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Subprime Mortgage Meltdown: Issues and Implications

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Subprime Mortgage Meltdown

In the following pages you will find a series of articles from Paul Hastings' newsletter, *Stay Current*, written expressly for our clients affected by or interested in the subprime lending meltdown.

Our Subprime Mortgage Group
Legal Strategies and Solutions in an Uncertain Marketplace

The full impact of the subprime mortgage industry collapse is yet to be known. What is clear is that many companies and investors are facing a new set of challenges requiring both immediate solutions and long-term vision.

Paul Hastings was among the first law firms in the United States to form a subprime mortgage group. Because the impact of this new market circumstance is being felt in finance capitals around the world, our team is comprised of lawyers based not just in North America, but Asia and Europe as well. Within our subprime mortgage group, many individual practices tailor their services to help clients with particular issues as they relate to subprime mortgage matters, including:

- bankruptcy and restructuring
- litigation and investigations
- bank regulatory
- securities and capital markets
- real estate and capital markets
- hedge fund
- government advisory

We help to guide investment banks, hedge funds, warehouse lenders, mortgage originators, and underwriters, both prior to the manifestation of legal issues and during the legal process. Alongside their private practices, members of the subprime mortgage group have SEC, FDIC and federal prosecutorial experience. They are looked to by business and legal media for their insight and experience and have been published and quoted widely on this topic.

Combining deep experience with a determined vision, Paul Hastings is focused on executing efficient, clearly defined strategies to achieve best results in this highly challenging environment.

Paul Hastings

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A Client Alert from Paul Hastings

Subprime Mortgage Meltdown: Is Litigation on its Way?

By Keith W. Miller and Matthew R. Paul

An institutional purchaser of mortgage-backed securities ("**MBS**") recently brought an action against the MBS issuer and underwriter (among other parties) after the securities were downgraded and lost almost all of their value. This case, along with a recent Ninth Circuit decision upholding a jury verdict against a warehouse lender for aiding and abetting a subprime mortgage originator's fraudulent sales practices, should serve as a warning of the types of claims warehouse lenders and MBS issuers and underwriters could face as a result of the recent meltdown of the subprime mortgage sector.

MBS PURCHASER ACTION AGAINST ISSUER AND UNDERWRITER

On April 23, 2007, Bankers Life Insurance Company ("**Bankers Life**") filed a civil action in the United States District Court for the Middle District of Florida against the issuer and underwriter (the "**Issuer/Underwriter**") of two related MBS, both of which were issued in 2001. Bankers Life purchased the MBS in the secondary market in 2004 for $1.4 million. (*See Bankers Life Insurance Company v. Credit Suisse First Boston Corporation, et al.*, Case No. 8:07-cv-00690-FAK-MSS (M.D.Fl.)). The complaint also names various affiliates of the Issuer/Underwriter involved in the origination, servicing and securitization of the underlying mortgage loans, the mortgage guaranty insurer and the MBS trustee.

According to the complaint, the MBS carried investment grade Moody's ratings of A2 and Baa2 at the time of purchase in 2004. Starting in March 2005, the MBS suffered a series of downgrades culminating in speculative grade ratings that reduced the market value of the MBS to a small fraction of the original purchase price. Bankers Life alleges that, had the Issuer/Underwriter not withheld material information regarding the underlying mortgage loans, the downgrades would have occurred sooner and Bankers Life would never have purchased the MBS in the first place.

Bankers Life also alleges that the defendants were engaged in a corrupt scheme to sell high risk MBS in the guise of "safe" fixed-income products. Specifically, Bankers Life alleges that the Issuer/Underwriter of the MBS knew or should have known that many of the underlying loans were:

- originated with inadequate underwriting criteria;
- originated in such a way as to result in excessive risk to subsequent purchasers;
- originated by wholesale originators who were openly and actively engaging in improper lending practices;
- originated as adjustable rate mortgages to subprime borrowers by qualifying the borrowers with low initial payments without proper analysis of the borrowers' ability to make payments at the fully indexed rate;
- originated without appropriate documentation and income verification;
- originated in a form that would necessitate frequent refinancing;
- originated to borrowers with inadequate debt-to-income ratios, and
- originated without proper consideration of borrowers' ability to meet their overall level of indebtedness.

The complaint also alleges that the Underwriter/Issuers and its affiliated servicer advanced principal and interest payments to maintain the illusion of "good performing" loans, failed to pursue available insurance claims, and failed to pursue foreclosure and other

available remedies against defaulting mortgage borrowers.

Based on these and other allegations, Bankers Life is asserting claims for negligent misrepresentation, fraud, breach of fiduciary duty, civil conspiracy, breach of contract and violations of federal and Florida securities laws.

NINTH CIRCUIT "AIDING AND ABETTING" DECISION

Warehouse lenders to subprime mortgage originators should be aware of a recent decision by the United States Court of Appeals for the Ninth Circuit. In *In re First Alliance Mortgage Co.*, 471 F.3d 977 (9th Cir. 2006), the Ninth Circuit affirmed a class action jury verdict against a warehouse lender for aiding and abetting a subprime mortgage originator's allegedly fraudulent sales practices. The jury found that the warehouse lender knew of the practices and yet continued to finance the fraudulently induced loans. The Ninth Circuit rejected the warehouse lender's argument that specific intent rather than mere knowledge was required for aiding and abetting liability under California law. The *First Alliance* case represents a move toward holding warehouse lenders accountable for the predatory or fraudulent sales practices of subprime mortgage originators.

A PREVIEW OF WHAT LIES AHEAD?

The *Bankers Life* and *In re First Alliance* cases exemplify the types of lawsuits mortgage borrowers and MBS investors are considering against financial institutions in response to the subprime mortgage meltdown. Issuers and underwriters of subprime MBS would be well advised to follow the *Bankers Life* case and watch how other MBS investors react in the face of subprime-related losses. Given the numerous bankruptcy filings by subprime mortgage originators, it is likely that MBS investors and mortgage borrowers may attempt to impose liability on deep-pocketed underwriters, issuers and warehouse lenders under various theories, including aiding and abetting.

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A Client Alert from Paul Hastings

Subprime Mortgage Meltdown: Is Litigation on its Way? – Part II

By Keith W. Miller and Matthew R. Paul

We previously wrote regarding the types of claims warehouse lenders and mortgage-backed securities ("**MBS**") issuers and underwriters could face as a result of the recent meltdown of the subprime mortgage sector. (*See* **Paul Hastings Client Alert**, *Subprime Mortgage Meltdown: Is Litigation on its Way?*) In addition to understanding the potential exposure as a defendant in subprime mortgage-related litigation, investment banks that have purchased subprime mortgage loans directly from mortgage originators should also evaluate and consider potential claims against nonperforming mortgage originators or sellers. A series of recent lawsuits filed by a number of investment banks against various mortgage originators could foretell more widespread litigation of this type.

ACTIONS AGAINST MORTGAGE ORIGINATORS

Within the past several weeks, a number of investment banks have filed lawsuits against mortgage originators. Most of these lawsuits stem from the mortgage originators' failure to repurchase loans that appear to be bad. For example, on May 25, 2007, DB Structured Products, Inc. ("**DBSP**") filed fifteen lawsuits in the United States District Court for the Southern District of New York against different mortgage originators from which DBSP had purchased mortgage loans.

The following is a list of those lawsuits:

(1) *DBSP v. Innovative Mortgage Capital, LLC* (07-CV-4099) (failure to repurchase mortgage loans with early payment defaults – $786,000);

(2) *DBSP v. Baltimore American Mortgage Corporation, Inc.* (07-CV-4109) (failure to repurchase mortgage loans with early payment defaults – $1.87 million);

(3) *DBSP v. First Capital Mortgage Corporation* (07-CV-4115) (failure to repurchase mortgage loans with early payment defaults – $3.43 million);

(4) *DBSP v. Prajna Group Inc., d/b/a Liberty Mortgage Funding* (07-CV-4116) (failure to repurchase mortgage loans with early payment defaults – $1.55 million);

(5) *DBSP v. ACT Lending Corporation* (07-CV-4117) (failure to repurchase mortgage loans with early payment defaults – $3.5 million);

(6) *DBSP v. Commonsense Mortgage, Inc.* (07-CV-4118) (failure to repurchase mortgage loans with early payment defaults – $1.8 million);

(7) *DBSP v. Lender Ltd.* (07-CV-4119) (failure to repurchase mortgage loans with early payment defaults – $2 million);

(8) *DBSP v. Maribella Mortgage, LLC* (07-CV-4120) (failure to repurchase mortgage loans with early payment defaults – $12.56 million);

(9) *DBSP v. Lancaster Mortgage Bankers LLC* (07-CV-4121) (failure to repurchase mortgage loans with early payment defaults – $14.1 million);

(10) *DBSP v. Greater Northern Financial Group Inc.* (07-CV-4122) (failure to repurchase mortgage loans with early payment defaults – $11 million);

(11) *DBSP v. Investaid Corp.* (07-CV-4123) (failure to repurchase mortgage loans with early payment defaults – $5.5 million);

(12) *DBSP v. Cameron Financial Group Inc.* (07-CV-4124) (failure to repurchase mortgage loans with early payment defaults – $8.2 million);

(13) *DBSP v. Transnational Financial Network Inc.* (07-CV-4125) (failure to repurchase mortgage loans with early payment defaults – $7.5 million);

(14) *DBSP v. Bayrock Mortgage Corp.* (07-CV-4126) (failure to repurchase mortgage loans with early payment defaults – $11.7 million); and

(15) *DBSP v. IFreedom Direct Corp. f/k/a New Freedom Mortgage Corp.* (07-CV-4127) (failure to repurchase mortgage loans with early payment defaults – $311,000).

In each action, DBSP asserted virtually identical claims of breach of contract, unjust enrichment, indemnification, and specific performance arising from the mortgage originator's failure to repurchase certain mortgage loans in early payment default as required under the parties' agreements. As a result of each defendant's alleged failure to repurchase the early payment default loans, which had an aggregate repurchase price per defendant ranging anywhere from $311,000 to $14.1 million, DBSP is seeking money damages, specific performance, as well as its attorneys' fees and costs. According to the allegations contained in the complaints, DBSP is unable to include these early payment default loans "in securitization or other packages," a specific purpose known to each defendant, for which DBSP purchased those loans.

There are several other investment banks that have filed similar actions. These "early payment default" cases may signal further turmoil with subprime mortgage originators. Investment banks and other financial institutions should closely monitor the performance of all subprime mortgage originators with which they have existing relationships to determine whether legal action might be warranted, and the consequences of early payment defaults on securitizations or whole loan sales.

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A Client Alert from Paul Hastings

Subprime Mortgage Meltdown – Part III: Federal and State Investigations

By Kenneth M. Breen and Thomas R. Fallati

Editor's Note: Key to Paul Hastings' business strategy is our ability to anticipate and respond to our clients' evolving needs. Our Subprime Mortgage Group was created to better coordinate our efforts in advising clients and prospects affected by the subprime mortgage crisis. As these issues continue to unfold, we will update you in future client alerts.

The mounting losses from subprime mortgages have caught the attention of regulators and prosecutors at the federal and state levels. In testimony before the House Financial Services Committee last month, U.S. Securities and Exchange Commission ("**SEC**") Chairman Christopher Cox confirmed that the SEC's enforcement division has formed a working group that is "actively on the lookout for possible securities fraud" related to the subprime market problems.[1] Federal prosecutors and banking regulators have also opened investigations.

Several state attorneys general have launched investigations of their own. In New York, for example, Attorney General Andrew Cuomo has issued subpoenas to lenders, mortgage brokers and appraisers in an expanding inquiry.[2] New York State Governor Eliot Spitzer has also formed an inter-agency task force called Halt Abusive Lending Transactions ("**HALT**") to examine abusive practices in the subprime lending market.[3] Similarly, California Attorney General Jerry Brown and Ohio Attorney General Marc Dann are among other attorneys general who have pending investigations.

THE SCOPE OF THE INVESTIGATIONS

The investigations of subprime lending practices have two potential areas of focus. The first concerns liability that mortgage lenders may face under federal and state deceptive practices laws and bank regulatory statutes. This aspect of the investigations focuses on the mortgage lending process and the interaction of borrowers, mortgage brokers, appraisers and mortgage lenders. The second aspect of the investigations focuses on liability that public companies, underwriters, credit agencies and other entities who are involved with subprime mortgages may face under federal and state securities laws.

MORTGAGE LENDING PRACTICES

The investigations relating to mortgage lending practices will be conducted largely by state attorneys general and federal and state banking regulators. Although the role of the attorneys general is jurisdictionally limited, to the extent an entity located outside the state conducts business within the border of the state, the state attorney general may have jurisdiction to prosecute. Despite the concentration of financial services firms who do business in New York, Attorney General Cuomo is likely to follow the lead of his predecessor, Eliot Spitzer, in attempting to reach firms nationwide.

The attorneys general are likely to focus in large part on consumer-oriented issues. In New York, for example, Attorney General Cuomo appears to be focused, at least initially, on whether mortgage brokers colluded with appraisers to procure inflated appraisals for properties for which subprime borrowers were seeking mortgages.[4] Other practices that may come under scrutiny include the procurement of inadequate, or even

fraudulent, loan documentation, the use of straw buyers or other practices that conceal the credit risks of borrowers.

State attorneys general typically have broad authority to bring civil claims for consumer-oriented wrongs. The New York State Attorney General's broadest authority to bring claims for consumer-oriented conduct arises under § 349 of the General Business Law, which outlaws "deceptive acts or practices in the conduct of any business, trade or commerce or in the furnishing of any service" in the state. Under § 349, the act or practice complained of must have been (1) consumer-oriented; (2) misleading in a material way; and (3) caused actual injury to the consumer.[5] The New York State Attorney General may seek injunctive relief, restitution and civil monetary penalties for violations of § 349, and he also has authority under Executive Law § 63(12) to seek injunctive relief and/or restitution and damages against persons who "engage in repeated fraudulent or illegal acts or otherwise demonstrate persistent fraud or illegality in the carrying on, conducting or transaction of business." In addition, although historically the New York State Attorney General has largely pursued civil remedies in mortgage lending cases, he may choose to pursue lenders and mortgage brokers criminally under provisions of the Penal Law. Two commonly charged financial fraud offenses are scheme to defraud and grand larceny.[6]

In some states, consumer protection violations can give rise to both criminal and civil liability. In California, for example, the Attorney General can enforce violations through civil claims, but a violation of the statute also constitutes a misdemeanor.[7]

BANKING REGULATORY ENFORCEMENT

Federal and state banking regulators are investigating subprime lending practices as well.[8] Federal and state regulators have promised to work closely in investigating subprime practices. These regulators have already begun to focus on the lending practices of the banks they directly supervise. In addition, several federal and state banking regulators – including the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Trade Commission, the Conference of State Bank Supervisors, and the American Association of Residential Mortgage Regulators – have launched a pilot project "to conduct targeted consumer-protection compliance reviews of selected non-depository lenders with significant subprime mortgage operations."[9] We are aware of several instances where, as part of the bank examination process, regulators are closely scrutinizing loan portfolios, and in at least one situation, have brought and settled charges based on a theory of failure to manage and control in a safe and sound manner the mortgage loan origination services outsourced to an affiliate. Where regulators identify troublesome practices, they are likely to pursue enforcement actions based on theories such as unsafe and unsound banking practices and unfair or deceptive practices under Section 5 of the Federal Trade Commission Act. We anticipate that many actions in the subprime area will give rise to claims of mortgage discrimination as well.

In addition, state banking regulators are likely to work closely with prosecutors. As noted above, New York State has created the multi-agency HALT task force. Richard Neiman, Superintendent of the New York State Banking Department and the head of the HALT task force, has promised enforcement actions against those engaging in wrongful conduct through a newly-formed Mortgage Fraud Unit.[10] In addition, the Banking Department may, pursuant to Executive Law § 63(3), request that the Attorney General investigate and prosecute violations of laws under the Banking Department's regulatory purview. These include provisions of the Banking Law relating specifically to subprime loans.[11] Banking Department regulations also provide that "engaging in unfair, deceptive or unconscionable practices in the course of advertising, brokering or making high cost home loans" is prima facie evidence that the lender lacks the character and fitness required to be licensed or registered.[12] Violators can also be subjected to fines or penalties.[13]

DEFENDING THE INVESTIGATIONS

Whereas the securities-related investigations will focus on disclosures to investors, the state attorneys general and banking regulatory investigations will focus to a greater degree on disclosures to borrowers, and whether borrowers were somehow misled. Plainly, the regulators will look for instances in which lenders colluded with mortgage brokers or appraisers. Lending institutions may still face scrutiny, however, even where they were not active participants in the wrongdoing. For example, the New York deceptive practice statutes discussed above do not require proof of intent to deceive.[14] This may prove problematic for lenders who

arguably were on notice of untoward conduct by mortgage brokers or appraisers. To defend against charges under these circumstances, lenders will need to build a solid record that they complied with all regulatory requirements concerning the review of appraisals and that they had no reason to suspect that they were not reviewing bona fide appraisals.

SECURITIES INVESTIGATIONS

1. Potential Theories Implicating Public Companies

A number of civil lawsuits have been filed against publicly traded companies alleging that they violated the federal securities laws because of improper practices or inadequate disclosures concerning their subprime mortgage businesses. The SEC and federal prosecutors conducting parallel investigations are likely to focus on similar issues. Potential accounting issues include whether the public company maintained adequate allowances for loan losses and whether loan portfolios were properly valued, and how the public company disclosed this information.

To establish securities fraud, however, the government must prove that the defendant acted with fraudulent intent. The government will therefore look for evidence that, for example, the public company (i) was made aware of, but consciously ignored, warning signs about the strength of its subprime mortgage portfolios; (ii) frequently diverged from mortgage underwriting criteria; and (iii) was aware of, or turned a blind eye to, untoward practices such as collusion between mortgage brokers and appraisers in the creation of inflated appraisals.

2. Potential Theories Pertaining to Collateralized Debt Obligations

The SEC has opened at least a dozen investigations into collateralized debt obligations ("**CDO**") linked to the sinking value of subprime mortgages.[15] A CDO is a security backed by a pool of loans or other fixed income securities. Issuers and underwriters value securities based on models that use ratings from credit agencies to judge the risk that the underlying loans will default. The SEC is likely to examine whether CDO issuers made adequate disclosures concerning the nature of the underlying assets. As explained above, to make out a fraud case, the SEC would need evidence that the CDO issuers knowingly concealed, or turned a blind eye toward, information that should have been made available to investors. Other industry players, such as the credit rating agencies who provide the ratings for the underlying securities, may also face scrutiny.

Hedge funds are also likely to face scrutiny. Already, a number of hedge funds have ceased redemptions or even begun liquidation as a result of losses on CDOs and other debt obligations backed by subprime mortgages. Like public companies, hedge funds will face questions relating to how they valued their subprime holdings and whether they adequately disclosed the risks associated with their portfolios.

3. New York State Attorney General's Authority Under the Martin Act

Although the SEC has historically taken the lead in securities fraud enforcement, former New York Attorney General Eliot Spitzer used the Martin Act, the state's securities fraud statute, to secure settlements and convictions for failure to disclose fees, risks, and commissions, and the misrepresentation of the nature of the services rendered by advisors. Current New York Attorney General Andrew Cuomo may seek to use the statute to prosecute failures to disclose risks associated with subprime mortgages. Notably, unlike the antifraud provisions of the federal securities laws, the Martin Act does not require a showing of scienter. The Attorney General need only prove (1) a misrepresentation or omission; (2) that is material, for conduct related to securities transactions.[16]

OTHER IMPLICATIONS

Of particular concern, of course, are the implications of investigations, both as a disclosure matter as well as potential private litigation exposure. The mere fact of an investigation may require disclosure by companies with registered securities. Any resulting drop in stock price may bring its own set of potential problems. Importantly, investigations, regardless of how they are concluded, typically prompt a spate of civil actions. In the subprime area, while mortgage brokers are certainly the most logical targets (in most instances they, after all, were dealing with the borrowers directly), they lack the deep pockets to make them attractive to private plaintiffs. Litigation has already commenced against the banks, underwriters and others involved in originating, packaging, selling and holding the loans.[17]

Given recent publicity concerning the continued subprime mortgage meltdown and its impact upon the

housing sector, we expect that state and federal agencies will continue to launch investigations and aggressively pursue violations. Financial institutions would be well-advised to stay current on these investigations in order to minimize any potential exposure.

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[1] Karey Wutkowski, *SEC's Cox Reveals CDO Probes, Fund Valuation Review* (June 26, 2007), *available at* http://www.reuters.com/articlePrint?articleID=USN2625573520070627. *See also Statement of the Securities and Exchange Commission before the House Financial Services Committee*, June 26, 2007, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/sec_testimony_(6-26-07).pdf.

[1] *See* Sharon L. Crenson, *Cuomo Expands Probe as Appraisers Attest to Pressure*, June 20, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCHC0uxmqYoU.

[1] *See* State of New York Banking Dept., *Superintendent Neiman Testifies on "Subprime Lending Practices"*, May 29, 2007, http://www.banking.state.ny.us/sp070529.htm.

[1] *See* Crenson, *supra* note 2.

[1] *Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank*, 85 N.Y.2d 20 (1995).

[1] *See* N.Y. PENAL LAW §§ 190.65 and 155.40, respectively.

[1] CAL. BUS. & PROF. CODE § 17500 (Deering 2007).

[1] *See Banking Regulators to Increase Scrutiny of Subprime Lenders*, N.Y. TIMES, July 18, 2007, *available at* http://www.nytimes.com/2007/07/18/business/18mortgage.html.

[1] *See Federal and State Agencies Announce Pilot Project to Improve Supervision of Subprime Mortgage Lenders*, *available at* http://www.ftc.gov/opa/2007/07/subprime.shtm.

[1] *See* State of New York Banking Dept., *supra* note 3.

[1] N.Y. BANKING LAW § 6-l(5) (McKinney 2007).

[1] 3 N.Y.C.R.R. § 41.5 (2007).

[1] N.Y. BANKING LAW §§ 595-a, 598 (McKinney 2007).

[1] *People v. General Electric Co., Inc.*, 756 N.Y.S.2d 520, 523 (1st Dep't 2003).

[1] Wutkowski, *supra* note 1.

[1] *See People v. Barysh*, 408 N.Y.S.2d 190, 193 (N.Y. Tr. Term 1978) (holding that the Martin Act does not require reliance or scienter).

[1] *See Bankers Life Insurance Company v. Credit Suisse First Boston Corp., et al.*, Case no. 8:07-cv-00690 (M.D. Fl. filed Apr. 23, 2007).

About Paul Hastings

Paul, Hastings, Janofsky & Walker LLP, founded in 1951, is a leading international law firm with 1,200 lawyers located in offices throughout Asia, Europe and North America. The firm serves a diverse client base including many of the leading global financial institutions and Fortune 500 companies and offers deep capabilities in banking and finance, capital markets, corporate/M&A, litigation and dispute resolution, intellectual property, project finance, investment management, real estate, labor and employment and tax advisory services. For additional information, please visit our website at www.paulhastings.com.

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