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LITIGATION, SUBPRIME LENDING AND THE FINANCIAL CRISIS

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Since 2007 the Federal Bureau of Investigation and the Securities and Exchange Commission have opened more than 1,200 criminal investigations and three dozen civil investigations into corporations, entities and individuals involved with subprime lending.

Both have formed internal task forces dedicated to investigating the myriad of issues pertaining to the subprime market. At the same time, United States attorneys and many state attorneys general have filed charges or brought claims against companies involved in subprime lending, and thousands of individual civil suits have been filed (at the time of this article, Reuters was reporting that 607 new mortgage-related civil lawsuits were filed in federal courts in the past 18 months). With this wave of criminal investigations and civil lawsuits, and now that the subprime lending crisis has morphed into the larger financial crisis, is anyone associated with subprime lending safe from litigation?

The answer is no. Subprime lending extends credit to individuals who cannot obtain conventional financing. Valuation of subprime loans incorporates the same market factors considered for conventional loans with the risk associated with subprime borrowers. The result is greater access to credit for borrowers who could not otherwise obtain it, with greater risk but higher returns for the lender. In the mid-1990s, the market for mortgage-related securities exploded. Investment banks increased the bundling of subprime loans into mortgage securities (mortgage-backed securities and collateralized debt obligations). Suddenly, lenders had a secondary market in which to sell subprime loans. This enabled lenders to spread the risk by diluting their subprime portfolios, which freed up credit that could be extended on the subprime market. The proliferation of subprime credit availability coupled with the housing boom led to a marked increase in subprime loan generation. Loan products created to extend credit to borrowers who did not qualify for conventional loans were heavily utilized. Borrowers, with the assistance (or, without their knowledge, but as a result of the actions) of brokers, appraisers and a number of other actors, overextended themselves by obtaining loans that they ultimately could not afford. Lenders continued to fund and sell off these loans to investment banks which bundled the loans into asset-backed securities. Investment banks hired credit rating agencies to rate the securities based, in part, upon the collective risk of the mortgages. Investors purchased these securities using the ratings as a benchmark for the associated risk and, in some instances, purchased credit default swaps (insurance that covers the risk of the asset, or the debtor's failure to pay back the money loaned) to cover the risk.

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So how does this lead to litigation? Consider the following all-too-real scenario: A borrower contacts a broker of subprime loans to obtain financing for a $300,000 second home that he believes he will be able to sell for a profit in three years. The borrower has an annual salary of $50,000 and has $5,000 to use as a deposit. The borrower cannot get approval for a conventional loan because of

his credit history, his limited available income and the minimal deposit compared to the value of the home (creating a high loan-to-value ratio). His broker suggests a subprime loan vehicle that does not require poof of income and the two agree to misstate the borrower's annual income as $75,000. The appraiser appraises the property at $360,000, or 120 percent of the actual value, to show instant equity for the borrower and to decrease the loan-to-value ratio. The lender approves the loan with this information. The loan is sold into a security pool where an investment bank bundles it into a mortgage security with 2,000 other subprime loans. A credit rating agency grades the security at its highest rating and a national company, relying on the grade as a bellwether for the security's risk and return, purchases shares. Other investors and banks that participate in the security also purchase credit default swaps to cover the risk of their investment.

As long as the housing boom continues, and the value of the investment home continues to rise, every party stands to profit. But, of course, the bubble bursts and the housing market slows, indicating that the property's value will not increase. The borrower, unable to make payments or to refinance, defaults on his loan, and foreclosure proceedings are initiated. Because of a high default rate among the bundled mortgages, the security's value plummets and it is regraded at the lowest rating. This results in the national company losing money on its investment, the investment bank losing money on its security, and the insurance company facing claims on the issued credit default swaps. Needless to say, there are many variants to this scenario.

If the recent (and anticipated) wave of litigation is any indication, no one involved in this scenario is immune from litigation. Lenders currently face the largest volume of litigation including, most prominently, lawsuits filed by borrowers trying to get out of their loans. Federal and state officials are also taking aim at lenders, charging them with everything from fraud and deception to violation of consumer protection laws. Investment banks are bringing suit against the lenders that originated subprime loans demanding that they repurchase loans that are in early default. Employment litigation against subprime lenders is also on the rise, ranging from improper termination claims to allegations that retirement plans funded with company stock were not prudent investments. To the extent not already initiated, additional investigations by federal

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law enforcement authorities, state attorneys general, state regulatory agencies and federal banking regulatory agencies, as well as shareholder and investor class actions are all on the horizon.

But lenders are not alone. Borrowers, brokers and appraisers are being investigated for mortgage fraud and related state and federal violations. Mortgage fraud is defined by the FBI as the intentional misstatement, misrepresentation or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan. It includes falsifying loan applications, creating fake loan documents and preparing inflated appraisals. Mortgage fraud is punishable by up to 30 years in prison or a $1 million fine or both.

While much attention has been given the sympathetic borrower who enters into a loan that he cannot afford, data shows that no category of participant is entirely free from fault. In 2006, the Mortgage Asset Research Institute reported that a sampling of 100 stated income loans (loans that do not require proof of income) revealed that 90 percent of the borrowers reported an income of at least 5 percent higher than that on record with the IRS. The same examination showed that a whopping 60 percent of the borrowers inflated their income by more than 50 percent. The FBI reports that an audit of more than 3 million loans found that up to 70 percent of defaults were linked to misrepresentations on loan applications by brokers and borrowers. State and federal agencies have levied similar allegations against appraisers, contending that they conspired with borrowers and brokers to defraud lenders (and, in some instances, with lenders to defraud borrowers) by inflating home values.

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Investment banks, while potentially protected by virtue of the rescue plan, also face the risk of litigation. State and local governments, as well as national and foreign banks, were major investors in mortgage securities. They have the power to bring (and have already brought) considerable lawsuits. Claims levied by investors range from breach of contract and breach of fiduciary duty to fraud and misrepresentation. Investment banks have also seen lawsuits from communities that bore the brunt of the market's collapse. One of the more creative claims includes Cincinnati's charge that banks created a public nuisance by trading in loans with a high default rate which resulted in a depletion of the local tax base. Rating agencies are also being investigated. Indeed, while many agencies have sought to limit liability by instituting new regulations for mortgage security rating, they are not immune from suit. Investigations by the SEC accusing agencies of failing to properly evaluate the risk of mortgage securities, failing to disclose known risks and ignoring conflicts of interests, have supported (and potentially prompted) recent suits by shareholders and state attorneys general.

Investors that purchased mortgage securities are also subject to litigation. Companies forced to write down devalued mortgage related assets, resulting in a negative impact on net income, are facing potential lawsuits by shareholders. Even companies that did not participate in mortgage securities may be vulnerable as the declining market leads to increased shareholder scrutiny. And with the increase in lawsuits against investors and banks, the insurance companies that issued credit default swaps are facing heightened claims submissions and potential litigation.

There is no foreseeable end to this tidal wave of litigation, nor any clear limitation on who is subject to its reach. With juries and courts potentially sympathetic in light of the nation's financial crisis, litigants (and their attorneys) are expected to become more creative in their quest for money that is already lost and their efforts to shift and assign the blame. The impact of government bailouts and other actions may further complicate the picture. With potentially many billions of dollars at stake in an already tumultuous economic environment, the explosion of litigation may end up being another consequence of the current subprime mortgage and financial crises. ■

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Mortgage fraud is defined by the FBI as the intentional misstatement, misrepresentation or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan.