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Forecasting the Subprime Storm

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Britons are once again facing a gathering storm, though this one is powered by economic winds. We are referring specifically to the legal fallout in the US from the subprime credit crunch and the extent to which these claims might serve as a harbinger for the UK.

Recent research from Navigant Consulting indicates that subprime mortgage and related civil litigation filed in US federal courts during 2007 and the first quarter of 2008 is on pace to eclipse the landslide of lawsuits seen in the wake of the US banking crisis of the early 1990s. For those of us who require a refresher on that earlier credit crunch, it was driven by lax underwriting standards, ultimately required a US tax payer bailout to the tune of USD 160 billion, and produced 559 lawsuits that were handled by the US government entity charged with overseeing the clean-up. This historic comparison brings the scale of the legal fallout from the current subprime situation into sharper focus and also underscores implications for the UK and other participants in the global economy.

According to the Navigant study, one hundred and seventy new cases were filed in federal courts during the first three months of 2008, an 85 percent increase over the previous busiest quarter. Moreover, the pace of filings throughout the quarter was unrelenting. The three months comprising the March 2008 quarter now stand as the first, second and fourth highest monthly totals yet observed. August 2007, previously the most active month, fell to third. Two hundred and seventy-eight subprime mortgage and related civil litigation cases were filed in the US federal courts in 2007.²

At least one Fortune 1000 company was named as a defendant in 57 percent of 170 cases filed during the first quarter of 2008. Fortune 500, 100 and 50 companies were names in 52, 33 and 22 percent of the lawsuits, respectively. At least one Fortune Global 500 company was named as a defendant in 42 percent of the 448 cases

filed to date. Ten percent of the 448 cases include at least one non-US Global 500 company as a named defendant; UK firms account for approximately half of this total.

The study provides a comprehensive analysis of the types of cases filed, the parties involved, jurisdictions, case status and claims alleged. Notably, the 448 cases have been filed over the 15 months ended 31 March, 2008 will soon surpass the 559 cases arising from the US banking crisis of the early 1990s, even though those earlier cases accumulated over a period of more than five years. Moreover, as the deterioration in the credit markets gained speed during the second half of 2007 and into the first quarter of 2008, so did the pace of US subprime litigation. The number of subprime-related cases filed in the US nearly doubled during the second half of 2007, from 97 during the first six months to 181 during the latter half of the year. Given the explosion of subprime litigation during the first quarter, there appears to be no let-up in sight for 2008.

Where there are losses, there is likely to follow litigation. And the estimated losses stemming from the subprime exposure are staggering. The International Monetary Fund recently pegged losses from the credit crunch (not limited to subprime mortgages) at nearly USD 1 trillion. The magnitude of the situation suggests the pain from the subprime fallout will be felt for years to come, including protracted legal disputes and regulatory investigations. While the origins of the credit crunch center on mortgages originated in the United States, the effects have been widespread and the implications global in nature.

A few notable cases with global implications include a lawsuit by HSH Nordbank, a large German bank, filed earlier this year against Switzerland's UBS in which the bank accuses UBS of acting against its interests in connection with a USD 500 million portfolio of collateralised debt obligations linked to US mortgages which

Notes

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- 2 Jeff Nielsen, with Scott Paczosa and William Schoeffler, 'Subprime Mortgage and Related Litigation: 2007 – Looking Back at What's Ahead', *Navigant Consulting* (February 2008); Jeff Nielsen, with Scott Paczosa and William Schoeffler, 'Subprime Mortgage and Related Litigation: First Quarter 2008 Update – Reaching New Heights', *Navigant Consulting* (April 2008). The information presented in this article is based largely on the results of these studies.

the German bank purchased in 2002. Another lawsuit was brought late last year by Barclays Bank against Bear Stearns and related entities over the spectacular collapse of two Bears Stearns affiliated hedge funds last summer. Barclays was a significant investor in those funds and is claiming the Bear Stearns entities were not forthcoming in their disclosures regarding the riskiness of the investment strategies employed.

Whether cases land in UK courts will be determined by a variety of factors, including the specific entities involved and where the subject transactions take place. At the mortgage lending end of the chain, the UK market does not appear to have put itself at risk from making subprime loans to the extent that occurred in the US. Therefore, it appears unlikely that the UK will see the same level of accusations from borrowers against their IEAs and mortgage providers that has been witnessed in the US. However, as it relates to subprime mortgages originated in the US, UK firms are more likely to be directly impacted, specifically in sectors such as banking, investment management, structured finance, and insurance/reinsurance. Navigant's research found that virtually every participant in the subprime collapse in the US is being sued which is particularly worrying news for those in the UK finance industry with subprime exposure either here or abroad.

While there has clearly been no abatement to date in the pace of filings (to the contrary, the lawsuits have continued to escalate), at some point, suits targeting lenders over mortgage origination practices will presumably have run their course given that these entities have largely exited the subprime lending business and the loan products that are the subject of these lawsuits are either no longer being offered or are being originated at dramatically reduced volumes.

However, the level of filings related to the other case types will continue to be sensitive to, among other factors, the state of the credit markets (including underlying US residential real estate values), episodic events such as the Bear Stearns collapse in March 2008, and spillover into other corners of the financial markets (e.g., auction rate securities). Intra-industry disputes appear likely to expand as financial institutions shun traditional mores and pursue remedies from one another through litigation. This is a process that will almost certainly take years to play out.

In addition, actions (or inactions) by central banks and macroeconomic indicators generally, including consumer sentiment, will play a critical role in determining the extent of the market upheaval and related litigation. In any case, the explosion of litigation activity in the US is likely to have long-lasting implications on both sides of the pond.

The Navigant research which is summarised below makes compelling reading as a road map for similar cases to be brought in the UK. Those involved with subprime-related loans and securities in the UK, whether directly or indirectly, would do well to make sure their

legal and forensic teams are up to strength to properly handle these complex claims.

Following are some of the highlights of the study.

Case types

Borrower class actions continue to dominate, making up 46 percent of the 170 case filings in the first quarter of 2008 and 43 percent of the total in 2007. The number of borrower class actions filed in the first quarter of 2008 (79) exceeded the previous most active quarter (September 2007) by 61 percent. Cases for which the principal claim centered on some form of inadequate disclosure in connection with the loan origination process accounted for 42 percent of borrower class actions in the first quarter of 2008; the majority of these (76 percent) involved option ARMs.

Securities cases, which accounted for 26 percent of total filings during 2007, also saw a new high (44) in first quarter 2008. Securities fraud class actions alleging temporary inflation in a company's stock price due to inaccurate or incomplete disclosures to shareholders, accounted for 57 percent of total securities cases filed during the quarter. Eight of these class action cases involved claims related to auction rate securities, providing clear evidence that the subprime mortgage-induced litigation has spread to other corners of the capital markets impacted by the crunch.

Commercial contract disputes fell to 10 percent of total filings during the first quarter of 2008, down from 22 percent in 2007. Nevertheless, total contract filings for the quarter (17) were still the second highest of the five quarters that were the subject of the research. Litigation over purported obligations to repurchase poorly performing and/or allegedly non-compliant mortgage loans decreased to 29 percent of the total contract cases for the quarter, relative to 58 percent in 2007. Disputes over the terms of collateralised debt obligations and credit default swaps accounted for approximately 30 percent of total contract cases for the quarter, a significant pick-up over 2007.

Defendants

Virtually no industry participants have been spared from the lawsuits. Defendants include mortgage brokers, lenders, appraisers, title companies, homebuilders, services, issuers, underwriting firms, bond insurers, money managers, public accounting firms and company directors and officers, among others. The categories of defendants named in first quarter 2008 filings were generally consistent with those observed in 2007.

With respect to the securities fraud class action cases filed in the first quarter, directors and officers were named as defendants in 72 percent of cases (down from 97 percent for 2007 filings). Underwriters were named

in 16 percent of cases during the quarter (compared to 21 percent for 2007 filings). To date, accounting firms have been named as defendant in a *de minimis* number of cases.

Claimants

Certain municipalities, particularly Baltimore and Cleveland, made a highly publicised entrance into US federal subprime litigation by filing claims against firms involved in the origination, servicing and securitisation of subprime mortgages. The claims generally allege loss of tax revenue and increased costs associated with repossessed properties under legal claims of discrimination and public nuisance.

Class actions account for 76 percent of the 170 cases filed during the first three months of 2008 (the figure for 2007 was 69 percent). Of the commercial plaintiffs,

the largest category during the first quarter of 2008 is National Commercial Banks, which accounts for 28 percent. This is a change from 2007 when the Mortgage Bankers and Loan Correspondents took the top spot.

Where are the claims being filed?

Consistent with the 2007 cases, California and New York combine to account for approximately half of the first quarter 2008 filings. California was again the most popular venue for borrower class actions, accounting for 42 percent of the total. Half of the securities cases were filed in New York, up from 36 percent in 2007, while New York was likewise home to 29 percent of the contract cases filed during the quarter.

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The Mortgage Origination and Securitisation Process

The mortgage origination process begins when a prospective borrower seeks to finance the purchase or renovation of a home, refinance an existing loan, or monetise existing home equity. The borrower may go directly to a lender or may instead use the services of a mortgage broker, who will typically have access to a variety of loan products from several lenders. Once the loan is approved and funded, the lender will often act as a conduit (or else deliver the loan to a separate entity acting as a conduit), which pools the loan with other like loans and transfers them into a bankruptcy-remote securitisation trust, or special purpose entity (SPE).

The lender may continue to service the loan on behalf of the SPE, or this responsibility may be contracted out to another party. The SPE will, through the services of an underwriter, issue and market various securities backed by the mortgages, which are commonly referred to as residential mortgage-backed securities (RMBS). Typically, the marketability of the securities, or tranches, is enhanced by virtue of receiving a credit rating from one or more of the major rating agencies (i.e., Standard & Poor's, Moody's, Fitch Ratings). Higher credit ratings are assigned to those tranches that are structured to benefit from some form of 'credit enhancement', usually either priority claims on the cash flows generated by the underlying mortgages and/or credit insurance purchased from a third-party bond insurer (Ambac, MBIA, etc.).

The securities may be purchased by institutional or individual investors the world over, including, for example, hedge funds or managers of collateralised debt obligations (CDOs), which re-securitise the subject RMBS, along with other assets, into a CDO. It is

through securitisation that the monthly mortgage payment made by a couple in California might be owned, at least in part, by a municipality in Norway.

What happened to cause the subprime mortgage market to explode with such a vengeance?

As interest rates reset on high-risk borrowers and the value of their homes fell, defaults skyrocketed, setting in motion a chain reaction:

- Investors exercised 'put' options, requiring originators to repurchase loans that went into early default.
- Warehouse lenders cut off financing to mortgage originators and seized collateral.
- More than 100 subprime mortgage lenders went bankrupt, were acquired, or substantially curtailed their loan production.
- Foreclosures spiked, adding inventory to the market at the same time lenders were pulling back.
- In the face of uncertainty, investors shunned securities backed by subprime mortgages and sought safe havens, which essentially brought trading in these hard-to-value securities to a halt (while forced sales exacerbated downward pricing pressure).
- Write-downs continue to mount and the magnitude of the exposure to financial institutions, insurers, hedge funds, and other entities around the globe is gradually coming into focus.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

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