

## Client Alert



PILLSBURY WINTHROP<sup>LLP</sup>

### Securitization and Bankruptcy: Court to Decide Whether Bankrupt Loan Servicer Retains Servicing Rights Terminated Prior to Bankruptcy Part I of II

February 2, 2005

A dispute between a bankrupt loan servicer and the insurer that guaranteed payments to bondholders secured by the loans, will be decided by a U.S. Bankruptcy Judge in Delaware next week. Part 1 of this Client Alert summarizes the issues and the positions of the parties. Part 2, which will be published after the Bankruptcy Court hearing on February 7, 2005, will summarize the Court's ruling or, if the matter is otherwise settled, the final resolution of the issues.

A lawsuit pending in a chapter 11 bankruptcy case raises the issue of whether a debtor may retain rights as servicer and other interests under a pooling and servicing agreement that were terminated prior to bankruptcy, when the debtor refused to transfer such rights to the back-up servicer. In the case, *In re American Business Financial Services, Inc.*<sup>1</sup> pending in the U.S. Bankruptcy Court in Wilmington, Delaware, the debtor, American Business Financial Services, Inc. ("ABFS") and certain of its subsidiaries had originated sub-prime home equity and purchase money mortgage loans, sold the loans to a securitization trust and serviced the loans for the trust under a pooling and servicing agreement ("PSA"). Radian Asset Assurance Inc. ("Radian") insures approximately \$63 million of bonds issued by the trust, which are backed by payments from borrowers on the underlying mortgage loans. The servicer, American Business Credit, Inc. ("ABC"), is a subsidiary of ABFS. In December 2004, prior to the bankruptcy filing, Radian terminated ABC as servicer and directed ABC to transfer servicing and the related mortgage loans and files to the back-up servicer. However, before ABC did anything, it filed bankruptcy on January 21, 2005 along with ABFS and other affiliated companies.

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<sup>1</sup> Case No. 05-10203 (MFW). The case is being jointly administered with chapter 11 cases filed by several ABFS subsidiaries including American Business Credit, Inc. which is the subject of this Client Alert.

On January 24, 2005, Radian filed a lawsuit and a motion for an injunction asking the Bankruptcy Court to compel ABC to transfer servicing. ABC responded on February 1, 2005 with a motion to dismiss the lawsuit and an objection to Radian's motion for an injunction. In its response, ABC argues that Radian is attempting unilaterally to terminate the PSA in violation of section 365 of the Bankruptcy Code<sup>2</sup> and to collect money damages from ABC in violation of the automatic stay in section 362(a) of the Code. The Bankruptcy Court set a hearing on Radian's motion on February 7, 2005.

### **Pre-Bankruptcy Termination of Servicing**

Under the PSA, entered into in March 2003, ABC was appointed as servicer for an initial 90-day period. Radian had sole discretion to extend the servicing period by delivering an extension notice to ABC prior to the end of each period. Radian extended ABC's servicing rights periodically, but the last extension notice expired on December 31, 2004. Radian elected not to extend ABC as servicer and did not send a notice to extend beyond that date. According to Radian's pleadings, ABC's right to service the mortgage loans automatically expired on December 31, 2004.

On January 1, 2005, Radian notified ABC of its decision not to extend servicing and outlined several actions ABC must take to transition servicing to the back-up servicer, EMC Mortgage Company ("EMC"). The principal actions Radian required of ABC – delivering mortgage files and data to EMC, delivering funds on account to the bond trustee, providing "RESPA" information<sup>3</sup> delivering executed assignments, and giving EMC access to books and records – were to be completed by no later than January 20, 2005. Other actions – providing updated information and servicing files – were to be completed by February 3, 2005. In addition, Radian states that the servicing transfer date for purposes of RESPA was intended to be February 1, 2005.

By January 21, 2005 when ABC filed its bankruptcy petition, it had taken none of the required actions.

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<sup>2</sup> 11 U.S.C. §§ 101-1330 (referred to herein as the "Bankruptcy Code" or the "Code").

<sup>3</sup> Under the Real Estate Settlement Procedures Act (RESPA), outgoing servicers are required to notify mortgage loan borrowers that their loans will be serviced by a different company. 15 U.S.C. § 2605(c)(2)(A).

### **Radian's Arguments**

Radian asserts that ABC's rights as servicer expired automatically on December 31, 2004 because Radian did not deliver an extension notice. Radian states that the clear language of the PSA gives Radian sole discretion to elect not to extend ABC's servicing and that Radian exercised that discretion in accordance with the agreement. The PSA further provides that upon termination, ABC is obligated to cooperate in transferring servicing to the back-up servicer. Radian claims that ABC breached the agreement by failing to cooperate and seeks to compel ABC to transfer servicing now, notwithstanding the bankruptcy filing, because ABC has no current right to service the loans or to retain the loan files.<sup>4</sup>

Radian also asserts a claim for conversion based upon ABC's retention of the mortgage files, data and other servicing documents without authorization. The principal elements of Radian's conversion claim are that ABC does not own the mortgage loans and has no equitable interest in them. In addition to relying on provisions of the PSA that vest ownership of the loans in the trust, Radian supports this argument by citing a provision of the Bankruptcy Code that expressly excludes mortgage loans and interests in mortgage loans from becoming property of the bankruptcy estate of a servicer.

### **Bankruptcy Code Exclusion for Mortgage Loans**

The Bankruptcy Code provides in general, that all property in which a debtor has a legal or equitable interest becomes property of the bankruptcy estate subject to the Bankruptcy Court's jurisdiction. This is true even for property that the debtor does not own but merely has in its possession. However, a specific Bankruptcy Code exception to this provision states that:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such

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<sup>4</sup> Radian contends that ABC breached other provisions of the pooling and servicing agreement by failing to repurchase or replace loans in the pool that do not comply with underwriting criteria.

mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.<sup>5</sup>

The legislative history of this exception supports Radian's position that it is intended to protect non-debtor parties with interests in mortgage loans that have been sold in the secondary market and are being serviced by companies in bankruptcy.

### Requested Relief

Radian seeks an order from the Bankruptcy Court directing ABC to immediately comply with its obligation to transfer servicing to EMC. Radian claims that without the mortgage files, EMC is not able to service the loans. If the mortgage loans are not serviced, the securitization trust and Radian can not tell if underlying mortgage borrowers are making their loan payments. If the loan payments are not being collected, the trust could default under the bonds and Radian, as insurer, would be obligated to pay the bondholders.

Specifically, Radian is asking the Bankruptcy Court to direct ABC to take the steps necessary to transfer servicing to EMC, including by delivering mortgage loan files and all related documents, data, and funds required to service the loans and make payments to the trust so that funds are available to pay bondholders.

In accordance with the applicable rules for obtaining injunctive relief, Radian acknowledges that it will likely be required to post security to protect ABC from any losses incurred as a result of the injunction if the Court ultimately determines that the injunction should not have been granted. Under the rules, the amount of the security should be sufficient to compensate the enjoined party for damages incurred as a result of the injunction. Radian states that the issues raised by the motion and complaint can be resolved by the Court within three months and requests that the Court fix the amount of the security at no more than \$253,869.30 which, Radian says,

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<sup>5</sup> Bankruptcy Code section 541(d). Subsections (a)(1) and (2) referenced in the above quoted provision sets forth the scope of property that does become property of the bankruptcy estate at the commencement of the case.

represents approximately three months of servicing income that would be paid to ABC if the injunction were not issued.

### ABC's Response

In its responding papers, ABC argues that Radian is attempting unilaterally to terminate the PSA in violation of section 365 of the Bankruptcy Code and that Radian's lawsuit violates the automatic stay provisions in Section 362 of the Code because it is a prosecution of a claim based on a pre-petition contract and seeks control over property ABC has in its possession.<sup>6</sup> ABC's position rests largely on its assertion that the PSA is an executory contract that ABC may choose to assume or reject in due course during the bankruptcy case, and because the transition to the back-up servicer was not completed before the bankruptcy case was filed, Radian's election not to extend ABC's servicing did not extinguish ABC's servicing rights under the PSA. ABC is asking the Court to dismiss Radian's adversary complaint and deny Radian's motion for an injunction.<sup>7</sup>

ABC notes that notwithstanding its bankruptcy filing, it continues to service the loans and has, in fact, already paid \$1.6 million to the trust. ABC asserts that if the Court does issue an injunction, the amount of Radian's security bond should be at least equal to the \$1.6 million ABC paid to the trust plus the reasonable sale price of the servicing rights, which ABC states is \$800,000.

### Preliminary Conclusion

The issues raised in the ABFS case are important to parties involved in securitization transactions. Depending upon how the Court ultimately rules and what it says about ABC's termination as servicer, its ability to retain servicing rights, and the scope of a servicer's interest in mortgage loan files under the Bankruptcy Code, parties in such transactions may need to consider modifying the forms of transaction documents they use to better protect their interests

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<sup>6</sup> Section 365 of the Code provides that a debtor may assume or reject an executory contract which is, in general, a contract for which some performance remains due by the parties at the time the bankruptcy case is commenced. Section 362 of the Code generally enjoins most types of actions against the debtor and its property.

<sup>7</sup> ABC also argues that Radian's claim for money damages violates the automatic stay and must be addressed as claim filed in the bankruptcy case.

in bankruptcy cases involving loan servicers. In addition, if ABC is deemed to have retained servicing rights under the PSA, the Court may permit ABC to sell those rights in a competitive bidding process and assign them to a third party over other parties' objections.

Under a procedural order entered by the Court, Radian may file a reply memorandum by February 4, 2005. A hearing on the motion for an injunction and ABC's motion to dismiss will be held on February 7, 2005 in Wilmington. Pillsbury Winthrop will continue to monitor the developments in the ABFS case and keep our clients and friends informed.

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