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# Massachusetts Ruling Highlights New Tensions Between Defaulting Borrowers and Securities Investors

The Massachusetts Supreme Court ruling in *U.S. Bank National Association et al. v. Ibanez et al.*, which sent tremors through bank stocks last week, raises new questions about the status of mortgage-backed securities (MBS) for banks and investors, as courts scrutinize the transfers that were part of the securitization process. The ruling may slow foreclosures by banks and lead to more litigation by investors against trustees, mortgage servicers or trust issuers when holders find that these parties to the MBS instruments cannot perform their obligations because of flawed or shoddy record-keeping.

**The *Ibanez* Case And Its Facts**

On January 7, 2011, the *Ibanez* court ruled that two banks (U.S. Bancorp and Wells Fargo) that had foreclosed on two defaulted loans in 2007, acting as trustees for trusts containing MBS, were not the holders of the mortgages at the time of the foreclosures, and thus the foreclosure sales were invalid.[1] The court held that the mortgages had been improperly transferred into two investment trusts, and that the transfers resulted in the banks failing to "own" the mortgages for purposes of seeking foreclosure. Moreover, the trust agreements that created the two investment trusts failed to contain detailed identifying information about the mortgages contained therein, and thus the trustees could not demonstrate sufficient evidence of ownership to make the foreclosures valid under Massachusetts law.

The decision raises concerns among investors that hold MBS, namely that faulty title documentation in the creation and ongoing custody of these investments may result in banks being unable to enforce their mortgage remedies. The core issue is whether the banks that now hold these mortgages as part of pooled securitized investments can demand foreclosure following the complicated transfers of sale, resale and bundling that brought an individual mortgage into a pool for securitization. Resolution of this issue will affect thousands of investors who have relied on the rights and recovery mechanisms outlined in their MBS investor agreements when the underlying mortgages default.

The *Ibanez* court seized on faulty documentation of the transfers of the two mortgages between parties in the securitization process. The transfer, the court noted, of one mortgage between the originator and Lehman Brothers Bank, FSB (Lehman) failed to identify a specific assignee. As a result, under Massachusetts law, the mortgage was never transferred to Lehman. Nonetheless, Lehman bundled the mortgage into a pool with hundreds of others and sold it to a subsidiary, which, in turn, transferred the pool to a MBS investment trust, with U.S. Bancorp acting as the trustee. Ten tranches of investment certificates were created out of the pool of mortgages, which were then sold by Lehman to investors.

**What It Means For Banks And MBS Investors**

The ruling is unsettling to both banks and MBS investors. Incomplete and inadequate documentation by banks transferring mortgages and creating MBS vehicles may prevent banks from establishing themselves as the rightful mortgage holders. This, in turn, prevents them from foreclosing on defaulting loans to comply with the terms of investment trusts that require such actions to protect investor rights. Like the banks in Ibanez, other banks acting as trustees may be prevented from bringing foreclosure actions on behalf of investors because securitization transfers are found to be invalid. Investors, who relied on the validity and enforceability of the trust agreements and the trustee's powers to foreclose, face the prospect of taking losses when banks and investors lose their foreclosure remedies. This ruling will force banks to work harder to convince both new investors and secondary market purchasers that the transfers underlying their MBS are proper. It may also spark new litigation by investors against trustees, mortgage servicers or trust issuers when holders find that flawed transfers or documentation during securitization results in trustees being unable to foreclose.

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1. *U.S. Bank v. Ibanez*, 10694, Supreme Judicial Court of Massachusetts (Slip Opinion dated January 7, 2011).