

WOLLMUTH MAHER & DEUTSCH LLP

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COURT SUSTAINS PHOENIX LIGHT'S CLAIMS AGAINST HSBC FOR BREACH OF RMBS TRUSTEE DUTIES

On June 1, 2015, Judge Shira A. Scheindlin of the Southern District of New York largely denied a motion to dismiss several complaints filed against HSBC Bank USA, N.A. ("HSBC") as trustee of residential mortgage-backed security ("RMBS") trusts, including a complaint the Firm had commenced in the Southern District of New York on behalf of Phoenix Light SF Limited and other entities affiliated with Erste Abwicklungsanstalt, a German public agency organized to manage the wind up of WestLB and certain other German banks (collectively, "Phoenix Light"). Their action was later consolidated with class and derivative actions filed by Royal Park Investments, an entity organized to hold distressed assets of Fortis Bank, and a group of institutional investors led by Blackrock and PIMCO. The Phoenix Light complaint alleges claims under New York and federal law arising out of HSBC's violation of its obligations to protect the interests of investors in the RMBS trusts by enforcing loan repurchase rights and policing the conduct of the loan servicers.

HSBC argued that as trustee it had no obligation to enforce representations and warranties as to loans held by RMBS trusts, and to ensure that loan servicers engaged in prudent loss mitigation practices. Judge Scheindlin rejected HSBC's arguments and sustained claims for recovery of every dollar of damages suffered by Phoenix Light. The Court's 51-page opinion makes the following rulings:

1. RMBS Trustees Have A Duty To Enforce Repurchase Rights. The Court rejected HSBC's argument that the bank had no contractual duty to enforce loan representations and warranties by requiring RMBS sponsors' or loan sellers' to repurchase defective loans. Instead, the Court held that the governing trust documents "give[] HSBC the right to enforce the Noteholders' rights using appropriate proceedings" and "obligate[] HSBC to exercise its rights as a prudent person would." Opinion at 24. The Court concluded that "[i]t is certainly plausible, as plaintiffs allege, that a prudent person would have taken actions to enforce the Sellers' repurchase obligations." *Id.* at 23-25.
2. RMBS Investors Need Not Allege Breaches Of Specific Loans. The Court rejected HSBC's argument that "plaintiffs' claims fail because instead of alleging specific representations and warranties in connection with specific loans that were breached, plaintiffs instead 'detail . . . systematic and widespread breaches.'" Opinion at 18. The Court declined to "import a heightened pleading requirement

to claims governed by Federal Rule 8, and instead held that the complaint's allegations of widespread, systemic abandonment of underwriting guidelines "raise a plausible inference that there were in fact breaches of the Sellers' representations and warranties with respect to the loans included in the trusts at issue." *Id.* at 19-21. The Court distinguished the Second Circuit's statement in *Retirement Board of the Policemen's Annuity and Benefit Fund of the City of Chicago v. Bank of New York Mellon* that claims against trustees must be proven "loan-by-loan and trust-by-trust" as pertaining to putative class plaintiffs' lack of standing to sue on behalf of trusts in which those plaintiffs did not own securities. The Court held that "nothing in [*Retirement Board*] implicates plaintiffs' burden at the pleading stage." *Id.* at 19-20.

3. RMBS Investors May Allege Trustee Knowledge Generally. The Court rejected HSBC's argument that "all of plaintiffs' allegations amount only to constructive knowledge of breaches, and not actual knowledge, as required by the Agreements." Opinion at 21-22. Instead, the Court concluded that "[b]ased on plaintiffs' detailed allegations, it is indeed plausible to infer that HSBC had actual knowledge of breaches in representations and warranties in the specific loans at issue." *Id.*
4. RMBS Trustees Cannot Prevent Events Of Default By Failing To Give Notice Of Breaches. The Court rejected HSBC's argument that Plaintiffs failed to allege the occurrence of events of default under the governing agreements because, despite their allegations of servicer breaches, Plaintiffs did not allege that the servicers received written notice of the breaches. The Court held that the governing agreements "specifically designate HSBC as one of the parties who could give the required notice to trigger an Event of Default" and, as such, "HSBC is insisting on the performance of a condition that HSBC itself had the power to satisfy." Opinion at 28. The Court held that HSBC could not prevent the occurrence of events of default through its own inaction because "[i]t has been established for over a century that a party may not insist upon performance of a condition precedent when its non-performance has been caused by the party itself." *Id.*
5. No-Action Clauses Do Not Bar Investor Claims Against RMBS Trustees. The Court rejected HSBC's argument that RMBS investors are prohibited from suing trustees unless they first comply with the no-action clauses in the governing documents. Instead, the Court reaffirmed the Second Circuit's ruling in *Cruden v. Bank of New York* that no-action clauses do not apply to claims against trustees "as it would make little sense to ask the trustee to sue itself." Opinion at 31.
6. RMBS Trustees Owe Investors Post-Event Of Default Fiduciary Duties. The Court rejected HSBC's argument that Plaintiffs' claims for breach of fiduciary duty were duplicative of their breach of contract claims, and therefore failed to

state a claim. The Court held that “after an Event of Default, an indenture trustee takes on a special fiduciary duty to exercise its powers in order to secure the trust,” and that “insofar as plaintiffs allege a post-Event of Default breach of fiduciary duty, they properly state a claim.” Opinion at 37.

7. New York’s Streit Act Applies To RMBS Trusts Not Covered By The Trust Indenture Act. The Court rejected HSBC’s argument that New York’s Streit Act – Article 4A of the Real Property Law – “does not apply to any of the trusts because they are collateral trusts” rather than direct investments in mortgages. Opinion at 41. The Court held that “the trusts here directly hold mortgages on real property, and therefore the Streit Act applies” to the RMBS trusts insofar as they do not fall within the statute’s exclusion of trusts covered by the federal Trust Indenture Act. *Id.* at 42. The Firm’s clients in this and other federal and state cases were the first investors to assert claims against RMBS trustees under the Streit Act.
8. Claims Against RMBS Trustees Are Direct, Not Derivative. Judge Scheindlin, joining a recent decision by Judge Katherine B. Forrest of the Southern District of New York, held that claims against the RMBS trustees are direct, dismissing derivative claims brought by the Blackrock/PIMCO group. While that group’s putative class allegations survive at this stage, HSBC will vigorously oppose class certification by asserting differing interests of proposed class members holding different tranches within a securitization. Given the uncertain prospects for class certification, investors are well advised to commence direct actions to be certain that their claims are protected, even if one or more of their trusts are currently included the Blackrock/PIMCO or Royal Park class actions.

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