Caught in the Cross-fire: Securitization Trustees and Litigation During the Subprime Crisis

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Over the past two years, the subprime crisis and related credit market collapse have been nothing if not full of surprises. While debate continues over whether the “house of cards” could or should have been predicted, the fallout has affected participants in the securitization market in a host of ways, both expected and unexpected.

This is vividly so in the case of securitization trustees. They have found themselves involved in, and in some cases the subject of, a wide variety of disputes and entanglements, some of which were to be expected once the nature and extent of the subprime market problems were understood, but many of which have been wholly unexpected and unforeseen.

As the reverberations worked their way through the securitization markets, some trustees found themselves in the cross-fire, or even in the cross-hairs, of feuding parties battling for recovery. In others, “Don’t shoot the messenger!” might best describe the trustee’s dilemma. But to a large degree, much of the experience of trustees and other market participants has been one of entering new territory, addressing situations not anticipated by transaction structures and not adequately addressed in transaction documents, where assumptions and so-called common understandings have been rejected by transaction participants seeking to protect their interests, and where aggrieved parties

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have shown no hesitation to challenge traditional notions of document interpretation and to pursue novel theories of recovery.

This can best be illustrated by looking at some of the litigation in which securitization trustees have been involved, or by which they have been affected, by during the crisis. This article will provide a brief sampling of some of the more interesting or noteworthy cases, along with others that are representative of the trustee’s experience. While not a complete or comprehensive survey by any means, it hopefully will offer a glimpse of the varied and unexpected nature of the challenges faced by securitization trustees, and the unenviable position in which many have found themselves.

**Mortgage-backed securities**

Relatively early in the subprime crisis, a glimpse of surprises to come occurred when U.S. District Court Judge Boyko handed down his much-publicized decision in *In re: Foreclosure Cases*, United States District Court Northern District of Ohio Eastern Division, cases no. 1:07-cv-02282, et al. Here a collection of fourteen (14) mortgage foreclosure suits brought by a securitization mortgage servicer in federal court were dismissed for failure to prove proper standing, or status as the “real party in interest”; in effect for failing to show that the securitization trust held adequate rights of ownership. Initially, the case sent shock waves through the securitization market, raising fundamental structural questions which were of immediate concern to securitization servicers and trustees in particular. The decision has since been better understood to be the product of a federal court’s particular scrutiny of the plaintiff’s burden of proof to establish diversity jurisdiction, dealing in this case with what is traditionally a state court matter, found inadequate under the circumstance because of a failure to prove that mortgage assignments showing a complete chain of title were properly recorded at the applicable land registry offices at the time the court action was commenced.

Judge Boyko’s decision came at a time when political and social activism in response to the subprime crisis was in full swing, and it added fuel to the fire. Both securitization servicers and trustees (as the mortgage owner of record) have been targets of widespread political pressure and legal attacks by homeowner and tenant rights activists, and other political groups and figures, seeking to protect homeowners and occupants from foreclosure and eviction.
In this connection a variety of litigation has been filed in many jurisdictions, against loan originators, investment banks, servicers, securitization trustees and others, and the theories on which some of the cases have been based have not been lacking in creativity.

To give just a flavor, in a case filed in California, *Amendola vs. Deutsche Bank National Trust Company, Home Loan Services, Cal-Western Reconveyance Corporation, et al*, case no. 37-2008-00068567-CU-OR-SC (Superior Court of California, San Diego County, South County Division), homeowners facing foreclosure included the securitization trustee along with the loan originator and loan servicer as defendants, seeking to enjoin foreclosure and recover damages, based primarily on alleged TILA and RESPA violations, and other bad acts, by the loan originator. The complaint also alleges “fraud and deception” on the part of the servicer and the trustee for bringing a foreclosure action without first recording a complete chain of mortgage assignments. As a result of the failure to record assignments, the complaint alleges, making allusions to Judge Boyko’s decision, “[i]n numerous cases...[the trustee] has been determined by courts to have no standing to bring a foreclosure action”, thereby “[depriving] the public and the homeowners the ability to determine the chain of ownership of a mortgage loan, including the ultimate owner.”

Similarly, plaintiff’s counsel in *Whittiker and Kimball vs. Deutsche Bank National Trust Company, Manley Deas Kochalski LLC, et al*, filed in the U.S. District Court for the Northern District of Ohio Eastern Division, use (and, in their complaint, directly cite) Judge Boyko’s decision as a springboard for a class action filed against the securitization trustee, the servicer and the servicer’s legal counsel, alleging, among other things, that the defendants’ “pattern and practice of seeking and obtaining foreclosure judgments in state and federal courts” by filing foreclosure actions without first recording mortgage assignments or, in the words of the complaint, “without possessing legally enforceable, recorded assignments which demonstrate the chain of ownership and assignment of the mortgage from the actual mortgagees”, constitutes a “pattern of illegal and corrupt activity” in violation of the state RICO Act and a “false, deceptive or misleading representation or means” in violation of the Federal Fair Debt Collection Practices Act.

No less creative but certainly more well-publicized were the suits filed by municipalities seeking recovery for blighted neighborhoods left in the wake of
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subprime-related foreclosures. A number of different city and state officials took action based on a variety of theories, but a few received the lion’s share of attention. One was the suit brought by the City of Cleveland against 21 major banks, including loan originators, servicers and investment banks, alleging that their involvement in “proliferating toxic sub-prime mortgages within [Cleveland’s] borders” and the resulting “epidemic of foreclosures” inflicted such damage to the city’s economy, housing market and property values, and created such a drain on municipal resources, that it amounts to a public nuisance under common law. Originally filed in state court and later removed to federal court, City of Cleveland vs. Deutsche Bank Trust Company, et al, case no. 1:08-CV-00139 (U.S. District Court, Northern District of Ohio) focused its theory on origination although allegations tied to servicing permeate the pleading.

Soon after the Cleveland case was filed, the City of Buffalo followed with a similar suit, City of Buffalo and Mayor Byron W. Brown vs. ABN Amro Mortgage Group, Inc., et al (New York Supreme Court, Erie County, no. 2008002200). This case names 36 banks as defendants with respect to 57 specific mortgaged properties. The suit alleges violation of city and state public nuisance laws as well as New York state property maintenance code violations. Although the primary targets of the Cleveland and Buffalo suits were loan originators and investment banks, banks acting as trustees were swept up in the broadly cast net of named defendants.

The cities of Baltimore and Minneapolis also received attention for suits that took very different approaches. In City of Baltimore vs. Wells Fargo Bank and Wells Fargo Financial Leasing, case no. L08CV062 (D. Md.), the city sued a single lender, alleging that it engaged in “reverse redlining” by targeting Baltimore’s African-American borrowers for high-cost loans in violation of the federal Fair Housing Act, 42 USC 3605(a). In City of Minneapolis vs. TJ Waconia, case no. 27CV0887880 (Hennepin Co. Minn., Dist. Crt.), the city filed a consumer fraud-based suit against a developer/lender who converted 140 homes into rental units. The suit alleges that the developer committed consumer fraud by engaging in a fraudulent residential real estate scheme to illegally drive up housing prices and the leave the area blighted with foreclosures. Given their more narrow focus, securitization trustees escaped being implicated in these suits.
An extreme example of a situation in which no securitization trustee would have expected to find itself, however, arose in *In re Nosek*, 354 B.R. 331 (D. Mass. 2006) and *In re Nosek*, 363 B.R. 643 (Bankr. D. Mass. 2007) (Rosenthal, J.), *rev’d* 544 F.3d 34 (1st Cir. 2008), involving a series of adversary proceedings and appeals in a personal bankruptcy, specifically concerning the debtor’s securitized residential mortgage. Among other interesting occurrences in the case, the bankruptcy court judge sanctioned the mortgage servicer under Rule 9011 in the amount of $250,000 for failing to disclose in its pleadings that the actual mortgagee was a securitization trust and not the servicer itself, a matter which came to the court’s attention only when the debtor brought an action for trustee process to collect from the servicer a $750,000 judgment for emotional distress and punitive damages related to the servicing of the debtor’s mortgage. However, the bankruptcy court went beyond sanctioning the servicer for this failure, and also sanctioned the securitization trustee (to the tune of $250,000), despite the fact that the securitization trustee participated in none of the court statements or hearings on which the sanction was based. In fact, the trustee was only brought into the proceedings after its ownership of the related mortgage came to light, when the debtor amended her action for trustee process in order to seek collection of the $750,000 emotional distress judgment from the trustee. Following a series of appeals and rehearings (and associated expense) the sanction against the securitization trustee was vacated as an abuse of discretion, and the $750,000 judgment was overturned, but the $250,000 sanction against the servicer was upheld.

Another securitization trustee found itself involved in unexpected litigation in a case filed in June of 2008 in federal court entitled *Radian Insurance, Inc. vs. Deutsche Bank National Trust Company, for itself and as trustee of the Home Equity Mortgage Loan Asset-Backed Trusts, Series INDS 2006-2B, INDS 2006-3 and INDS 2007-1, et al*, case no. 08-CV-02993 (United States District Court for the Eastern District of Pennsylvania). The Radian case, which received much attention, was filed by a mortgage pool insurer seeking to nullify mortgage pool policies that it issued in a series of home-equity loan securitizations. The complaint seeks a declaration by the court that the mortgage pool insurer is entitled to rescind each of the policies as a result of materially false representations and warranties made to it concerning the quality and characteristics of the mortgage pool, which induced it to issue the policies. Among other things, the complaint alleges misrepresentations
concerning loan-level borrower income, employment status, owner-occupancy and other underwriting violations.

A picture of life for MBS securitization trustees during the subprime crisis would not be complete without mention of mortgage servicer bankruptcies. The demise of the mortgage origination and servicing industry is well known, as the precipitous plunge in new mortgage originations, increased cost of servicing (due in large part to increased frequency of legal challenges and pressure to enter into loan modifications in lieu of foreclosure), and overwhelming volume of loan repurchase demands have forced many mortgage originator/servicers into bankruptcy or receivership. Examples include New Century, Homebanc, American Home Mortgage, WaMu and Fieldstone Mortgage, to name but a few. In each of these cases, securitization trustees have found themselves facing a variety of challenges, including bankruptcy-related litigation, preparation of proofs of claim for trusts holding hundreds or thousands of loans, and active participation in the proceedings to address the continuation and succession of servicing.

The administration and enforcement of repurchase obligations generally occupied a great deal of trustee time and attention. As an example, in *U.S. Bank National Association, as Indenture Trustee for the Benefit of the Insurers and Noteholders of Greenpoint Mortgage Funding Trust 2006-HE1, Home Equity Loan Asset-Backed Notes, Series 2006-HE1, et al vs. Greenpoint Mortgage Funding, Inc.*, case no. 600352/09 (Supreme Court of the State of New York, County of New York), a securitization trustee, acting in concert with and at the direction of the controlling insurer and controlling party under the indenture, filed suit to compel performance of repurchase obligations pursuant to loan sale agreements underlying the securitization. In addition to alleged breaches of representations and warranties relating to the attributes of the loans and the policies and practices pursuant to which some 30,000 residential mortgage loans were originated, underwritten and serviced, claimed to give rise to loan-specific repurchase obligations, the complaint alleges that the breach of a representation and warranty that the transaction documents do not “contain any untrue statement of fact or omits to state a fact necessary to make the statements contained therein not misleading” obligates the originator-seller to repurchase all of the $1.83 billion of loans under the terms of the related agreements.
A securitization trustee in a CMBS structure undoubtedly did not expect to be involved in initiating receivership proceedings against an underlying commercial loan borrower. The special mortgage servicer found it necessary to initiate a receivership proceeding against one of the borrowers, initiated in the securitization trustee’s name, in *Bank of America, N.A. v. Hermann Street DE, LLC, et al.* (San Francisco Superior Court Case No. CGC-09-491063, filed September 3, 2009). Sustained financial troubles and management deficiencies allegedly impaired the borrower’s ability to properly maintain its commercial properties, and when the borrower defaulted under the loan by failing to make certain required payments and to account for deposits held at the property securing the loan, the special mortgage servicer on behalf of the securitization trustee filed suit to enforce a provision of the deed of trust allowing it to take possession and control of the secured property through the appointment of a receiver.

Another case, not directly involving but of great interest to securitization trustees because of the issues it raises concerning loan modifications, is a class action filed in December of 2008 by MBS investors against Countrywide, which has been the target of multiple lawsuits arising out of the subprime meltdown. Filed in the Supreme Court of the State of New York, County of New York, captioned *Greenwich Financial Services Distressed Mortgage Fund 3, LLC and QEB LLC vs. Countrywide Financial Corporation, Countrywide Home Loans Inc. and Country Home Loans Servicing LP*, two investment funds, on behalf of themselves and similarly affected investors in 374 MBS securitizations sponsored by Countrywide and known as the CWL series and CWALT series, in effect challenged the predatory lending settlement agreement reached between Bank of America and attorneys general in 11 states, agreeing to modify thousands of mortgages written by Countrywide. Most of the loans subject to the settlement are held in securitization trusts, and the plaintiffs in this case allege that the settlement agreement, if implemented, will violate their rights, and those of other investors in the class, under the securitization trusts unless covenants are made in the governing securitization documents by Countrywide to repurchase all loans that are modified by way of a reduction in payments. The suit seeks a declaration from the court requiring Countrywide abide by its repurchase obligations under the securitization transactions.
The Greenwich case is a vivid illustration of the difficult position servicers, and potentially trustees, can find themselves in with respect to mortgages held in securitization pools: caught between enormous political and legal pressure to favor loan modification over foreclosure, while facing the risk of potential claims of liability from MBS investors who may allege violation of applicable securitization documents.

The plaintiffs in the Greenwich case recently received a boost when, in August, a federal judge in New York rejected an argument by Countrywide that the Helping Families Save Their Homes Act of 2009, under which servicers that agree to modify loans in accordance with the Act receive certain “safe harbor” protections from liability, effectively grants immunity which precludes the plaintiffs from trying to assert their rights under the MBS contracts. The court also rejected a request to remove the case to federal court.

Asset-backed securities, especially CDO

As the ripple effect of the subprime crisis worked its way through the MBS and ABS markets, the eventual triggering of CDO defaults lead to another range of unexpected litigation for securitization trustees.

While a variety of issues have arisen, many CDO transactions in default found themselves facing similar scenarios. Many quickly heard from the controlling class of noteholders wishing to accelerate in order to trigger subordination terms affecting or altering cash-flow priorities in their favor, or wishing to proceed with liquidation of the portfolio. Knowing that the most senior classes of notes would be paid first with the proceeds of the liquidation, senior controlling classes favored liquidation before further market deterioration could occur, thereby ensuring or maximizing their recovery, or at least stemming further losses. Subordinate classes sitting lower in priority, however, often objected and sought ways to challenge acceleration and liquidation, in the hope that maintaining the status quo would continue future distributions on their securities or allow time for future improvement in the value of the portfolio. Many transactions faced a reality in which liquidation proceeds would be insufficient to provide principal payment to any but the most senior class or classes, and in many cases with even the most senior class suffering a loss.
Challenges by junior classes took different forms, but often involved disputes over the occurrence of an event of default, challenges to the senior class’ right to accelerate or liquidate, or, most commonly, disputes over the proper application of subordination terms and priorities.

Many of these disputes have centered on ambiguous, or at least allegedly ambiguous, indenture language and very aggressive arguments of interpretation. As a result, many situations have resulted in litigation, often (although not exclusively) commenced by trustees, involving disputes over interpretation of documents. In this regard, it is fair to say that there has been a great deal of shared anxiety, and often outright dismay, among almost all market participants at the number of document interpretation disputes and challenges that have arisen in CDO and CLO transactions. It should be noted that CDO and CLO indentures that provide a separate waterfall for application upon the occurrence of an event of default and acceleration appear more often to have avoided these disputes.

While there are many other cases that have been filed involving a variety of disputes over the interpretation of CDO indentures, swap agreements and other constituent documents (and certainly many more that have managed to be resolved without litigation), the following are a few examples.

In *Deutsche Bank Trust Company Americas, as Trustee, vs. Lacrosse Financial Products, LLC et al*, case no. 08-CV-0955 (United States District Court, Southern District of New York, 1/28/08), originally filed in New York Supreme Court and later refiled in U.S. District Court, an interpleader action was commenced by the securitization trustee in a CDO (Sagittarius CDO I) to resolve an interpretation dispute concerning application of the subordination provisions of the indenture as applied to the payment distribution terms (the so-called indenture “waterfall”). In a nutshell, the super senior swap counterparty, acting as controlling class under the indenture, argued that language in the indenture subordination provisions calling for “all amounts payable” to the super senior swap counterparty to be paid “before any further payment of distribution” to subordinate interests upon the occurrence of an event of default and acceleration required that all interest proceeds and principal proceeds, after payment of the most senior administrative fees and expenses, must be diverted into a permanent reduction reserve account until the super senior notional amount, and the super senior swap counterparty’s exposure, is reduced to zero, ahead of any distributions to noteholders.
Noteholders objected, arguing that, absent more specific language in the
subordination provisions or express language in the waterfall itself, the
subordination language at issue entitled the super senior swap counterparty
only to be paid amounts actually due and payable to it at the time each
waterfall distribution takes place. The embattled trustee quickly brought the
matter to court seeking guidance.

In *LaSalle Bank National Association, as Indenture Trustee, vs. BNP Paribas,
London Branch, et al*, case no. 08-CV-6143 (United States District Court,
Southern District of New York, 7/3/08), the indenture trustee in a CDO (ESP
Funding I) faced contradictory indenture language with regard to the
governing priority of proceeds to be applied after an event of default. The
complaint describes the conflict as follows;

“[Indenture] Section 11.1(c) requires that, following an Event of
Default, interest payments be made on Class A-2, Class A-3 and Class
A-4 Notes prior to making payments in respect of principal to the
Class A-1 Notes; Section 13.1(d), in contrast, requires that, following
an Event of Default, the Class A-1 Notes be paid in full prior to
making any payments in respect of the Class A-2, Class A-3 and Class
A-4 Notes.”

A payment date followed closely on the heels of the occurrence of the event of
default, presenting the trustee with a dilemma. The trustee addressed the
situation by distributing cash down to the level of the waterfall at which the
issue required a decision, suspending and holding in escrow all distributions
below that point, and distributing a notice to alert noteholders and other
interested transaction parties to the situation, inviting their input. Not
surprisingly, it received responses from some parties favoring a reading that
would require application of all proceeds to fully pay down the principal of
Class A-1 Notes prior to any further payments of interest on the Class A-2, A-
3 or A-4 notes and demanding distribution of funds accordingly, and received
responses from others taking a contrary position. As a result, the trustee filed
the interpleader action seeking a determination by the court.

The same trustee faced what appear to be substantially similar facts in *LaSalle
Bank National Association, as Indenture Trustee vs. Citigroup Global
Markets Limited, et al*, case no. 08-CV-6294 (United States District Court,
Southern District of New York, 5/21/08), relating to Plettenberg Bay CDO.
Although the complaints in the ESP Funding and Plettenberg cases do not provide a complete recitation of the indenture language at issue, the Plettenberg pleading discloses that the governing sentence in the subordination provisions (Section 13.1) states that the subordinated notes shall be junior to the senior notes “to the extent and in the manner set forth in this Indenture, including as set forth in Section 11.1(a) and as hereinafter provided” (phrasing which is commonly found in many CDO indentures). Holders of the Class A-2 Notes argued that this phrasing in effect defers to, and does not override or change, the priorities contained in the Section 11.1 waterfalls, while holders of Class A-1 disagreed.

The trustee in *U.S. Bank National Association, as trustee, vs. MBIA Insurance Corporation, et al*, case no. 08-CIV-4791 (United States District Court, Southern District of New York, 5/21/08) faced a similar dispute, namely whether the application of the subordination terms (Section 13.1) to the waterfall terms (Section 11.1) under a CDO indenture (Wadsworth CDO) required payment in full of principal of the Class A-1 Notes before any further payments of interest or principal on any other class of notes. In this case, shortly after the occurrence of an event of default, the controlling party exercised its right to accelerate the notes, and shortly before the following payment date sent a notice to the trustee demanding interpretation of the applicable terms to require application of all proceeds received after the event of default and acceleration to the payment in full of the Class A-1 Notes before any further payment or distribution to other holders, and demanding that the trustee apply funds accordingly. Unfortunately, the complaint does not provide detail as to the exact language at issue. In any event, other noteholders disagreed, as a result of which the trustee set aside in escrow the disputed portion of the proceeds available for distribution and commenced the interpleader action.

Elements of each of the above situations appear to have been at issue in *Wells Fargo Bank, N.A., as Trustee, vs. Calyon, et al*, case no. 08-CV-1297 (United States District Court, Southern District of New York, 02/08/08), originally filed in New York Supreme Court and later refiled in U.S. District Court. Upon the occurrence of an event of default in the CDO (Orion 2006-2), the holder of a majority of the controlling class of senior notes (Class A-1A), which was also the credit default swap counterparty in the transaction, exercised its right to accelerate the notes and at the same time directed the
trustee thereafter to apply all interest proceeds and principal proceeds, pursuant to the indenture subordination provisions (Section 13.1), to the payment in full of the outstanding principal amount of the Class A-1A Notes, and then to deposit remaining amounts into a reserve account established under the indenture to reduce the remaining unfunded commitment amount in respect of the Class A-1A Notes until reduced to zero, thereby eliminating the holder’s obligation to make future advances, before making any payments to other classes of notes. The collateral manager for the CDO objected to the controlling class holder’s interpretation and at least one holder of notes objected to the determination that an event of default had occurred. For these reasons, and upon information and belief that noteholders in other classes would likewise object, the trustee commenced the interpleader action.

A somewhat different conflict over interpretation is described in the interpleader complaint filed by the trustee in *LaSalle Bank National Association vs. UBS AG and Merrill Lynch International*, case no. 08 CIV 3692 (United States District Court, Southern District of New York, 4/7/08). According to this complaint, an acceleration of maturity occurred under each of three CDO indentures at issue (Hartshorne CDO I, Lancer Funding II and ACA ABS 2007-2). The trustee was directed by the controlling party to liquidate the collateral securing the transaction and to apply the proceeds in accordance with the related indenture, including making termination payments owed to the controlling party as counterparty under related swap agreements. In an interpretive twist, certain non-controlling class noteholders argued that the acceleration by the controlling class noteholders resulted in a payment default to the non-controlling class noteholders (in contrast to a failure to make interest or principal payments in the ordinary course, which under the terms of the indenture did not constitute a default), which meant that any liquidation of the collateral was subject to their consent. The non-controlling class noteholders informed the trustee that they did not so consent and instructed the trustee not to liquidate the collateral. In addition, the non-controlling class noteholders challenged the priority of payments to be applied, arguing that if the collateral were to be liquidated, the proceeds should not be applied to pay termination payments owed to the controlling party as counterparty under the related swap agreements, but should instead be applied giving priority to the notes. Here too, the embattled trustee sought the protection and guidance of the court.
Interpretive disputes in CDOs have arisen in a variety of contexts, by no means limited to subordination and waterfall priorities. Another example of a securitization trustee thrust into a Hobson’s choice of contract interpretation arose in Cooperatieve Centrale Raiffeisen-Baerenleenbank, B.A. vs. Brookville CDO I Ltd. and Wells Fargo Bank, N.A., as trustee, United States District Court, case no. 08-Civ. 9565 (DLC)(THK). In a nutshell, the complaint, filed by a hedge counterparty, alleges that, under a CDO indenture upon an event of default, the controlling class noteholder directed the collateral manager to designate all of the portfolio securities “credit risk”, and to undertake asset-by-asset sales of the entire portfolio pursuant to the indenture ordinary-course trading provisions. This was allegedly done to avoid proceeding with an acceleration and formal “liquidation” pursuant to the remedial provisions of the indenture. This was done allegedly because the exercise of acceleration and liquidation would trigger a right of termination under a related hedge agreement (described by the plaintiff as an “up-front loan” and interest rate hedge), the resulting termination payment for which would be payable at a senior position in the applicable waterfall, ahead of noteholders. Instead, the complaint alleges, distribution of ordinary-course sale proceeds (as would result from the controlling party’s direction to the collateral manager) under the applicable indenture waterfall, without acceleration and liquidation, was intended to avoid triggering termination under the hedge agreement and subordination of noteholders to the hedge counterparty under the indenture.

The plaintiff alleges that the original collateral manager declined to follow the controlling party’s direction, in response to which the controlling class noteholder removed the original collateral manager and brought in a successor which followed the direction. When the hedge counterparty protested, a battle over the proper interpretation and application of the relevant indenture and hedge agreement provisions was joined. When the securitization trustee, caught between the two, found itself unable to act upon the hedge counterparty’s objection, the hedge counterparty filed suit seeking declaratory judgment and injunctive remedy.

While at the time of writing this article the author is not aware of any related litigation, many CDO and CLO trustees also have been busy this year addressing questions raised, and in some cases disputes, involving proposed indenture amendments to modify trading provisions governing discounted
securities and CCC haircut treatment. In many cases, the stated rationale has been to modify terms to take into account unanticipated market developments which are causing existing indenture restrictions governing discounted securities and CCC haircuts to have unintended consequences adverse to the transaction. However, although each situation is different with regard to its facts and governing indenture provisions, debates have arisen concerning the desirability of the proposed amendments, the collateral manager’s ability to put through the modifications without obtaining noteholder consent, whether a determination of “no material and adverse effect” is required and, if so, on what basis it properly can be made, as well as other related issues concerning supporting opinions of counsel, officer certificates and ratings confirmations. Some CDO and CLO trustees also have faced situations recently involving proposed surrender of certain transaction notes for cancellation without payment. Here too, each situation is specific to its own facts and circumstances and the terms of the applicable indenture, sometimes involving a variety of different questions, depending whether the notes proposed to be surrendered are already owned or to be purchased specifically for the purpose of surrender, and often involving questions concerning the resulting impact, if any, on portfolio test calculations, especially overcollateralization tests.

The plight of securitization trustees has not been limited to the domestic arena, and battles over ambiguous language have certainly not been limited to CDOs. Another interpretive dispute that received a great deal of market attention was the suit initiated by the trustee in an SIV structure in *Bank of New York v. Montana Board of Investments*, [2008] EWHC (Ch.) 1594 (Eng.). In this case, the London Chancery Court resolved certain ambiguities in a security agreement (by its terms governed by New York law) as to whether a senior class of noteholders of a structured investment vehicle (Orion) had the right to direct the trustee as to time, manner, and place of the sale of the SIV’s collateral following an event of default.

In this case, the senior and subordinate noteholders provided the trustee with conflicting direction for the timing and manner of the liquidation of the SIV’s assets. The senior noteholders claimed that they had the right to direct the time, place, and manner of the sale of the collateral, because the subordinated noteholders had agreed to full subordination in payment and that the security agreement required the trustee to enforce the collateral in a manner consistent with full subordination of the subordinated noteholders. The court concluded
that under the security agreement, the trustee had the exclusive control of the
collateral after an event of default and right to determine the appropriate time,
place, and manner of the sale of the collateral. The court also concluded that
the senior noteholder’s direction to sell the collateral “as soon as reasonably
practicable” was in conflict with the New York Uniform Commercial Code,
which requires the trustee to act in a “commercially reasonable” manner in
selling collateral. Of importance, among other things, are that the security
agreement at issue gave exclusive rights concerning the time, place, and
manner for the sale of collateral to the trustee instead of the senior
noteholders, and that the decision of the English court interpreting New York
law is not binding upon U.S. courts.

Lehman Swaps

The Lehman Chapter 11 bankruptcy proceeding (In re: Lehman Brothers
Holdings, Inc., Bankruptcy Case No.: 08-13555 (JMP), and related cases)
filed in the United States Bankruptcy Court for the Southern District of New
York in September and October of last year, has been the source of many
unforeseen challenges and dilemmas for securitization trustees, most
frequently concerning swap agreements written or guaranteed by Lehman
affiliates. To give an idea of its impact, in a motion filed by Lehman early on
in its proceedings, it was estimated that at the time of the commencement of
the proceeding, Lehman affiliates were parties to approximately 960,000
outstanding derivative contracts. Although a recent filing estimates that
number has since been reduced to just a few thousand that remain in need of
resolution, it comes as no surprise that a great many securitization structures
have been impacted by the Lehman bankruptcy.

Trustees have wrestled with questions and disputes surrounding termination
and exercise of remedies. Lehman has adopted a number of aggressive
positions concerning termination and the treatment of swap payments under
related securitization indentures, pooling and servicing agreements or other
governing instruments. Once again, the trustees in these situations frequently
have found themselves caught between opposing parties or conflicting
demands. A few examples of the more closely watched legal actions arising in
the Lehman proceeding and involving trustees are summarized below.
In July of this year, much attention was paid to the ruling of the English High Court in *Perpetual Trustee Company Limited v. BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.* (and a similar case entitled *Belmont Part Investment Pty Limited and Others v. BNY Corporate Trustees Services and Lehman Brothers Special Financing Inc.*) In this case, Perpetual Trustee Services, as trustee for retail investors in Australia, New Zealand and Papua New Guinea, brought suit against the trustee and Lehman Brothers Special Financing (“LBSF”) as swap counterparty, with respect to the investors’ holdings in credit-linked notes issued under the Lehman sponsored Dante Note Programme. The Court considered a number of issues raised in the suit, but an issue of principle concern was Lehman’s argument that the securitization trustee should be precluded from applying the noteholder priority terms of the governing documents with respect to any distribution of the proceeds of liquidation of the collateral.

The noteholder priority terms of the transaction documents, governed by English law, provide for a reversal of the priority of payments upon acceleration and liquidation, allowing noteholders to be paid ahead of LBSF as swap counterparty with respect to termination payments arising from an event of default under the swap agreement for which LBSF was the defaulting party. The Lehman bankruptcy, and other events, triggered such an event of default under the swap agreement in this case, but LBSF challenged the enforceability of the provisions calling for the reversal of priorities, based on its reading of certain provisions of the U.S. Bankruptcy Code (the so-called "ipso facto" clause) and, in the alternative, on provisions of English law.

Perpetual Trustee, on the other hand, sought enforcement of the priority provisions in accordance with their terms and opposed LBSF’s challenge, with the securitization trustee, caught squarely in the middle, maintaining a neutral stance.

The Court’s decision addressed only matters of English law and, to that extent, ruled against LBSF, confirming that provisions in contracts governed by English law that subordinate the rights or entitlements of a swap counterparty in an insolvency or other default will generally not be prohibited by English law. It left the validity of the provisions under U.S. law to be determined by U.S. courts. Leave to appeal the English High Court’s decision has been granted.
The U.S. law-based arguments raised by LBSF in the Perpetual case, not addressed in the English High Court’s decision, are presently (as of the date of this article) pending before the U.S. Bankruptcy Court in a related adversary proceeding captioned *Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services Limited*, Adversary Proceeding No. 09-01242 (JMP). This action, which relates specifically to two transactions issued under the Dante program (Saphir Finance Public Company Series 2006-5 and Series 2004-11), was filed by LBSF against the securitization trustee, seeking a declaratory judgment that provisions modifying LBSF’s payment priority under the transaction documents constitute unenforceable *ipso facto* clauses that violate 11 U.S.C. §§365(e) and 541(c)(1)(B), and that modification of LBSF’s payment priority violates the automatic stay of 11 U.S.C. § 365(a)(3) because it improperly exercises control over LBSF’s estate, each of which LBSF argues fall outside the “safe harbor” for swap agreements under 11 U.S.C. §560. As of the date of this article, a ruling has not been issued in the Saphir case.

Lehman’s Dante program is also the subject of another adversary proceeding filed this year in the Bankruptcy Court as a class action captioned *Ka Kin Wong, Sui Lui Ching, Chun Ip, Jin Liu, Yin Ying Leung, Lai Mei Chan and Sing Heung, on behalf of themselves and others similarly situated vs. HSBC USA, Inc, et al.*. The action is brought on behalf of individual retail investors in Hong Kong who invested in 28 series of “Minibonds” issued by Pacific International Finance Limited in a derivatives-based program reportedly arranged by Lehman Brothers Asia Limited and built upon credit-default swaps written between the Minibond issuer and LBSF as counterparty (with Lehman Brothers Holdings Inc. as credit support provider). The suit is filed against the bond issuer, the administrator, individual directors of the issuer, the trustee, the custodians for the bonds and the derivatives, and LBSF, seeking declaratory and injunctive remedy, including a declaratory order that the transaction collateral does not constitute property of the estate of the Lehman bankruptcy, and damages. The wide-ranging complaint alleges that the investments were wholly inappropriate for retail investors, who were allegedly subjected to misleading marketing and inadequate disclosure about the quality and nature of the transactions and associated risks, and includes allegations of misdeeds on the part of the issuer and its directors in the structuring and documentation of the transactions, alleging a duty, and failure, on their part to “investigate diligently” the nature and terms of the transactions.
and the reference portfolio underlying the credit default swaps, faulting them for the “one-sided” nature of the documents in favor of LBSF. The complaint alleges that the defendants “permitted [LBSF] to negotiate with itself over the collateral...and to establish the terms and conditions of the swap agreements” as a result of which “Lehman exploited its position and control to enter into unjust and one-sided swap agreements.”

Another interpretive battle placing a securitization trustee squarely in the middle of a high-stakes dispute is found in another adversary proceeding pending in the Lehman bankruptcy, captioned Lehman Brothers Special Financing Inc. vs. Ballyrock ABS CDO 2007-1 Limited, Wells Fargo Bank, N.A., as trustee, et al, Adversary Proceeding No. 09-010132 (JMP), U.S. Bankruptcy Court, Southern District of New York. The Ballyrock case involves a synthetic CDO structure in which the CDO and LBSF (with Lehman Brothers Holdings Inc. serving as credit support provider) entered into a credit default swap agreement in which LBSF made an up-front payment, which was invested by the CDO in collateral held by the trustee under an indenture, pursuant to which notes were issued to investors. Thereafter, periodic premium payments were paid by LBSF under the swap (which were used, together with earnings on the collateral, to make interest payment on the investor notes), in return for credit protection to LBSF on a reference portfolio comprised mostly of residential mortgage-backed securities. The swap agreement thereby entitled LBSF to receive credit protection payments (paid by the CDO from the collateral held under the indenture) upon the occurrence of credit events with respect to the reference portfolio during the term of the swap agreement.

Upon the filing of the Lehman bankruptcy, however, the CDO exercised its right to terminate the credit default swap agreement (based on the event of default triggered by the counterparty’s and credit support provider’s bankruptcy filings, under the terms of the swap) and to liquidate the collateral held under the indenture. In that situation, the applicable payment priority terms contained in the indenture reportedly call for any termination payments owing to the credit default swap counterparty when it is the “defaulting party” to be subordinated to payments on the investor notes. Accordingly, when the securitization trustee completed the liquidation of collateral and reported liquidation proceeds of approximately $327 million, it also reported that although a termination payment of over $404 million was owing to LBSF, no
amounts would be available for payment to LBSF after payment to 
noteholders of principal and interest due on the notes, along with other 
payments senior in priority under the terms of the indenture.

After distribution of approximately $190 million of liquidation proceeds by 
the trustee, LBSF filed suit, seeking declaratory judgment, injunctive remedy 
and damages. In response, the trustee interpled the remaining liquidation 
proceeds of approximately $137 million.

In its Ballyrock complaint, Lehman does not specifically allege non-
compliance with the terms of the documents, but argues that the termination 
of the credit default swap agreement and the subordination of termination 
payments to LBSF were improper and should not be enforced for the reason 
that those results are fundamentally contrary to the original economic intent of 
the transaction. Lehman asserts that the economic reality of the swap 
transaction was that LBSF purchased credit protection from the CDO, and the 
termination of the swap has occurred solely as a result of the filing of the 
Lehman bankruptcy, an event which LBSF argues has, in of itself, had no 
actual economic impact on the swap agreement or the CDO transaction. In 
effect LBSF argues that it made a good investment and the note investors 
made a bad investment, and that this economic bargain should not be reversed 
simply as a consequence of the Lehman bankruptcy:

“…because of the steep decline in the housing market and ensuing 
poor performance of residential mortgage-backed securities, LB 
Financing’s investment is now worth more than $400 million, while 
[the note] investors in Ballyrock should be expecting to receive little 
or none of their investment since the deal has turned out so badly for 
them...”

In effect, Lehman argues, the termination of the swap and application of the 
subordination terms should not be enforced where triggered solely by the 
Lehman bankruptcy and where the result would effectively reverse the 
benefits or economics of the original investment. The noteholders, on the 
other hand, argue that the documents should be enforced in accordance with 
their terms as written, with the trustee once again serving as the beleaguered 
referee.
Conclusion

Hopefully these cases provide a taste of what life has been like for securitization trustees during the subprime crisis. While no segment of the securitization market has been untouched by the developments of the past two years, it has been a particularly wild and unexpected ride for trustees. What were supposed to have been primarily administrative engagements involving well-defined duties to be performed within carefully crafted documents and predictable structures became in many cases something more closely resembling the duties of a triage officer on a sinking ship having too few lifeboats and too many passengers. Trustees often found themselves in unchartered waters, looking for guidance in documents in which none was to be found or in which the situation at hand was never anticipated, or facing highly charged disputes over the meaning of those documents. Hopefully, securitization trustees and other market participants will emerge from these experiences better prepared, or at least better forewarned, for the future.