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Mortgage Mess Unleashes Chain of Lawsuits

By Tomoeh Murakami Tse and Carrie Johnson

When something goes badly on Wall Street, people wind up in court. And the subprime mortgage mess is no exception.

A consortium of investors is going after the collapsed Bear Stearns hedge funds. Home buyers, shareholders and investment banks have filed suits against more than a dozen mortgage lenders. A working group at the Securities and Exchange Commission is examining accounting and disclosure issues, as well as stock sales earlier this year by executives at companies that since have been ensnared by the subprime mess.

"We will look at those responsible for any potential fraud, by company management, auditors, lawyers, credit-rating agencies or others," said Walter Ricciardi, a deputy enforcement director at the SEC.

And this is just the beginning, say legal experts tracking the steady stream of lawsuits. It has only been a few months since the credit market turmoil began, when home buyers with risky credit histories -- subprime borrowers -- started defaulting on their loans in large numbers.

There is almost no end to the list of potential legal targets, analysts say, because so many players share a piece of the blame for the mortgage meltdown. There are the home buyers who overstated their income to obtain risky loans, the mortgage lenders that made the loans and the Wall Street securities firms that repackaged the loans into tradable securities. There are the credit agencies that assigned ratings to those hard-to-value securities, the hedge funds and institutional investors that bought those assets to get an extra boost in returns and the individuals who invested in those fund managers.

The high-profile busts at Enron and WorldCom resulted in "a handful of focused litigation against a handful of very particular parties," said David Reiss, an associate professor at Brooklyn Law School. "The difference now is you have an immense amount of litigation against an incredible range of parties. . . . Everybody can point

fingers at so many other people that you just don't know when it'll stop."

Securities lawyers are standing at the ready, with some firms creating special groups to focus exclusively on the mortgage mess.

"We kind of looked at the subprime mortgage industry from top to bottom . . . and saw that there would be litigation as well as securities-fraud issues as well as regulatory issues," said Rick Antonoff, a partner at Pillsbury Winthrop Shaw Pittman, who heads the firm's subprime industry group, which was established in March.

Among the group's clients are Wall Street banks that are suing subprime lenders to get them to repurchase loans that went bad shortly after they were sold. Antonoff expects the group to keep busy, most likely into 2009.

Credit agencies, which graded billions of dollars worth of mortgage-backed securities as safe investments throughout the recent housing boom, are also feeling the heat.

Members of Congress are calling for hearings and oversight, saying the rating agencies are conflicted because they are paid by investment banks that issue the securities the agencies rate. Institutional investors accuse the rating firms of being slow to downgrade securities.

"Essentially, the originators and credit raters shoved enough pigs and laying hens in with the beef herd that investors expecting prime ribs on their silver platter and money in their pocket ended up with pork ribs on their paper plate and egg on their face," Rep. Gary L. Ackerman (D-N.Y.) said in an opening statement during a Financial Services Committee hearing last week.

Credit agencies have maintained that they fully disclose their relationships with the issuers they rate and that this setup does not compromise their work. They say they were warning of problems well before the subprime meltdown.

"Our rating criteria is publicly available, non-negotiable and consistently applied," said Frank Briamonte, a spokesman for McGraw-Hill, which owns Standard & Poor's rating agency. What is taking place now is "repricing of risk, not an upsurge in defaults, and it's the latter that poor ratings speak to," Briamonte said.

A Moody's Investors Service spokesman said the company intends to "fully assist" ongoing government inquiries.

The obstacles to winning a case against credit-rating agencies are particularly daunting, according to John C. Coffee, a law professor at Columbia University. In past cases, the raters have invoked constitutional protections of free speech, comparing their evaluations of a company's debt to judgments made in a newspaper editorial.

"Credit-rating agencies have never been held liable in any class-action suit since the beginning of time," Coffee said. "They have had virtual legal immunity to any kind of statement."

In the Enron case, wherein raters failed to downgrade the Houston energy trader until four days before it filed for bankruptcy protection in 2001, a massive class-action lawsuit did not target or wrest any money from the nation's largest credit-rating firms, Coffee noted.

Steven Caruso, an attorney in New York who represents investors, is preparing to take legal action in coming weeks against

Bear Stearns, operator of two hedge funds that collapsed this summer after investing in subprime securities.

He says his clients -- six individual and institutional investors with $1 million to $14 million in investments -- were not told of material facts, such as the funds' performance, that would have kept them from investing or prompted them to pull out of the funds.

The claims echo those made in an arbitration claim with the Financial Industry Regulatory Authority, the largest non-governmental regulator for securities firms. The investor, co-represented by Jacob Zamansky, a New York attorney, said he was misled by fund managers during their monthly conference calls with investors.

Russell Sherman, spokesman for Bear Stearns, said the allegations are "unjustified and without merit.

"We intend to defend ourselves vigorously," he said. "The accredited, high-net-worth investors in the fund were made very aware that this was a high-risk, speculative investment vehicle."

Just how successful some of these lawsuits are likely to be is unclear. A 1994 Supreme Court precedent precludes investors from suing companies that aided and abetted fraud, instead requiring them to go after the central players in a scheme. Government lawyers can continue to bring lawsuits under a lower standard.

A law passed by Congress in 1995 requires plaintiffs to allege improprieties that "give rise to a strong inference of fraud" in order to proceed with a case and access corporate documents. The law amounts to something of a Catch-22 for shareholders who have a hunch about malfeasance but little direct evidence to support it, said Christopher Keller, a plaintiff lawyer at Labaton Sucharow in New York.

His law firm is suing Countrywide Financial, the country's largest independent mortgage lender, for allegedly misleading investors about the strength of its finances and its underwriting standards.

Countrywide could not be reached for comment last night but has said that it has taken steps to strengthen the company and ensure the quality of its loans.

Keller's law firm also has been retained by hedge funds that lost tens of millions of dollars in the collapse of the Bear Stearns funds, but it has not sued the investment bank, Keller said. Five full-time investigators, including former FBI agents, are gathering data about the issues.

"There's hearing it, and then there's getting real direct evidence like internal e-mails," Keller said.