & Haas, *Corporate Finance & Governance*, p 342, 3d edition, Carolina Academic Press

<sup>3</sup> See below, *Reasons Behind the Increase in Sub-Prime Loans*

<sup>4</sup> Subprime lending is lending at a higher rate than the prime rate i.e. the interest rate normally charged for “prime borrowers”. The borrowers in a subprime lending are referred to as “subprime borrowers”; generally borrowers with poor credit history. A sub-prime borrower is one who has a high debt-to-income ratio, usually an impaired credit history, or other characteristics that are correlated with a high probability of default relative to borrowers with good credit history. For further explanation, see below, n. \_\_\_

<sup>5</sup> Securitization is the creation and issuance of debt securities whose payments of principal and interest derive from cash flows generated by separate pools of assets. From an accounting perspective, securitization can be explained as the process of removing loans from the balance sheet of lenders and transforming it into debt securities that can be purchased by investors. In the case of mortgages, securitization is the process of turning pools of home loans into bonds, which are generically referred to as mortgage- backed securities (MBS).

<sup>6</sup> Government National Mortgage Association (Ginnie Mae)

<sup>7</sup> Federal Home Loan Mortgage Corporation (Fannie Mae) and Federal National Mortgage Association (Freddie Mae)

<sup>8</sup> Fabozzi, Frank J. and Kothari, Vinod, *“Securitization: The Tool of Financial Transformation”*. Yale ICF Working Paper No. 07-07, available at

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=997079#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997079#PaperDownload)

<sup>9</sup> See *Securitization: When it goes Wrong*, The Economist, September 20, 2007, available at [http://www.economist.com/finance/displaystory.cfm?story\\_id=9830765](http://www.economist.com/finance/displaystory.cfm?story_id=9830765) (last visited April 10, 2008)

<sup>10</sup> Investors have different risk-return profiles based on their liability structures and objectives of their respective investors or stakeholders. There might be a yield-hungry investor looking for a BBB rated security and his portfolio might be diversified enough to account for the high risk in that security

<sup>11</sup> Gangwani, Sunil, *Speaking of Securitization*, Deloitte & Touche, July 20, 1998, available at <http://www.vinodkothari.com/gangwan2.pdf> (last visited April 10, 2008)

<sup>12</sup> As contained in Cadwalader, Wickersham & Taft, *Memorandum: Recent Interagency Expanded Guidance on*

such borrowers are varied.<sup>13</sup> First and foremost, favorable conditions existed for the residential housing market in the period between 2002 and 2005. Interest rates were low when compared to historical averages and home prices were appreciating in most markets.<sup>14</sup> For example, the appreciation rate in the third quarter of 2004 in the US housing market was a staggering 17.27% and the average appreciation rate in the years 2004 and 2005 remained around 13-14%.<sup>15</sup> This created an equity cushion for the subprime borrowers with the result that they always had the option of refinancing their loans or pulling their equity out of the properties if they experienced financial problems. Further, the underwriting criteria became more borrower-friendly. For example, a subprime borrower having a credit score<sup>16</sup> between 450 and 680 could obtain a mortgage loan with almost no down-payment. The reason for a change in the underwriting criteria can be attributed to the challenge of maintaining the affordability of home purchases. As noted above, the significant acceleration rate in house prices made house purchase less affordable for many buyers.<sup>17</sup> In order to maintain, and even increase, loan origination, lenders offered mortgage loans on borrower-friendly criteria. Additionally,

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Subprime Lending, February 8, 2001, available at [http://www.cwt.com/assets/client\\_friend/CF02-08-01.pdf](http://www.cwt.com/assets/client_friend/CF02-08-01.pdf) (last visited April 10, 2008)

<sup>13</sup> For example, in the year 2001, the origination of sub-prime mortgage loans was to the tune of \$190 billion. It increased to \$335 bn in 2003 reaching an all-time high in 2005 where the figure stood \$625 billion. Along with increase in origination, the ratio of originations to actual loans issued increased from 46% in 2001 to 75% in 2006.

<sup>14</sup> Office of Federal Housing Enterprise Oversight, News Release, House Prices Weaken Further in Most Recent Quarter, November 29, 2007, available at <http://www.ofheo.gov/media/pdf/3q07hpi.pdf> (last visited April 10, 2008)

<sup>15</sup> *Id.*, p 4 (OFHEO House Price Index for USA)

<sup>16</sup> Credit score is a numerical expression based on credit report information representing creditworthiness of the buyer

<sup>17</sup> Krinsman, Allan N., Subprime Mortgage Meltdown: How did it Happen and How will it End, The Journal of Structured Finance, Vol. XIII, No. 2 (Summer, 2007), available at <http://www.stroock.com/SiteFiles/Pub533.pdf> (last visited April 10, 2008)

limited documented proof of income and assets, relaxed monthly payments, adoption of hybrid subprime adjustable rate mortgages<sup>18</sup>, use of stated income loans<sup>19</sup>, the ability to have take a double mortgage on one's home<sup>20</sup> and use of technology for approval of mortgage loans<sup>21</sup> and were some of the key factors that were conducive to the rapid increase in subprime lending. In addition to such factors that enabled mortgage lending to be easier, there was a marked increase in securitization of subprime loans. Specifically, the number of asset-backed securities increased. For example, in 2005, the number of mortgage backed securities issued was to the tune of \$508 billion.<sup>22</sup> Such securities were usually high yield securities which generated vast amounts of liquidity<sup>23</sup> increasing the volume of credit available to subprime borrowers. Indeed, this led to an exponential increase in the work that structured finance lawyers were involved in keeping them very busy.

Originally, mortgages essentially characterized a relationship between a homeowner and a lender which could be a bank or a savings institution. The lender would decide whether to grant the loan, collect regular interest and/or principal payments or foreclose in case of defaults. In modern times, mortgage loans are pooled according to their characteristics in a

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<sup>18</sup> ARMs had a relatively low fixed introductory teaser rate and sub-prime borrowers qualified for the low rate.

<sup>19</sup> Stated income loans permitted borrowers to provide limited documentation to support their income

<sup>20</sup> The usual mortgage was for the remaining purchase price of the property after paying downpayment. In many cases, a second mortgage loan was offered for the downpayment ("piggyback" loan). It was often a home equity loan

<sup>21</sup> For example, New Century Financial Corporation used an automated internet-based loan submission and pre-approval system called *FastQual* and the period between 2000 and 2004 witnessed an annual growth rate of 59% in mortgage loans

<sup>22</sup> Source: Inside Mortgage Finance 2007, as cited in Ashcraft, Adam B. & Schuermann, Till, Understanding the Securitization of Subprime Mortgage Credit, Staff Report, Federal Reserve Bank of New York (March, 2008), available at [http://www.newyorkfed.org/research/staff\\_reports/sr318.pdf](http://www.newyorkfed.org/research/staff_reports/sr318.pdf) (last visited April 10, 2008)

<sup>23</sup> Liquidity is the ability to convert an asset to cash

way that can enable such a pool to be sold to potential investors through the process of securitization. This process includes a number of various parties<sup>24</sup> in addition to the traditional borrower homeowner and lender bank/savings institution.

The first stage is the traditional mortgage lending. The borrower obtains a loan from the lender bank or savings institution (which shall be, and is commonly, referred to as “originator”). Usually, brokers advertise the mortgage loans to prospective borrowers, evaluate the creditworthiness of the borrower, and undertake the process of loan applications to mortgage lenders. In some subprime mortgage deals, the pool of loans is purchased from the originator by the arranger/issuer. An arranger/issuer is usually an investment bank which has an expertise in dealing with securitizing such a pool. This party is responsible for structuring the deal in consultation with credit rating agencies, creating a special purpose bankruptcy-remote vehicle and undertaking necessary formalities with the SEC including sometimes, underwriting issuance of securities by the trust to investors. Most law firms having a Structured Finance practice group or a concentration on structured finance in their Finance group represented investment banks in structuring the deal. Next, the originator identifies a pool of mortgage loans that satisfy certain characteristics making them acceptable to be securitized. The underlying basis for creating a pool of mortgage loans is a probability risk distribution analysis.<sup>25</sup> This is done in a way so that the probability of suffering extreme losses due to a huge number of loans becoming delinquent is low. This concept can be analogized, though not in complete conformity, with the diversification objective of the portfolio theory<sup>26</sup> that guides a

rational investor to invest in an appropriate combination of investments considering risk and returns from the investments. The key is to understand that the more diversified the pool, the lower the probability that a loan will be delinquent and the higher the attractiveness of the security created out of the pool. The transfer of such mortgage loan receivables must adhere to an accounting technique approved by the Financial Accounting Standards Board to perfect a “true sale”, or what is descriptively referred to as an “irreversible transfer”<sup>27</sup>. Generally, the determinants of a true sale are enlisted in FASB 140<sup>28</sup>. Law firms were also involved in counseling originators or arrangers to ensure the “true sale” of receivables in accordance with the law and accounting policies.

Once the mortgage loans are pooled and a “true sale” is ensured, the pooling takes form of a debt instrument which is tradable i.e. that can be sold to private and institutional investors. The two major forms of debt instruments used in the sub-prime mortgage debt securitization were MBS (mortgage-backed securities) and CDOs (collateralized debt obligations) where the latter has different sub-categories. Mortgage backed securities (MBS) are referred to as “first-tier securitizations”<sup>29</sup> in which the collateral consists of mortgage loans pooled into a special purpose vehicle that issues various classes of securities as described above. This is in contrast to CDOs that have as the underlying collateral an investment in the cash flows of the

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explain that an investor can reduce portfolio risk simply by holding instruments which are not perfectly correlated. In other words, investors can reduce their exposure to individual asset risk by holding a [diversified](#) portfolio of assets. Diversification will allow for the same portfolio return with reduced risk.

<sup>27</sup> See Fabozzi & Kothari

<sup>28</sup> The Financial Accounting Standards Board (FASB) is an organization whose primary purpose is to develop [generally accepted accounting principles](#) (GAAP) within the [United States](#).

<sup>29</sup> Adelson, Mark & Jacob, David, [Risk Management Lessons from the Sub-prime Problem](#), p. 2 (March, 4, 2008), available at [http://www.securitization.net/pdf/Publications/Adelson\\_RiskMn\\_gmnt\\_Mar08.pdf](http://www.securitization.net/pdf/Publications/Adelson_RiskMn_gmnt_Mar08.pdf) (last visited April 10, 2008)

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<sup>24</sup> These parties are described in the Section on the Securitization Process

<sup>25</sup> See Fabozzi & Kothari

<sup>26</sup> See Harry Markowitz, Portfolio Selection, [Journal of Finance](#), 7 (1), 77-91 (1952). The diversification objective seeks to

assets rather than a direct investment in the underlying collateral. Additionally, in other CDOs, the collateral underlying them consist of mortgage backed securities as well. Thus, sometimes in a CDO, the “asset” transferred to an SPV in order to create a security instrument, is an MBS itself.<sup>30</sup> In such cases, a CDO will be issued through a securitization process, the difference being that instead of a “true-sale” of mortgage loans, a sale of such mortgage-backed securities will take place. Therefore, in contrast to ordinary sub-prime mortgage MBS instruments, CDOs are second-tier securitizations<sup>31</sup> and their dealing occurs in what is referred to as a “credit derivative market”.<sup>32</sup> A significant difference between a traditional MBS and CDO is that while the underlying collateral in an MBS is a fixed pool of real estate mortgages, CDOs are backed by varied categories of collateral that are permitted to be traded within established parameters.<sup>33</sup> One of the problems with CDOs, that understated the risks inherent in the sub-prime mortgage crisis, was that some institutions investing in such CDOs lacked the competency to monitor credit performance and estimate expected cash flows. Furthermore, from a valuation point of view, since CDO instruments are held on a mark to market basis<sup>34</sup>, the paralysis in the credit markets and the collapse of liquidity in these products has led to substantial write-downs in 2007 and are still continuing. This meant that CDOs were valued on the basis of

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<sup>30</sup> Kothari, Vinod, Securitization of Banking Assets, CBOs, CLOs and CDOs, available at <http://www.vinodkothari.com/bankloan.htm> (last visited April 10, 2008)

<sup>31</sup> See Adelson & Jacob

<sup>32</sup> See *supra.*, n 70

<sup>33</sup> See Stern, Jeffrey, Esq. and Klingenberg, Erik D., Esq., Collateralized Debt Obligations: New Technology for MBS and Other Real Estate Assets, available at

<http://www.securitization.net/pdf/mbscbo.pdf> (last visited April 10, 2008). Such parameters include geographic and industry concentration limits and debt service coverage requirements.

<sup>34</sup> Mark to market valuation means assigning a value to a financial instrument based on the current market price for that instrument.

how markets perceived the value of their underlying collateral i.e. how markets perceived the value of such cash-flows or mortgage-backed securities. The mark to market basis of valuation leads to a highly over-rated figure on the accounting statements of the investors and when the figures stand corrected through an adjustment bringing them closer to their inherent value, it results in such write-downs.<sup>35</sup> One can envisage the role of law firms in creation of such securities advising originators and investment banks at various stages as well as drafting offering circulars for the securities offered to investors. The issuer/arranger underwrites the sale of securities, with the pool of subprime mortgage loans acting as collateral, to an asset manager who is an agent for the ultimate investor. Asset managers have two roles: they conduct the credit analysis and maintain the records for the regulators and auditors. Asset managers are the “gatekeepers” of safety and quality for the portfolio managers in the credit arena.<sup>36</sup> Asset managers also retained law firms to assist them with their agency relationship with the investor.

#### Causes of the crisis

The crisis can be explained by an analogy of a stone thrown in still water causing a ripple effect. As the United States and many parts of the world have noticed, the ripple assumed a much larger form than expected and, as widely believed and substantiated, it has not stopped yet. The most striking and distinct explanation can be referred to the fact that because of the soaring of house prices and significant reduction in interest rates earlier in the decade, sub-prime lending became big business for

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<sup>35</sup> See for example, Outlook Sags Under Weighty Writedowns, available at <http://www.securitization.net/knowledge/article.asp?id=137&aid=7899> (last visited April 10, 2008)

<sup>36</sup> Rossow, Katy, The Role of Research in Money Market Investing, available at [http://www.geassetmanagement.com/us/geaminst\\_talking\\_cash\\_4q06.html](http://www.geassetmanagement.com/us/geaminst_talking_cash_4q06.html) (last visited April 10, 2008)

lenders. This encouraged people to invest in “more risky and exotic instruments”<sup>37</sup> persuading themselves that risks were not as large as warnings indicated. It is debatable whether this behavior was guided more by greed for such instruments knowing fully well the risk involved or whether the risks perceived weren’t what they materialized to be. To add to the chain of events, interest rates increased from an alarming 1% to around the 5% mark. A low U.S. federal-funds rate in response to the dot-com crash in the earlier part of the 21<sup>st</sup> century, and especially the 1% rate set in mid-2003 to counter potential deflation, lowered interest rates on adjustable-rate mortgages (ARMs) and may have contributed to the rise in U.S. home prices that continued to rise for two years subsequent to the peak of ARM originations.<sup>38</sup> After the initial “teaser” period, which enabled sub-prime borrowers with poor credit history to obtain those loans, the monthly payment is based on a higher interest rate, usually equal to an interest rate index plus a margin rate fixed for the lifetime of the loan. The increase in the US federal funds rate resulted in interest rates on both fixed- and adjustable-rate mortgage loans moved upward due to an increase in the index rate reaching multi-year highs in mid-2006.<sup>39</sup> Due to this, some of the debt instruments i.e. securities diminished significantly in value and the market for such debt began disappearing rapidly and investors were left holding debt to which it is almost impossible to attach a value.<sup>40</sup> The losses on

<sup>37</sup> I would classify MBS on sub-prime mortgage loans as risky instruments and CDOs as exotic ones on the basis of the description set out above.

<sup>38</sup> Alan Greenspan, The Roots of the Mortgage Crisis, December 12, 2007, available at <http://opinionjournal.com/editorial/feature.html?id=110010981> (last visited April 10, 2008)

<sup>39</sup> See Bernanke, Ben S., *supra n* \_\_\_\_

<sup>40</sup> Bank of America in sub-prime hit (November 13, 2007), available at <http://news.bbc.co.uk/2/hi/business/7093464.stm> (last visited April 10, 2008)

mortgages have had a big impact on the markets for mortgage-backed securities and on the financial institutions and investors who purchased securities based on subprime mortgages.<sup>41</sup> The markets in those risky and opaque and complex natured instruments dried up and became “illiquid” i.e. it became increasingly difficult to sell such instruments because of lack of willing investors and get cash to keep the wheels of liquidity churning.<sup>42</sup> Once investors realized that subprime mortgage-backed securities could lose money, they began shunning all complex securitization products. The impact of this crisis then extended beyond mortgage-backed securities to the general securities market, which many regarded as highly-liquid and secure, and to credit markets generally which caused, what is referred to as, the “credit crunch”.<sup>43</sup> This summarizes the chain of events that triggered the sub-prime mortgage crisis.

#### Impact of the crisis

The impact of the financial losses incurred by mortgage lending institutions that dealt with lending sub-prime loans to borrowers, investment banks that arranged the sale of the pooled mortgage loans to a special purpose vehicle and investors who held securities in their portfolio has been huge. Hedge funds and banks around the world purchased bonds, or risk related to bonds, backed by bad home loans in the form of C.D.O.s.<sup>44</sup> It

<sup>41</sup> See Rosengren, Eric, CEO, Federal Reserve Bank of Boston, Subprime Mortgage Problems: Research, Opportunities and Policy Considerations, p 2, available at <http://www.bos.frb.org/news/speeches/rosengren/2007/120307.pdf> (last visited April 10, 2008)

<sup>42</sup> Interview with Mervyn King, the Governor of Bank of England, (November 6, 2007), available at [http://news.bbc.co.uk/2/shared/bsp/hi/pdfs/06\\_11\\_07\\_fo4\\_king.pdf](http://news.bbc.co.uk/2/shared/bsp/hi/pdfs/06_11_07_fo4_king.pdf) (last visited April 10, 2008)

<sup>43</sup> See Schwartz, Steven, Markets, Systemic Risk, and the Subprime Mortgage Meltdown, (March 18, 2008), available at [http://www.huffingtonpost.com/steven-schwarz/markets-systemic-risk-a\\_b\\_92198.html](http://www.huffingtonpost.com/steven-schwarz/markets-systemic-risk-a_b_92198.html) (last visited April 10, 2008)

<sup>44</sup> See Anderson, Jenny & Timmons, Heather, Why a US Subprime Mortgage Crisis is felt around the world, August 31, 2007, available at <http://www.nytimes.com/2007/08/31/business/worldbusiness/31>

has run up to billions of dollars and billions in other currencies due to losses that incurred to global participants in the US subprime market. An estimate observes that banks may face up to \$300 billion of losses from the subprime credit crisis over the next 18 months. The impact of such huge losses was not just confined to its reflection on the financial statements of the affected banks. Large financial institutions and investment banks acquired subprime mortgage originators and servicers at a strikingly low price. Countrywide Financial Corp., for example, was acquired by Bank of America for a price of \$4 billion which was 53% of its valuation. Indeed, in absence of an interested acquirer, Countrywide was very well on its way to bankruptcy. Many hedge funds were wound up by investment banks<sup>45</sup> and diverse remedies were used to obtain additional capital for the huge amount of losses which included issuance of new shares and selling a portion of the stock to other entities. Those banks that simply could not be saved had to file for Chapter XI bankruptcy proceedings.<sup>46</sup>

This led to what is symbolically referred to as “credit crunch”. Credit crunch or credit crisis means a financial environment where investment capital is in short supply. It is a period where growth in debt money slows down which subsequently leads to a drying-up of liquidity in an economy. In such a situation, the banks will not or cannot lend and investors cannot or will not buy debt.<sup>47</sup> It is characterized by a reduction (usually a sudden reaction, therefore, resulting in a “crisis”) in the availability of loans or an increase (usually, sudden) in the

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[derivatives.html? r=1&fta=y&oref=slogin](#) (last visited April 10, 2008)

<sup>45</sup> For example, Bear Stearns wound up two of its hedge-funds following losses in the US sub-prime mortgage market. See, [Fed Caution shakes global shares](#), available at <http://news.bbc.co.uk/2/hi/business/6905652.stm> (last visited April 10, 2008)

<sup>46</sup> Example, New Century Financial

<sup>47</sup> See Macfarlane, *supra*

cost of obtaining a loan from the banks.<sup>48</sup> Because of the huge losses suffered by mortgage lenders and investment banks, banks in general became wary of offering credit to subprime borrowers. Because the debt instruments were both riskier and more opaque and complex, in particular the CDOs, the markets in those instruments became illiquid and the ability to sell the instruments and realize cash was diminished. The liquidity in those markets “dried up”.<sup>49</sup> This multi-dimensional drying up of liquidity characterized by diverse concerns led to what is referred to as “credit/liquidity crunch”. While this universal caution in the credit market may not necessarily have bad effects, and may even promote responsible lending, it is characterized by an increased pessimism about the creditworthiness of the participants in such a market. This has resulted in banks hoarding liquidity and making access to credit difficult.

#### Legal business fallout

The fallout due to the credit crisis in legal business around the world is perhaps selective. Indeed, a feeling would permeate across the global legal field that the credit crisis has affected the *overall* legal business. However, it might well seem counter-intuitive. It is pertinent to note that lawyers in general shall attract the same demand as they did while participating in the subprime mortgage loans and its securitization market. The difference is that there was a strong need then for transactional lawyers engaged in the structured finance practice, whereas now, the need is for lawyers active in corporate restructuring and litigation of the contentious issues arising from the crisis; in

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<sup>48</sup> There are a number of reasons why [banks](#) may suddenly increase the costs of borrowing or make borrowing more difficult. This may be due to an anticipated decline in value of the [collateral](#) used by the [banks](#) when issuing loans, or even an increased perception of risk regarding the [solvency](#) of other [banks](#) within the banking system.

<sup>49</sup> Mervyn King interview

other words, practice areas where business is boosted by a bad economy. Firms are likely to engage in “practice diversification”, “practice enhancements”, and “strategic redeployment” of certain individuals. Essentially, law firms relying on major Wall Street banks are being hit the hardest right now. Associates who specialized in private equity a year or so ago may be finding that corporate governance, bankruptcy or litigation are better practice areas, or “countercyclical practices” for them right now. For example, the statistics indicate a boom for the bankruptcy practice. In 2007, bankruptcy filings rose 38 percent, according to the Administrative Office of the U.S. Courts. The number of filings in 2007 totaled 850,912, up from 617,660 in 2006. Filings involving business debt rose 44 percent compared with 2006, from 19,695 to 28,322.

The financial reason for *fallout* is simple - fees may not be as large; deals may not be as large or complex, markets in securities like MBS and CDOs and even a significant portion of asset-backed securities are becoming illiquid after a tremendous boom until a year ago. Because the transactional work in the structured finance practice group is severely hit and a recession looms large, there is not enough work to ensure periodic fees to keep the wheels churning for those firms where concentration was heavily skewed in favor of structured finance.

It must be noted at the outset that not all firms are engaged in “laying off” their associates and counsels. Indeed, as a senior partner of a US law firm, well-known for its active involvement in the CDO market, remarks that encouraging its associates and counsel to take sabbaticals or consider a change in their practice group is *not* the quintessential pink slip layoff. Law firms around the world are cognizant of the fact that due to the “fundamental disruption in the credit markets”, there isn’t enough work to keep structured finance lawyers fully busy.

Thus, they are encouraged to be productively engaged in other practice areas till ‘market sorts itself out’. On the other hand, a managing partner at another US based law firm, also actively involved in securitization products, does concede a drop in activity and a slowdown. However, he remarks that although starting over in a new practice area can understandably cause some jitters, good lawyers can readily meet the challenge. It is, indeed, a testing time for lawyers and law firms.

Lay-offs might well be inevitable and arguably perhaps the only feasible way for law firms heavily engaged in structured finance; however, there are strategic offshoots of adopting the pink slip strategy. As a leading US law journal reports, law firms are hesitant to engage in lay-offs because of the adverse public relations consequences and a fear that they will soon find themselves short of associates, once the economy improves. Redeployment, they believe, is expected to produce a long-term benefit attaining two goals with one strategy; retain the services of associates and counsels while ensuring adequate supply in the busier practice areas. Despite these consequences, lay-offs have occurred when law firms have faced inevitability. Strikingly, one of the world's highest-grossing law firm dismissed six senior associates who worked on mortgage-backed securities in its structured finance practice in November last year. Two other firms asked associates and salaried lawyers to take sabbaticals or transfer to other departments, a move that is often seen to precede job cuts. Most lay-offs have occurred through associates and counsels leaving the firm through attrition rather than being handed pink slips. This can be attributed to the business decisions taken by these firms. For example, some firms were “bullish” in their views about the growing market a couple of years ago. They went on what can be colloquially called a “hiring spree” to handle the high volume of work. A spokesman

of a major international law firm remarks that the firm had built up capabilities in anticipation of increasingly higher levels of business activity but instead the market experienced a significant fall-off. Some firms who have not engaged in lay-offs are considered to have “learnt their lessons” from previous downturns that the United States has experienced.

However, those facing a lay-off due to the inevitability have been responsible with the otherwise negative morale effect that the lay-off brings. Some firms are very thoughtful about how they engage in lay-offs and have partners designated to help situate every person with another job. Firms recognize the reason for this “legal restructuring” and are much less likely today to cloak this action as a quality failure on the part of the associates. A question that can perhaps throw some light on improving the overall efficiency in firms around the world can be raised at this point: could the slowdown be a dazed little silver lining? A client head of a firm’s private equity group remarks that firms might also be using this slowdown as an opportunity to “raise the performance bar” and clean out the bottom 5 percent of their performers. While, firms might run the risk of playing foul when they engage in lay-offs only when alarm bells went ringing, it might turn out to be a slight blessing in disguise with an appropriate change in workforce leading to overall efficiency.

A prevailing view is that more layoffs are likely in the works. Some firms will be looking at layoffs as the impact of the capital markets continues to be felt. However, one must note the “optimistic reality” of being in the legal world – depending on the economy, there's always going to be a boom in some areas and some slower areas, but nothing comes to a standstill. The key advice, and seconded by authors of this article, comes from chairman of a national law firm consultancy. In the crisis that

shook the United States in the 1990s, many firms “cut too deep” and paid a price when the economy came back. There is a sensible need to maintain a base of “bench strength” which is a balancing act that the personnel management of law firms must ensure to face the tides of the economy. The advice really is to ensure the right balance. Viewing this fallout similar to perceiving a glass half-full rather than half-empty, the slowdown comes as a challenge to law firms to engage in some strategic restructuring and having appropriate cushion for their long-term survival and, thereby, growth.

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**“Zone of Insolvency” Meets the  
“Zone of Coverage” in the Mortgage Meltdown –  
Liability Lessons from the Official  
Take-Under of Bear Stearns!**

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**Part I – Issues Overview - All Sides**

It was beyond another historic day on Wall Street. The Federal Reserve (Fed) hadn't made a similar move for over 50 years. Rumor had it that Bear Stearns was to file bankruptcy that Monday, March 17, 2008, but the Fed invoked an arcane regulation which effectively "forced" the take over of Bear Stearns by suitor JP Morgan Chase. This move was guaranteed by the unknowing taxpayer to the tune of \$29 billion when the Fed granted access to the Discount Window and accepted collateral in amounts and quality which remains secret, uncertain and unknown. Maybe we should call it what it is: a take-under and lateral pass. Over that infamous weekend the Fed, JP Morgan Chase and Bear Stearns agreed to a \$2 per share buyout; against a recent \$84 per share book value. As late as January 2007, Bear Stearns had a \$171 share price. JP Morgan Chase will pay \$236 million (with the downside "put option" guarantee or backing of the Fed), including an option on the building. The building is said to be worth more than the deal price alone.

What are the legal ramifications? What laws come into play from such conduct?

**Lawsuits > Corporate Duties > Business Judgment Rule > Insurance Litigation**

The Fed apparently fashioned a credit guarantee take-under (with lateral pass) template for the investment banks, which wipes out common equity while passing the revised and taxpayer guaranteed going-concern to the suitor. It circumvents, and operates outside of the bankruptcy fiefdom, at fire sale prices; at least initially.

**Lawsuits >**

Investor, shareholder, counterparty, creditor and employee lawsuits are likely to skyrocket around the Bear Stearns take-under or this type of resolution model. For example, JP Morgan Chase will have access to \$6-7B allocated to a litigation fund. These lawsuits will further define the gray lines that exist in "**zone of insolvency**" litigation (i.e.: conflicting duties owed by directors and officers to shareholders, creditors, employees and other interested

parties). The emerging and heightened duties owed when making decisions in the zone of insolvency will focus much litigation around the *decision-making-process*. The broad issue may be defined as: what duties are owed to whom, when insolvency is foreseeable? A flood of coming lawsuits will determine whether or not (fiduciary) duties were owed to shareholders, creditors, employees, counterparties or other interested parties, which required the filing of an actual "bankruptcy" instead of the perfection of a secret take-under fire sale. Other issues that must be answered may include: whether or not Directors and Officers (Board of Directors) owe a heightened or fiduciary duty to shareholders, creditors, employees, counterparties or other interested parties when facing insolvency which requires inclusion of such parties in the decision making process?

**Corporate Fiduciary Duties >**

Similarly with all jurisdictions, directors and officers manage the corporation (entity) for the shareholders. For example, in California, Corporations Code 300 states in pertinent part:

- (a) ... the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board. The board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

When the company is clearly solvent, the duty of care (to act prudently) and the duty of loyalty (to refrain from self-dealing) are clearly focused on the entity and the shareholders. As found in most jurisdictions, by way of example, California Corporations Code 309 (a) defines the statutory duty of care and loyalty as:

- (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be **in the best interests of the corporation and its shareholders** and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. [Emphasis added]

**Extension of Duties Owed > Threshold Question: Zone of Insolvency >**

Historically in California and Delaware, the general rule is that directors owe a fiduciary duty of care and loyalty to the entity and its shareholders; but not to creditors or warrant holders (Simons v Cogan (Del 1988) 549 A2d 300. However,

in times of insolvency, or when operating within the zone of insolvency, a question remains: whether or not additional duties or heightened duties arise to others, namely creditors.

In times of historic illiquidity, credit impairment, and economic downturn, compounded by the existence of historic levels of securitized mortgage backed securities (MBS) facing serious devaluation, credit rating downgrades and uncertain insurance coverage, managers (and the Board of Directors) must discern whether they are in the zone of insolvency, and whether or not they owe duties to more remote constituencies, such as creditors, counterparties and employees. To make this determination, they must ascertain whether they are solvent or operating within the zone or vicinity of insolvency (*Geyer v Ingersoll Publications* (Del Ch 1992) 621 A2d 784). With no clear definitions of the 'zone of insolvency', directors and officers are very often operating within the zone, whether they recognize it or not. California Civil Code 3439.02 states:

- (a) A debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets.
- (b) A debtor which is a partnership is insolvent if, at fair valuations, the sum of the partnership's debts is greater than the aggregate of all of the partnership's assets and the sum of the excess of the value of each general partner's nonpartnership assets over the partner's nonpartnership debts.
- (c) A debtor who is generally not paying his or her debts as they become due is presumed to be insolvent.
- (d) Assets under this section do not include property that has been transferred, concealed, or removed with intent to hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable under this chapter.
- (e) Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset.

When operating in the grey area of the 'zone of insolvency', directors and officers may owe additional (fiduciary) duties to creditors, and by analogy, others such as investors, and employees (*North American Catholic Education Programming Foundation, Inc., v. Gheewalla*, (Del 2007) 930 A2d 92 at 101). The board is often vulnerable to legal attack for not fully acknowledging and addressing or protecting, the interests of these other parties when operating in the zone of insolvency. By failing to address, resolve or safeguard these inherent conflicts of interests among these conflicting diverse self-interests, the board may assume liability - for failure to do so.

The law is not settled in this area, and is uncertain in many respects. But in jurisdictions imposing such duties, directors and officers are better advised to include such diverse groups in the decision-making-process. Similar to the administration of a bankruptcy estate, creditor groups are entitled to participate in the litigation of all such issues. For example,

did the Bear Stearns merger team have a duty to invite its major creditors, investors, counterparties or employee representatives to the negotiation table to avoid violating these (possibly) heightened duties? No opinion is drawn herein. The author acknowledges that there may be a business judgment defense argument that the Bear Stearns merger was in part motivated by the Feds to avoid a potential broad market meltdown that would have caused total loss to the company (and economy).

### **Zone of Insolvency in the Mortgage Meltdown > Key Questions >**

Zone of Insolvency is the grey-matter of this tumultuous issue. What exactly is the zone of insolvency, and how do directors and officers know they are operating within it? Are the decisions of directors and officers (Board) always susceptible to attack when operating in economic times of foreseeable financial stress when credit and liquidity are uncertainty or much less available than in prior (good) times? What about banks, lenders and investment banks (like Bears Stearns) who have great amounts of Mortgage Backed Securities (MBS) on their books that are subject to probable high default rates, huge write-downs, and additional capital (call) requirements; are they operating in the zone of insolvency? What about their counterparties, especially when probable Rating Agency downgrades are foreseeable? What about holders of securitized MBS and commercial back mortgage securities (CMBS) that are facing probable write-downs, and downgrades from rating agencies, and hold "representations and warranties" from known thinly capitalized mortgage lenders, who have either gone out of business or are likely to do so at any time, and may (or may not) have insurance to cover the losses? These fact patterns and many others may support the elements of numerous causes of action that are generally accepted and/or emerging.

### **Causes of Action > Personal & Entity Level Liability >**

There are many potential causes of action that may ensue to seek redress consistent with the theme conduct of recklessness, gross negligence or intentional conduct intended to defraud the creditors (or others) from assets sufficient to cover the foreseeable debts owed, or to defraud the creditors (or others) of a remedy. Causes of action that may encompass such theme facts may also include, breach of contract, fraud, breach of fiduciary duty, by derivative actions (*North American Catholic Education Programming Foundation, Inc., v. Gheewalla*, (Del 2007) 930 A2d 92 at 102), and fraudulent transfers, conspiracy to defraud creditors (others), Unfair Business Practices (California Business & Professions Code §17200), sham sale liability, RICO, and Deepening Insolvency ((*Bankr. D. Del. 2003*) Official Comm. of Unsecured Creditors v Credit Suisse First Boston 299 B.R. 732, 750-52). Creditors may be entitled to use derivative actions, as authorized by most courts, however, direct actions are not generally authorized as yet.

A deepening insolvency cause of action or damages element occurs when the directors and officers incur additional debt while operating in the zone of insolvency, in an attempt to

bridge the insolvency gap into the solvency zone. A few courts have indicated that they would or may allow such redress or direct claim. ((Bankr. D. Del. 2007) Miller v McCown De Leeuw & Co., Inc. (In re The Brown Schools), 368 B.R. 394, and Jetpay Merchant Services, LLC. v. Miller, 2007 WL 2701636, 7 (N.D. Tex. Sept. 17, 2007).

Some cases arising out of the Delaware General Corporation Law 271 should serve as a reminder that creditors (and other like parties) who are defrauded out of repayment or assets by which to be redressed, or legal or equitable remedies, will have authority to pursue such claims. For example, the sale, lease or exchange of assets without fair consideration, or made with “disparity (is) so great as to shock the conscience of the court or warrant the conclusion that the majority was actuated by improper motives, thereby working injury to the minority...” (Massaro v Fisk Rubber Corp. 36 FSupp 382 (D Mass 1941), California General Corporation Law at 1000, 1001, and 1100, CSC California Law Affecting Business Entities). The provisions of this section are for the benefit of the stockholders and creditors and they alone can object to the transfer (Gunther v. Thompson, 211 Cal 631).

Moreover, failing to adopt a plan to pay creditors (Delaware General Corporation Law 280, 281; California General Corporation Law, 2004-2011, CSC California Law Affecting Business Entities) may result in further action against the purchaser and seller. “Creditors may pursue the corporate assets into the hands of the transferee corporation when, on the sale of corporate assets, no provision is made for the payment of corporate debts. (McKee v. Standard Minerals Corp. 156 A 193 (Ch Ct 1931); Colonial Ice Cream Co. v Southland Ice Utilities Corp., 53 F2d 932 (CD Cir 1931). For pleading, law & motion and damages purposes, litigators may very well seek cases limited to facts that indicate that the directors and officers have failed to acknowledge that they are operating in the zone of insolvency, and failed to address, resolve or include creditors, counterparties, investors or employees from participating in the resolution of the these diverse interests. These cases with successful expert testimony would tend to show that the directors and officers acted recklessly, with gross negligence or with the intention to defraud creditors (or others), and/or to wrongfully destroy such remedies.

The defenses of such actions will revolve around the general limitations of corporate duty rules holding that no duty is due such remote parties, no direct action for a deepening insolvency cause of action or as damages exists, invocation of the Business Judgment Rule defense and the factual expert defense argument that the circumstances were merely foreseeable business risks.

However, one thing is for certain: one of the hottest areas of litigation that will arise from the mortgage meltdown will be over insurance coverage. Bad faith actions against carriers should see a rise as disputes over coverage, exclusions, and notice requirements materialize. One example of where a vast landmine of coverage disputes reside is in the buyback or repurchase demand and litigation area.

## **Related Insurance Coverage & Litigation >**

Several types of insurance policies might afford coverage to various buyers or beneficiaries of such mortgage industry related policies, including corporate directors and officers, investment banks, investors, pension funds, assignee trusts, REMICS, owners of mortgage backed securities, shareholders, employees, lenders, and in some cases, borrowers. Coverage may be available for investigations, litigation, defense or indemnity. Directors and Officers (D&O), Errors & Omissions (E&O), Commercial General Liability (CGL), Employment Practices Liability (EPL), Credit Risk, Accounts Receivable or Private Mortgage Insurance (MI), and Investors Residential Value (IRV) insurance policies may be in play.

Whether or not directors and officers (Board of Directors) are required to give notice of a ‘potential’ claim to their carrier(s) or whether certain exclusions preclude coverage, will be hotly contested as investigations and lawsuits are filed and coverage requests are made. There are very short claims notice requirements (i.e. 10 days) in many of these policies, which may act to preclude coverage (in some states). There are many policy provisions that may preclude coverage or be counter intuitive to good business judgment. Moreover, this uncertainty, and/or potential or actual loss of coverage may add to the argument that the entity operated within a zone of insolvency, and therefore owed a higher or expanded duty (i.e. to creditors).

## **The Zone of Coverage >**

### **Special Warning: “BuyBacks” & Potential Waiver of Insurance Coverage >**

The unwary investment bank or investor demanding subprime defaulted buybacks from the unwary lender or originator, may preclude insurance coverage when adverse positions are taken which outright deny or prove that there is no liability (debt) under the repurchase agreement or buyback demand because certain credit risk policies (MI) have clauses which require the buyer to be in actual debt to gain policy coverage. So the lender industry norm of ‘dispute and deny’ when faced with buyback demands, may very well jeopardize insurance coverage.

Disputes might better seek further information and evidence of such demands on a loan by loan and document by document level, without an outright denial of such indebtedness, but at the same time, trigger a notice of potential claim to the carrier; but only after consultation with an expert (bad faith and mortgage industry) insurance litigator.

Furthermore, directors and officers must consider whether insurance may or may not be available for such underlying buybacks or its related litigation as a factor in determining whether the company is operating in the zone of insolvency with heightened duties, and how that might affect creditors, counterparties, investors, employees and other interested parties; including the availability of insurance (loss) coverage

to each diverse related interest. Buyers of insurance must act quickly when facing investigations, buyback demands, disputes or litigation, to ascertain how to act within the zone of coverage.

*Directors and officers must act immediately to seek the advice of expert insurance litigation attorneys – or face the potential of uninsured losses, personal and/or entity level liability.*

### **Resolution of Conflicting Priorities > New Optimal Best Practices Safe Harbor >**

For those cases where directors and officers include creditors, counterparties, investors, or employees to participate in the resolution of such diverse interests, such efforts of inclusion may tend to preclude such actions altogether, limit liability and lessen or preclude findings of intent or malice. Moreover, such inclusive participatory resolution strategy practices are or will become the safe harbor or optimal best practice as it benefits all related interests.

An inclusive resolution strategy can be implemented by bringing creditor, shareholder, investor, counterparty, employees or conflicting self interest groups into the "**decision-making-process**" at the time of assessment or acknowledgment of the zone of insolvency. This will also serve the interests of all related parties. However, **confidentiality** may be necessary when structuring an inclusive participatory resolution strategy. Otherwise, filing for bankruptcy protection may be the preferred step for the 'prepared' entity (directors and officers).

### **The Zone of Coverage Meets the Zone of Insolvency >**

The author recommends that the industry consider immediate steps to ascertain optimal best practices that enhance the likelihood that related participants are operating within the "zone of coverage" before "fair value" valuations (FASB 157, etc.) more accurately recognize loss severity due to insecure or uncertain related insurance coverage (procedures), that can be used to support the argument that the entity was (knowingly) operating within the zone of insolvency; finding extended (fiduciary) duties and uninsured liabilities owed not only to first parties, but to third parties, such as creditors, and others. The author will continue this debate for industry executives on [www.zoneofcoverage.com](http://www.zoneofcoverage.com) , [www.procouncil.com](http://www.procouncil.com) and at upcoming AFN industry conferences.

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*Default Referral™*

*Shared Built In Equity Mods™*

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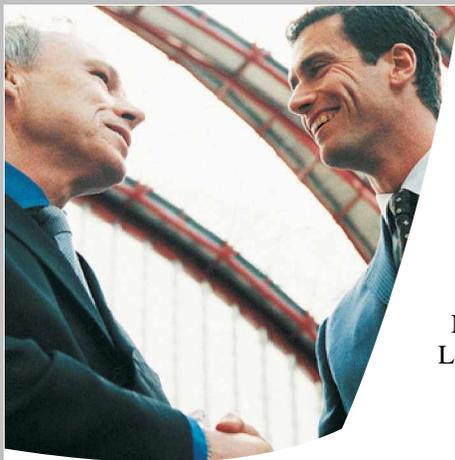
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