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CLIENT ALERT

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NINTH CIRCUIT RULES MORTGAGES ARE LIKE DOG FOOD

A Federal Court of Appeals cleared Freddie Mac and a mortgage bank of wrongdoing in connection with their decision to stop doing business with a loan broker in a recent decision. The court ruled that Freddie Mac's listing of the plaintiff on a "Exclusionary List" that identifies entities with which it will not do business was privileged, and that it could not be liable even though Freddie Mac shared the Exclusionary List with third parties who sell loans to or service loans for Freddie Mac.

Learning that certain loans in mortgage pools it securitized were prepaying at a faster rate than anticipated, the Federal Home Loan Mortgage Corporation ("Freddie Mac") contacted the lender that sold it the mortgages, National City Mortgage Company ("National City"). The loans in question were solicited by a mortgage broker under contract with National City named Family Home and Finance Center, Inc., which conducted business as "Park Place Funding." Loan origination was conducted by National City.

Park Place Funding employed a repetitive refinancing strategy, through which it encouraged borrowers to apply for initial loans with high interest rates in order to earn a Yield Spread Premium under the terms of its Mortgage Loan Purchase Agreement with National City. Park Place Funding paid a portion of the Yield Spread Premium back to its borrowers in the form of a rebate, which would help offset the cost of the higher interest loans. Park Place Funding then encouraged its borrowers to quickly refinance into lower interest rate loans to reduce their borrowing costs.

The strategy used by Park Place Funding was legal and consistent with National City's policy of allowing early prepayment of its loans. In addition, the rebates paid by Park Place Funding were disclosed in the loan documents. But the early loan payments caused losses by the investors in Freddie Mac's securities (called Participation Certificates) and caused certain investors to cease trading in Freddie Mac's Participation Certificates. The court explained: "Loans with rapid repayment rates resulted in losses to capital market investors, and Freddie Mac's customers did not wish to invest in such loans. In the debt market, packaged loans are a product offered for sale. If potential buyers do not want to buy the product, Freddie Mac is under no obligation to order more of it. Like dog food, if dogs won't eat it, the store won't buy it."

In March 2005, National City terminated its contract with Park Place Funding. Freddie Mac also began an investigation. It notified Park Place Funding that its loans were not investment quality and that it intended to place Park Place Funding on an Exclusionary List. The Exclusionary List identifies those entities that are prohibited from participating in transactions with Freddie Mac, whether directly or indirectly. It is sent by Freddie Mac only to lenders with whom it does business. After an unsuccessful appeal to Freddie Mac's Exclusionary List Appeal Committee, Park Place Funding was placed on Freddie Mac's Exclusionary List on January 31, 2006.

Park Place Funding brought claims against Freddie Mac for intentional interference

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with contractual relations, unfair competition and defamation because its placement on the Exclusionary List effectively denied it access to a market for loans it wrote. The Ninth Circuit Court of Appeals upheld summary judgment in favor of Freddie Mac. It concluded that Freddie Mac acted properly in refusing to purchase any more loans written by Park Place Funding since it had no market for those loans. Its action in placing Park Place Funding on its Exclusionary List served Freddie Mac's legitimate business interests of insuring that it did not mistakenly purchase any loans written by Park Place Funding since they were not appropriate for inclusion in mortgage pools used for securitization.

Park Place Funding argued that the Exclusionary List is understood in the mortgage industry as a "fraud list" and that placing it on the list mistakenly identified it as an entity engaged in mortgage fraud. The Court found that the list is used not only to identify entities engaged in fraud, but also to identify those whose lending practices make their loans inappropriate for the secondary markets in which Freddie Mac plays such a major role. As for defamation, California's Common Interest Privilege protected Freddie Mac, since the Exclusionary List furthers the common interest of both Freddie Mac and the businesses to whom it sends the list in dealing only with investment quality loans.

The opinion was issued on May 7, 2008 by the United States Court of Appeals for the Ninth Circuit in the case entitled Family Home and Finance Center, Inc. v. Federal Home Loan Mortgage Corporation, ___ F.3d ___, 2008 WL 1959494 (9th Cir. 2008).

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