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Subprime Time

By David B. Bayless

In the wake of the housing and subprime meltdown, companies face unprecedented legal exposure ranging from regulatory and criminal investigations to private litigation.

To put this situation into historical perspective, the savings-and-loan crisis of the late 1980s and early 1990s ultimately cost an estimated $160 billion and affected more than 1,600 U.S. banks insured by the Federal Deposit Insurance Corp. It was one of the worst financial scandals in history. But the S&L crisis, while costly, was limited to only a section of U.S. financial institutions. In contrast, the breadth and the depth of the subprime mortgage crisis will likely far exceed that of the S&L crisis. Standard & Poor's has estimated that losses from securities linked to subprime mortgages will exceed $265 billion as financial institutions worldwide write down the value of their holdings. And the breadth and depth of regulatory investigations and private litigation, as discussed in this column, is unprecedented.

To better understand the legal ramifications for companies, a brief recap of the housing bubble burst will be helpful. Since 2001, historically low interest rates led to increased housing demand, price appreciation and nuerous refinancings. The mortgage industry turned to subprime and nontraditional mortgage loans to facilitate loans for less credit worthy home purchasers. Instead of holding onto and servicing these mortgages, as was traditional, lenders sold them to third parties, who packaged them into securitized pools and sold the cash flows to investors as mortgage-backed securities (MBS). Some MBS purchasers in turn resecuritized to create collateralized debt obligations (CDO).

When interest rates were low, and housing prices were increasing, MBS's and CDO's performed well. But in late 2006 and early 2007, interest rates increased, real estate apreciation slowed and the $1.3 trillion U.S. subprime mortgage market began to collapse. As borrowers failed to make mortgage payents, third parties who had purchased the mortages sought to exercise their right to return them for new ones or receive cash refunds. This caused originating mortgage lenders with little capital and limited liquidity to fail. As a result, MBS's and CDO's backed by subrime mortgages also deteriorated.

Importantly, due to the securitization of these loans, the subprime mortgage crisis affects more than just borrowers and lenders. Those with potential exposure include mortgage brokers, appraisers, title companies, trusts or special purpose entities, rating agencies, hedge funds, investment banks, underwriting firms, mutual funds, insurance companies, government pension funds, auditors, public companies and company officers and directors.

Both state and federal banking and securities regulators are devoting extensive resources in this area. State attorneys general from California, New York and Ohio, along with federal and state banking regulators, have announced investigations into the subprime lending industry. These investigations focus on borrowers, mortgage brokers, appraisers and lenders and on the lending process itself for possible violations of federal and state deceptive practices laws and bank regulatory statutes.

In addition, the securitization of these mortgages has brought the SEC and federal criminal prosecutors into the picture. As of early March, the SEC has opened more than three dozen investigations into the subprime mortgage business and continues to take a lead role in investigating subprime industry players and their practices. In 2007, the SEC's enforcement division formed a subprime working group specifically focused on possible securities fraud and breaches of fiduciary duty involving CDO's. Earlier this year, SEC Chairman Christopher Cox announced that the working group's investigative priorities include: (1) whether bank holding companies and securities firms made proper public disclosures of what they knew about the value of their CDO portfolios; (2) whether brokers carefully followed suitability requirements when they sold complex debtrelated derivatives that went bad shortly afterward; and (3) possible insider trading to sell out of these

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securities or to sell them short, in violation of the securities laws.

The SEC this year is also forming an agency-wide subprime task force, chaired by the director of the division of trading and markets. It includes the heads of the office of the chief accountant, division of corporate finance, division of investment management and the general counsel's office. This task force will focus on: (1) significant accounting questions, such as when off-balance sheet CDO related liabilities will be forced back on to an entity's balance sheet; (2) the adequacy of investment banks' capital and liquidity and the strengths of their risk management practices; (3) the impact on money market funds from the devaluation of presumptively safe assets; (4) the adequacy of disclosure by public companies involved in the subprime mortgage industry; (5) the role of the credit rating agencies over which the SEC recently gained regulatory authority under the Credit Rating Agency Reform Act; and (6) the possibility of violations of the securities laws by subprime lenders, investment banks, brokerdealers and other market participants.

Moreover, criminal investigations have mushroomed. In January, the FBI disclosed that it had opened inquiries into at least 14 different companies involved in the subprime crisis. The criminal focus is on accounting fraud, loan securitization and insider trading. This adds to the FBI's long standing focus on mortgage fraud, where the bureau said it has more than 1,200 mortgage fraud cases under investigation.

Finally, recognizing the global impact of the subprime crisis, governmental agencies worldwide are displaying unprecedented coordination when it comes to navigating the global issues raised by this crisis. For example, the International Organization of Securities Commissions (IOSCO) last November announced the creation of a dedicated subprime task force to review the issues facing securities regulators following recent events in the global credit markets. SEC Chairman Cox, who co-chairs this task force and IOSCO's credit rating agency task force, recently joined representatives from two dozen countries in analyzing the latest data from the subprime crisis.

Among the issues being analyzed by IOSCO's task forces are (1) how the domestic securitization of U.S. mortgages and the rules governing U.S. based rating agencies affected risk management by banks and institutional investors around the world; (2) transparency by issuers of structured products and appropriate due diligence from investors; (3) the risk management process for intermediaries; and (4) valuation and accounting issues.

Private lawsuits, of course, have been proliferating. During 2007, at least 278 cases were filed in federal courts, including borrower class actions, securities class actions and commercial contract disputes. Borrower class actions — the largest category of cases — were filed against mortgage brokers, mortgage companies and commercial banks, alleging inadequate disclosures in the mortgage origination process, some form of discriminatory lending or involving option ARMs.

Federal securities class actions have been filed against securities brokers, dealers, commercial banks, mortgage bankers, underwriters, accounting firms and officers and directors. Such lawsuits allege securities fraud, ERISA claims related to companysponsored plans and shareholder derivative claims based on undisclosed investments in subprime mortgage securities. Cases filed against investment managers or broker dealers and underwriters relate to the issuance of residential mortgagebacked securities. Commercial contract disputes involve purchasers of subprime loans suing mortgage originators for misrepresentations and failure to comply with repurchase obligations triggered by early payment defaults.

One additional issue, often overlooked, is the impact of the subprime mortgage crisis on insurance policyholders. Numerous insurance coverage claims will soon surface as insurers are likely to resist coverage. The three relevant types of coverage are directors and officers (D&O) coverage, professional liability or malpractice insurance and fiduciary liability policies. Securities fraud claims will lead to D&O claims; correspondent bank claims will lead to bankers professional liability and financial institutions professional indemnity claims; and breach of ERISA imposed duties (or similar fiduciary duties) will implicate fiduciary liability policies.

So where does it all go from here?

The current wave of government investigations and litigation surrounding the subprime crisis will not be shortlived. Companies should brace themselves and prepare for a prolonged wave of attacks and actively seek legal advice. More lawsuits can be expected, particularly against deeppocket underwriters and financial institutions (and their officers and directors) involved in the securitization of subprime loans. More regulatory and criminal investigations are guaranteed. Many laws firms have set up subprime task forces or have coordinated their internal expertise in various practice areas to address issues affecting clients caught up in the crisis.

General counsel should not wait for private plaintiffs, state attorneys general, the SEC or the FBI to come pounding on the door. Much like the stock option backdating issue, companies are better served by taking a proactive approach, evaluating their possible exposure in this area now and addressing the issues up front. Be prepared. This unprecedented legal crisis is not going away anytime soon.