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Subprime Lawsuits Stretch Far and Wide in 2008

A massive wave of subprime lawsuits bigger than what was seen in 2007 hit mortgage lenders and the secondary mortgage market in the first quarter, adding to the woes of an industry already under pressure by the credit and housing crises.

The lawsuits indiscriminately target anybody who had ever touched a subprime loan that soured, and the ripple effect has been felt by the mortgage industry, Wall Street, investors, homeowners, and other mortgage market players.

Subprime litigation has been steadily increasing since 2005, when the housing market peaked and began to decline. A recent study by Navigant Consulting Inc. reports a surge of subprime-related filings in federal court in the first quarter of 2008, dramatically outpacing 2007 filings.

According to the Chicago-based firm, 170 subprime-related cases were filed during the quarter, fast approaching the 181 filings – up from 97 – reported over the second half of last year. That was an 85 percent increase from year-end 2007.

Filings during the first quarter averaged approximately two per day, including weekends, said Jeff Nielsen, managing director of Navigant Consulting. He said the cases are piling up and, at this point, "appear to be going nowhere fast."

Like the S&L disputes, which took six years to resolve, the subprime claims will also likely take years to play out, he added.

Borrower class actions account for the majority of cases, 46 percent, in the first quarter, followed by securities cases, 26 percent, and commercial contract disputes, 10 percent. Class actions accounted for 76 percent of the 170 subprime cases filed during the period, the Navigant study said.

Securities Litigation

Jacob Zamansky, a securities litigation expert, said that 32 class-actions have been filed as of December 2007 by investors against subprime mortgage lenders, Wall Street firms that underwrote MBS and CDOs, as well as by investors in funds and other securities that have subprime mortgage exposures. Real estate agents, title companies, real estate appraisers, and independent auditors also have been sucked into the litigation nightmare.

The claims are based on a range of allegations: fraudulent practices, failure to disclose information regarding loans sold to third parties; breach of securitization contracts; and failure to perform or insufficient due diligence on mortgages prior to securitization.

Other claims include excessive loan fees and charges, loans made without regard to the borrower's ability to repay, and steering.

Many of the lender lawsuits are aimed at underwriting practices and accounting estimates, including estimates of allowance for loan losses, valuation of mortgage servicing rights and residual securities, and liabilities for loan repurchases, according to Anthony Lendez, a certified public accountant with BDO Consulting.

For example, when a company enters into a securitization, it usually establishes adequate reserves to absorb any potential losses that may arise from reps and warranties issues. In the event of a mandatory repurchase of a soured home loan, the asset is no longer worth its initial purchase price and must be written down to its actual current value. This results in a gain-on-sale that is higher than it should have been – and a lawsuit, says Lendez.

Another type of lawsuit involves a change in the valuation of residual securities. In such cases, plaintiffs claim that the assets were overvalued because of weak underwriting.

"Any time there is an understatement of liability or overstatement of the asset on the date of securitization that has an impact on the gain-on-sale, it all comes back to the allegation that the lender inflated the gain recorded on the sale of the loans," Lendez said.

Subprime securities litigation may be classified into two types. The first type is where the issuer is sued by its shareholders for failure to disclose the risks inherent in their mortgages, for example, lax underwriting standards.

The second type is brought against entities that issued, advised or underwrote MBS or CDOs that eventually went bad as the subprime market collapsed. Investors who suffered losses on these instruments claim insufficient or improper disclosure of the risk of the underlying collateral, which may have been fraudulent or negligent.

For example, insurers of MBS tranches are being sued by investors on grounds that the firm had failed to disclose its high risk exposures. "We're also seeing MBS investors taking big writedowns and being sued by their shareholders because they didn't disclose their exposures, and cases against underwriters and accounting firms alleging insufficient due diligence," said Lendez. "Even credit rating agencies are getting sued for over-rating certain MBS tranches."

One bright spot in the grim subprime litigation landscape is that some courts are now beginning to understand that some of the writedowns were caused by events that couldn't have been anticipated by the defendants, said Lendez.

For example, residual securities that were initially valued at $100 million based on information that was available at the time took a tumble months later resulting in a significant reduction in value. As a result, a lawsuit was filed alleging overvaluation.

"Some courts are now looking at some of these losses and finding in favor of defendants on the basis that there was no evidence that they ignored information at the time they made the initial valuation," Lendez explained. "If, in fact, the reason why these valuations changed was because the markets have changed, then there really was no basis for the lawsuits."

The best defense against subprime lawsuits is to have ironclad support, both internal and external, for accounting estimates and assumptions, Lendez advised. Independent auditors also must make sure they have sufficient support and documentation in their work papers to show they actually analyzed the methodologies and assumptions thoroughly and found them to be reasonable. ✦

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