

FIRST FOCUS

The Subprime Crisis

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How to Prepare for Subprime-Related Litigation

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The high-profile collapse of the subprime mortgage market has affected both domestic and global financial markets. The meltdown has been blamed for a tightening credit environment for consumers and businesses, the dramatic drop in consumer confidence, and even a potential recession. It has also triggered a wave of litigation.

This article examines the types of claims being asserted in litigation related to the subprime meltdown. It also reviews the targets of the claims. Finally, and maybe most importantly, the article focuses on some strategies businesses can use to prepare for such claims.

Claims related to the subprime mortgage crisis have become a trendy litigation topic. As with most industry collapses, those adversely affected by the subprime market have looked for alternative sources of recovery to shore up their losses. Unfortunately, litigation is often the answer. Plaintiffs have sued nearly every player in the subprime market: lenders, mortgage brokers, investment banks, hedge funds, officers and directors, and even credit rating agencies.

Law firms have taken notice. Several large law firms have created subprime-mortgage task forces to assist investment banks, bondholders, trustees and other institutional clients that face lawsuits and potential bankruptcy. These teams include lawyers from numerous areas of expertise, such as class actions, securities, financial restructuring and real estate.¹

Fueling the litigation are the dramatic loss in investor returns and the increasing number of bankruptcy filings by companies affected by the subprime crisis. Several of the nation's largest investment banks have posted significant write-downs caused in part by their involvement in the subprime industry. These write-downs have, in turn, led to lower investor returns and dampened already shaky investor and consumer confidence.

The subprime crisis has so damaged some companies that they have looked to the bankruptcy courts for relief. Several subprime mortgage lenders have recently filed for bankruptcy, including American Home Mortgage, New Century

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Financial Corp. and Sentinel Mortgage.² Others, notably Countrywide Mortgage, have barely survived and may ultimately file for Chapter 11 protection. Once in bankruptcy, the lenders and their officers and directors often face shareholder class-action suits and claims by other parties in the bankruptcy case.

In the American Home Mortgage bankruptcy, for example, a class of shareholders sued the debtor and its officers and directors for alleged violations of the Securities Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a), relating to the company's failure to disclose subprime mortgage loan defaults, an inability to sell packaged loans at desired prices and the resulting adverse impact on profit margins.³

Home builders are also feeling the effects of the subprime market collapse. Several have dealt with securities class-action lawsuits. Others face more dramatic events. As inventories of completed homes escalate, builders, large and small, face liquidity problems. Some may survive if they have sufficient cash reserves. Others face insolvency. Florida bankruptcy courts, for example, have seen two significant home builders recently file for Chapter 11: Levitt & Sons and TOUSA Inc.⁴ The distress these builders face ripples down to their suppliers and subcontractors, which have seen their cash flow severely impaired.

Below is an overview of some of the potential targets of subprime-related litigation.

Lenders

Mortgage lenders face the most scrutiny. Three types of claims against lenders have become prevalent.

First, lenders face borrowers' claims for predatory lending. About 1,600 borrowers sued NovaStar Mortgage in a class-action lawsuit claiming that certain loan officers and brokers were financially rewarded for steering the borrowers toward inappropriately high interest rates. NovaStar settled the case for more than \$5 million.⁵

The NAACP recently sued various lenders for allegedly discriminating against blacks by providing them with generally higher subprime mortgage interest rates than other borrowers.⁶

Second, lenders face shareholder accusations that they made misrepresentations and material omissions relating to valuations, accounting methodologies and poor underwriting. This is particularly evident in bankruptcy cases.⁷

Third, subprime mortgage lenders are increasingly being sued by their own lenders (such as warehouse lenders) for conversion. The suits claim the mortgage lenders failed to properly escrow and turn over mortgage loan proceeds collected for the benefit of their lenders. For example, UBS Real Estate Securities sued New Century Mortgage for breach of contract, conversion and breach of fiduciary duties in New Century's Chapter 11 bankruptcy case.⁸

UBS alleges that New Century failed to deposit into a third-party custodial account millions of dollars of mortgage payments it received from borrowers on loans UBS purchased and owned. Similar claims have been asserted or alleged in recent Florida bankruptcy cases.⁹

Rating Agencies

Once considered untouchable in certain types of lawsuits, credit rating agencies are now facing claims triggered by the subprime meltdown.¹⁰ Moody's, Subprime's Frightening Litigation Potential

TARGETS	TYPES OF CLAIMS
Mortgage lenders	<ul style="list-style-type: none"> • Borrowers allege predatory lending. • Shareholders accuse lenders of misrepresentation and material omissions relating to valuations, accounting methodologies and poor underwriting. • Mortgage lenders' own lenders sue for failure to escrow and turn over loan proceeds.
Credit rating agencies	<ul style="list-style-type: none"> • Shareholders claim agencies assigned bonds high ratings without disclosing they were backed by subprime mortgages.
Investment banks	<ul style="list-style-type: none"> • Plaintiffs like REITs sue banks over specific investments. • Institutional investors sue advisers, claiming poor advice. • Customers sue banks for engaging in subprime securitization.
Financial institutions	<ul style="list-style-type: none"> • Institutional investors sue companies that sold them mortgage-backed securities.
Hedge funds	<p>Investors may charge hedge funds with failure to:</p> <ul style="list-style-type: none"> • Make prudent investments • Follow internal guidelines • Manage risk
Bond trustees	<ul style="list-style-type: none"> • Suits against trustees could include breach-of-fiduciary-duty claims.
Directors and officers	<ul style="list-style-type: none"> • D&O policy underwriters will more closely scrutinize insureds' books and records.

for example, was recently sued in an Illinois federal court for alleged violations of the Securities Exchange Act.¹¹ The shareholders say Moody's "misrepresented or failed to disclose that [it] assigned excessively high ratings to bonds backed by risky subprime mortgages—including bonds packaged as collateralized debt obligations—which was materially misleading to investors concerning the quality and relative risk of these investments."¹²

Investment Banks

Investment banks have become litigation targets as the financial markets have started to feel the adverse effects of the subprime crisis. Shareholders are suing banks in their capacities as advisers, underwriters, parties to repurchase agreements and publicly traded companies.¹³ The claims generally fall into three categories.

First, plaintiffs such as real estate investment trusts are suing the banks in connection with specific transactions, including repurchase or swap agreements.

Second, institutional investors are suing their advisers for supposedly poor investment decisions or advice.

Third, plaintiffs are suing banks and their executives for their decisions to engage in the subprime securitization business (such as collateralized debt obligations) and their failure to minimize the bank's risk.¹⁴

Financial Institutions

Institutional investors have sued companies that sold them mortgage-backed securities. Bankers Life Insurance Co. recently filed a lawsuit claiming Credit Suisse First Boston did not provide material information on the status of the securities that, if disclosed, would have resulted in substantial downgrades.¹⁵

Hedge Funds

last summer's high-profile collapse of two Bear Stearns hedge funds focused on subprime mortgage-backed securities has heightened the scrutiny of the funds.¹⁶ Investors could argue that the hedge fund did not make suitable and prudent investments, failed to follow internal investment guidelines, and did not follow or implement proper risk-management procedures.

Bond Trustees

Trustees of bonds backed by subprime mortgages may face lawsuits if bond returns start to diminish. Suits against trustees could include breach-of-fiduciary-duty claims.

Directors and Officers

Officers and directors of any company in the subprime industry face potential claims. Some commentators suggest that as a consequence of the subprime meltdown, D&O policy underwriters will increasingly scrutinize their insureds' books and records, particularly for potential claim exposure.¹⁷ It is likely that companies with perceived subprime exposure will face higher insurance premiums and tightened terms and conditions.

While the increase in litigation during the next year may be inevitable, companies can take steps to prevent such lawsuits from being filed or at least reduce their exposure if they face such claims.

Find the Problem

The most important step is determining if a problem exists. Companies often avoid facing issues, hoping they will simply go away. Such complacency usually allows the problem to worsen to a point where it cannot be fixed. The old adage "nip it in the bud" is truer than ever in this situation.

A company should first initiate a thorough internal review of its credit and lending practices and procedures. Are these practices and procedures sound? If so, are they being followed? If unsound, what measures should be taken to improve the practices and procedures?

A company should consider engaging independent outside attorneys who have no prior involvement with the conduct at issue. Outside counsel may provide a fresh review of the situation with the independence necessary to properly analyze a potential problem. The investigation may also come to include looking at potential criminal conduct or other improprieties by individuals in the company.

Many claims asserted against lenders focus on "rogue" loan officers. If an employee is engaging in extremely bad conduct, the company should consider taking steps to eliminate that concern.

A company may also consider establishing a special committee of independent directors to review and monitor the investigation. The key is recognizing that a

Directors and officers of any company in the subprime industry face potential claims.

problem may exist and then taking proactive steps to first identify the problem and its cause and find a long-term fix.

Be Proactive

A company should analyze its D&O, fiduciary liability and other insurance policies. The policies should be up to date and cover any of the applicable claims described above. Again, the D&O insurance marketplace is likely far different now than it was a few years ago for companies involved in the subprime industry. Underwriters might be more critical, and premiums could increase.

A thorough review of applicable regulations and reporting requirements is also important. In particular, banks and publicly traded companies should review their reporting and disclosure requirements because many of the shareholder lawsuits allege failure to disclose material information.

Assess individual involvement and consider possible responses. This review should be at both the executive and rank-and-file levels. Terminating employment or board memberships may seem like an extreme step, but it may be appropriate in certain circumstances.

A debated measure is self-reporting to the Securities and Exchange Commission. While some believe that self-reporting may garner leniency, others suggest otherwise. A recent Wall Street Journal article suggests that U.S. authorities are aggressively prosecuting claims regardless of self-reporting.¹⁸

Some circumstances may warrant self-reporting. For example, a company with new management may be more inclined to self-report on issues that occurred before their arrival than a company whose management team has been in place for years. The bottom line is that each company's circumstances are different. So, a full analysis of the pros and cons of self-reporting should be made before taking this step.

Companies lucky enough to have escaped litigation so far should not get complacent.

Take Steps to Minimize Risk

1. Determine if there is a problem:
 - Initiate an internal review of credit and lending practices.
 - Consider engaging independent counsel.
 - Consider creating a committee of independent directors to monitor the investigation.
2. Be proactive:
 - Analyze D&O, fiduciary liability and other insurance policies.
 - Review regulations and reporting requirements.
 - Assess employee involvement at all levels, and be prepared to respond.
 - Analyze the pros and cons of self-reporting.
 - Implement a document preservation procedure.

Finally, a company should implement a document preservation procedure. It is critically important to maintain and preserve all records (including electronic versions) related to the dispute. In an age of evolving modes of electronic communications and record preservation, this task may be costly and cumbersome. The cost of not doing so can be steep, though. Courts are increasingly likely to levy harsh penalties not only on the companies involved in evidence destruction, but also on the law firms the companies retained.

Conclusion

The subprime crisis promises to continue affecting the global and domestic marketplace into this year and possibly beyond. The far-reaching impact of the crisis has already hit the courtroom. Companies lucky enough to have escaped litigation so far should not get complacent. Rather, they should take proactive steps to prepare for potential lawsuits. At worst, the exercise will permit a review of business practices. It could also lead to improving company procedures in a difficult and increasingly litigious environment.

Notes

- ¹ Posting of Peter Lattman to WSJ.com Law Blog, Hot New Practice Group: Subprime!, <http://blogs.wsj.com/law/2007/04/17/hot-new-practice-group-subprime> (Apr. 17, 2007, 14:16 EST). Beth Bar; *Legal Claims Proliferate From Mortgage Meltdown*, N.Y. L.J., Aug. 22, 2007, available at <http://www.law.com/jsp/article.jsp?id=1187686932130>.
- ² *New Century Files for Chapter 11 Bankruptcy*, CNN MONEY.COM, available at http://money.cnn.com/2007/04/02/news/companies/new_century_bankruptcy/index.htm.
- ³ See Lattman, *supra* note 1.
- ⁴ *In re Levitt & Sons LLC et al.*, No. 07-19845 (Bankr. S.D. Fla.); *In re TOUSA Inc. et al.*, No. 08-10928 (Bankr. S.D. Fla.).
- ⁵ The D&O Diary, "This Year's Model" (2007 Edition): Subprime Lending Lawsuits, <http://dandodiary.blogspot.com/2007/07/this-years-model-2007-edition-subprime.html> (July 12, 2007).
- ⁶ *Id.*
- ⁷ The D&O Diary, Counting the Subprime Lending Lawsuits, <http://dandodiary.blogspot.com/2007/04/counting-subprime-lender-lawsuits.html> (Apr. 28, 2007).
- ⁸ See Bar, *supra* note 1.
- ⁹ *In re Premier Mortgage Funding Inc.*, No. 07-5713 (Bankr. M.D. Fla.).
- ¹⁰ Nelson Schwartz & Vikas Bajaj, *Missed Signs Led to Mortgage Meltdown*, INT'L HERALD TRIB., Aug. 19, 2007, available at <http://www.iht.com/articles/2007/08/19/business/mortgage.php>; Tomoeh Murakami Tse & Carrie Johnson, *Mortgage Mess Leads to String of Lawsuits*, WASH. POST, Sept. 15, 2007, available at http://seattletimes.nwsourc.com/html/realstate/2003884853_lawsuits16.html.
- ¹¹ *Nach v. Wyman*, No. 07-CV-4071 (N.D. Ill. July 19, 2007), complaint at 1-5, 27.
- ¹² *Id.* at ¶ 4.
- ¹³ John Doherty & Richard Mans, *The Changing Landscape of Subprime Litigation*, ANDREWS BANKR. LITIG. REP., Jan. 14, 2008, at 3.
- ¹⁴ *Id.*
- ¹⁵ See Bar, *supra* note 1.
- ¹⁶ The D&O Diary, The Wave Grows: More Subprime Lending Lawsuits, <http://dandodiary.blogspot.com/2007/08/wave-grows-more-subprime-lending.html> (Aug. 7, 2007); Faten Sabry & Thomas Schopflochler, *The Subprime Meltdown: Not Again!*, 26 AM. BANKR. L.J. (September 2007).
- ¹⁷ The D&O Diary, Will the Subprime Meltdown Affect the D & O Marketplace? <http://dandodiary.blogspot.com/2007/08/will-subprime-meltdown-affect-d-o.html> (Aug. 23, 2007).
- ¹⁸ See D&O Diary, *supra* note 16.

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