Mortgage Pools. Barclays purchased a large number of mortgage loans in 2006 from the now bankrupt New Century Capital Corp., an active subprime lender. Using ''Pooling and Service Agreements,'' Barclays then pooled the approximately 10,000 mortgage loans into the BR2 and BR3 Trusts, which issued the mortgage-backed securities or pass-through certificates. LSF5 then purchased about $60 million of the securities.

The prospectuses and supplements for the trust offerings contained warranties and representations from Barclays that there were no 30-day delinquencies within the mortgage pools as of the ''transfer servicing date.'' However, Lone Star soon discovered that almost 300 of the BR2 mortgages were at least 30 days delinquent as of the date LSF5 made its purchase. Further investigation revealed that almost 850 of the mortgages in the BR3 Trust were more than 30 days overdue as well.

''The quality of the mortgage pool is crucial,'' the court said. ''Delinquent mortgages result in smaller payment streams and smaller payments to securities holders,'' it added.

Contradictions Alleged. Following the delinquency revelations, Lone Star sued Barclays in Texas state court claiming violations of both state and federal law. The complaint alleged that the Trusts' holding of numerous delinquent loans directly contradicted Barclays' representations, and those misrepresentations constituted fraud. After removing the case to the federal district court as a matter ''related to'' New Century's bankruptcy, Barclays filed a motion to dismiss. Citing the language in the offering documents, Barclays argued that if the Trusts contained delinquent loans, then Lone Star's only remedy was for Barclays to either repurchase or substitute the delinquent mortgage loans.

Rejecting the plaintiffs' request for a remand, the district court found it had jurisdiction ''under the extremely broad standard of Bankruptcy Code section 1334(b),'' because the plaintiffs' claims ''could conceivably'' have an effect on the New Century bankruptcy case. The district court also agreed with Barclays' interpretation of the 'repurchase or substitute' clauses, and granted the motion to dismiss.

On appeal, the court rejected the private equity firms' assertion that the trial court lacked ''related to'' jurisdiction because any indemnity claim Barclays had against the bankrupt New Century was not conclusively established. Within the Fifth Circuit, the court said, ''contractual indemnification rights may give rise to 'related to' jurisdiction.''

As to the merits of Lone Star's appeal, the court said that in order ''to prevail, Appellants must successfully allege both that Barclays represented that the BR2 and BR3 Trusts had no delinquent mortgages and that the representations were false when made.''

'Mistakes Are Inevitable.' But there were no such representations, the court said. ''Because mistakes are inevitable, both seller and purchaser are protected by a promise that the mortgage pools will be free from later-discovered delinquent mortgages. This is what Barclays promised and Lone Star agreed,'' it concluded. Furthermore, ''As a sophisticated investor placing a $60 million investment in the trusts, Lone Star has no basis to ignore these provisions or their consequences,'' it added.

The court also rejected Lone Star's ''fallback'' argument that the repurchase or substitute clauses waived the firms' right to sue for fraud, and thus, the clauses were void as a violation of public policy. ''Under federal and Texas securities laws and Texas common law, a party cannot waive its right to bring fraud claims by contract or otherwise,'' the court said.

Financial Institutions

Financial Crisis Has Brought Reforms But Won't Change Oversight, Official Says

HOUSTON—The most damaging financial crisis in more than three generations has resulted in ''marginal positive reforms'' at the edges of the American capital system but such reforms will not fundamentally change the financial sector's oversight, the executive director of the Group of 30 said Jan. 14.

In an address at Rice University's James A. Baker III Institute for Public Policy and the Jesse H. Jones Graduate School of Business, Stuart P.M. Mackintosh called the American financial regulatory system ''far too complex'' but noted that ''we must learn the lessons, close the gaps, and make those necessary changes.''

''When all is said and done, thousands of lobbyists and literally hundreds of millions of dollars have been spent and managed to stymie reform and may halt progress,'' Mackintosh said.

''Despite experiencing a crisis of the system, not in the system, we will fail to secure meaningful change,'' he said.

While government officials address the drivers of financial reform in the United States, Mackintosh said he worried that ''we may miss the opportunity'' to make fundamental changes to the American financial system, strengthen capitalist free markets, and provide a more efficient system in the future. Furthermore, he thought there was a danger that the United States could end up with a ''patchwork of standards inconsistently applied'' that undermine capital markets and constrain the American and worldwide economic recovery.

Imbalance With China Cited. ''People know that the macroeconomic reasons underlie the financial crisis,'' he said. ''We saw and still see growing imbalances in trade and international payments. To put it bluntly, we spend and rely on the Chinese savings to fund that spending.''

With most Americans spending beyond their means, a period of low interest rates and inflation allowed individuals and banks to increase capital risk-taking, he said.

''Old school banking practice where you needed to know your customer before you did business was jettisoned.''

Instead of loans being held to maturity, they were ''sent off'' and securities were ''sliced and diced with hefty fees'' and then resold at better rates, Mackintosh said.

This ''financial engineering'' was supposed to bring sustained growth, but it became unclear who owned those assets and their worth became harder to judge, he continued.

Mackintosh Sees Modest Growth in 2010. In a forecast for 2010, Mackintosh said he expected to see modest economic growth that hopefully would improve the jobs picture.

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One of the lessons learned from the financial crisis is that a sustained, more conservative regulation of financial markets is necessary if free markets are to function efficiently, according to Mackintosh.

''We simply cannot have a major financial crisis every seven to 10 years,'' he told the Rice audience. Such events are too destructive to financial and employment markets, he said.

Firms that might financially collapse should not be given ''complicit protected advantage'' because of their size and status, Mackintosh said. Regulators need to address the ''moral hazard'' created by making those firms subject to much tougher regulations.

'Too Big to Fail' Fails Test. ''If those banks and financial firms still choose to take those large risks, they must be allowed to fail,'' he pointed out. ''No one and no business should be too big to fail.''

Congress should close regulatory gaps such as those that permitted ''low income/no job'' loans to appear in the market, he said. Gaps further allowed complex securities markets for derivatives to grow largely without oversight.

Congress also should demand that financial leaders take direct, firm charge of their institutions to ensure that risks are managed effectively and compensation practices go along with the long-term health of the firm, he said.

Work is under way internationally so that the top 20 to 30 financial firms around the world have ''living wills'' allowing each company to formulate rules and procedures as to how they would be dismantled if they faced a sudden crisis and imminent failure.

By Susanne Pagano