

# The Subprime Meltdown Litigation Tsunami

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Following the subprime mortgage market collapse in 2006 - 2007, there has been an unprecedented wave of subprime mortgage litigation, regulatory actions and congressional proposals which can fairly be characterized as nothing less than a litigation tsunami.

This paper examines some of the major litigation events which have occurred and which can be expected to continue for the next several years while the courts sort out responsibility among the major subprime market participants who have been responsible for this devastating economic events which have shaken Wall Street, investors and homeowners to their core.

## **Background**

From 1994 to 2005, the subprime mortgage market grew from \$35 billion to \$665 billion. At the end of 2006, subprime mortgages accounted for approximately 23% of the nation's mortgages.

Subprime mortgage lending grew as the housing "bubble" expanded with housing prices in the United States generally increasing during the period of 2002 - 2005. Lenders made mortgage loans to "subprime" borrowers who were not credit worthy and who generally took out adjustable rate mortgages (ARMs) which offered a low introductory rate which then increased to levels which the subprime borrowers were not able to pay.

When the housing market peaked and began to decline in 2005 - 2006, mortgage lenders and Wall Street firms who packaged and resold the mortgage loans into bonds and mortgage backed securities knew or should have known that the implosion of the housing market would lead directly and quickly to a collapse in the subprime mortgage, MBS and collateralized debt obligations (CDOs) markets causing a rippling effect which

would be felt by major Wall Street firms, investors, homeowners and other market participants.

As a result of the subprime mortgage collapse, it is predicted that 2.2 million U.S. homeowners would lose their homes to foreclosures.

- Banks worldwide to date have announced more than \$135 billion in credit losses and write-downs since the turmoil in the U.S. housing market started in 2007.
- Some analysts estimate that total write-downs could reach a staggering \$800 billion by 2008 - 2009. Major firms who have had to take multi billion dollar write-downs include Citigroup, Merrill Lynch, UBS and Bear Stearns.
- In May 2005, former federal reserve chairman Alan Greenspan stated that the housing market had “froth, that there were “local bubbles” and that the housing price increases were “unsustainable.” Notwithstanding, mortgage lenders, mortgage brokers and real estate brokers continued to push housing transactions and loans upon subprime and other non creditworthy borrowers.
- Starting in January 2006, major subprime lenders began to fail and some eventually filed for bankruptcy such as New Century, NovaStar. The Nation’s largest lender Countrywide, is experiencing severe financial difficulty is on the verge of being acquired by Bank of America.
- January 2007 - Major subprime lenders start to collapse as defaults rise and Wall Street firms withdraw credit lines.
- The subprime mortgage market implosion began to cause a worldwide credit crisis in the summer of 2007 and could spark a global economic recession which could last for some time.

### **The Mortgage Securitization Process**

Subprime mortgages are generally packaged by Wall Street firms and investment banks into CDOs which generated tremendous investment banking fees for firms involved in the repackaging process. Law firms who prepared disclosure documents and other related documents regarding CDOs also received tremendous fees as did the accountants and other professionals involved in the securitization process.

- CDOs are packages of debt such as asset-backed securities, or other investments that are sold as bonds and are structured to pay out at different rates of interest based on a different level of risk. An investment in a mortgage-backed CDO, therefore, is an investment in the possibility of repayment of the mortgages along with the associated risk, not an investment in the mortgage itself.
- Ideally the diversification of high risk subprime mortgages combined with lower-risk mortgages would generally reduce the overall risk of such securities. However, many CDOs have a large stake in only subprime mortgages. Although riskier investments yield higher returns, the potential default on a subprime mortgage is significant and could lead to enormous losses.
- CDOs gain exposure to the credit of a portfolio of fixed-income assets and divide the credit risk among different “tranches”: Senior tranches (often rated AAA), “Mezzanine” tranches and Equity tranches (unrated).
- Senior and mezzanine tranches are typically rated (by rating agencies such as S&P, Moody’s and Fitch Ratings), with the former receiving ratings A to AAA and the later receiving ratings B to BBB. The ratings reflect both the credit quality of underlying collateral as well as how much protection a given tranche is afforded by tranches that are subordinate to it.
- Losses are applied in reverse order of seniority so junior tranches offer higher coupons (interest rates) to compensate for the added risk.

### **Subprime Mortgage Litigation**

As of December 2007, 32 class action lawsuits have been filed by investors against the subprime mortgage lenders, Wall Street firms who underwrote MBS and CDOs, and investors who purchased shares of hedge fund, bond funds and other securities containing subprime mortgage exposure.

- Numerous individual lawsuits have been commenced by various parties to the subprime mortgage lending and securitization markets and many more such lawsuits are expected to be filed in 2008 -2009. These claims run the gamut of claims involving fraudulent practices, failure to disclose information regarding loan

packages sold to third parties, breach of contracts involving securitization and due diligence on mortgage loans prior to repackaging as CDOs and other securities.

- The following is a summary of some of the leading cases which have been filed.
- Subprime originators and homeowners.
- Lawsuits have been filed against subprime originators, real estate agents, title companies and real estate appraisers alleging a variety of predatory lending practices and securities violations based on misrepresentation in the loan origination process.
- Claims include charges that excessive fees were financed into loan principal amounts; loans were issued regardless of a homeowner's ability to pay; and loans were made with higher interest rates than the lowest rate the homeowner might have been eligible for.
- Zamansky & Associates filed a lawsuit in New York State Court on behalf of a group of retired and elderly mortgage borrowers claiming that the mortgage lenders and mortgage brokers aided and abetted the group's investment advisor in committing a fraud by stealing their loan proceeds and that their lenders made "unsuitable" mortgage loans.

Following the collapse of the leading subprime lender, NovaStar Financial, which has now filed for bankruptcy, borrowers filed a federal class action lawsuit accusing the company of bait-and-switch practices that increased borrowers' costs. The borrowers allege that NovaStar used hidden commissions as early as 2003 to generate high-cost loans that may have run afoul of state consumer protection laws.

- Mortgage lenders New Century Financial, NovaStar and Accredited Home Lenders have all been hit with federal securities class action lawsuits.
- The New Century complaint charges that the company failed to disclose and misrepresented that New Century was under-reserving for loan losses as conditions in the subprime industry deteriorated; the company failed to take timely write-downs for residual interest in securitizations; the company failed to properly account for its allowances for early payment defaults and loan repurchase losses; the company lacked adequate internal and financial controls and the financial statement

were not prepared in accordance with GAAP.

- The SEC, the California U.S. Attorney's office and as the Massachusetts Attorney General are investigating New Century Financial's loan origination practices in a probe meant to protect consumers.
- In *DLJ Mortgage Capital v. NetBank, 06-CIVI5211*, DLJ Mortgage Capital, a unit of Credit Suisse Group that purchases mortgage loans, has sued mortgage lenders in New York Federal Court accusing the defendant companies of failing to honor the requirements of loans that it purchased from them or of failing to pass along to them money as part of mortgage servicing agreements. DLJ is seeing more than \$30 million from the companies, which sold a variety of loans to DLJ. Some, but not all, of the loans are at issue in the case are subprime.
- Employees of subprime originators, such as Fremont General Corp., have filed securities or ERISA claims.
- Subprime originators and lenders lawsuits - Lawsuits have been filed by "warehouse" lenders and underwriters against subprime originators such as New Century Financial Corp alleging misrepresentation made by subprime originators to underwriters and misrepresentation made in subprime originators' financial statements.
- Mortgage originators are suing underwriters claiming that they were pressured to make loans so that underwriters would have a sufficient supply of loans for securitization.
- Trustees of bankrupt subprime originators will likely pursue claims against business counter parties especially warehouse lenders and underwriters.
- Investors have begun suing underwriters. For example, in *Bankers Life Insurance Company v. Credit Suisse First Boston Corp.*, Bankers Life filed suit regarding mortgage securities that it purchased in the secondary market. Allegations include claims that CSFB knew or should have known about inadequate underwriting criteria; CSFB made improper advances of principal and interest to conceal the deficiency of certain mortgage loans; and CSFB withheld material information on the securities.
- Rating Agencies and Insurers - lawsuits have been filed against Moody's and other

rating services alleging that the rating agencies mislead investors by assigning excessively high ratings to bonds backed by risky subprime mortgages, including bonds packaged as collateralized debt obligations. Moody's and other credit rating agencies counter that they fully disclosed their relationship with the issuers they rate and that this set up does not compromise their work. They claim that they were warning of problems before the subprime meltdown. Significantly, courts generally give "legal immunity" to rating agencies comparing them to media who have general immunity for rendering "opinions" rather than stating facts upon which investors could rely.

- Wall Street banks are suing subprime lenders to get them to repurchase loans that went bad shortly after they were sold.
- Suits by municipalities. Municipalities such as the state of Alaska, a town in Australia and Springfield, Massachusetts have brought lawsuits against Wall Street firms who sold them risky CDOs without disclosing the risk and, in any event, claiming that the sales of such risky securities were "unsuitable" for such municipalities.
- For example, the City of Springfield, Massachusetts recently sued Merrill Lynch for selling the City CDO at a price of \$13.9 million which are now worth only \$1.2 million. The City claimed that it did not approve the purchase of these investments and that the investments were "unsuitable" for the City. Merrill Lynch agreed to repurchase the CDOs at the initial purchase price of \$13.9 million and agreed to pay \$1.2 million in the City's legal fees.
- Following this settlement, the Massachusetts state authorities accused Merrill Lynch of fraud and misrepresentation relating to the firm's sale of debt securities that rapidly collapsed during the credit crisis including the sale to the Town of Springfield.

### **Bear Stearns Hedge Fund Litigation**

In June 2007, two internal Bear Stearns Hedge Funds that had been heavily invested in mortgaged backed securities collapsed and kicked off the full-fledged market panic that peaked in August, 2007.

- On August 1, 2007, Zamansky & Associates filed the first arbitration case on behalf of

a group of investors who claimed that Bear Stearns misled them about the extent of subprime exposure in the hedge funds, misrepresented the “risk controls” which were in place purported to mitigate losses, and misrepresented the performance of the fund during conference calls held with investors from January to June 2007, which was designed to keep investors in the fund and dissuade them from redeeming their shares.

- On November 14, 2007, the Massachusetts Securities Division filed an administrative complaint against Bear Stearns Asset Management (BSAM) alleging violations of securities laws based on BSAM’s failure to obtain approval by “unaffiliated directors” for numerous related party transactions with Bear Stearns and/or other entities controlled or managed by BSAM, and its failure to disclose to investors in the hedge funds that, in doing so, BSAM violated the Investment Adviser’s Act of 1940, as well as certain provision of the offering materials of the funds. The Massachusetts complaint alleged that hundreds of so-called “principal transactions” were process without prior approval by unaffiliated directors. Massachusetts also charged that Bear Stearns and BSAM used the hedge fund as a place to unload excessively risky or troubled assets that could not be sold to other investors at the prices paid by the hedge funds.
- The U.S. Attorney’s office for the Eastern District of New York has commenced a criminal investigation of Bear Stearns and the individual hedge funds managers including Ralph Cioffi. The investigation of Cioffi includes a claim that he allegedly engaged in insider trading by pulling his personal money out of the hedge fund prior to disclosure to investors that the subprime market turmoil had destroyed the value of the hedge funds resulting in virtually a total loss to all investors.
- The U.S. Attorney’s office is working in conjunction with the Securities and Exchange Commission (SEC) investigating various securities law violations regarding the marketing practices of the hedge funds, whether the “pricing” of the mortgage backed securities was fraudulent and whether Bear Stearns and other financial firms should have told the public earlier about the declining value of such securities and how they priced them on their books.
- In December 2007, Barclays Bank sued Bear Stearns to recover \$400 million which Barclays lent to the Bear Stearns Enhanced Leveraged Hedge Fund which started

operations in September 2006. The suit claims that Bear Stearns misled Barclays about the performance of the highly leveraged fund. Barclays claims that as the fund faltered, its desperate state was concealed by Bear Stearns from bank officials, whose calls and emails were dodged as they sought performance information.

- Barclays claims further that the fund managers concealed performance numbers from Barclays and others, actions that worsened losses and contributed to the Fund's collapse. Barclays also claims that Bear Stearns made false promises about savvy risk management and open communication to win loan money from the bank.

### **Regulatory Investigations**

- On January 30, 2008, the FBI reported that it had opened criminal inquiries into 14 companies as part of a wide-ranging investigation of the troubled mortgage industry. The FBI was looking into possible accounting fraud, insider trading and other violations in connection with loans made to borrowers with weak or subprime credit.
- The FBI investigation involves companies across the financial industry, including mortgage lenders, loan brokers and Wall Street banks who packaged home loans into securities.
- The FBI is cooperating with the SEC which is conducting about three dozen civil investigations into how subprime loans were made and packaged and how securities backed by them were valued.
- New York Attorney General (NYAG) Andrew Cuomo is investigating whether Wall Street banks withheld damaging information about the loans they were packaging.
- Prosecutors in Ohio, Massachusetts, Illinois and Connecticut have also been looking into the industry.
- The NYAG has secured cooperation from Clayton Holdings, which reviews loans for investment banks conducting "due diligence" before the loans are turned into securities and sold to investors.
- The investigation's focus is whether investment banks disclosed enough to investors and to credit-rating firms about the securities after receiving reports by due diligence firms such as Clayton Holdings, which showed that an increasing number of loans in recent years did not conform to minimum lending standard. The investigation also aims to determine whether the credit rating firms asked enough questions about the

quality of the loans that backed the securities they rated.

- Among the issues are loans known as “exception loans”, a potentially questionable loan not meeting all of the originator’s lending standards. The investigation is looking at whether the broad language written in prospectuses about the risky nature of these securities changed little in recent years, even as due diligence reports noted that the number of exception loans backing the securities was rising. In 2006, about 30% of the loans examined by Clayton had some kind of exception.

### **Legislative Proposals**

- On December 6, 2007, President Bush announced a plan by bank regulators and the U.S. Treasury Department to freeze rates on some adjustable mortgages for up to five years.
- Every major presidential candidate has offered a plan of their own to assist subprime and other borrowers in the face of the subprime mortgage and housing crisis.
- On November 13, 2007, the U.S. House of Representative passed the “Mortgage Reform and Anti-Predatory Lending Act of 2007” (H.R. 3915). The legislative proposal aims at relieving predatory mortgage lending practices and protecting consumers of mortgages and mortgages securities. The bill would provide a national standard of liability to “Wall Street firms” to assure accountability “at the federal level for their actions in the mortgage market” and to “subject Wall Street firms to liability if they buy, sell and securitize loans that consumers cannot repay”.
- A wave of states laws and regulations aimed at curbing unsuitable mortgage loans is opening the door to more litigation by allowing borrowers to file lawsuits instead of complaining to regulatory agencies.
- Colorado, Maine, Minnesota, North Carolina and Ohio have all recently passed laws to addressed consumer’s ability to repay their mortgages.