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THE LEGAL FALLOUT FROM THE SUBPRIME CRISIS

ROBERT S. FRIEDMAN AND ERIC R. WILSON

The authors examine the relationships involved in the subprime mortgage industry and explore how they may play out in court.

The $650 billion "subprime" mortgage market has experienced a highly publicized freefall brought on by many factors, including rising interest rates, an inverted yield curve and, in many parts of the country, significant declines in home prices.[1] This has resulted in a perilous perfect storm of higher defaults. Wall Street has been driving much of the tremendous growth of the sector, particularly in structuring the securitizations of portfolios of subprime mortgage loans.[2] It is therefore not surprising, given the size of the sector and the dramatic changes in the market realities, that the impacts will occur on Main Street and on Wall Street. The next stop will no doubt in many instances be the courthouse, as judges are asked to unwind the myriad relationships involved in the subprime industry. This article examines these relationships and explores how they may play out in court. While we expect that the plaintiff's class action bar will be active in pursuing consumer claims,[3] we concentrate here on the relationships that occur after the origination of the consumer loans. Because several subprime

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originators have filed for bankruptcy or will do so in the future, bankruptcy judges may play a significant role in making law in this area. Because of this, we address special bankruptcy considerations that practitioners and industry professionals should be aware of.

The place to start in discussing the legal fallout is to follow the money path. A subprime originator typically has four major ways it comes up with the liquidity in order to fund new originations:

(1) revolving credit lines from "warehouse lenders" secured by the mortgages and subject to repurchase obligations;
(2) whole loan sales, generally with a repurchase obligation for early payment defaults ("EPDs");
(3) securitizations in which a special purpose entity ("SPE"), usually a trust, purchases a pool of loans with funds raised from the certificate holders in the trust; and
(4) loan servicing.

In addition, some originators have issued corporate debt, in certain cases secured by residual interests that the originator takes in the securitization trusts.

The complicated and varied relationships are giving rise to claims sounding in both contract and tort.[4] In addition, lenders, purchasers, and bankruptcy trustees or creditors' committees may assert competing claims to a finite pool of assets, which often has been highly leveraged. If market factors continue on their current course, we expect these disputes to increase dramatically.

THE LITIGATION FALLOUT

A prime area for litigation concerns originators' repurchase obligations contained in the agreements between subprime originators and their warehouse lenders or whole loan purchasers. As subprime lenders experience the ripple effects of borrower defaults, those repurchase obligations may be triggered. Financial institutions that purchase mortgages and provide funding to mortgage lenders have recently been attempting to invoke these repurchase clauses to offload defaulting mortgages. Subprime lenders are now being faced with demands to repurchase mortgages as a result of early payment defaults by the underlying borrowers or based on alleged violations of representations and warranties in connection with the sale of the loans.

One recent lawsuit by a purchaser against an originator is illustrative. On March 27, 2007, American Home Mortgage Corporation filed a lawsuit against Agency Mortgage Corporation in the United States District Court for the Southern District of New York.[5] American Home had purchased several mortgages from Agency pursuant to contracts which included certain "Representations and Warranties" including the warranty that the mortgage loan and documentation did not "contain any fraudulent statement or misstatement or omission of material fact," that the mortgage was "originated in a manner consistent with prudent mortgage banking practices," and that the originator was not aware of any information which could be "reasonably expected to cause institutional investors to regard the Mortgage Loan as an unacceptable investment, cause the Mortgage Loan to become delinquent or materially adversely affect the value or marketability of the Mortgage Loan."

The contract also contained a "Repurchase Obligation" clause. That clause, common to these types of contracts, provided:

> [Agency] agrees to repurchase on [American Home's] demand, any Mortgage Loans subject to this Agreement upon the terms and conditions hereinafter set forth in the event that: (a) any ... breach of warranty contained herein or other material breach of this Agreement, is discovered by [American Home] ...; provided that the effect of such ... breach is to materially and adversely affect the market value or salability in the secondary market of such Mortgage Loan.

After purchasing the mortgages, American Home allegedly discovered a host of problems which, in its view, violated the representations and warranties. Specifically, American Home claims it discovered, among other things, that the borrowers made misrepresentations concerning marital status, employment, income, and assets. These misrepresentations allegedly breached the representations and warranties and triggered Agency's repurchase obligation. When Agency refused to repurchase the mortgages, American Home sued for breach of contract.

In addition, American Home alleged that Agency refused to repurchase the mortgages due to insolvency which was brought about by the transfer of funds to Agency's principals. Thus, American Home also sued two of Agency's shareholders and principals to recover the alleged fraudulently transferred funds.

Similarly, DLJ Mortgage Capital has filed several actions against various mortgage bankers in the Southern District of New York for failure to comply with their repurchase obligations.[6] The complaints allege claims for more than $30 million for breach of contract and unjust enrichment and seek to have the defendants indemnify DLJ for its legal fees pursuant to the purchase agreements.

As these examples demonstrate, litigation between purchasers and originators will depend a great deal on the terms of the contracts by which the mortgages are purchased. Breach of contract actions are likely to depend on the representations and warranties and the repurchase obligations of the originators. Officers, directors, and controlling shareholders of originators may also find themselves facing claims.

In addition to contract actions against originators, tort actions may also be possible. Claims for fraud, fraudulent inducement, and negligent misrepresentation may arise if financial institutions which purchase mortgages allege, as American Home did, that the originators failed to adequately investigate the borrowers and/or made misrepresentations concerning the mortgages.

A recent California case demonstrates the expanding theories of liability and the potential for litigation against originators, loan purchasers, or warehouse lenders. In *In re First Alliance Mortg. Co.*, a class of borrowers sued not only the originator of the mortgages (First Alliance), but also the warehouse lender (Lehman) which underwrote the mortgages and provided the lender with a revolving line of credit to fund new mortgages.[7] A jury verdict, upheld on appeal, found Lehman liable for aiding and abetting the originator's fraud:

> Among other evidence in the record, the Borrowers highlighted the facts that throughout its investigations into First Alliance, Lehman received reports that detailed the fraudulent practices in which First Alliance was

> engaged, and that in one report, a Lehman officer noted his concern that if First Alliance "does not change its business practices, it will not survive scrutiny." That same evaluation recounted that First Alliance "does not have the clear-cut defenses that the management believes" and that "at the very least, this is a violation of the spirit of the Truth in Lending Act." It was not unreasonable for the jury to rely upon these evaluations in concluding that Lehman had actual knowledge of First Alliance's fraudulent loan origination procedures.[8]

Moreover, the jury found that Lehman substantially assisted the fraud because "Lehman satisfied all of First Alliance's financing needs and, after other investment banks stopped doing business with First Alliance, kept First Alliance in business, knowing that its financial difficulties stemmed directly and indirectly from litigation over its dubious lending practices."[9]

Underwriters of the securities issued by the securitization SPEs may also face lawsuits from holders of such securities. Most of the trusts are structured with varying risk profiles, often ranging from AAA to BBB, as well as residual interests (equity in the securitization SPE). Depending on a variety of factors, including, for example, default rates, prepayment speeds, interest rate trends, and collateralization ratios, the ripple effect may cause the SPE to only be able to satisfy certain obligations toward the top of the "waterfall," thereby being unable to satisfy obligations to certain holders. In these situations, the underwriters may find themselves targets of bondholder suits. Alleged misrepresentations in offering memoranda, registration statements, prospectuses, and other documents concerning the quality of the underlying mortgages or the diligence of the originators, lenders, or underwriters may be the basis of claims.

These types of suits, of course, will face hurdles. For example, a review of a prospectus from September 2002 in connection with the issuance of Mortgage Pass-Through Certificates in a New Century securitization, reveals a lengthy discussion of the various risks to investors, including the fact that there are less stringent underwriting standards for subprime mortgages which may lead to more frequent defaults, that many subprime mortgages require large balloon payments at maturity which may create a greater risk of default, that prepayments on the underlying mortgages may lead to shortfalls in the distribution of interest, that the bankruptcy of the originator may adversely affect investors, that violation of federal, state and local laws may result in losses on the mortgage loans, and that the originators may not be able to repurchase defective mortgages.[10] Whether these types of disclosures are sufficient to protect underwriters from lawsuits by their own investors remains to be seen.

BANKRUPTCY CONSIDERATIONS

The declining subprime market and the collapse of the financing structures outlined above have led several subprime mortgage originators to file for bankruptcy protection. In November 2006, Ownit Mortgage Solutions defaulted on its warehouse credit facility with JP Morgan Chase and Merrill Lynch demanded that Ownit repurchase a large number of underperforming loans based on missed payments by the underlying borrowers.[11] Within weeks, Ownit filed Chapter 11 in the Central District of California. Since then, the termination of funding and the dramatic increase in repurchase demands by warehouse lenders and loan purchasers, has resulted in severe liquidity crunches for a number of originators, leading to bankruptcy filings by some of the industry's biggest players, including Mortgage Lenders Network, ResMAE Mortgage Corp., People's Choice, and New Century, once the second largest subprime loan originator in the country. With so many subprime originators in bankruptcy, many of the legal issues confronting the industry may play out in the bankruptcy theater. Accordingly, it is important for practitioners and industry professionals to be aware of certain bankruptcy principles.

Bankruptcy provides the loan originator an opportunity to restructure its debts and reorganize its business or to liquidate its assets. In the cases noted above, the originators have used bankruptcy to sell or begin the process of selling some or all of their assets. The marketable assets typically consist of the loan portfolio, loan origination and servicing businesses, and residual interests in loans sold for securitization. For example, ResMAE sold substantially all of its assets as a going concern to Citadel Investment Group LLC. Citadel paid approximately $157.6 million for ResMAE's loan portfolio and approximately $20 million for its loan origination platform.[12] Subject to higher bids, New Century has agreed to sell certain residual interests and whole loans to Greenwich Capital for $47.3 million and its loan servicing business to Carrington Capital Management LLC for $133 million. New Century currently is seeking bidders for its loan origination platform.[13]

From a creditor's perspective, the bankruptcy filing operates as a stay applicable to all entities of the commencement or continuation of litigation against the debtor, any act to obtain possession of the debtor's property, and the enforcement of a claim against the debtor or property of the bankruptcy estate.[14] Unless excluded from the automatic stay, litigation outside of the bankruptcy court against the bankrupt originator, including lawsuits by warehouse lenders, whole loan purchasers and other investors, requires a bankruptcy court order. Relief from the stay is available only in limited circumstances,[15] and the majority of claims will likely be resolved by the bankruptcy court through the claims reconciliation process.[16]

As a result of recent amendments to the Bankruptcy Code, warehouse lenders' rights to set off amounts owed by originators against loans pledged as collateral to secure the originator's repurchase obligations in most cases are exempt from the stay.[17] The exemption permits warehouse lenders to sell the loans to satisfy the originator's obligations under its repurchase agreements without regard to the bankruptcy filing. As a practical matter, the exemption deprives the originator of the opportunity to use what is often its most significant asset, if already pledged as is often the case, to reorganize its business. The originator is left with underperforming loans, loan servicing and origination platforms, and any residual interests in sold loans. Because the revenue that may be realized from these assets is often insufficient to fund a reorganization, the company is forced to liquidate, particularly in instances where the company does not have a diversified portfolio (beyond subprime).

While the majority of claims against originators will be resolved through the claims process, certain creditors, including warehouse lenders and loan purchasers, may seek to resolve disputes through adversary proceedings filed in the bankruptcy court. An adversary proceeding is a lawsuit related to the bankruptcy case that is not subject to the automatic stay. Actions that may be brought by an adversary proceeding include actions to recover money or property, to determine the validity, priority, or extent of a lien, and to obtain injunctive or equitable relief.

For example, in the New Century case, UBS Real Estate Securities, Inc., filed an adversary proceeding against New Century in bankruptcy court in Delaware alleging that New Century misappropriated funds belonging to UBS.[18] UBS purchased loans from New Century pursuant to an agreement whereby New Century serviced the loans and agreed to repurchase those loans at a later date.[19] As the servicer, New Century was obligated to collect and deposit mortgage and escrow payments from borrowers and hold the payments in trust accounts for the benefit of UBS.[20] According to UBS, as of March 2007, the trust accounts were short by approximately $3.8 million, and New Century had failed to account for an additional $1.7 million in escrow payments.[21] UBS is suing New Century for breach of contract, conversion, and breach of fiduciary duty.

Alaska Seaboard Partners L.P. has also filed an adversary proceeding against New Century seeking to recover approximately $500,000 in proceeds of purchased loans.[22] According to Alaska Seaboard, New Century serviced the purchased loans from the closing date of the sale until March 2007.[23] Thereafter, New Century allegedly failed to turn over the loan proceeds, the loan documentation, and various related escrowed funds.[24] Alaska Seaboard contends that it is unable to service the loans without the documentation.[25] Moreover, because the loans were sold, Alaska Seaboard asserts that the loan proceeds are not property of New Century's bankruptcy estate.

The originator may also bring adversary proceedings for bankruptcy specific causes of action, including actions to avoid and recover preferential and fraudulent transfers and improper setoffs.[26] Generally, avoidance actions allow the debtor to recover preferential transfers made in the 90 days (one year for insiders) prior to the bankruptcy filing and fraudulent transfers made several years prior to the filing depending on applicable state law.[27] Debtors also have the ability to avoid setoffs taken by creditors in the 90 days prior to the bankruptcy filing that allow a creditor to improve its position vis-à-vis the debtor.[28] However, there are exclusions from liability under these provisions for settlement payments made and setoffs taken pursuant to repurchase agreements unless the settlement payments are made with the actual intent to defraud.[29] These exclusions will significantly reduce litigation by originators against warehouse lenders and loan purchasers arising from the parties' pre-bankruptcy transactions.

To maximize recovery and minimize exposure in bankruptcy, creditors of originators should consider participating in the creditors' committee. The committee is a group of five to seven of the debtor's largest unsecured creditors charged with maximizing the distribution to all unsecured creditors. The committee selects professionals to perform services and investigates the debtor's pre-bankruptcy conduct and ongoing business operations. Committee participation provides many advantages, including access to critical financial and operational information. In many cases, the committee will take the lead role in prosecuting causes of action belonging to the debtor.

In ResMAE, for example, the committee is investigating whether a surge in Merrill Lynch's repurchase demands in late 2006, which totaled $308 million, form the basis for a lawsuit.[30] According to ResMAE, the borrowers were required to make the first one or two payments under the loan following the sale. If the borrower failed to make the required payments, an early payment default was deemed to occur potentially giving rise to ResMAE's repurchase obligation. If, however, the loan purchaser failed to make a repurchase demand within a specified time period, ResMAE's repurchase obligation expired. Whether creditors' committees will pursue such claims, and how the actions will play out, is yet to be determined.

For creditors of bankrupt originators, it may be months or even years before disputes are resolved and distributions are made. Under the amended Bankruptcy Code, a company has 120 days from the date of the bankruptcy filing, which a court may extend for up 18 months, to file a plan.[31] There is a two-year statute of limitations running from the date of the filing to commence avoidance actions.[32]

Distributions typically are not made until after a plan has been confirmed by the bankruptcy court and such actions have been resolved.

CONCLUSION

As the subprime market continues to see a marked rise in defaults by underlying borrowers, the financial, and therefore, legal fallout is likely to reach far and wide. Originators, warehouse lenders, loan purchasers, underwriters and their officers and directors are well-advised to re-double their efforts to maintain tight procedures and risk management controls. Unfortunately, regardless of the controls, with the increasing number of bankruptcies and the never-ending quest by plaintiff's lawyers for deep pockets, all participants are potential targets.

NOTES

1 Bajaj, Vikas, "Prospering in an Implosion," N.Y. Times, April 12, 2007.

2 *Id.*

3 For example, according to a recent motion by the U.S. Trustee in the New Century bankruptcy case, at least 19 class actions lawsuits have been filed against New Century and its corporate officers and directors in federal court alleging violations of federal securities laws, and at least eight derivative lawsuits have been filed in state and federal courts alleging breach of fiduciary duty and gross mismanagement, among other causes of action. *See In re New Century*, Case No. 07-10416 (Bankr. Del. April 2, 2007), Motion for Appointment of a Chapter 11 Trustee (docket 278), at p. 6.

4 Potential players include: originators; servicers; warehouse lenders; securitizers/underwriters; equity holders; hedge funds; monolines; rating agencies; indenture trustees; securitization trustees; accounting firms; law firms; directors and officers; unsecured lenders/noteholders; secured lenders/noteholders; valuation experts; wholesale brokers; retail brokers; trade creditors; and technology providers.

5 *American Home Mortgage Corp. v. Agency Mortgage Corp.*, 07-cv-2520 (S.D.N.Y. March 27, 2007).

6 *DLJ Mortgage Capital, Inc. v. Net-Bank, Inc. et al*, 06-cv-15211 (S.D.N.Y. December 18, 2006), *DLJ Mortgage Capital, Inc. v. Right-Away Mortgage, Inc.*, 07-cv-2791 (S.D.N.Y. April 6, 2007), DLJ *Mortgage Capital, Inc. v. Infinity Home Mortgage Company*, 06-cv-15380 (S.D.N.Y. December 21, 2006), and *DLJ Mortgage Capital, Inc. v. Sunset Direct Lending, LLC et al*, 07-cv-1418 (S.D.N.Y. February 27, 2007).

7 471 F.3d 977 (9th Cir. 2006).

8 *Id.* at 994.

9 *Id.* at 995.

10 Prospectus Supplement for Prospectus Dated September 20, 2002, Credit Suisse First Boston Mortgage Securities Corp., Depositor (available at http://www.sec.gov/Archives/edgar/data/802106/000095011602002835/four24b5.txt).

11 Reckard, E. Scott, "Demise of Ownit Mortgage Hits Home," L.A. Times, January 3, 2007.

12 Giannone, Joseph A., "ResMae Sale to Citadel Approved by U.S. Court," Reuters, March 5, 2007, http://yahoo.reuters.com/news/articlehybrid.

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13 Hall, Jessica, "New Century Bankruptcy Judge OKs Auction of Unit," Reuters, April 19, 2007, http://www.reuters.com/article/bondsNews/idUSN1941951520070419; "New Century Can Sell Mortgages, Make Payments," Reuters, April 13, 2007, http://www.reuters.com/article/ousiv/idUSN1343751020070413 (last visited April 19, 2007).

14 11 U.S.C. § 362(a).

15 11 U.S.C. § 362(d).

16 In bankruptcy, claimants file proofs of claim against the debtor. The filing of a proof of claim provides notice to the debtor and creditors of the claim and, if allowed, enables the claimant to share in any distribution of the debtor's assets. A filed proof of claim is *prima facie* evidence of the validity of the claim, subject to the rights of any party in interest to object. 11 U.S.C. §§ 501-502.

17 11 U.S.C. § 362(b)(7).

18 *UBS Real Estate Securities Inc. v. New Century Mortgage Corporation et al,* Adv. Proc. 07-50875 (Bankr. Del. April 5, 2007).

19 *Id.*, Complaint at pp. 4-5, ¶¶ 18-19.

20 *Id.* at p. 5, ¶¶ 20-21.

21 *Id.* at pp. 6-7, ¶¶ 27-32.

22 *Alaska Seaboard Partners Limited Partnership v. New Century Mortgage Corporation et al.*, Adv. Proc. 07-50962 (Bankr. Del. April 16, 2007).

23 *Id.*, Complaint, at p. 4, ¶¶ 11-14.

24 *Id.*, at p. 7, ¶¶ 25-26.

25 *Id.*, at p. 7, ¶ 26.

26 11 U.S.C. §§ 547(b), 548 and 553(b).

27 11 U.S.C. §§ 544, 547. and 548.

28 11 U.S.C. § 553(b).

29 11 U.S.C. §§ 546(f) and 553(b)(1). The recent amendments to the Bankruptcy Code expanded the list of parties entitled to these protections to specifically include parties to repurchase agreements involving mortgage loans and interests in mortgage related securities entered into with the debtor at any time prior to the bankruptcy filing. *See, e.g.*, 11 U.S.C. §§ 101(46) and 101(47).

30 *In re ResMAE*, Case No. 07-10177 (Bankr. Del. February 12, 2007), Disclosure Statement (docket 252), at p.10.

31 11 U.S.C. §§ 1121(b) and 1121(d).

32 11 U.S.C. § 546(a).

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