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Lenders Court Lawsuits With Modified Mortgages

By CHARLES PROCTOR - 12/8/2008

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A hedge fund's decision to sue troubled mortgage lender Countrywide Financial Corp. over the company's loan modification program could mean trouble ahead for similar programs.

As government officials pressure banks to modify mortgages to help struggling homeowners, frustrated investors who own pieces of those mortgages are likely to push back in court.

"These investors decided to go into the banking business, and now they don't like the results," said Gonzalo Freixes, a professor at the UCLA Anderson School of Management. "I think you will see more lawsuits."

The recent suit stems from Countrywide's agreement to settle allegations from about a dozen state attorneys general that the company engaged in predatory lending practices. As part of the settlement, Countrywide, which is based in Calabasas and was acquired in July by Charlotte, N.C.-based Bank of America Corp. for \$2 billion, agreed to modify up to 400,000 loans.

When the agreement was announced in October, it was widely hailed as landmark decision to assist homeowners fighting to meet mortgage payments. But it put investors in a bind, given the structure of mortgage-backed securities – which promise investors a certain rate of return assuming that the underlying mortgages supporting the bonds perform.

If they protested, they would take an unpopular position at a time when it had become politically popular to go after Wall Street investors. If they held their tongues, they stood to absorb potentially billions of dollars as the modified home loans produced lower income.

"From an investor's point of view, you were damned if you do, damned if you don't," said Lon Morton, chief executive of Calabasas-based Morton Capital Management, an investment firm not involved in the lawsuit.

The lawsuit against Countrywide, filed in New York on Dec. 1 by Connecticut-based Greenwich Financial Services LLC, charges that under the terms of its bond agreements Countrywide must purchase from investors all the loans on which it reduces payments.

"Countrywide plans not to absorb the \$8.4 billion reduction in mortgage payments itself ... but rather to pass most or all of that reduction on to the trusts that purchased mortgage loans from Countrywide," the lawsuit charges.

The lawsuit is seeking class-action status on behalf of 374 trusts holding Countrywide loans that could lose up to \$25 billion, said William Frey, president of Greenwich Financial. Frey said Countrywide's modifications could apply to \$80 billion worth of loans.

"Countrywide got caught speeding and they want the guy in the passenger seat to get arrested," Frey told the Business Journal.

Bank of America officials declined to comment on the lawsuit. In an e-mailed statement, a spokeswoman said, "Countrywide believes the plaintiffs' lawsuit represents an unlawful effort to assert rights of the trusts."

Fundamental tension

The dispute exposes the fundamental tension between the dual roles that lenders like Countrywide took on when they began selling mortgage-backed securities. On the one hand, it might be in the best interest of

Countrywide's lending arm to modify loans for troubled homeowners. But on the other, the company also has a fiduciary responsibility to its bond investors. Los Angeles has numerous banks with high home loan default rates that might want to implement modification programs.

Which of those obligations takes precedence will likely be thrown into sharp relief as President-elect Barack Obama hammers out his economic bailout plan. Last week, Obama signaled a clear desire to use some of the \$700 billion in financial bailout funds to help struggling homeowners.

"We've got to start helping homeowners, in a serious way, prevent foreclosures," Obama said Wednesday during a Chicago news conference to introduce New Mexico Gov. Bill Richardson as his commerce secretary.

That could mean more loan modifications, similar to the ones made when the Federal Deposit Insurance Corp. took over IndyMac Bank, a Pasadena-based thrift that failed in July. In those modifications, homeowners loans were adjusted downward so that borrowers aren't paying more than 38 percent of their pretax income on housing. So far no lawsuits prompted by the IndyMac modifications have come to light.

Some officials are pushing for the federal government to use \$24 billion in bailout funds to help 1.5 million borrowers by guaranteeing modified mortgages. But if the government does push for additional modifications, Congress will likely have to pass a law giving lenders legal immunity or risk more investors filing suit, Freixes said.

The lawsuit filed by Greenwich, Freixes said, could be a shot across the bow of the federal government and the banks "to sort of splash some cold water in their faces before they start renegotiating all these mortgages."

Some government officials already are engaging the possibility of legal challenges to loan modifications.

Last week, Sheila Bair, the head of the FDIC, addressing the Consumer Federation of America, said that investors in mortgage securities who challenge home-loan modification programs could provoke a "backlash" from Congress.

Frey of Greenwich stressed that he isn't against modifying home loans. But he said they should be done "in accordance with the contract and paid for by those who are responsible for them."

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