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Subprime Crisis

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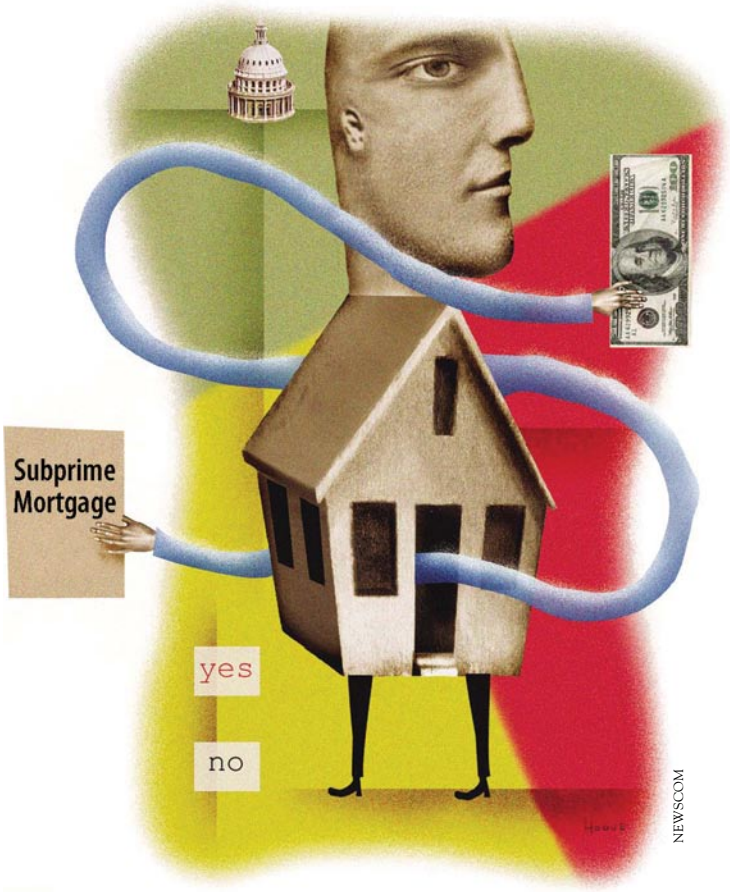

BY MONICA PINCIAK-MADDEN AND KATYA JESTIN

DURING the first half of this decade, hundreds of thousands of Americans who had never before qualified for a mortgage were able to realize the dream of owning a home. Historically low interest rates made owning cheaper than renting. New demand and real estate speculation kept home prices on the rise, making housing stock seem like a relatively liquid asset that would continue to climb in value. Additionally, the rapid expansion of automated underwriting software allowed loans to be made at lightning speed, often with little or no documentation provided by the borrower.[1]

High-risk, high-interest subprime loans to borrowers with low credit scores and high debt-to-income ratios had moved from being a niche product in the industry to accounting for almost 14 percent of all mortgages outstanding during this period. By 2006 they were among the mortgage market's fastest growing products, with mortgage originators competing to offer "no-doc," "interest-only," and other risky variations to what seemed to be a never-ending stream of home buyers.[2]

At the same time, a well-oiled Wall Street securitization machine allowed originators to hand off baskets of these mortgages, or mortgage-backed securities (MBS), to yield-hungry investors across the world, almost as fast as they could write them, which, in retrospect, provided little incentive to lenders to scrutinize a borrower's creditworthiness when providing a loan.[3]

But opportunity quickly turned to turmoil in the mortgage markets. By late 2006, warning signs of a collapse began to emerge: the housing market cooled and the low introductory rates often attached to subprime loans began to reset, causing a nationwide spike in foreclosures.[4] Now things seem to be getting worse. This month, the Mortgage Bankers Association reported that a record 6.99 percent of all outstanding mortgage loans are now delinquent, with 19.5 percent of all subprime loans more than 30 days past due.[5] The unraveling promises to increase the number of civil suits and criminal investigations already blossoming across the country; this article provides an overview of that landscape.

Civil Lawsuits

The trickle of subprime-related civil litigation that began in late 2006 gave way to a torrent of lawsuits in mid-to-late 2007, and that pace has continued. Of the more than 800 subprime suits that have been brought since 2006,[6] more than half were filed in 2008. At the onset of the crisis, suits typically involved issuers suing originators for breach of contract/Master Loan Purchase Agreements, and borrowers suing originators for "predatory lending," mainly under the Truth in Lending Act and the Real Estate Settlement Procedures Act. Shortly thereafter came the shareholder suits, not alleging breach of contract, but alleging securities fraud by public companies—mainly lenders, builders, and investment banks—whose stock was hit by the growing market collapse. As the crisis has unfolded, the litigation trends have become increasingly complex and inventive; parties involved in the securitization process itself, such as insurers and underwriters, have been dragged into the fray.

Although the litigation continues to evolve, subprime civil litigation can generally be divided into five main categories: contract actions against loan originators, securities suits, ERISA beneficiary suits, suits against credit ratings agencies, and consumer-related suits.

Contract Actions, Loan Originators

Loan originators were among the first to be hit by a wave of breach of contract actions. The plaintiffs in these cases were most often the companies responsible for buying, pooling, and securitizing the subprime loans for resale to investors, and the issues usually revolved around alleged mischaracterizations made by the loan originators about the health of the underlying mortgages. For example, in *GMAC Bank v. HTFC Corp.*,[7] GMAC alleged that HTFC breached its warranties in the Master Loan Purchase Agreement by refusing to repurchase 27 subprime loans tainted by inflated appraisals and borrower misrepresentations. Over 100 similar lawsuits have been filed to date, and numerous other repurchase claims have been resolved through negotiations.

Securities Fraud Lawsuits

Shareholders have filed securities suits against lenders for alleged misrepresentations relating to subprime lending. The suits have alleged misleading or inadequate disclosures as

MONICA PINCIAK-MADDEN *and* KATYA JESTIN *are litigation partners at Jenner & Block in the Chicago and New York offices, respectively.* JOHN ROBERTS *and* JUSTIN STEFFEN, *associates in the firm's Chicago office, assisted in the drafting of this article.*

to subprime exposure, accounting treatments, loan loss reserves, underwriting standards, and numerous other issues. For instance, in early 2007 shareholders of Novastar, a loan originator, filed a series of lawsuits in the Western District of Missouri after Novastar's stock price plummeted 42 percent, alleging that Novastar deceived the investing public by hiding its subprime lending practices and lying about the strength of its loan portfolio, despite downturns in the subprime market and rising foreclosure rates.[8]

In June 2008, Judge Ortie Smith of the Western District of Missouri dismissed the suits against Novastar, reasoning that companies are not expected to be "clairvoyant," and that "bad decisions" do not constitute fraud. Any optimism to be derived from Judge Smith's ruling, however, recently suffered a blow in light of two significant decisions emanating from the Central District of California. Specifically, in subprime securities class actions filed against Countrywide and New Century Financial Corp., plaintiffs in both cases secured significant victories by surviving motions to dismiss.[9]

More recently, insurers have found themselves on the other side of the "v." In February 2008 a Teamsters pension fund filed suit against MBIA Inc., one of the country's largest insurers of credit risk, alleging that MBIA concealed from its investors that it insured some of the riskiest structured securities in the subprime market space—collateralized debt obligations (CDOs) collateralized by a pool of CDOs, or "CDO-squared securities."[10] Similar suits have been filed against MGIC[11] and Ambac.[12]

Auditors and underwriters have been sued as well. In a pending New York Supreme Court case, a municipal retirement system brought suit against Merrill Lynch, the underwriters of certain Merrill securities, and Merrill's auditor Deloitte & Touche, alleging that they failed to disclose Merrill's subprime exposure in offering documents and improperly valued the MBS on its own books.[13] Underwriters such as Goldman Sachs, JP Morgan Chase, Lehman Brothers, and Citigroup have been sued in similar actions in New York federal and state courts.[14]

As the breadth of securities lawsuits has swelled during the crisis, the number of such lawsuits has also grown: two-thirds of the approximately 300 subprime securities suits filed occurred in 2008 alone.

ERISA Lawsuits

On the ERISA front, plaintiffs have targeted the trustees of company-sponsored retirement plans, alleging that the trustees recklessly invested plan assets in the parent company's stock, the value of which plummeted after the parent company's investment in subprime MBS came to light.[15] In *Rinehart v. Lehman Brothers Holdings Inc.*, for example, the plaintiff, on behalf of participants in the Lehman Brothers Savings Plan, alleged that Lehman and certain of its officers, directors, and Savings Plan fiduciaries allowed imprudent investment in Lehman stock.[16] According to the complaint, investment in Lehman stock was irresponsible because the company was heavily invested in CDOs and other subprime mortgage-backed derivatives. This case is still pending, and there have been between 30 and 40 similar actions filed across the country.[17]

Credit Ratings Agencies

In July 2008 a report issued by the Securities and Exchange Commission (SEC) blamed the ratings agencies (Moody's Investors Service, Standard & Poor's, and Fitch Ratings, Ltd.) for contributing to the crisis.[18] The SEC report concluded that the agencies struggled significantly with the increase in the number and complexity of subprime securities, and that the agencies suffered from the so-called "issuer pays" conflict—arising from the fact that the entity that issued the security also paid the ratings agency's bills. Although ratings agencies implemented policies to prohibit analysts from discussing fees with issuers, "these procedures still allowed key participants in the rating process to participate in the fee discussion process."[19] The SEC also found that the rating agencies did not take appropriate steps to prevent considerations of market share and other business interests from influencing ratings or ratings criteria.

The SEC report has inspired plaintiffs to apportion some blame for their losses to the ratings agencies themselves. Recently, a municipal retirement system sued Moody's, its officers and directors, alleging that corruption in the Moody's credit ratings process resulted in the sale of trillions of dollars of highly risky subprime-backed securities to unsuspecting investors.[20] Plaintiffs in other cases have alleged that ratings agencies improperly accorded triple A ratings to securities with high default risk, while failing to disclose that they collected fees for these ratings from the issuers themselves.[21]

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One of the more interesting matters pending against two of the ratings agencies was brought by the National Community Reinvestment Coalition, a coalition of more than 600 community-based housing advocacy organizations. In what may be a first, the coalition filed a civil rights complaint with the Department of Housing and Urban Development alleging that, driven by profit motives, Fitch and Moody's facilitated predatory lending practices against minority homebuyers by assigning "inflated, inaccurate, and inappropriate ratings to securities backed by subprime mortgages." The thrust of the coalition's argument is that the high ratings provided by the agencies helped to fuel subprime lending to minority customers, and that many of these mortgages "were designed to fail" because of, inter alia, draconian payment terms.[22]

Consumer Actions

Initially, borrowers filed small Truth in Lending Act and Real Estate Settlement Procedures Act cases against lenders. However, as with securities suits, consumer suits have expanded in scope. The cities of Cleveland and Buffalo, for instance, have filed public nuisance claims against major subprime originators.[23] In the Cleveland case, the city alleges that 21 of the nation's largest mortgage lenders created a nuisance across broad parts of the city because their loans led to a widespread abandonment of homes. Cleveland is seeking damages from Countrywide, Morgan Stanley, Bank of America, and other lenders for lost tax revenue from these devalued properties, for the money spent demolishing and boarding up abandoned homes, and for increased police and fire protection costs.

In another case, the mayor and city council of Baltimore have sued Wells Fargo, alleging that Wells Fargo violated the Fair Housing Act (FHA) by selling a greater number of high-interest subprime mortgage loans to black loan applicants.[24] Other cities, such as Minneapolis and St. Paul, Minn., are considering similar lawsuits,[25] while individual plaintiffs in states like Texas have also filed FHA and Equal Credit Opportunity Act claims against originators.[26]

The Future of Civil Litigation

There seems to be no end in sight to the current financial crisis. The recognition by financial services companies of billions of dollars in future losses, recent spikes in unemployment, the edging up of bankruptcies, and the continuing rise in both loan delinquencies and foreclosures all point to a more litigious future for companies connected to the subprime machine.

The web of companies swept into the fray will likely continue to increase as well. Bankruptcies are a case in point. For example, after Lehman Brothers entered bankruptcy, Lehman and companies that invested in Lehman were sued on multiple fronts. In recent weeks: a former Lehman employee filed a class action against Lehman, alleging that he was terminated in violation of the WARN Act's 60-day notice provision just shortly before Lehman filed for bankruptcy;[27] top Lehman officials were sued for allegedly lying about the investment bank's financial health;[28] a securities class action was filed against UBS Financial Services for its alleged failure to discover materially inaccurate statements in Lehman's prospectuses before its bankruptcy;[29] and investors have sued the issuer of their money market fund because of its investment in Lehman debt.[30] Similar lawsuits have been filed against other companies exposed to Lehman securities, such as Constellation Energy and JA Solar Holdings.[31]

Only time will reveal how much further the crisis litigation tentacles will go.

Criminal Investigations

Civil litigants are not alone in looking to apportion blame. Both the Department of Justice (DOJ) and the Federal Bureau of Investigation (FBI) have felt intense pressure from Congress and the public to bring criminal charges against those responsible for the financial downturn. So far, Attorney General Michael Mukasey has resisted pressure to create a national task force similar to that created in the wake of the Enron scandal, apparently out of concerns about available resources.[32] Some former law enforcement officials believe that the DOJ is reluctant to investigate criminal charges aggressively for fear that it would destabilize an already fragile stock market and

would chill what the administration believes is legitimate corporate risk-taking.[33] There also is concern that the FBI, which has shifted much of its focus to anti-terrorism initiatives, lacks the resources to devote to white-collar criminal investigations.[34]

In spite of these concerns, however, the pace of federal investigations into subprime-related fraud appears to have increased. The FBI now has approximately 200 agents working on mortgage fraud cases; it has opened 1,522 investigations to date, and these investigations have resulted in 523 indictments and 282 convictions.[35] The SEC brought 671 enforcement actions over the last fiscal year, the second-highest number in the agency's history.[36]

Many of these convictions have been the result of Operation Malicious Mortgage, launched in March 2008 to investigate and prosecute mortgage fraud across the United States. The principal focus of the operation was on mortgage brokers who induced borrowers to enter into mortgages that they could not afford and then falsified the loan application by misrepresenting income or inflating the value of the home. In some cases no borrowers existed; the applicant was simply a "straw man" created by the broker to facilitate the sham transaction. While the total number of convictions is impressive, federal officials acknowledge that those charged were involved mostly in small-scale schemes, akin to what Mr. Mukasey has called "white-collar street crime."

It remains to be seen how aggressively the DOJ and the FBI will pursue bigger institutional targets such as investment firms, credit ratings agencies, bond insurers, and banks in connection with the subprime crisis. FBI Director Robert Mueller recently testified that the FBI had launched 24 investigations into major Wall Street firms and investment banks, and investigations are also being conducted by state and local officials.

Major federal investigations have been launched against Fannie Mae, Freddie Mac, Lehman Brothers, and American International Group. Fannie and Freddie are now facing a New York federal grand jury investigation into accounting, disclosure, and corporate governance practices.

If federal law enforcement has clear evidence of wrongdoing, they will likely bring charges. For example, in June 2008, Ralph Cioffi and Mathew Tannin, formerly hedge fund managers at Bear Stearns Companies Inc., were indicted on charges of securities fraud, wire fraud, conspiracy, and insider trading for allegedly touting the prospects of the funds while privately acknowledging that the risky mortgage-backed securities had lost much of their value.[37] In September 2008, two former brokers at Credit Suisse Securities (USA) LLC were indicted on fraud charges for allegedly selling auction rate securities backed by subprime mortgages to unwitting customers who thought they were purchasing auction rate securities backed by federally guaranteed student loans.[38]

State law enforcement officials have been even more aggressive; New York Attorney General Andrew Cuomo's office has issued scores of subpoenas to major Wall Street institutions and banks, including Merrill and Deutsche Bank. Most of the subpoenas have been issued under the 1921 Martin Act,[39] which contains a broad definition of securities fraud that does not require proof of intent to defraud.

As the crisis unfolds, criminal litigation, like civil litigation, will likely spread and take on new shape.

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