

Subprime Litigation

THE MORTGAGE INDUSTRY'S SUBPRIME SECTOR GREW IN 2007 TO \$650 BILLION. THIS dramatic expansion allowed subprime borrowers to take advantage of low introductory rates while planning to later refinance their way out of higher interest rates. But when the real estate market declined, these borrowers defaulted on those subprime loans. Mortgage market liquidity dried up, resulting in monumental losses to lenders and investors. This crisis has resulted in substantial litigation and regulatory policy changes, with new trends emerging, as discussed by our panel. They are Darren Robbins of Coughlin Stoia Geller Rudman & Robbins; Jami Wintz McKeon and Christian Bartholomew of Morgan, Lewis & Bockius; Michael Agoglia of Morrison & Foerster; and Michael Tu of Orrick, Herrington & Sutcliffe. The discussion was moderated by Bo Links.

MODERATOR: What litigation issues have developed from the subprime crisis?

McKEON: One area involves litigation by individuals in a default scenario who try to escape liability by accusing lenders of “predatory lending” or fraud and misrepresentation. Lawsuits span the criminal and civil side; you have borrowers suing their brokers but also trying to bring in the banks, claiming that those institu-

tions should have known that these loans were not in the consumers’ interests. Some lawyers are seeking out borrowers to bring class-based litigation, often alleging discrimination on the basis of race, language, or economic class.

Whenever you have default situations, you are also going to have bankruptcy litigation. The fact that some of the originators are themselves in bankruptcy is an added complexity. Finally, you have the secondary lawsuits starting to develop, involving institutional investors, disputes between and among institutions, and lawsuits between the sellers and the purchasers of the securitization pools.

AGOLIA: Though some of the litigation we are seeing now is new, a lot isn’t. The mortgage market is a highly regulated industry, with lots of federal regulation on the origination side in terms of disclosures, mandated by statutes like the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA).

Although there is public concern and policy interest in Washington around the market implosion, the subprime mortgage litigation is

still in search of viable legal theories. The trial bar is looking for claims that will resonate with judges, allow cases to survive threshold challenges, and ultimately resonate with juries. For example, there is an attempt to reintroduce concepts of suitability—should the lender have made the loan to the borrower—but that issue has been litigated for decades. In California, mortgage lenders do not owe a duty to borrowers to assess whether a particular loan is right for a particular borrower. In fact, because of fair lending regulations, if a borrower came to the lender as a subprime applicant and met the lender’s applicable underwriting criteria, you were legally obligated to make them a loan.

So far, the species of consumer litigation that has been most prevalent has been in fair lending challenges, securities litigation—which increasingly is being filed against secondary participants like mortgage insurers who have been devastated because of expected losses—and attacks on particular types of products, such as adjustable rate mortgages.

McKEON: Approximately 50 percent of the cases to date have been brought in California

EXECUTIVE SUMMARY

The subprime mortgage crisis is market-wide, threatening nearly every sector of the economy, from multinational banks to small mortgage lenders and real estate appraisers. Our panel of experts discuss the resulting upsurge in subprime mortgage litigation, including the typical parties to litigation, tricky issues faced by the plaintiffs and defense bars, as well as legal issues the courts are zeroing in on.

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and New York. California is considered an attractive venue for plaintiffs because California Business and Professions Code Section 17200 can be used to suggest that a wide variety of activities are “unfair business practices,” even where some statutory claims like TILA or RESPA claims are either exhausted or not viable. When creative lawyers are looking for a cause of action, they hope to use 17200 to get over that early threshold, hoping that once they do, it becomes a different ball game for lenders.

ROBBINS: What started this ball rolling and this contagion spreading was that loans were extended without appropriate documentation and legitimate appraisals were not obtained. Notwithstanding the representations of these issuers about the appraisal process, the appraisals were manipulated or not obtained at all.

As a result of these misrepresentations, investors from individuals to state pension funds that purchased these securitized assets have seen substantial parts of their portfolios vaporized. And it wasn't the small portion of their portfolios that were put into risky speculative investments. It's the most conservative portion of their portfolios. In my practice area, looking at the representations that were made in connection with the sale of these securities, for almost every major investment bank and packager of securities, the misrepresentations concerning the sale of securitized debt obligations and mortgage-backed securities are legion.

TU: The first wave of securities cases that were filed immediately after the subprime crisis got its legs last year was against the mortgage originators and lenders that engaged in subprime, and in some cases Alt-A lending. What we are now seeing is courts beginning to issue dispositive rulings in this first wave of lawsuits, and the record so far has been decidedly mixed. Some of them have been allowed to go forward. Some of them have been dismissed by the courts. With respect to this wave of cases, there is not a whole lot that really distinguishes these complaints from traditional securities fraud class actions.

The plaintiffs are going to have to show that their allegations can pass muster under the heightened pleading requirements applicable to these cases, including the Private Securities Litigation Reform Act (PSLRA), which means the plaintiffs are going to have to clear a number of hurdles, including showing that there's an actionable misstatement or omission, that there's a sufficient showing of scienter, and that they've met the loss causation requirements. That's not to say that some of these cases are not going to go forward. It's pretty clear that some will. But the courts are going to need to sort through the myriad of complaints and a number will be dismissed.

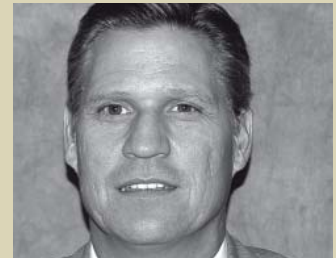
AGONGLIA: You will not likely see significant actions based upon inadequate appraisals because appraisers are almost always unaffiliated with the lending institutions. They could have been chosen by a realtor or mortgage broker. Courts are unlikely to allow a class action to proceed if the case must address the conduct of separate appraisers in separate transactions.

MODERATOR: What is the regulatory response to the subprime crisis?

ROBBINS: The FBI has publicly announced it is conducting its own investigation of several dozen mortgage-related entities, including several major investment firms. That's pretty telling. It seems to be a full-bodied discussion of consumer-related-type causes of action and securities-type causes of action, which are both relevant to this discussion.

BARTHOLOMEW: On the securities side, a great deal of regulatory activity is going on where the SEC, the New York Attorney General and other states as well as the Financial Industry Regulatory Authority that regulates broker/dealers are all looking into how securitized products were sold and to whom they were sold, what was said about them, whether the institutions that were selling these kind of securitized products like collateralized debt obligations, collateralized mortgage obligations or asset-backed securities were saying different things to different kinds of customers.

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The regulators are also very focused on valuation issues—whether sellers of these products were holding them on their own balance sheets or in their proprietary accounts at different values than they were selling them to clients—as well as on whether these products were suitable for a particular kind of customer. The regulatory interest really runs the gamut from suitability to valuation issues.

The difficulty that regulators face is that these are not easy products to understand and they are not easy products to value on any given day. They do not trade like a listed stock on the NASDAQ or the New York Stock Exchange. Many, if not most, of these products are not listed and trade relatively infrequently. So it would certainly not be unreasonable for an investment bank to have a particular CDO [collateralized debt obligation] on its books at a different value or at different values over time than it had sold it to a customer, particularly if time had elapsed.

Also, as the liquidity freeze has worked its way through every part of the market, demand for these products has evaporated and that has obviously dramatically affected their market value as well. This means that securities that might have had a high value and been perfectly appropriate are now valued by the market at much less, due merely to the drying up of demand and the liquidity freeze. So it will be difficult to get to the bottom of those issues given that the products are very complicated and that you can have a range of valuations that certainly are supportable.

TU: One thing that we've heard, particularly from the federal regulators, is that they are looking closely at valuation issues. That's not surprising. We've seen the difficulties involved in fairly and accurately valuing not only subprime mortgage investments, but broader structured finance instruments, particularly when you are in the midst of a deteriorating credit environment. So that's resulted in a number of financial institutions and companies having to make piecemeal disclosures and write-downs, which of course creates additional problems.

McKEON: Accounting in subprime securitization is different, and that adds to the complexity for regulators and to the difficulty of making a determination about appropriate valuations. It's an unfamiliar area for many, and that leads to confusion.

AGOLIA: There's no duty of a lender to ensure a loan is right for somebody. A mortgage broker, however, in states like California, is the fiduciary of the borrower. But legislative efforts may overtake the litigation. On the consumer class action side, efforts are underway in Congress and at state/local levels to address the mortgage crisis, everything from moratoriums on foreclosures to fundamental changes, including suitability standards being introduced on a federal level. Those would not materially affect existing litigation, but would likely alter entirely the playing field for how the mortgage markets work and who is left to make loans.

In the existing litigation, taking, for instance, the fair lending litigation, they consistently seek declaratory relief, and the perception is that those cases were as much political gestures as traditional lawsuits, and that what they ultimately seek is some form of programmatic reform in the industry. It's going to be difficult to affect some programmatic reform when events in Congress are outpacing anything that is likely to be achieved in a class action lawsuit. So there is a direct interplay between the existing litigation and the changing standards potentially introduced through legislation.

TU: You also have regulatory changes underfoot and not only do you have the federal government beginning to get involved, you also have, for example, Treasury Secretary Paulson proposing federal regulatory reforms that would significantly change the scope of oversight of the federal government and create new federal agencies. There's already substantial debate and disagreement over those proposed reforms.

BARTHOLOMEW: It's fair to call the proposal a sweeping overhaul of the entire financial regu-



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latory system. It would merge the SEC and the CFTC [Commodities Futures Trading Commission], put the securities enforcement function into the Federal Reserve, and create several new federal agencies as well as a self-regulatory organization for mutual funds. The proposal would overlay all of this with something called “principles-based” regulation, which is different than “rules-based” regulation that has historically been in place here in the U.S. But it’s unlikely that there’s going to be much movement on the proposal in the short term, given the election, and there has already been a lot of opposition expressed to the proposal, mostly by Main Street as opposed to Wall Street banks.

MODERATOR: Do you expect any surprises in how subprime litigation and regulation will develop?

BARTHOLOMEW: It remains to be seen whether there will be litigation among and between the major financial institutions and their counterparties with respect to securitized products, credit default swaps, and the like. I’m specifically talking about hedge funds and other sophisticated institutions pursuing brokers and dealers. On the one hand, you can certainly see how that kind of litigation might not be terribly attractive, for example, to a sophisticated hedge fund. On the other hand, if real losses are on the table, that might motivate folks. But that is an area where there has been, to date, not much activity. That’s also true when it

comes to what I’ll call retail customer litigation with respect to securitized products. There’s not been a lot of that to date, although a rash of cases has recently been filed in federal court relating to auction rate securities. Whether those will proceed in federal court or end up in arbitration is an open question.

On the other hand, there’s been a lot of securities fraud litigation, where investors are suing issuers like some of the big banks for allegedly not making good enough or accurate disclosures about their exposure in this area. That’s very different than lots of cases involving folks who bought products or had other dealings with investment bankers.

McKEON: You have a lot of people who wear different hats in this situation. It’s going to be a little while before you start seeing the full array of institution-versus-institution lawsuits. There are risks to taking a position against somebody else further down the chain if you also could be in that position vis-à-vis another party. When the insurance situation starts to sort out, and as the economic impact trickles down, insurers may put institutions in a position of having to pursue that litigation.

TU: Another interesting area to watch out for is how far the litigation is going to extend outside the financial sector, putting aside the financial institutions, the insurance companies, and the banks. For example, many nonfinancial public and private companies have invested significant amounts of money in auction rate securities and we are now beginning to see these companies announce significant write-downs related to that. So it is conceivable that there might be potential litigation involving these nonfinancial companies related to their investments in these types of instruments, even though these companies are not within the financial sector.

BARTHOLOMEW: Institutional investors are very sophisticated outfits, and the question is going to be whether even under state laws they can honestly and legitimately say that they didn’t understand the product or that something in the private placement memorandum



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or other disclosure document they received wasn’t accurate at the time they bought the securities. I don’t think the mere fact that something may have occurred after the fact, due to the liquidity freeze that has swept the country, is going to be legally meaningful when it comes to trying to prove a fraud or suitability case in front of a judge or arbitrator.

McKEON: There are a lot of places where if you don’t have a federal securities class action, you are not going to have any traction in a state action. The one thing that makes 17200 appealing to plaintiffs lawyers is that you have a better likelihood of getting over that threshold initially. The question is where you think the battle is ultimately going to be fought, whether it’s at the end of the case or whether it’s going to be fought by getting past a motion to dismiss early on.

TU: Plaintiffs now are also trying to bring fed-

eral claims in state court, arguing that under the Securities Act of 1933, because there's concurrent jurisdiction written into the statute, that they should be allowed to proceed. That's a trend we are seeing and is an issue that the courts are confronting. Sitting here on the defense side, the answer is that under the Securities Litigation Uniform Standards Act (SLUSA) and the Class Action Fairness Act (CAFA), these state cases should be removable to federal court. But not all the courts have ruled in that way and so that's an issue that's out there.

BARTHOLOMEW: After the passage in 1995 of the Private Securities Litigation Reform Act, there was a substantial effort by the plaintiffs bar for several years to make an end run around the PSLRA and its very demanding pleading standards—which require very particularized and specific facts regarding the fraud and the defendant's intent to mislead—by filing securities fraud suits in state court. Congress specifically passed the SLUSA law to stop these end runs. Although there was some uncertainty in the courts initially applying SLUSA, I think it's fair to say that in the last three years or so the courts have been pretty consistently saying that if it looks and walks and talks like a securities fraud action, then it needs to be in federal court. Some of the cases in this area have been very strict in their interpretation.

For example, there have been cases that—fairly read—were not really based on a securities fraud theory, but, because those cases had been consolidated with a securities fraud case, they were deemed to be governed by SLUSA. This meant that they had to be removed to federal court where they were then dismissed because they didn't meet the very demanding standards of the PSLRA. So although there are some courts that haven't ruled on this, the tide in my judgment had really shifted in favor of the defense bar on this issue

ROBBINS: I'm not aware of any of the subprime cases that were brought in state court that were removed. There is a substantial portion of the victims of this crisis who have securities that are

not covered. So the reality is there are statutory definitions, and talking and walking and chatting like ducks doesn't change it. A definition is a definition.

Covered securities is a defined term and there is a huge portion of victims here who do not own and did not purchase covered securities. So SLUSA is going to be of little or no help to the defendants who wish to avoid the state court venue selected by plaintiffs. And you also have large funds, I would say those funds with \$10 billion or more in assets, who have substantial individual claims, which even under SLUSA are not preempted and can be asserted in state court. Again, not all of them will choose state court, but when they do, these victims will be able to have their claims tried before a jury of their choice.

McKEON: It also remains to be seen whether the new wave of activity under the Unfair Practices Act in California will be successful. There are some very early cases with decisions that were, frankly, not very well analyzed and that allowed plaintiffs to pursue questionable causes of action. Whether or not those will prevail as we go forward remains unclear. We are still in the very early stages, and in some of these cases, circumstances are delaying resolution. For example, in some of the class actions the brokers involved are facing criminal proceedings resulting in stays in the civil litigation while the criminal litigation is going forward. It will be awhile before there is a clear indication of where the courts will go with these creative causes of action.

TU: The tremendous amount of leverage that's built into our financial system has created the conditions for many of the issues that we are now seeing in the credit markets. For example, there are collateralized debt obligations that are themselves comprised of other CDOs, which are known as CDO squared. We've also talked about credit default swaps for which the market is in the trillions of dollars. That's a lot of counterparty risk out there, and one can see how one event lower down on the leverage ladder can quickly ripple up and cause all these other consequences.

McKEON: We've already started to see the usual dance of insurance-related claims, including issues relating to the timeliness of notice and arguments over exclusions, but this is a new area and there often aren't specific descriptions or specific exclusions that necessarily apply to the claims being made. Not surprisingly, we're seeing early creative advocacy on both sides.

So much of the battle is going to be shaped by what the courts allow in terms of the claims in the litigation and, as we've been discussing, those claims are themselves taking shape. If they are not the classic securities claims, are they being brought in federal court or state court or are they being described as contract issues or described as unfair business practice issues? There are very different coverage implications for those different descriptions, so as the cases and nature of the claims sort out, we'll see the coverage dispute take more shape at that point. Many people realize the importance of looking at the coverage issues early, because the economic implications of what's going on and the potential losses are fairly severe.

ROBBINS: I don't think that insurance is a major component given the magnitude of the losses in many of these cases. These are massive claims, and although we don't have perfect insight into what the actual relevant insurance is at the commencement of the case, there are very few circumstances where the D&O insurance coverage reaches into the hundred plus million-dollar range.

AGOLIA: If the predictions of a shallow but long recessionary period are true and you don't see fairly significant recoveries in home values around the country, then what you might also see are additional efforts, such as the city of Cleveland lawsuit, by local municipalities to try to put moratoriums in place with respect to foreclosures. Those efforts take place typically in the state forums. I expect those cases to pick up if you continue to see a malaise economically that prevents folks from refinancing loans that they, in hindsight, ought not to have gotten into in the first place. ●