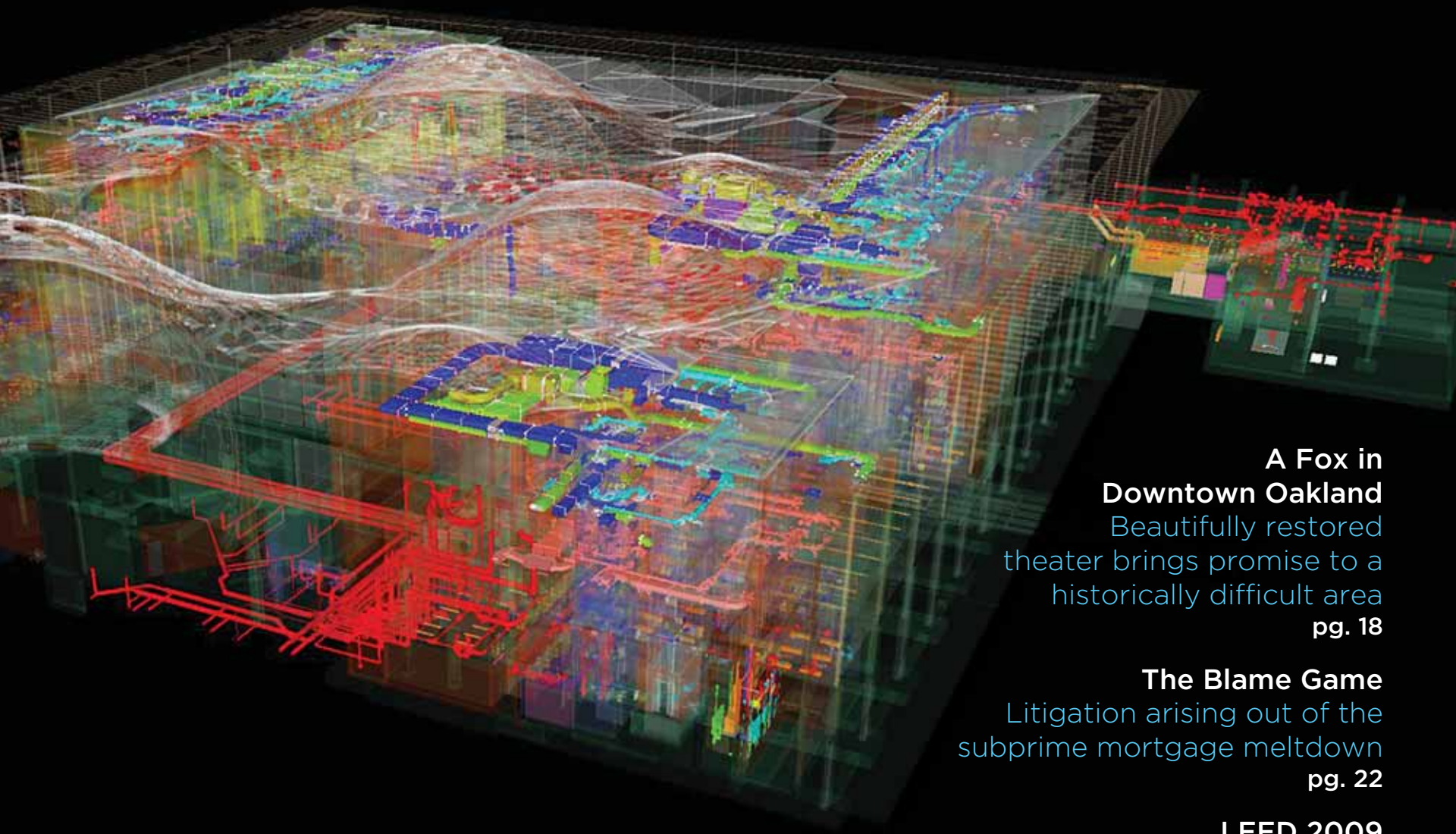


## Model Behavior

Advances in technology are changing the way buildings are conceived and built

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## The Blame Game

Litigation arising out of the subprime mortgage meltdown.

By **Jean Bertrand** and **Nicole Magaline**

**W**hen the going gets tough, it seems the tough...go to the courthouse. The blame for the financial crisis arising out of the subprime mortgage market meltdown is finding its way to almost every participant of the mortgage securitization process through complaints filed all over the United States. Almost all players, at every level, will find themselves as either a plaintiff, defendant, or both, in what is sure to be a long-lasting litigation blame game.

The lawsuits have started with the most obvious targets—mortgage lenders. In turn, the lenders have turned against the issuers and underwriters of securities backed by subprime mortgages. Now, litigation also includes suits against remote investors who either purchased or packaged these securities. As more companies expose their losses due to subprime mortgage securities, they will likely find themselves in litigation as well. Civil plaintiffs are looking beyond shallow-pocketed individuals such as mortgage brokers who participated in mortgage fraud schemes, to the deep-pocket financial institutions blaming them for failing to disclose the true vulnerability of these risky mortgages and the extent of their involvement in securities backed by these mortgages. Bankruptcy may insulate some players from the lawsuits filed against them, but that will be counter balanced by the bankruptcy trustees' obligations to institute lawsuits against non-bankrupt participants to recover losses suffered by the estate.

A brief description of some of the claims follows:

### ACTIONS AGAINST LENDERS

Subprime lenders (sometimes called originators) are the first step in the mortgage securitization process. They have also been the first to be sued. In addition to lawsuits for securities and ERISA violations, described below, lenders also are defendants in actions for deceptive/unfair practices. For example, in April 2008, Wells Fargo & Company settled a class action lawsuit over its financial unit's subprime lending practices. The complaining borrowers alleged Wells Fargo failed to properly disclose prepayment penalties to borrowers and failed to accurately report loan balances to credit agencies.

Under attack from both sides, subprime lenders are also sued by the purchasers of the loans they originated. Common allegations in these types of lawsuits are negligent underwriting, lack of due diligence and misrepresentation. Last year, UBS Real Estate Securities sued New Century Mortgage Company for New Century's failure to buy back loans it originated. Because New Century did not have enough reserves to repurchase the loans, it filed for bankruptcy.

### ACTIONS AGAINST SECURITIES ISSUERS

Securities issuers are under attack by both lenders and shareholders. In October 2007, American Home Mortgage Investment Corporation, a lender, sued Lehman Brothers, a securities issuer. Lehman had agreed to finance certain subordinated note purchases integral to American Home's loan origination business. American Home sold two series of notes to Lehman pursuant to their agreement. When Lehman called on the two notes in a margin call, American Home could not satisfy one of them, and Lehman issued a formal notice of default. American Home then filed for bankruptcy protection. Lehman retaliated by terminating the repurchase agreement, and foreclosing on the notes. American Home's bankruptcy trustee sued Lehman, claimed Lehman "unjustifiably pointed to the crisis of confidence in the mortgage arena instead of giving a fair, good faith valuation" of the collateral on which Lehman foreclosed.

On the other side, lawsuits by shareholders against issuers generally claim the issuer did not disclose the extent of its exposure to subprime mortgage losses. They often also claim the issuer failed to write-down the value of impaired securities backed by subprime loans.

Issuers are also exposed to lawsuits for failure to inform the market of the instability of their CDO portfolios due to the subprime mortgage crisis. Merrill Lynch was sued by Life Enrichment Foundation, which alleged Merrill Lynch's statements were "materially false" because Merrill Lynch failed to disclose to the market the "ticking time bomb" in its portfolio from the decline of the subprime market.

### ACTIONS AGAINST MORTGAGE INSURERS

The mortgage insurance industry has been hit with securities class action lawsuits for failing to disclose their dangerous entanglement with subprime mortgages. In May 2008, Mortgage Guaranty Insurance Company (MGIC), a mortgage insurer, was sued by its shareholders for statements made in its 2006-2007 public disclosures that allegedly misled investors amid an "industry-wide decline." Ultimately, in February of 2008, MGIC disclosed that it lost \$1.47 billion in 2007, causing its stock to plummet. MGIC shareholders claimed defendants violated sections 10(b) of the Securities and Exchange Act and Rule 10-b-5, by intentionally deceiving the investing public to induce them to purchase MGIC securities. They also alleged that MGIC officers and directors used their controlling positions to disseminate the false public disclosures in violation of section 20(a) of the Securities and Exchange Act.

### ACTIONS AGAINST HEDGE FUNDS

Hedge funds have also become subprime mortgage litigants, as both plaintiffs and defendants. Many hedge funds entered into credit default swaps with banks, such as Citigroup and Wachovia, essentially acting as an insurer in a speculative and risky market. With the decline in value of mortgage-backed securities, the fallout from these deals is likely to be a major feature of the litigation to come.

As an example, in 2007, a hedge fund, VCG Special Opportunities Master Fund Limited, entered into two credit swaps with Citibank and Wachovia in which the banks bought protection against securities backed by subprime-mortgage assets. These two swaps represented 40% of VCG's capital. In early 2008, VCG brought suit against both banks accusing them of improperly requiring that the Fund pay out money amid a steep decline in the value of the mortgage-backed bonds. VCG sought to rescind both credit swaps on the grounds of fraud and mistake and sought damages for fraud, breach of contract and breach of the covenant of good faith and fair dealing, as well as unjust enrichment.

Hedge funds have also been defendants. Shareholders have sued for

allegedly misleading statements and omissions regarding the security of their investments. In July 2008, shareholders commenced a class action against Falcon Strategies Two, LLC, a fund affiliated with Citigroup, Inc. The complaint alleged, among other things, that Falcon invested in asset-backed mortgage instruments that were intrinsically tied to the condition of the credit and bond markets. When these markets fell, the underlying investments failed, causing the shareholders to lose money.

## SECURITIES CLASS ACTIONS

Securities class actions are one of the most prevalent types of cases arising out of the mortgage meltdown. According to Kevin LaCroix, the author of the blog *The D&O Diary*, as of October 24, 2008, 127 subprime-related securities lawsuits had been filed against lenders, 87 of them in 2008.

NERA Economic Consulting, an international firm of economists, reports as of April 21, 2008, almost half of the plaintiffs in mortgage-related securities lawsuits were shareholders. Following shareholders are investors (28% of the plaintiffs), plan participants (10%), and securities issuers/underwriters (5%). As for the defendants, 26% were asset management firms (such as mutual funds, hedge funds, etc.). Mortgage lenders constituted 23% of defendants, securities issuers/underwriters accounted for 20%, insurers 7% and home builders 5%.

The most common allegations are breach of fiduciary duties, false and misleading disclosures, fraud on the market and 10(b) violations (a link to each of the complaints in these lawsuits can be found at <http://69.177.1.186/clients/blog/subprimelawsuitslist.doc>). For example, on February 12, 2008, a class of individuals who purchased Morgan Stanley securities in 2007 brought a class action suit against Morgan Stanley's Executive Vice President and Chief Legal Officer, Gary Lynch, blaming him for the decline in their shares' value. Morgan Stanley offered CDOs made up of bonds primarily backed by subprime mortgages. The complaint alleged Morgan Stanley and Lynch failed to publicly disclose "significant exposure" to losses related to the declining value of the subprime mortgage-related derivatives.

## ERISA/401(K) LAWSUITS

In ERISA/401(k) lawsuits, plaintiff employees allege that fraudulent actions caused the company's stock to collapse and therefore caused the employee pension contribution plans to lose value. These actions are brought by plan participants against lenders, asset management firms, home builders and securities issuers. LaCroix reports 18 subprime mortgage-related ERISA/401(k) class actions against lenders have been filed so far, 10 of which were filed in 2008. Common allegations in these lawsuits are breach of fiduciary duties in violation of ERISA, breach of duties of loyalty and prudence in violation of ERISA, failure to provide complete and accurate information and failure to monitor.

On June 11, 2008, Wachovia Corporation was sued for ERISA violations in its handling of Wachovia Savings Plan investments. The complaint alleged that Wachovia violated its fiduciary duties to Plan participants by continuing to invest in and hold Wachovia stock despite knowing Wachovia was not reporting its financial condition accurately. Listed among the company's alleged failures was the fact that Wachovia issued mortgages to borrowers without considering their credit score or verifying their assets or employment.

As this article's long list of defendants demonstrates, every participant along the subprime mortgage chain is subject to litigation over who bears responsibility for the subprime mortgage meltdown. The federal government's unprecedented investment in the financial industry surely

## As The Pot Boils

**Subprime mortgage** refers to mortgages to subprime borrowers—borrowers with a high debt-to-credit ratio, poor credit history, and/or other factors that make them relatively more likely to default on their loans. To spread the risk of loss, these mortgages generally are consolidated and sold to investors as mortgage-backed securities (MBS). The subprime industry boomed throughout the 1990s. By 2005, 20 percent of mortgages were subprime. Nearly \$600 billion new subprime loans were made in 2006.

When lenders sell a pool of subprime mortgages, the pool comes with a limited guaranty, or a **repurchase agreement (repo)**, by which the lender agrees to buy back loans if the default rates exceed a specific threshold. Lenders are expected to set up reserves in case the agreements are enforced. When the economy is going well, and interest rates are low and housing values are high, the repurchase agreements are rarely executed. However, when interest rates rise and housing prices fall, defaults accelerate, and repurchase rights are often exercised.

**Collateralized debt obligations (CDOs)** are unregulated asset-backed securities. Although CDOs can be backed by a variety of assets, they often are backed by mortgage-backed securities and therefore are exposed to the mortgage meltdown. As CDOs declined in value, the value assessed to these CDOs became more difficult for financial institutions to determine which, in turn, impaired the ability of the institution to make new loans.

A **credit default swap** is an agreement between two parties, under which the seller agrees (for a payment), to provide the buyer with protection in the event of a default or other credit event involving an underlying instrument. The market for these swaps is significant—nearly \$45 trillion—according to a March 2008 Wall Street Journal article by Susan Pulliam, et al., *Swap Skirmish: Risks Hidden, Says Hedge Fund*, WSJ.COM, Mar. 4, 2008, <http://tinyurl.com/9wcxed>.



will have an effect on the level of litigation, but it is too early to predict what that effect will be. It is safe to say that many lawsuits will be filed no matter what the government does, however, and that the ultimate allocation of liability and blame will take many years to sort out. ■

*Jean Bertrand can be reached at 415.901.8753 or [jbertrand@schiffhardin.com](mailto:jbertrand@schiffhardin.com); Nicole Magaline can be reached at 415.901.8621 or [nmagaline@schiffhardin.com](mailto:nmagaline@schiffhardin.com).*