State of Illinois
Circuit Court of Cook County
Law Division

Raymond W. Mitchell
Judge

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IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

DEUTSCHE BANK NATIONAL TRUST COMPANY, as Trustee for MORGAN STANLEY ABS CAPITAL I INC. TRUST 2007-HE6

Plaintiff,

vs.

DECISION ONE MORTGAGE COMPANY, LLC and HSBC FINANCE CORPORATION,

Defendants.

No. 2013 L 005823
Calendar S
Judge Raymond W. Mitchell

ORDER

In this breach of contract action regarding mortgage-backed securities, Defendants Decision One Mortgage Company, LLC and HSBC Finance Corporation separately move to dismiss the complaint under 735 ILCS § 5/2-615(a). For the reasons set forth below, Defendants' motions are granted in part and denied in part.

I.

This case arises from the 2007 sale of 2,789 mortgage loans that were originated by Decision One, a subsidiary of HSBC Finance, with a value exceeding $500 million. These loans were compiled into a trust entitled the Morgan Stanley ABS Capital I Inc. Trust 2007-HE6. The trust was designed as a mortgage-backed securitization, structured to use the constituent mortgage loans as collateral for certificates issued by the trust to investors. As mortgage servicers collected payments on both the principal and interest from the underlying loans, the cash flow would pass to the Certificateholders as income.

According to the Pooling and Servicing Agreement, following the mortgage loans' origination by Decision One, the loans passed through two intermediaries—entities designated as the Sponsor and Depositor—prior to being sold to the trust. The PSA was signed by Deutsche Bank, Decision One, and other related parties with the closing date designated as May 31, 2007. Once the transaction closed, the Trust issued certificates to Certificateholders and over $500 million was transferred to Decision One.

Because the value of the transaction is predicated on the quality of the mortgage loans, the PSA included 69 representations and warranties made by Decision One for the loans that it sold to the trust. Although Decision One would not service these mortgage loans, it was to be responsible for breaches of these representations and warranties in two respects. Decision One had to notify the Trustee of breaches of those representations and warranties, § 2.03(b), and it had to repurchase mortgage loans that materially breached those representations and warranties under a repurchase protocol, § 2.03(f). Whether Decision One made the discovery independently or through notice from a third party, Decision One had a duty under the PSA to cure defects or repurchase loans in material breach.

On March 25, 2013, the Securities Administrator sent a letter to Decision One from a group of Certificateholders, alleging that Decision One had materially breached its representations and warranties for 799 loans and demanding repurchase of the defective loans. This letter was the first notice provided under the PSA's repurchase provision. A second letter followed days later, alleging breaches with respect to an additional 644 loans and again demanding repurchase for those loans in material breach. These letters were issued following a "forensic analysis," which evaluated the loans with publically available records alongside an automated valuation model. The results of the forensic analysis yielded 2,558 breaches, and the letters together demanded repurchase of 1,444 mortgage loans.

In addition to the forensic analysis, a firm performed a re-underwriting analysis. This analysis entailed an individual review of each mortgage loan within the trust to identify material breaches within the loan documentation. The re-underwriting analysis reported numerous defects, including income misrepresentations, debt obligation misrepresentations, and appraisal errors and misrepresentations. Drawing from these results, the consulting firm estimated with a 95% confidence interval that between 53% and 62% of the mortgage loans were in material breach.

In 2007, HSBC Finance acquired Decision One. That year, HSBC Finance announced that Decision One would cease operations, laying off many of the employees and terminating Decision One's leases. Decision One remains a valid corporation incorporated in North Carolina. However, last year, Decision One was administratively dissolved (as of April 16, 2012) for a failure to file annual reports with the North Carolina Secretary of State over the course of five years. Decision One was reinstated on October 20, 2012 following its submission of reinstatement forms and retroactive annual reports. HSBC Finance owns Decision One through an intermediary corporation, which Deutsche Bank avers is a shell corporation. Pursuant to its October 20, 2012 annual report, the three managers of Decision One all hold senior-level positions in HSBC Finance's Mortgage Services business.

On March 31, 2103, Deutsche Bank filed this complaint against Decision One and HSBC Finance for breach of contract under the PSA. The complaint identifies four counts: (1) a breach of the representations and warranties of the mortgage

loans in the trust, (2) a breach of an obligation to cure or repurchase the defective mortgage loans, (3) a breach for failure to notify Deutsche Bank about breaches as they were discovered, and (4) a claim seeking indemnification for damages and other expenses suffered due to these breaches. Deutsche Bank seeks compensatory and rescission or rescissory damages along with the specific performance of repurchase. Deutsche Bank alleges that HSBC Finance is an alter ego of Decision One through its dominion and control of Decision One, and it accordingly seeks to hold Decision One jointly and severally liable under each claim.

II.

A section 2-615 motion attacks the legal sufficiency of a complaint. *Weatherman v. Gary Wheaton Bank of Fox Valley, N.A.*, 186 Ill.2d 472, 491 (Ill. 1999). The dismissal of a count in a complaint for legal insufficiency is appropriate under section 2-615 only if, when viewed in a light most favorable to the opposing party, the factual allegations underlying the count are not sufficient to state a cause of action upon which relief can be granted. *Abbasi v. Paraskevoulakos*, 187 Ill. 2d 386, 391 (Ill. 1999). A claim should not be dismissed on the pleadings unless it clearly appears that no set of facts can be proved under the pleadings that will entitle the plaintiff to recover under that claim. *Linker v. Allstate Ins. Co.*, 342 Ill. App. 3d 764 (1st Dist. 2003).

While Illinois law establishes the procedural standards, the PSA designates that New York law governs the transaction. Questions concerning alter ego liability are resolved under the law of Decision One's state of incorporation, North Carolina.

A.

As a preliminary matter, Decision One argues that the complaint should be dismissed in its entirety because a procedural prerequisite set by the PSA has not been met. Decision One argues that, under the PSA, the Trustee may only bring suit upon receiving authorization from the Depositor. The argument is based on section 2.03(f), which provides that "[t]he Trustee shall pursue all legal remedies available to the Trustee against the applicable Responsible Party under this Agreement as directed in writing by the Depositor." Decision One reads this section to limit the Trustee's ability to pursue legal remedies to only those specified by the Depositor. Absent that direction, Decision One argues, the Trustee cannot bring suit under the PSA. Decision One maintains that this reading of 2.03(f) reflects the structure of the PSA's remedial scheme, which grants the Depositor the opportunity to repurchase defective loans prior to seeking repurchase from Decision One.

Under New York law, the PSA is to be interpreted according to the general rules of contract interpretation "so that a clear and unambiguous policy provision is given its plain and ordinary meaning." *Dalton v. Harleysville Worcester Mut. Ins. Co.*, 557 F.3d 88, 90 (2d Cir. 2009). Section 2.03(f) does not offer the meaning that Decision One suggests. The plain reading of 2.03(f) identifies an obligation of the

Trustee to pursue all legal remedies when directed to do so by the Depositor. But this duty does not circumscribe the Trustee's legal authority to only those matters specified by the Depositor—the fact that it is required to pursue legal remedies when directed does not prevent the Trustee from undertaking legal remedies on its own accord. Given that the obligation described in section 2.03(f) does not inherently require this limitation, there is no basis to draw such a sweeping inference from the text. If, as Decision One contends, such a limitation was instrumental to the remedial scheme established by the PSA, it stands to reason that the clause would be manifestly clear to that effect. Interpreted in the light most favorable to the nonmovant, section 2.03(f) does not warrant dismissal of this suit.

B.

Breach of Representations and Warranties

Deutsche Bank's first claim alleges breach of contract with respect to representations and warranties made concerning the trust's mortgage loans. Broadly speaking, the complaint alleges a breach at two moments. First, Deutsche Bank avers that Decision One was aware or should have been aware of breaches of these representations and warranties at the time of origination, triggering an obligation to cure or repurchase the loans. The complaint states that this knowledge may be inferred in accordance with industry standards and what would have been apparent in the course of processing and issuing the mortgage loans. Second, Deutsche Bank states that Decision One was made aware of breaches following receipt of the two 2013 letters that identified, in detail, breaches of a subset of the mortgage loans. Either argument, if supported by sufficient factual allegations, would constitute an independent basis on which to seek recovery for a breach of representations and warranties. To date, Defendants have not cured any mortgage loan in material breach in the trust.

Challenging the first ground, Decision One responds that the complaint's allegation that Decision One knew or should have known of the breaching loans is "conclusory," offering no factual basis upon which to draw the inference that Decision One would have made such discoveries. However, Deutsche Bank need not advance specific factual allegations at this stage regarding Decision One's knowledge of the breaching loans. Under Illinois law, a statement of a defendant's knowledge is an allegation of ultimate fact and not a conclusion. *Ward v. Cmty. Unit School Dist. No. 220*, 243 Ill. App. 3d 968, 974 (1st Dist. 1993). Accordingly, Deutsche Bank does not need to plead the evidentiary facts necessary to prove the Defendants' knowledge. *See id.*; *Bd. of Educ. v. Kankakee Fed'n of Teachers Local No. 866*, 46 Ill. 2d 439, 446–47 (Ill. 1970) ("[O]nly the ultimate facts to be proved should be alleged and not the evidentiary facts tending to prove such ultimate facts.").

Even though, as stated, evidentiary facts are not necessary to demonstrate Decision One's knowledge, the complaint nonetheless alleges facts that provide a basis on which to infer knowledge. Due to the forensic review (both through the statistical and re-underwriting analyses), the complaint states "pervasive" and "flagrant" breaches that would have been apparent to an underwriting firm following industry standards. Viewed in the light most favorable to Deutsche Bank, because Decision One had an immediate obligation to cure breaches it was aware of prior to notice from the Trustee, these allegations support a breach of contract action. *See Trust for the Cert. Holders of the Merrill Lynch Mortg. Pass-Through Certs. Series 1999-C1 v. Love Funding Corp.*, No. 04 Civ. 9890, 2005 WL 2582177, at *7 (S.D.N.Y. Oct. 11, 2005); *Deutsche Alt-A Secs. Mortg. Loan Trust v. DB Structured Prods., Inc.*, No. 12 Civ. 8594, 2013 WL 3863861 at *6 (S.D.N.Y. July 24, 2013).

For the purposes of this motion, because the complaint establishes the factual allegations sufficient to support Decision One's independent knowledge of the mortgage-loan breaches, it is not necessary to assess whether the 2013 loan-specific notice was prompt and proper. Decision One contends that the notice was not. However, because the broader ground (that Decision One knew or should have known of the breaches) is available, the subsequent foundation of breach (the Securities Administrator's notice in 2013) would not support dismissal of the count. Even if the Court reached the matter, the question of the notice's sufficiency does not lend itself to resolution on a motion to dismiss. This assessment would require a fact-intensive analysis—as indicated by the fact that the cases Decision One cites in support of its argument that considered this question at the summary-judgment stage. *See, e.g., MASTR Asset Backed Sec. Trust 2006-HE3 v. WMC Mortg. Co.*, 2012 WL 4511065 (D. Minn. Oct. 1, 2012); *M & I Bank v. Coughlin, FSB*, No. 09-02282, 2012 WL 602365 (D. Az. Feb. 24, 2012), *Bank of N.Y. Mellon Trust Co. N.A. v. Morgan Stanley Mortg. Capital, Inc.*, No. 11 Civ 0505, 2013 WL 3146824 (S.D.N.Y. June 19, 2013).

Barring the broad dismissal of the entire claim, Decision One seeks to dismiss specific breaches relating to the repurchase of an unspecified number of mortgage loans that have since been liquidated. Decision One contends that Deutsche Bank may not seek recovery for the liquidated loans, even if there was determined to have been a breach of representation or warranty. Under Decision One's interpretation, the PSA does not compel the repurchase of liquidated loans because such loans do not meet the PSA's definition of a "Mortgage Loan." Decision One submits that once a mortgage loan is liquidated through foreclosure, it is, by definition, no longer a mortgage loan—foreclosure extinguishes the underlying mortgage. Without a mortgage loan, there is nothing to repurchase, and so the obligation set by the PSA falls away. Thus, Decision One argues that 2.04(f) operates to limit its responsibility for extant mortgage loans.

Deutsche Bank counters by noting that the PSA definition of "Mortgage Loan" contains no exclusion of liquidated loans—it only enumerates as exempt those mortgage loans that have been replaced and repurchased. Moreover, by including "Liquidation Proceeds" and "REO Disposition Proceeds" in the definition for "Mortgage Loans," Deutsche Bank argues that the PSA must have included liquidated loans in the term as both of those proceeds arise through liquidation. Decision One responds that the terms "Liquidation Proceeds" and "REO Disposition Proceeds" only indicate that all rights, benefits, proceeds, and obligations traveled with the mortgage loan when it transferred to the trust.

A party's ability to recover the value of liquidated loans in a mortgage-backed security transaction has produced a split in the case law. Recent cases have considered this issue in evaluating similar contracts to the one here. Decision One relies primarily on *MASTR Asset Backed Sec.*, 2012 WL 4511065, which supports its position that liquidated loans are not covered by a repurchase provision. In *MASTR*, the court noted that the contract's language could not be interpreted to include liquidated loans given the nature of the repurchase protocol. In particular, the reassignment of the loan under the contract triggered by repurchase was an impossibility, as there was no title for the collateral to assign following liquidation. The court bolstered that conclusion from its view of the practical understanding of a "mortgage loan," which is, by definition, secured by real property. *Id.* at *6. Without that collateral, the court did not consider it reasonable to require a party to repurchase liquidated loans as if they were mortgage loans.

Deutsche Bank cites the other line of cases, which hold that the structure of such deals necessitate an interpretation that liquidated loans are subject to the repurchase agreement. *See Deutsche Alt-A*, 2013 WL 3863861 ("[T]his implication would give [the originator] the ability to frustrate the Trust's repurchase remedy by delaying or refusing to repurchase the breaching Mortgage Loans until the servicer had, in mitigation of the Trust's losses, foreclosed on them."); *ACE Secs. Corp. v. DB Structured Prods., Inc.*, 965 N.Y.S. 2d 844, 849 (N.Y. Sup. Ct. May 13, 2013) ("[The originator] would be perversely incentivized to fill the Trust with junk mortgages that would expeditiously default."); *Resolution Trust Corp. v. Key Fin. Servs., Inc.*, 280 F.3d 12 (1st Dist. 2012) ("[The originator] appears to be the party that is trying to take advantage of whatever 'windfall' will result from the fact that the vast majority of the disputed loans have gone off-line.")

Thus, there is a split of authority on the availability of Deutsche Bank's recovery here, but a blanket dismissal—without establishing which loans would be affected—is premature. As was the case in *Deutsche Alt-A* and *ACE Securities*, a resolution of this matter is not yet warranted. There must first be discovery as to which of the non-conforming loans have in fact been liquidated. *Deutsche Alt-A* at *13; *ACE Secs.* at 849. The case on which Decision One relies, *MASTR*, approached the issue at the summary-judgment stage, with evidence as to which specific loans were liquidated. *Id.* at *9.

In any event, both *Deutsche Alt-A* and *ACE Securities* are persuasive that excluding liquidated loans from the repurchase remedy is an implausible interpretation under the structure of such transactions. *Deutsche Alt-A* considered the reasoning offered by *MASTR*, but deferred to the *ACE* court's conclusion that exempting liquidated loans would render the repurchase remedy "virtually worthless." *See ACE*, N.Y.S.2d at 849. Under the arrangement Decision One describes, an originator could avoid the repurchase requirement by electing to both issue bad loans likely to face foreclosure and neglecting to seasonably cure defects. *Id.*

Availability of Compensatory Damages and Rescission or Rescissory Damages

In addition to specific performance, Deutsche Bank seeks compensatory damages and rescission or rescissory damages. Decision One seeks to dismiss the first claim to the extent that it pursues either of these remedies, circumventing the sole-remedies provision of the PSA found in § 2.03(q). The sole-remedies provision designates the repurchase remedy set by § 2.03(f) as the sole method of recovery for breaches of representations and warranties. By virtue of this provision, Decision One argues that the parties agreed to forego broad monetary remedies, giving Decision One the opportunity to cure, repurchase, or substitute defective loans on a loan-by-loan basis. This precludes both compensatory and rescission or rescissory damages. *See Metro. Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 643 N.E.2d 504, 507 (N.Y. 1994) (noting that New York law enforces contractual limitations on remedies). Moreover, by operation of the sole-remedies provision, Decision One claims that there is a "complete bar to equitable relief" in the form of rescission. *See Rubinstein v. Rubinstein*, 244 N.E.2d 49, 52 (N.Y. 1968).

In response, Deutsche Bank first suggests that for the purposes of this case there is not a meaningful distinction between a repurchase remedy and compensatory or rescissory damages. Specific performance or damages would be tied to the repurchase amount and simply operate to make it whole. *See, e.g.*, *Deutsche Alt-A*, 2013 WL 3863861 at *11. But more broadly, Deutsche Bank argues that the sole-remedies provision may not foreclose these forms of recovery. First, such a provision is unenforceable where there has been an alleged act of gross negligence—as was alleged here. *See Gold Connection Disc. Jewelers, Inc. v. Am. Dist. Tel. Co.*, 212 A.D.2d 577, 578 (N.Y. App. Div. 1995). Additionally, remedy provisions may be set aside where they—though initially fair and reasonable at a contract's inception—are rendered to deprive a party the benefit of the bargain. *See Cayuga Harvester, Inc. v. Allis-Chalmers Corp.*, 95 A.D.2d 5, 11 (N.Y. App. Div. 1983).

With respect to compensatory damages, the damages sought by Deutsche Bank are fungible. *Orix Real Estate Capital Mkts., LLC v. Superior Bank, FSB*, 127 F. Supp. 2d 981, 983 (N.D. Ill. 2000). It does not matter whether the remedy is fashioned as a repurchase remedy or as compensatory damages. *Id.* And a sole-

remedies clause does not apply in a breach of contract action where the losses are the result of gross negligence. *Gold Connection*, 212 A.D.2d at 578. Only when the allegations are "insufficient to plead gross negligence or willful misconduct" will compensatory damages be disallowed in light of a limited liability clause. *See Morgan Stanley & Co. Inc. v. Peak Ridge Master SPC Ltd.*, No. 10 Civ. 8405, 2013 WL 1099059, at *10 (S.D.N.Y. Mar. 15, 2013). That is not the case here: the complaint can support a claim of gross negligence or willful misconduct.

So too with respect to rescission or rescissory damages. As *Deutsche Alt-A* observed: "whether the Trustee's remedy is characterized as 'compensatory damages,' 'rescissory damages,' or 'specific performance' has little practical significance given that the form of the relief (if not necessarily the quantum) is the same in each case: the payment of money to make a Plaintiff whole." 2013 WL 3863861, at *11. Yet even setting aside the fungibility of these classifications, at this stage, there is a plausible basis for Deutsche Bank to maintain rescission or rescissory damages. To strike this remedy would require factual determinations to counter the justifications which have been offered to support them. New York district courts have repeatedly denied motions to dismiss these remedies in cases with similar factual circumstances. *See Assured Guar. Mun. Corp. v. UBS Real Estate Secs., Inc.*, No. 12 CV 1579, 2012 WL 3525613, at *7 (S.D.N.Y. Aug. 15, 2012); *Syncora Guar. Inc. v. EMC Mortg. Corp.*, No. 09 Civ. 3106, 2012 WL 2326068, at *10 (S.D.N.Y. June 20, 2012); *Ambac Assurance Corp. v. EMC Mortg. Corp.*, No. 08 Civ. 9464, 2009 WL 734073, at *2 (S.D.N.Y. Mar. 16, 2009). At this stage, there is not a sufficient basis to dismiss these damages.

C.

Breaches for Failure to Repurchase and Failure to Provide Notice

Decision One argues that the second and third claim must fail because they improperly transform a remedial provision into independent duties giving rise to separate claims. The complaint alleges breaches by Decision One for its failure to repurchase and to provide notice of breaches of representations and warranties. These claims, Decision One argues, are both duplicative and contrary to the sole-remedies provision, as Deutsche Bank's theory would permit a claim for general contract damages whenever the remedies provision does not operate to the parties' satisfaction. *See Nomura Asset Acceptance Corp. v. Nomura Credit & Capital, Inc.*, No. 6533541-2011, 2013 WL 2072817, at *8 (N.Y. Sup. Ct. May 10, 2013). Permitting such a claim renders the sole-remedies provision "essentially meaningless." *See Ronnen v. Ajax Elec. Motor Corp.*, 671 N.E.2d 534, 536 (N.Y. 1996).

Deutsche Bank defends both claims by grounding them in different portions of the complaint, distinguishing the section concerning representations and warranties, 2.03(b), from the section concerning the repurchase obligation, 2.03(f).

Additionally, Deutsche Bank finds support for its independent claim of the 2.03(f) remedy in a line of cases such as *LaSalle Bank Nat. Ass'n v. Lehman Bros. Holding, Inc.*, 237 F. Supp. 2d at 638, which notes, "[u]nder New York law, a loan seller's failure to repurchase non-conforming loans upon demand as required by a contract is an independent breach of the contract entitling the plaintiff to pursue general contract remedies." Neither of Deutsche Bank's arguments are persuasive. The fact that the remedial provision exists in a discrete portion of the contract from the breach of representations and warranties is not a meaningful distinction—separate provisions alone do not give rise to independent duties. Nor can Deutsche Bank rely on the authority of *LaSalle*. As the *Nomura* decision points out, *Lasalle* misapplied a First Circuit decision in reaching its result, *see* 2013 WL 2072817 at *13—the First Circuit had in fact disclaimed the availability of an "independent breach" theory. *See Resolution Trust v. Key Fin. Servs., Inc.*, 280 F.3d 12 (1st Dist. 2002).

Deutsche Bank next aims to narrow the effect of the sole-remedies provision. The section states that for any mortgage loan "as to which a breach of a representation and warranty has occurred and is continuing," repurchase "shall constitute the sole remed[y] ... respecting such breach." § 2.03(q). Noting the type of mortgage loan referenced by "such breach," Deutsche Bank argues that the sole-remedies provision only applies to breaches of representations and warranties. Accordingly, Deutsche Bank reasons, the failure to comply with 2.03(f) is not limited by the sole-remedies provision: such a failure is not a breach of a representation and warranty. In favor of its interpretation, Deutsche Bank notes that under New York law, an exclusive remedy applies only where the language is plain and unmistakable. *See Sanford v. Brown Bros. Co.*, 134 A.D. 652, 656 (N.Y. App. Div. 1909). If the court instead finds an ambiguity, then the claim must survive a motion to dismiss. The document must be read in its entirety, with provisions given effect in their overall context. *Perreca v. Gluck*, 295 F.3d 215, 224 (2d Cir. 2002).

Given the structure of the contract, the sole-remedies provision can only be *a pre-suit* remedial provision. The PSA identifies the remedies for breaches of representations and warranties and sets these as the sole remedies in the contract. To elevate that remedial procedure to a separate duty—unbound by the sole-remedies provision—defeats the purpose of the agreement. A failure to render specific performance would give rise to general contract damages in every instance, even where the parties had bargained for a limitation of remedy to specific performance. While Deutsche Bank does identify an ambiguity in the phrasing of the sole-remedies provision, it cannot be given the meaning that Deutsche Bank seeks to attach to it.

As with the preceding arguments raised by Decision One, this independent remedial-breach argument has been considered and rejected in other mortgage-backed security cases. Surveying the case law, *Deutsche Alt-A* concluded that New York law "does not recognize pre-suit remedial provisions as constituting separate promises which can serve as the basis for independent causes of action." 2013 WL

3863861 at *10. A cause of action where a cure or demand requirement is provided by the contract accrues when the breach occurs, not when the demand is subsequently made or refused. *Id.* Accordingly, in *Deutsche Alt-A*, the party's claim averring an independent breach for failure to repurchase was dismissed. *Id.*; *but see ACE Secs. Corp.*, 965 N.Y.S.2d at 849 (assessing the issue in the context of a statute of repose and determining that the originator "commits an independent breach of the PSA each time it fails to abide by and fulfill its obligations under the Repurchase Protocol").

Indeed, the contract in issue in *Deutsche Alt-A* contained a similar provision to the one here. *Deutsche Alt-A* assessed a sole-remedies provision which contained similar phrasing establishing the sole remedy "respecting ... a breach of the representations and warranties[.]" *Id.* at *8. Recovery under such a transaction, the court held, is "limited to the [sole-remedies provision] in the PSA." *ACE Secs. Corp.*, 965 N.Y.S.2d at 849. Decision One's failure to repurchase and failure to provide notice are not independent breaches that circumvent the PSA's sole-remedies provision.

D.

Claim for Indemnification

In its fourth count, Deutsche Bank seeks indemnification under section 2.03(p) of the PSA which permits indemnification for "any losses, damages, penalties, fines, forfeitures, legal fees and expenses and related costs, judgments and other costs and expenses resulting from any claim, demand, defense or assertion based on or grounded upon, or resulting from, a breach of [Decision One's] representations and warranties." Decision One argues that dismissal of this count is appropriate pursuant to New York law that narrowly construes indemnification clauses to exclude first-party claims unless clearly stated otherwise. Decision One argues that Deutsche Bank brings a first-party claim and has failed to identify language that suggests it is eligible for indemnification. *See TAG 380, LLC v. ComMet 380, Inc.*, 890 N.E.2d 195, 201 (N.Y. 2008).

Deutsche Bank argues that the Certificateholders are third parties, and thus Deutsche Bank's is not a first-party claim. Given that the Certificateholders did not sign the agreement, Deutsche Bank argues that they may be considered third-party beneficiaries under New York law. *See Warner v. U.S. Sec. & Futures Corp.*, 257 A.D.2d 545, 545 (N.Y. App. Div. 1999). Decision One responds that the proper test for third-party status considers whether the party was a "stranger" to the agreement. *Sequa Corp. v. Gelmin*, 851 F. Supp. 106, 110 (S.D.N.Y. 1994). By contrast, Decision One maintains, the PSA contemplated the Certificateholders to be an essential component of the agreement. The Certificateholders each received a certificate that was "issued under and is subject to the terms, provisions and conditions of the [PSA], to which [PSA] the Holder of this Certificate by virtue of the acceptance hereof assents and by which such holder is bound." The PSA was drafted

for the purpose of governing such certificates, and it itself sets forth the rights and obligations of the Certificateholders in section 12.08. Accordingly, Decision One argues, the parties cannot be viewed as strangers to the agreement.

Under New York law, an indemnification provision will shift attorney's fees in a first-party claim only if it is "unmistakably clear" that the provision was intended to do so. *Hooper Assocs., Ltd. v. AGS Computers, Inc.*, 548 N.E.2d 903, 905 (N.Y. 1989). This determination is informed by both the language of the agreement and the surrounding facts and circumstances. *Id.* The default presumption is that indemnification clauses apply only to disputes with third parties, as opposed to disputes between the parties to the contract. *See Atlantic Richfield Co. v. Interstate Oil Transp. Co.*, 784 F.2d 106, 115 (2d Cir. 1986) ("[I]ndemnity agreements are generally designed only to protect against liability for damage to third parties.").

In *Bear Stearns Mortg. Funding Trust 2007-AR2 v. EMC Mortg. LLC*, 2013 WL 164098 (Del. Ch. Jan. 15, 2013), the court considered an indemnification claim advanced in favor of the Trustee of a trust of mortgage-backed securities. The *Bear Stearns* trustee, situated as Deutsche Bank is situated here, was a party to the agreement and pressed recovery on behalf of certificateholders. *Id.* at *2–3. The trustee aimed to defeat the presumption against first-party indemnification. But the approach was unavailing. The *Bear Stearns* court held that indemnification was not appropriate in light of New York's position concerning indemnification clauses. *Id.*

Deutsche Bank presents a restyled version of the argument advanced by the trustee in *Bear Stearns*. There, the trustee aimed to receive indemnification for the cost of bringing the suit. The court held that this constituted a first-party indemnification demand. Here, in contrast, Deutsche Bank states that indemnification is appropriate because the demand did not originate from the Trustee itself. Rather, the suit originated from a third-party demand, the Certificateholders. But this distinction is one of form, not substance. In both situations, indemnification is for the cost of the suit to recover for a breach by a party to the PSA. It is designed to indemnify the costs of the Trustee in pursuing the suit against another signatory to the PSA. That the demand originates from the Certificateholders does not affect this—such was the case in *Bear Stearns* as well. The complaint filed by Deutsche Bank arises directly from the PSA and concerns an essential element of the PSA: the application of the sole-remedies provision to breaches of representations and warranties. The structure of the deal makes it implausible to treat a demand by the Certificateholders under the PSA's repurchase agreement as a proper third-party claim. Enforcement of the PSA by the Certificateholders would then require indemnification in every instance when they themselves are central to the agreement. In light of New York's presumption against first-party indemnification requiring a clear statement to support, the motion to dismiss the claim for indemnification is granted.

E.

Piercing the Corporate Veil

Finally, Deutsche Bank seeks joint-and-several liability against HSBC Finance for Decision One's breaches pursuant to a veil-piercing theory. The requirements for such a theory are governed by the law of North Carolina, Decision One's state of incorporation. North Carolina adopts the instrumentality rule to pierce the corporate veil. *Glenn v. Wagner*, 329 S.E.2d 326, 330 (N.C. 1985). The instrumentality rule permits the court to disregard the separate identities of the parent and subsidiary. To state the claim, three factors are required:

> "(1) Control, not mere majority or complete stock control, but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and
>
> (2) Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff's legal rights; and
>
> (3) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of."

Id. Together, these factors determine whether a subsidiary may be considered an instrumentality of the parent, thus establishing whether to treat the two "as one for purposes of assessing liability." *Muse v. Charter Hosp. of Winston-Salem*, 452 S.E.2d 589, 594 (N.C. App. 1995). But North Carolina law instructs that alter-ego liability is a "drastic remedy" to be "invoked only in an extreme case where necessary to serve the ends of justice." *Best Cartage, Inc. v. Stonewall Packaging, LLC*, 727 S.E.2d 291, 300 (N.C. App. 2012).

The complaint states that HSBC Finance operated Decision One as a highly-integrated business unit. It draws this conclusion from the two corporations' sharing of personnel and office space, their use of a shared services group, and the degree to which HSBC Finance winded down Decision One's activity shortly after acquiring it in 2007. Deutsche Bank also claims that HSBC Finance has left Decision One undercapitalized, but it provides no factual allegations to suggest this. Lastly, Deutsche Bank notes a failure by Decision One to observe necessary corporate formalities.

However, each of the three *Glenn* factors are necessary to pierce the veil. Because there are not sufficient allegations of HSBC's "complete domination" of Decisione One, the complaint does not support a claim HSBC's alter-ego liability. To demonstrate the requisite level of control, *Glenn* recognized that a combination of

factors would be instructive, including but not limited to: inadequate capitalization, non-compliance with corporate formalities, complete domination and control so that the corporation lacks an independent identity, and excessive fragmentation of a single enterprise into separate corporations. *Glenn*, 329 S.E.2d at 330–31.

Overlapping facilities and personnel could constitute "complete domination," but under North Carolina law, this requiring more than some shared employees and officers. *See Huski-Bilt, Inc. v. First-Citizens Bank & Trust Co.*, 157 S.E.2d 352, 358 (N.C. 1967); *cf. E. Mkt. St. Square, Inc. v. Tycorp Pizza IV, Inc.*, 625 S.E.2d 191, 197 (N.C. App. 2006) (noting the permissible, but not automatic, inference of domination where an individual is a president, sole director, and sole shareholder of a hierarchy of corporations). Deutsche Bank has only identified the existence of the corporations' shared office space and their sharing a few employees and officers. This is not sufficient. Deutsche Bank argues that *Dassault Falcon Jet Corp. v. Oberflex, Inc.* resembles the case at hand. Yet there, the court had evidence that showed that the corporation in question was a "mere conduit" for the parent corporation; and when the dispute arose, the parent corporation sold off all of the subsidiary's assets, leaving it as a "shell corporation without any function or assets." 909 F. Supp. 345, 351 (M.D.N.C. 1995).

Deutsche Bank also presents evidence of complete domination by virtue of HSBC winding down Decision One's mortgage services business in 2007, including HSBC's laying off 750 Decision One employees and terminating Decision One's leases for its headquarters and satellite offices. But a parent's dissolving a subsidiary due to prevailing financial conditions does not itself establish the basis for alter-ego liability. *See Statesville Stained Glass, Inc. v. T.E. Lane Constr. & Supply Co., Inc.*, 430 S.E.2d 437, 440–41 (N.C. App. 1993). Particularly in light of the subprime mortgage crisis developing through 2007, it is not surprising that Decision One would face a substantial contraction.

With respect to Deutsche Bank's capitalization argument, a subsidiary's failure to account for its capitalization may be sufficient to establish a prima facie case for alter-ego liability. *See Copley Triangle Assocs. v. Apparel Am. Inc.*, 385 S.E.2d 201, 203 (N.C. App. 1989). Deutsche Bank argues that it pled that HSBC undercapitalized Decision One, and that this allegation is sufficient under Illinois pleading standards . *See Stap v. Chicago Aces Tennis Team, Inc.*, 63 Ill. App. 3d 23, 29–30 (1st Dist. 1978). This argument elides portions of *Stap*'s analysis. *Stap* recognized the potential use of some conclusory statements, but did not suggest that alter ego liability is appropriate based *solely* on such statements. In *Stap*, the complaint did include the bare assertion that the corporation was "undercapitalized," but this was only one allegation out of several, including allegations that two individuals owned six corporations and had funneled funds among these corporations according to profitability. *Id.* Aside from the transfer of $500 million upon the closing of the PSA, there is no factual allegation regarding the capitalization of Decision One. While it is true, as Deutsche Bank insists, that

the transfer does not mean that Decision One is properly capitalized, this court can of course not infer that such a transfer has left Decision One undercapitalized.

Finally, while HSBC Finance may have failed to "observe appropriate corporate formalities," the appropriate reports were eventually filed in accordance with North Carolina law, and Decision One was reinstated on October 20, 2012. The momentary lapse in submission of these annual reports does not alone suggest a high degree of control. *See Jorja Props., LLC v. Midtown Sundries Elizabeth, LLC*, 2011 WL 4440178 at *3 (W.D.N.C. Sept. 23, 2011) (noting that failure to submit annual reports is alone not enough evidence to support an instrumentality finding).

Absent the limited evidence of control, HSBC Finance cannot be deemed to be an alter ego of Decision One, even under the generous motion-to-dismiss standard. To find alter-ego liability here would pull HSBC Finance into this complex litigation essentially on the basis of its parent-subsidiary relationship with Decision One.

III.

Based on the foregoing, it is hereby ORDERED:

(1) Defendant Decision One's motion to dismiss is GRANTED in part and DENIED in part. Count I stands, and Counts II, III, and IV are dismissed with prejudice.

(2) Defendant HSBC Finance's motion to dismiss is GRANTED, and Defendant HSBC Finance is dismissed as a party.

(3) Defendant Decision One has twenty-one days until December 11, 2013 to answer Count I.

(4) The case management conference scheduled for December 11, 2013 at 10:30 a.m. stands. The parties should confer in advance of that date and be prepared to propose a comprehensive discovery schedule.

Judge Raymond W. Mitchell

ENTERED, NOV 19 2013

Circuit Court 1992

Judge Raymond W. Mitchell, No. 1992