Quick Guide to Pooling and Servicing Agreements in Foreclosure Cases

What are Pooling and Servicing Agreements (“PSAs”) and why do they matter in defending your clients?

- A PSA is a legal document, usually filed with the Securities and Exchange Commission, that defines the rights and obligations of the parties involved.
- A PSA defines what should have occurred with your client’s promissory note.
- By understanding a few critical components of a PSA, you can explain to a Court why it matters that the Plaintiff did not follow the PSA, which they rarely do.

Attached is a paper from the SEC’s EDGAR site on finding PSAs: see http://www.sec.gov/edgar/searchedgar/webusers.htm

Securitization 101

Most foreclosures are filed by securitized trusts. A securitized trust did not finance your client’s loan. Instead, your client’s loan was bundled and sold to the trust as part of a process called securitization. The following facts from an actual case illustrate securitization.

On January 3, 2003, Oties Jordan borrowed $75,000.00 from Delta Funding Corporation and signed a promissory note payable to Delta.1 Thus Delta originated this loan. The note was secured by a mortgage. On or about March 1, 2003, Delta “pooled” Mr. Jordan’s Note with 1,752 other mortgage notes it originated and sold those notes to a trust named “Renaissance Home Equity Loan Trust 2003-1” (“Renaissance”). Renaissance was a Real Estate Mortgage Investment Conduit (“REMIC”), which is defined in I.R.C. § 860D.2 In broad terms, a REMIC is an entity that purchases a fixed pool of mortgages secured by real property and distributes the payments it collects from the borrowers as mortgage-backed securities.3 A REMIC is not taxed on the money it collects from borrowers.4 REMICs are subject to a 100% tax on net income derived from non-permitted assets, including mortgage notes acquired after the start up date in the PSA.5

Renaissance was also called the issuer because it issued $258,551,000.00 in securities in a public offering. Those who purchased the securities were called investors. Renaissance retained Ocwen Federal Bank FSB as the “the servicer” to collect payments from the 1,753 loans. The Trustee, Wells Fargo, distributed these payments to investors. Delta, the originator, filed for bankruptcy under Chapter 11 on December 17, 2007.

1. Wells Fargo v. Jordan (8th Dist. 2009), 2009-Ohio-1092. The Jordans were pro se. The Legal Aid Society of Cleveland filed an amicus brief successfully opposing a discretionary appeal to the Ohio Supreme Court.
2. I.R.C. § 860(D); 26 U.S.C.A. § 860(D).
5. I.R.C. § 860(G)(a)(3)(A); 26 U.S.C.A. § (G)(a)(3)(A). There are qualifications to this rule you should examine. A PSA start up date contains a 10 day grace period.
The Technical Language

With this example in mind, it is now important to place securitized trusts in a legal context.

In its simplest form, securitization works like this: loans are pooled and transferred to a business entity whose purpose is to hold the pool of mortgages, oversee the servicing and pay the investors at specified intervals. These companies are separately incorporated from the original lender. Corporate separateness is strictly observed in order to avoid having the loan assets dragged into a bankruptcy that the original lender may subsequently file. They are often referred to generically as a “special purpose vehicle (SPV)” or “bankruptcy remote entity.” A trust is the most common form. . . . The trustee issues the certificates of securities that will ultimately be purchased by investors. . . . [O]ften an investment bank will purchase the certificates. . . . In any given securitization, the agreements between the parties are contained in the Pooling and Servicing Agreement (PSA).

Why Physical Handling of Notes Matters

“Tax exemption” and “bankruptcy remote” are the key points in reviewing a PSA. The PSA, Renaissance’s founding document, contained instructions on how to preserve (1) its tax exempt status as a REMIC, and (2) its right to collect on the 1,753 loans it purchased from Delta without interference from Delta’s creditors if Delta went bankrupt, which Delta did. These instructions state how and when the notes were to be handled.

The key point of PSA analysis is that contract language alone cannot preserve a REMIC’s tax exemption, nor its bankruptcy remote status. The physical handling of the notes matters. And the foreclosure mills and servicers frequently ignore this critical fact.

Drafters of Pooling and Servicing Agreements follow a template. The key section for your purposes is Article II, Section 2.01, which defines how the loans were to be assigned. The Section requires physical transfer of the notes by the startup date. If not assigned by the startup date, then the income should be taxed at 100%.

The physical negotiation of notes matters for bankruptcy too. Without delving into the law on the doctrine of a “true sale,” one should argue that if the note is not negotiated by the originators, then the originator’s bankruptcy creditors, not the trust, has the right to collect on the note.

Applying this to Your Case

Experience demonstrates that foreclosure mill attorneys and servicers rarely comply with Section 2 of the PSA. Usually, the document the Trustee files as proof that it holds the note is dated after the start date in the PSA. Thus, income from this should be taxed at 100%. Also, if the originator filed for bankruptcy, the document presented to the court usually is dated after the date the originator filed for bankruptcy.

The question is how this helps you and your client. You cannot sue to enforce tax laws, but you can raise the following.

➢ Unclean hands – foreclosure is an equitable remedy, thus you can demonstrate to the Court how the trust violated securities and tax law.

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➢ If the originator filed for bankruptcy, you can argue that the note is an asset of the bankruptcy estate (if a chapter 7 bankruptcy) or that the lender has no rights to the loan if it was not assigned before any claim bar date.

➢ Defeating holder-in-due-course status by using prospectus or other documents to show knowledge of default at the time the loan was transferred into the pool.

➢ Argue that under state law governing the Trust, limits are placed upon its authority to negotiate or accept a note, except as defined in the PSA.

➢ Unjust enrichment – a counterclaim to recover money paid before the note was assigned to the Trust.

➢ Avoidance of acceleration – determine if the trustee had a right to accelerate if it did not possess the note.