THE EMERGING SUB-PRIME SCANDAL and STRATEGIC APPROACHES TO CLAIMS FOR COVERAGE

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I. OVERVIEW

Today's mortgage market has separated into two segments: the prime market and the sub-prime market. The prime market extends loans to the majority of households with average to excellent credit, while the sub-prime market extends more costly loans to households with less financial security and lower credit scores. Ideally, the sub-prime market presents an opportunity to lenders to extend credit to a class of people that normally would not qualify for home loans and expands the opportunity to own a home to a larger segment of the population.

The U.S. housing market of the past few years has led to a staggering number of sub-prime loans. But, this market expansion has come at a significant cost. To justify the heightened risk, lenders often attach significant fees and balloon payments to loans. Although contested by some market analysts, many attribute increasing defaults on home mortgages and a virtual meltdown of the sub-prime industry to these expensive high risk loans. Although certain sub-prime lenders are experiencing significant financial difficulties, including bankruptcy, the sub-prime meltdown is affecting more than just the originators of the loans. Investors, including large banks, hedge funds and insurance companies, are feeling the financial pressure resulting from the failure of the sub-prime market. In the wake of the crisis, Congress is seeking to strengthen laws to combat the often predatory nature of sub-prime loans to prevent increased default rates in the future.

Over the last several months, lawsuits and investigations of many varieties have been filed or threatened, as investors, trustees and homeowners scramble to recoup losses predicated on the decline of the sub-prime market. It is only a matter of time before litigants embroiled in what may prove to be a long and expensive journey turn to the insurance industry in an effort to defray costs. This paper examines the genesis of the sub-prime market problems and provides an overview of the regulation and litigation reaction that is developing, and the potential effect on insurers.

II. BACKGROUND

Sub-prime lending is a general term that refers to the practice of extending credit to borrowers who do not qualify for loans at market interest rates because they exhibit characteristics indicating a significantly higher risk of default due to deficient credit history. Sub-prime lending encompasses a variety of credit and loan instruments, including bank loans, mortgages, and credit cards, among others.

The term "sub-prime" refers not to the interest rate on the loan instrument itself, but to the credit status of the borrower. The credit status or default risk of a borrower may be measured by traditional credit risk measures (credit and repayment history, debt to income levels, etc.) or by alternative measures such as credit scores. The best known and most widely used credit score model in the United States was developed by the Fair Isaac Corporation ("FICO"). The FICO Score is calculated statistically, taking information from a borrower's credit files collected by credit reporting agencies. Based on FICO, credit scores range between 300 to 900, with most

consumers scoring in the 600s and 700s. While there is no official credit profile that describes a sub-prime borrower, most of them have credit scores below 620. [1]

Sub-prime lending involves risk not only lenders, but for borrowers as well. Sub-prime borrowers often default on payments, resulting in either higher debt on the loan or credit card, or in some cases, foreclosure proceedings. Lenders, therefore, use a variety of techniques to offset the default risks associated with these loans, most often using higher rates, loan fees and penalty payments.

Sub-prime lending is highly controversial. Opponents have argued that sub-prime lending companies engage in predatory lending practices such as deliberately lending to borrowers who could never meet the terms of their loans, while proponents maintain that the practice extends credit to people who would otherwise not have access to the credit market.[2]

A. DEFINITIONS

i. SUB-PRIME LOANS

As stated, sub-prime loans are loans offered to borrowers with low credit scores. Due to the credit risk associated with such loans, lenders offset these risks with a higher interest rate compared to equivalent prime loans.

ii. SUB-PRIME CREDIT CARDS

Sub-prime credit cards are given to credit card holders with a deficient credit history. The risk of default is set off with low credit limits and extremely high late payment fees and interest rates. Sub-prime credit card customers are generally not even given a "grace period" to pay late unlike prime credit card customers.

iii. SUB-PRIME MORTGAGES

Sub-prime mortgages are loans made to borrowers unable to qualify under traditional, more stringent criteria because of a limited or blemished credit history. The risks associated with such mortgages are offset by higher rates, prepayment penalties, and/or balloon payments.

Sub-prime mortgages, in particular, have become increasingly popular since the late 1990s, currently totaling $600 billion and accounting for one-fifth of the U.S. home loan market. Several iterations of sub-prime mortgages have emerged, including Interest-Only Mortgages (allowing borrowers to pay only the interest on the loan for five to ten years); Pick-a-Payment Mortgages (allowing borrowers to choose their monthly payment by making full payments, interest only payments or other minimal payments); and Adjustable Rate Mortgages.

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[1] *Sub-prime Mortgages*, BANKRATE.COM, May 1, 2006, http://www.bankrate.com/brm/green/mtg/basics2-4a.asp?caret=8.

[2] *Economic Scene; 'Irresponsible' Mortgages have Opened Doors to Many of the Excluded*, Austan Goolsbee, New York Times, March 29, 2007

The most common sub-prime loan is the Adjustable Rate Mortgage ("ARM"). An ARM is a mortgage loan whose interest rate adjusts periodically based on a defined index. In sub-prime mortgages, the interest rate is set at some margin over the index. The adjustable rates transfer part of the interest rate risk from the lender to the borrower, generally allowing borrowers to lower their initial payments. A hybrid ARM is a mortgage with a low "teaser" rate and payments that jump explosively after the first two or three years.[3] A common payment scheme for a hybrid ARM is the "2-28" loan, which offers a low, fixed interest rate for the first two years and a higher adjustable rate for the rest of the life of the loan, usually 28 years. Although hybrid ARMs are seen as a way of protecting borrowers who acquire ARMs because it allows borrowers to increase their income during the period of lower payments, many borrowers are unaware of the subsequent rise in their monthly payments when they acquire such a loan.

B. SUB-PRIME MELTDOWN

i. THE BEGINNING: "RATE WAR OF 2004"

The crisis in the sub-prime industry began with what industry analysts refer to as a "rate war" beginning in 2004.[4] Sub-prime lenders began cutting rates in order to attract a bigger market share of borrowers. Although the low rates attracted both quality and sub-standard borrowers alike, the business plan was not very profitable in light of increasing lenders' costs imposed by the Federal Reserve.[5] The result was a "giant game of chicken," as described by industry analysts,[6] with lenders trying to increase profits by raising lending rates. To make up for the higher rates, lenders began to compete for customers by relaxing underwriting standards.[7] The industry's game of chicken resulted in several sub-prime lenders declaring bankruptcy beginning in late 2006, including ResMae Mortgage, Mortgage Lenders Network USA, and OwnIt Mortgage Solution.[8]

ii. DOMESTIC FALLOUT: BANKRUPTCIES AND STOCK MARKET DOWNFALLS

By early 2007, various lenders reported troubles in their sub-prime portfolios.[9] HBC, for example, announced it was setting aside 20% more money than previously estimated to cover

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[3] Les Christie, *Sub-prime Lenders Push Back*, CNNMONEY.COM, Mar. 22, 2007, http://money.cnn.com/2007/03/22/real_estate/sub-prime_lenders_deny_responsibility/index.htm?postversion=2007032218.

[4] Peter Coy, *Why Sub-prime Lenders are in Trouble*, BUSINESS WEEK. Mar. 2, 2007, *available at* http://www.businessweek.com/bwdaily/dnflash/content/mar2007/db20070302_477856.htm?chan=top+news_top+news+index_businessweek+exclusives (quoting Michael Youngblood, head of asset-backed securities research at Friedman, Billings, Ramsey Group (FBR)).

[5] *Id.*

[6] *Id.* (quoting Robert Lacoursiere, Banc of America Securities (BAC) analyst).

[7] *Id.*

[8] Justin Bachman & Sonja Ryst, *A Painful Hiss from the Sub-prime Balloon*, BUSINESS WEEK, Feb. 22, 2007, *available at* http://www.businessweek.com/bwdaily/dnflash/content/feb2007/db20070221_387085.htm.

[9] Maya Roney, *Sub-prime Time Bomb*, BUSINESS WEEK, Feb. 9, 2007, *available at* http://www.businessweek.com/bwdaily/dnflash/content/feb2007/db20070206_488329.htm.

bad loans in 2006, and watched its stock drop by 3%.[10] New Century Financial, the second largest sub-prime lender in the world, restated results of the first three quarters of 2006 to report a 30% loss in stock price, as well as an expected loss for the fourth quarter. Countrywide Financial's ("CFW") stock fell by 2% and Accredited Home Lenders Holding's ("LEND") was down 7%. Recently, European shares declined.[11] Lehman Brothers Holdings Inc. analysts predict that European investment banks will take a 'material hit' to earnings from the fallout of rising U.S. sub-prime-mortgage defaults.[12] Deutsche Bank AG and Credit Suisse Group were downgraded and had their share price estimates cut.

In late February 2007, news from the sub-prime industry looked bleak, with more bankruptcies and other losses being reported everyday. Novastar Financial reported a quarterly loss and stated that it may not have any taxable income until 2011.[13] Mortgage Lenders Network filed for Chapter 11 protection in February 2007 and identified more than 7,000 creditors with debts of more than $100 million each.[14] New Century filed for Chapter 11 Bankruptcy on April 2, 2007.[15] In July, Bear Stearns announced that assets in the hedge fund were essentially worthless.[16] On August 6, American Home filed for Chapter 11 bankruptcy-court protection,[17] while on August 22, First Magnus Financial Corporation, one of the largest independent American mortgage lenders, sought protection.[18] Ameriquest Mortgage, the largest American sub-prime lender, closed its operation while the assets of its parent company, ACC Capital Holdings, were purchased by Citigroup.[19]

Some of the bankruptcies referenced were triggered by the withdrawal of financing by large banks, such as Merrill Lynch and J.P. Morgan.[20] Typically, sub-prime lenders sell their loans to big banks, which package the loans and sell them as mortgage backed securities to hedge funds and other institutional investors.[21] During the period it takes for the sales to be processed, banks provide lenders with a "warehouse" in which to store the loans. Warehouse

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[10] *Id.*

[11] *European Stocks Decline on Worries – Credit-Market Troubles Could Spill Over*, Sarah Turner, Wall Street Journal, September 6, 2007

[12] *Lehmann Sees 'Material Hit' to Europe Investment Banks (Update 3)* by Charles Penty, Bloomberg. Com, September 5, 2007

[13] Bachman & Ryst, *Painful Hiss*, *supra* note 8.

[14] Lingling Wei & Marie Beaudette, *Mortgage Lenders Network Files for Ch. 11 Bankruptcy Protection*, BOSTON.COM, Feb. 5, 2007, http://www.boston.com/news/local/connecticut/articles/2007/02/05/mortgage_lenders_network_files_for_ch_11_bankruptcy_protection/.

[15] Sonja Ryst and Justin Bachman, *The Sub-prime Story's Latest Chapter: 11*, BUSINESS WEEK, Apr. 3, 2007, http://www.businessweek.com/bwdaily/dnflash/content/apr2007/db20070403_365053.htm?chan=search.

[16] *Barclays May Have Lost Big in Bear Fund: Report*, ABCNEWS.COM, July 21, 2007, http://abcnews.go.com/Business/wireStory?id=3401582.

[17] *At Mortgage Banks, 'Going Concerns,' Going, Gone* by Jonathan Weil, Bloomberg.com, August 15, 2007

[18] *Big Mortgage Lender in Chapter 11 filing*, Reuters, New York Times, August 22, 2007

[19] *Ameriquest, a Sub-prime Lender, Is Closing*, Reuters, New York Times, August 31, 2007

[20] Alistair Barr, *Big Banks Control Fate of Sub-prime Lenders*, MARKETWATCH, Feb. 16, 2007, http://www.marketwatch.com/News/Story/big-banks-deciding-fates-troubled/story.aspx?guid={08BF0083-33AD-47C7-9EDC-3AB1085BBE43}.

[21] *Id.*

banks keep lenders supplied with sufficient cash to make more loans immediately. In light of the suspect future of sub-prime lenders, however, warehouse banks have begun to ask for higher fees. Other warehouse banks have cut their financing completely, forcing sub-prime lenders to post significant collateral. Moreover, purchasers of loans have begun to exercise their right to send loans back to the originators (i.e., sub-prime lenders) in certain circumstances (if the borrowers fail to make payments within the first few months).

In the wake of the rising mortgage default rates around the country, investors have likewise become concerned about the stability of sub-prime lenders. A lack of financial support from banks has led to financial woes for many sub-prime lenders. Examples of the direct impact a non-supportive bank can have on a sub-prime lender are found in the demise of OwnIt and ResMae. JP Morgan provided warehouse financing to OwnIt and, in November 2006, withdrew almost half of OwnIt's cash after making a margin call and withdrawing its finances.[22] In February 2007, Merrill Lynch, the largest buyer of ResMae's loans, asked the company to repurchase $300 million worth of loans, which triggered a liquidity crisis at ResMae.[23] Both OwnIt and ResMae were forced into bankruptcy as a result.

New investors have tried to keep sub-prime lenders afloat. Following ResMae's bankruptcy, Credit Suisse offered to purchase its assets for $19 million,[24] only to be outbid by Citadel Investment Group, which offered $22.4 million. Citadel also purchased ResMae loans for $160 million, 98.5% of their face value.[25] Lehman Brothers agreed to fund all of Mortgage Lenders Network's pending loans,[26] while Farallon Capital Management provided Accredited Home Lenders with a $230 million loan.[27] Finally, CIT Group and Greenwich Capital Financial products agreed to provide New Century with $150 million.[28] Despite these efforts, the sub-prime industry continues its downward trend.

Most recently, industry analysts have attributed a market slowdown to the sub-prime crisis. In July 2007, an unprecedented number of negative rating actions were taken on sub-prime bonds. Standard & Poors ("S&P") put 612 securities backed by sub-prime mortgages on "Credit Watch negative," while Moody's downgraded 399 securities and placed an additional 32 on review for possible downgrade. S&P took the actions because of high delinquencies stemming from lax underwriting standards.[29] These actions caused investors to become worried,

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[22] Alistair Barr, *Big Banks Control Fate of Sub-prime Lenders*, MarketWatch, Feb. 16, 2007, http://www.marketwatch.com/News/Story/big-banks-deciding-fates-troubled/story.aspx?guid={08BF0083-33AD-47C7-9EDC-3AB1085BBE43}.

[23] Barr, *ResMAE*, *supra*.

[24] Alistair Barr, *Citadel Buys Bankrupt Sub-prime Lender ResMAE*, MarketWatch, Mar. 6, 2007, http://www.marketwatch.com/news/story/citadel-buys-bankrupt-sub-prime-lender/story.aspx?guid={69BAF585-B597-46CE-891D-F49B4614A6E7}.

[25] *Id.*

[26] *Lehman to Fund Pending Mortgage Lenders network Loans*, MARKET WATCH, Jan. 5, 2007, http://www.marketwatch.com/news/story/lehman-fund-pending-mortgage-lenders/story.aspx?guid=%7b9B608AD7-35EC-4FA2-954C-E1FD46C3037E%7d&print=true&dist=printTop.

[27] Ryst & Bachman, *Latest Chapter:11*, *supra* note 15.

[28] *Id.*

[29] Les Christie, *Rating Agencies to Cut Sub-prime Bond Ratings*, CNNMONEY.COM, July 10, 2007, http://cnnmoney.printthis.clickability.com/pt/cpt?action=cpt&title=Sub-prime+bond+ratings+to+be+slashed+-

resulting in an overall downturn of the U.S. stock market. In addition, Federal Reserve Chairman Ben Bernanke's grim comments about the continued downfall of the U.S. housing market triggered a market fall.

iii. GLOBAL FALLOUT: FROZEN FUNDS

The sub-prime lending crisis has not exclusively been a domestic problem, as reflected by BNP Paribas, France's largest bank, decision to freeze $2.2 billion worth of funds on August 9, 2007. BNP cited instability of the U.S. sub-prime mortgage sector as the catalyst for its action,[30] stating "[t]he complete evaporation of liquidity in certain market segments of the U.S. securitization market has made it impossible to value certain assets fairly, regardless of their quality or credit rating."[31]

One of the largest banks in Germany, IKB Deutsche Industriebank AG, dropped 18% in the stock market after the bank acknowledged its losses from exposure to the United States sub-prime mortgage market,[32] requiring emergency funding. In response, several German banks provided € 3.5 billion to IKB to cover its potential losses.[33] Emergency funding was also provided to the German Landesbank Sachsen Girozentrale in August 2007.[34] German prosecutors and public interest groups are keeping a close watch on IKB to discover how the bank was so heavily exposed to the sub-prime market and to determine whether the involvement of German government banks in the loan to IKB constitutes an illegal government subsidy.[35]

iv. EFFECT ON DOMESTIC HOUSING MARKET

Of obvious concern to homeowners and financial analysts is the impact the rising default rates and the collapse of the sub-prime lending industry will have on the US housing market. Some analysts believe the troubles in the sub-prime lending market will not spread to the housing market because most of the homes purchased with sub-prime mortgages were at the low end of the market.[36] However, other experts are more concerned. Michael Simonsen, president and CEO of Altos Research, which studies California and fifteen other U.S. real estate markets, stated that the sub-prime mortgage crisis is "one of the scariest signs" for the U.S. housing

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+Jul.+10,+2007&expire=-1&urlID=23000753&fb=Y&url=http://money.cnn.com/2007/07/10/real_estate/Sub-prime-bond-ratings-to-be-slashed/index.htm&partnerID=2200.

[30] *Sub-prime Woes Hit BNP Paribas*, CNNMONEY.COM, August 9, 2007, http://money.cnn.com/2007/08/09/news/international/bnp_sub-prime.reut/?postversion=2007080910.

[31] *Id.*

[32] Robert Daniel, *IKB Stock Slumps After Warning on Sub-prime Impact*, MARKETWATCH, July 30, 2007, http://www.marketwatch.com/news/story/german-lender-ikb-slumps-us/story.aspx?guid={78C7C9A1-8669-4157-9E76-5213F1634C46}.

[33] John O'Donnell, *IKB Sub-prime Shockwaves Continue to Rock Germany*, SIGNONSANDIEGO.COM, Aug. 3, 2007, http://www.signonsandiego.com/news/business/20070803-0641-ikb-rescue-.html.

[34] *Lehmann Sees 'Material Hit' to Europe Investment Banks (Update 3)* by Charles Penty, Bloomberg. Com, September 5, 2007

[35] *Id.*; *German Prosecutors to Look at IKB's Sub-prime-Related Collapse*, INT'L HERALD TRIBUNE, Aug. 3, 2007, http://www.iht.com/articles/ap/2007/08/03/business/EU-FIN-COM-Germany-US-Sub-prime-Woes.php.

[36] Bachman & Ryst, *Painful Hiss, supra* note 8.

market.[37] Federal Reserve Chairman Ben Bernanke recently told Congress that the Federal Reserve believes the housing slowdown will last longer than anticipated.[38] Market analysts interpreted his comments on housing as related to the sub-prime mortgage crisis, causing a downward slide in the stock market in July 2007.

Despite the large fallout, some lenders continue to claim that sub-prime mortgage lending has not contributed to the increasing defaults on mortgages around the country. At a recent Senate Banking Committee hearing, Sandy Samuels, an executive with Countrywide Financial, proffered that the majority of hybrid ARMS have not gone through reset (only 20,000 of the 540,000 of the sub-prime loans Countrywide issued are going into default).[39] Scott M. Polakoff, COO for the Office of Thrift Supervision, has observed that problems in local economies, especially in Ohio, Pennsylvania, and Michigan, are causing the rising default rates.[40]

III. LITIGATION ISSUES

A. SUMMARY OF PENDING LAWSUITS

The sub-prime lending and mortgage crisis has set off a wave of litigation in 2007. Borrowers have sued lenders. Lenders have sued financial institutions. Financial institutions have sued lenders. Even regulators have looked to the Courts for relief. **See attached Exhibit for a list of filed actions.**[41] Current actions generally fall into three categories: 1) Lender Liability claims brought by originators or bankruptcy trustees against lending banks; 2) U.S. Securities Act claims brought by investors whose mortgage-backed securities have suffered significant losses; and 3) homeowners' claims against mortgage originators, brokers and banks premised on improper lending practices. Allegations include breach of contract, breach of fiduciary duty, violations of U.S. Securities laws, fraud and "aiding and abetting" improper or fraudulent conduct.

i. LENDER LIABILITY CLAIMS

As stated, much of the fallout in the sub-prime market is the result of warehouse banks withdrawal of financing to mortgage loan originators. Because, in many instances, the mortgage originator's only business is the sale of new loans, credit lines and financing from warehouse banks is the lifeblood of the originator's business model. Once the source of funds to the originator stops, so too does the ability of the originator to generate new loans. The result, in many instances, is insolvency for the mortgage originator.

Insolvent originators and Bankruptcy Trustees have begun to file suits against lenders that have terminated credit facilities to originators. These actions may take the form of breach of

[37] *Id.*
[38] Kristina Cooke, *Bernanke's View, Sub-prime Mess Push Wall St. Down*, ABCNews.com, July 18, 2007, http://abcnews.go.com/Business/wireStory?id=3390232
[39] Christie, *supra* note 1.
[40] *Id.*
[41] The list is not exclusive

contract or tort liability. While a breach of contract claim will largely depend on the contract terms and conditions of the agreement between originator and lender, the viability of business tort claims, like breach of fiduciary duty, is less clear. Actions under a theory of breach of fiduciary, for example, are premised on the notion that "[t]he essence of a fiduciary relationship is that one party places trust and confidence in another who is in a dominant or superior position. The fiduciary relationship arises between two persons when one person is under a duty to act for or give advice for the benefit of another on matters within the scope of their relationship."[42] "The virtually unanimous rule is that creditor-debtor relationships rarely give rise to a fiduciary duty."[43] "Fiduciary relationships implied in law are premised upon the specific factual situation surrounding the transaction and the relationship of the parties."[44] "As aptly noted by the Court of Appeals for the Third Circuit, it 'would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table,' because their respective positions are essentially adversarial."[45] There is, therefore, a general presumption that the "relationship between lenders and borrowers is conducted at arms-length, and the parties are each acting in their own interest."[46]

In addition to claims seeking recovery on behalf of mortgage originators, several other contract based claims have been asserted against those same originators. Mortgage loan purchasers, such as investment banks, have sued originators due to the failure to repurchase defaulted loans, as required under certain loan purchase agreements. Fifteen of these claims have been filed by DBSP, Inc. (Deutsche Bank Structured Products), a subsidiary of Deutsche Bank, alone. Moreover, warehouse lenders have asserted breach of contract claims of their own for failure to repurchase early payment default loans. At least 25 such cases have been filed in New York state courts.[47]

ii. <u>SECURITIES ACT CLAIMS</u>

Several lawsuits have been filed against mortgage lending companies or mortgage originators. Claims asserted typically include violation of the Securities Exchange Act of 1934, breach of contract (loan purchase agreements), and violation of laws governing lending practices (e.g., Fair Housing Act and Equal Credit Opportunity Act).

Shareholder claims made under the Securities Exchange Act of 1934 allege that mortgage lending companies issued materially false and misleading statements regarding the company's business and financial results, leading to artificially inflated stock prices. Lawsuits are premised on the company's failure to disclose (1) an increasing level of loan delinquencies; and (2) insufficient liquidity. Once true disclosure is made, shareholders argue, stock value rapidly declines, and often leading to a halt in trading.

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[42] F.G. v. MacDonell, 150 N.J. 550, 563-64 (1997).
[43] *Id.* at 552 (citations omitted).
[44] *Ibid.*
[45] *Id.* at 552 (quoting Paradise Hotel Corp. v. Bank of Nova Scotia, 842 F.2d 47, 53 (3d Cir. 1988).
[46] *Id.* at 552.
[47] *Legal Claims Proliferate From Mortgage Meltdown* by Beth Bar, August 22, 2007

Investment banks and others have likewise been sued under the Securities Exchange Act of 1934 for misrepresentation or failure to disclose material facts. Examples of such actions include the following:

- **Credit Suisse**

  In 2004, Bankers Life Insurance Co. purchased security certificates from Credit Suisse First Boston (CSFB) collaterized by pools of individual sub-prime mortgage loans on residential real estate. The mortgage loans were serviced and sold by CFBS affiliates and maintained in a trust with Bank of New York as trustee.

  The certificates, commonly known as Asset Backed Securities suffered a downgrade commencing in January 2005 due to problems with loan delinquencies. Bankers Life sued Credit Suisse alleging claims of negligent misrepresentation in the prospectus, common law fraud, and breach of fiduciary duty.

- **Bear Stearns**

  It has been reported that investors intend to file suit against Bear Stearns alleging misrepresentation in response to the fund revealing in July 2007 that the company's assets were essentially worthless.[48] Enforcement agencies will assess the lenders' underwriting standards and their risk-assessment oversight for ensuring compliance with consumer protection laws and intend to initiate corrective or enforcement action as necessary based upon the results of the studies.[49]

- **Moody's CFO**

  The CFO and executive vice president of Moody's has been sued by an individual investor under the Securities Exchange Act for 1934 for misrepresentation and failure to disclose that the company assigned excessively high ratings to bonds backed by risky sub-prime mortgages. Although there typically is no duty to disclose in a normal lender-borrower relationship, a court may imply a duty to disclose in cases of egregious breaches of good faith and fair dealing.[50]

Claims of fraud and "aiding and abetting fraud" are also quite appealing to plaintiffs, as each presents the opportunity to recover punitive damages. Legal fraud consists of the material misrepresentation of a fact, made with the intention that the other party rely [on the misstatement], resulting in detrimental reliance by that party[51] and, therefore, is often difficult to

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[48] *Barclays May Have Lost Big in Bear Fund: Report*, ABCNews.com, July 21, 2007, http://abcnews.go.com/Business/wireStory?id=3401582.

[49] Federal and State Agencies Announce Pilot Project to Improve Supervision of Sub-prime Mortgage Lenders, *supra* note 117.

[50] *Id.* at 557-58.

[51] *Id.* at 551 (quoting Jewish Center of Sussex County v. Whale, 86 N.J. 619, 624 (1981)).

prove. However, "silence in the face of a duty to disclose may constitute a fraudulent concealment."[52] Thus, the exposure remains a real threat.

iii. Consumer Actions

In addition to claims asserted by commercial entities concerning secondary market issues, various claims have been asserted on behalf of consumers against mortgage lenders for misrepresentation and failing to disclose loan terms and fees. Notably, several racially-premised discrimination actions have been filed, including:

- Wells Fargo sued by African-American borrowers for violations of the Fair Housing Act.
- Four African American homeowners sued Countrywide Financial Corp. alleging racial discrimination in the company's lending practices and are currently seeking class action status.[53] The plaintiffs accused Countrywide of marking up interest rates or tacking on fees to loans to African Americans after agreeing to lend based on criteria such as credit histories or home values.
- The NAACP has sued 14 lenders in a class action alleging violations of the Fair Housing Act, Equal Credit Opportunity Act and Civil Rights Act.[54] The NAACP bases its allegations on studies by the Center for Responsible Lending and National Community Reinvestment Coalition which state that African Americans are more likely to be issued sub-prime and high rate loans than Caucasian borrowers. The NAACP has charged that the lending industry had a long history of discrimination and has alleged that the fees associated with the loans are not properly disclosed to borrowers.

While by no means an exhaustive list of consumer claims, the aforementioned matters are indicative of types of predatory lending actions that have, and will continue to be, asserted on behalf of consumers. Such claims have also exposed purported shortfalls in the regulation of sub-prime lending and related issues.

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[52] *Id.* at 551.

[53] Jonathon Stempel, *Countrywide Sued for Racial Bias in Mortgage Loans*, ABCNews.com, July 12, 2007, http://abcnews.go.com/Business/IndustryInfo/wireStory?id=3372236.

[54] NAACP press release, July 11, 2007
http://www.naacp.org/get-involved/activism/alerts/110aa-2007-7-11/index.htm
NAACP Sub-prime Discrimination Suit, MortgageNewsDaily, July 16, 2007, http://www.mortgagenewsdaily.com/7162007_NAACP_Sub-prime_Lawsuit.asp (providing a link to the complaint filed in the class action suit).

IV. REGULATING SUB-PRIME LENDING

A. FEDERAL REGULATION

In reaction to the sub-prime mortgage crisis, federal regulators have been criticized for a lack of regulation in the sub-prime area. Questions abound concerning whether sub-prime lending requires stricter federal regulations to prevent predatory lending business.

Currently, only a minority of sub-prime lenders are regulated by federal law and monitored by the Federal Reserve Board of Governors, members of which include the twelve federal reserve banks, national chartered banks commencing business in the United States; and certain state chartered banks. Moreover, in 2005, only about one-quarter of sub-prime loans originated from such federally regulated lenders. The remaining book of sub-prime business originated sources operating with limited federal regulations.[55] Although the Federal Reserve has authority under the Home Ownership and Equity Protection Act of 1994 ("HOEPA") to regulate all sub-prime lenders, it has, in the past, been hesitant to use this power and has instead left regulation to the states.

This is not to suggest that there are no federal regulations or mechanisms in place to address concerns over lending activities. Indeed, many such regulations exist for the specific goal of preventing predatory lending. These regulations include the following:

- ***Truth in Lending Act and Home Ownership and Equity Protection Act***

Although not specifically anti-predatory in nature, the Federal Truth in Lending Act requires certain disclosures of APR and loan terms.[56]

In 1994, § 32 of the Truth in Lending Act, entitled the Home Ownership and Equity Protection Act of 1994 (HOEPA), was created. This law is devoted to identifying certain high-cost, potentially predatory mortgage loans and reining in their terms. HOEPA is implemented by Regulation Z[57] which sets forth further obligations. Open ended or closed ended home equity loans under which the total points and fees paid by the consumer exceed the greater of 8% of the loan or $400.[58] HOEPA and TILA, however, do not apply to home purchase loans.[59]

Under HOEPA and TILA, creditors must disclose certain items to a borrower when issuing a home mortgage. Lenders must affirmatively represent to the borrowers that they are not required to complete the agreement merely because they have signed loan application.[60] Lenders must also inform borrowers that

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[55] *Banking Regulators to Increase Scrutiny of Sub-prime Lenders*, N.Y. TIMES, July 18, 2007, at C2.
[56] 15 U.S.C. §1601 et. seq.
[57] 12 C.F.R. pt. 226.
[58] 15 U.S.C. §1602(aa); 12 C.F.R. §226.32(a)(1).
[59] 12 C.F.R. §226.32(2).
[60] 15 U.S.C. §1639(a)(1)(A); 12 C.F.R. §226.32(c)(1).

foreclosure can result for a failure to meet obligations under the loan.[61] In addition, lenders must disclose the annual percentage rate, [62] the amount of a regular monthly payment, and the amount of increase in the monthly payments. [63] For variable rate transactions, lenders must additionally disclose that the monthly payment may increase and the amount of the maximum payment.[64]

Finally, loans subject to TILA and HOEPA can not contain the following terms:[65]

2. balloon payments for loans with terms of less than 5 years
3. negative amortization
4. advance payments
5. increased interest rate after default
6. rebates calculated in a method less favorable than HUD's actuarial method
7. prepayment penalties
8. due on demand clause

- ***Real Estate Settlement Procedures Act (RESPA)***

The RESPA[66] sets procedures for lending practices and closing and settlement procedures for the purpose of ending unnecessary costs and minimizing difficulties of purchasing housing. However, the act is binding only on lending in federally related mortgage transactions.[67]

- ***Home Mortgage Disclosure Act (HMDA)***

The HMDA[68] provides the public with loan data in order to determine whether financial institutions are meeting the community's housing needs, assist public officials in the distribution of public investment, and identify discriminatory lending practices. [69] HMDA applies to financial institutions as defined under the HMDA.[70]

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[61] *Id.* §1639(a)(1)(B); 12 C.F.R. §226.32(c)(1).
[62] *Id.* §1639 (a)(2); 12 C.F.R. §226.32(c)(2).
[63] 12 C.F.R. §226.32(c)(3).
[64] *Id.* §226.32(c)(4).
[65] *Id.* §226.32(d).
[66] 12 U.S.C. §2601 et seq.
[67] 12 U.S.C. §2602
[68] 12 U.S.C. §2801 et seq.
[69] 12 C.F.R. §203.1(b).
[70] *Id.* §203.1(c).

- ***Fair Housing Act (FHA)*** [71]

FHA was enacted in 1968 to prohibit discrimination in real estate transactions. FHA states, "[i]t shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction, because of race."[72]

- ***Equal Credit Opportunity Act (ECOA)*** [73]

ECOA was enacted in 1974 to prohibit discrimination in the issuing of credit. ECOA states, "[i]t shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction…on the basis of race."[74]

- ***Federal Deposit Insurance Act (FDIA)*** [75]

FDIA established the Office of Comptroller of the Currency, Guidelines for Residential Mortgage Lending Practices, designed to prevent predatory lending practices.[76]

- ***Federal Deposit Insurance Corporation (FDIC) Statements of Policy*** [77]

The FDIC issued Interagency Guidance on sub-prime lending as early as March 1, 1999 that state "[i]nstitutions that originate or purchase sub-prime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory 'steering" of borrowers to sub-prime products for reasons other than the borrower's underlying creditworthiness."

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[71] 42 U.S.C. §3601.
[72] *Id.* §3605.
[73] 15 U.S.C. §1691 *et seq*.
[74] *Id.* §1691(a)(1).
[75] 12 U.S.C. §1831.
[76] 12 C.F.R. pt. 30, Appendix C.
[77] 5000 – FDIC Statements of Policy "Interagency Guidance on Sub-prime Lending", March 1, 1999

- ***Federal Trade Commission Act (FTCA)*** [78]

Under the FTCA, the Office of Thrift Supervision (OTS)[79] is responsible for promulgating regulations to prevent unfair or deceptive acts or practices by "savings associations."[80] Pursuant to the FTC, OTS is given the authority to define specific acts or practices as unfair or deceptive and impose measures to prevent unfair or deceptive practices.[81] The following are defined as unfair or deceptive practices for the purposes of the FTC:

(1) A cognovit or confession of judgment (for purposes other than executory process in the State of Louisiana), warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon;

(2) An executory waiver or a limitation of exemption from attachment, execution, or other process on real or personal property held, owned by, or due to the consumer, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation;

(3) An assignment of wages or other earnings, unless:

(i) The assignment by its terms is revocable at the will of the debtor;
(ii) The assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes a series of wage deductions as a method of making each payment; or
(iii) The assignment applies only to wages or other earnings already earned at the time of the assignment;

(4) A nonpossessory security interest in household goods other than a purchase-money security interest.[82]

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[78] 15 U.S.C. §41-58.
[79] The FTC refers to the OTS's predecessor agency, the Federal Home Loan Bank Board (FHLBB). However, Congress transferred the rulemaking power of FLHBB to OTS. 12 U.S.C. §1462a(e).
[80] 15 U.S.C. §57a(f)(1). The Federal Reserve Board is given the power to promulgate regulations for banks, OTS for "savings associations," and the National Credit Union Administration Board for national credit unions. *Id.*
[81] 15 U.S.C. §57a(f)(1).
[82] 12 C.F.R. §535.2.

Home Owners Loan Act (HOLA) [83]

> HOLA gives OTS the authority to proscribe regulations governing unfair or deceptive practices that cover a broader category of institutions within the savings and loan association structure than the FTC Act. Under HOLA, OTS has the authority to regulate subsidiaries owned in whole or in part by a savings association, savings and loan holding companies other than a bank and their subsidiaries, and certain service providers.[84] OTS uses this rulemaking authority to supplement that granted to it under the FTC Act. OTS has used this rulemaking authority to promulgate its Advertising Rule, which prohibits savings associations from engaging in deceptive advertising, and its Nondiscrimination Rule, which prohibits discrimination in areas not covered by the federal fair lending laws.[85]

Moreover, the Department of Justice and the Department of Housing and Urban Development ("HUD") are empowered under 12 U.S.C. §1818 to combat predatory lending. The enforcement power applies to savings and loan holding companies.[86] Section 1818 can require an institution to make restitution or provide reimbursement for a loss if the practice resulted in unjust enrichment of the lender or involved a reckless disregard for the law.[87] The enforcement power also includes the authority to restrict the growth of the institution, dispose of the loan or asset involved in the illegal practice, rescind agreements or contracts, employ qualified officers, or take any other necessary action.[88]

B. STATE REGULATION

At least twenty-four states have passed anti-predatory lending laws.[89] Arkansas, Georgia, Illinois, Massachusetts, North Carolina, New York, New Jersey, New Mexico and South Carolina are among those states considered to have the strongest laws. State anti-predatory lending laws usually extend the protection afforded by HOEPA.

State law usually describes one or more classes of "high-cost" or "covered" loans, which are defined by the fees charged to the borrower at origination or the APR. While lenders are not prohibited from making "high-cost" or "covered" loans, a number of additional restrictions are

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[83] 12 U.S.C. §1461 et seq.
[84] *Id.* §1462a(b)(2), 1463(a), 1464(a), 1464(d)(7)(A), 1467a(b), 1467a(g).
[85] 12 C.F.R. §528.2.
[86] 12 U.S.C. §1818(9).
[87] *Id.* §1818(6)(A).
[88] *Id.* §1818(6)(B-F).
[89] Giang Ho & Anthony Pennington-Cross, *The Impact of Local Predatory Lending Laws* (Federal Reserve Bank of St. Louis, Working Paper Series, 2005), *available at* http://www.newhomebuyer.org/home/finance/predatorylendinglaws.pdf. The list of states with anti-predatory lending laws used in this paper includes the following 24 states: Arkansas, California, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, south Carolina, Texas, Utah, Wisconsin. *Id.* at 16.

placed on these loans, and the penalties for noncompliance can be substantial. Prepayment penalties are often prohibited in the early life of the loan and balloon payments can be limited in size.[90] An examination of New York's regulatory scheme is instructive.

New York State's anti-predatory lending law took effect on April 1, 2003. The law applies to "high cost home loans."

> "Home loan" means a home loan, including an open-end credit plan, other than a reverse mortgage transaction, in which:
>
> (i) The principal amount of the loan does not exceed the lesser of:
> (A) conforming loan size limit for a comparable dwelling as established from time to time by the federal national mortgage association; or
> (B) three hundred thousand dollars;
>
> (ii) The borrower is a natural person;
>
> (iii) The debt is incurred by the borrower primarily for personal, family, or household purposes;
>
> (iv) The loan is secured by a mortgage or deed of trust on real estate upon which there is located or there is to be located a structure or structures intended principally for occupancy of from one to four families which is or will be occupied by the borrower as the borrower's principal dwelling; and
>
> (v) The property is located in this state.[91]

A "high cost" loan is one which exceeds one or more of the following thresholds:

- If it is a first-lien mortgage, the annual percentage rate of the home loan exceeds 8% of the yield on treasury securities having comparable maturities;
- If it is a junior-lien mortgage, the annual percentage rate of the loan exceeds 9% of the yield on treasury securities having comparable maturities;
- If the loan is a conventional loan for more than $50,000, and total "points and fees" exceed 5% of the loan;
- If the loan is an FHA or VA loan for more than $50,000 and the total "points and fees" exceed 6% of the loan; or
- If the loan is less than $50,000, and the total "points and fees" exceed 6% of the loan or $1,500, whichever is greater.[92]

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[90] *Id.*
[91] N.Y. BANKING LAW §6-l 1.(e) (McKinney 2007).
[92] *Id*. §6-l 1(g).

New York's anti-predatory lending law applies the following restrictions to define "high cost home loans":

- No call provisions
- No balloon payments within the first fifteen years of the loan
- No negative amortization
- No interest rate increase in response to default
- No limitations on advance payments
- No modification or deferral fees
- No oppressive mandatory arbitration
- No financing of insurance
- No "loan flipping"
- No refinancing of special mortgages
- No lending without regard for a borrower's ability to repay the loan
- No lending without counseling disclosure and a list of counselors
- No financing of points and fees in an amount which exceeds three percent of the loan amount
- Lender can not pay a home improvement contractor with proceeds from a high cost loan unless it is done through certain mechanisms which protect the borrower
- No kickbacks to mortgage brokers
- No points and fees are to be charged when a lender refinances its high cost loan with another high cost loan
- No encouragement of default.[93]

A borrower can bring a private action against a lender for violation of New York's anti-predatory loan laws within six year of the violation and the lender can be found liable to the borrower for actual and statutory damages and attorney's fees.[94] In addition, New York's Attorney General and Superintendent can enforce the provisions of this law.[95]

State bank regulators are beginning to enforce lending practice regulations in an effort to protect consumers within its borders. For example, Connecticut Banking Commissioner Howard Pitkin issued a cease and desist order in January alleging that Mortgage Lenders failed to satisfy its funding commitments to 93 borrowers in state and 1,400 in other states. Mortgage Lenders could be fined up to $7 million.[96]

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[93] *Id.* §6-l 2.
[94] *Id.* §6-l 6-8.
[95] *Id.* §6-l 5.
[96] Wei & Beaudette, *supra* note 14.

C. NEW STEPS IN REGULATING THE INDUSTRY

On June 29, 2007, the Federal Reserve, comptroller of the Currency, the Federal Deposit Insurance Corporations, the Office of Thrift Supervision, and the National Credit Union Administration, issued a Statement on Sub-prime Mortgage Lending,[97] which contains guidelines on "how institutions can offer certain adjustable rate mortgage (ARM) products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume."[98] One important aspect of the guidelines instructs lenders to base a borrower's approval on the loan terms after the rate resets higher.[99] The guidelines also state that, because sub-prime lending involves a greater credit risk, lenders should require that a borrower's assets, income, and liabilities should be verified unless there are mitigating circumstances.[100] Although this is an "important first step,"[101] the federal government does not have control over all sub-prime lenders and it is unclear if state regulators will adopt these policies.

On July 12, 2007, Alabama Representative and Republican head of the U.S. House Financial Services Committee, Senator Spencer Bachus, introduced the Fair Mortgage Practices Act.[102] The bill seeks "to increase uniformity, reduce regulatory burden, enhance consumer protection, and reduce fraud" in the sub-prime mortgage industry.[103] The bill, if enacted, would require lenders to be licensed,[104] set licensing standards for mortgage lenders,[105] and catalog those lenders in a national database.[106] Lenders who had a lending license or similar license revoked in the past five years or been convicted of a felony would not be eligible for a license under the bill.[107] The applicant must also demonstrate financial responsibility and good character, have completed an approved education course, and pass a written test.[108] Lenders would also have to submit to a criminal background check and fingerprinting,[109] and those convicted of fraud would not qualify for a license under the proposed standards.

The bill would amend TILA to require disclosure of certain information for all mortgages secured by the borrower's principal dwelling.[110] Like the previously mentioned Statement on Sub-prime Mortgage Lending, the bill would require lenders to evaluate a borrower's ability to

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[97] Floyd Norris, *Regulators Set Final Rules to Limit Sub-prime Mortgage Lending*, N.Y. TIMES, June 30, 2007 at C2.
[98] Statement on Sub-prime Mortgage Lending, 72 Fed. Reg. 37,569, 37,569 (July 10, 2007).
[99] *Id.* at 37,573.
[100] *Id.*
[101] Norris, *supra* note 97 (quoting Michael D. Calhoun, president of the Center for Responsible Lending).
[102] *Republican Lawmaker Introduces Sub-prime Legislation*, CNBC.COM, July 12, 2007, http://www.cnbc.com/id/19730997; Fair Mortgage Practices Act of 2007, H.R. 3012, 110th Cong. §§101-701 (1st Sess. 2007).
[103] H.R. 3012, §101.
[104] *Id.* §103.
[105] *Id.* §104(b)
[106] *Id.* §106.
[107] *Id.* §104(b)(1-2).
[108] *Id.* §104(b)(3-5).
[109] *Id.* §104(a).
[110] *Id.* §201.

repay the loan[111] and prohibits penalties against homeowners that refinance into a lower cost loan.[112]

The Office of Thrift Supervision issued the Prohibited Consumer Credit Practices rule over 20 years ago.[113] In August 2007, OTS published an Advanced Notice of Proposed Rulemaking to solicit comments on how to promulgate additional regulation to protect consumers from predatory lending practices.[114] OTS is considering a variety of sources to gain insight into how to remodels its consumer protection regulations, including agency guidelines, including that of FTC, and state laws.[115] OTS is also considering using regulations targeted at specific practices such as credit card lending and residential mortgage lending.[116]

Finally, the Federal Reserve, the Office of Thrift Supervision, the Federal Trade Commission and two associations of state regulators, the Conference of State Bank Supervisors and the American Association of residential Mortgage Regulators are set to cooperate in a pilot program to conduct consumer-protection compliance reviews of selected non-depository sub-prime lenders.[117]

As demonstrate above, regulators have a wide variety of resources available to them to investigate, prosecute and collect from individuals or entities involved in prohibited lending practices. Just how far regulators push, or where its investigations might lead, remains uncertain at this time.

V. CONCLUSION

While a substantial amount of litigation and regulation activity has already ensued as a result of the declining sub-prime market, its effect on insurers and reinsurers is still somewhat of an unknown. It is likely that litigants will look to defray litigation costs and exposure by turning to professional liability and directors and officers' insurers for coverage. The costs in responding to government investigations, for example, may also prove to be a source of exposure to insurers. An expansion to claims against auditing and accounting firms remains a distinct possibility as well.

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[111] *Id.* §412.
[112] *Id.* §411.
[113] 50 Fed. Reg. 77440 (March 1, 1984).
[114] 72 Fed. Reg. 43,570 (Aug. 6, 2007).
[115] *Id.* at 43,573-74.
[116] *Id.* at 43,574-75.
[117] Press Release, The Federal Reserve Board, Federal and State Agencies Announce Pilot Project to Improve Supervision of Sub-prime Mortgage Lenders (July 17, 2007), *available at* http://www.federalreserve.gov/BoardDocs/press/bcreg/2007/20070717/default.htm.