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Subprime turmoil promises to generate a heap of litigation

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Subprime loans are not loans made at less than the current prime rate of interest. On the contrary, they are loans to subprime borrowers at rates well above prime rates with conditions attached that likely will increase the interest rate significantly -- thus increasing monthly payments.

Interest rates on a prime loan might be at 6 percent while the subprime loan may be at 12 percent or higher, coupled with enhanced costs, prepayment penalties, and an interest rate destined to increase in the near future.

Subprime lending is a relatively new and, until very recently, rapidly growing segment of the mortgage market. Borrowers typically who might be denied credit are targets for aggressive mortgage brokers who encourage these expensive loans. These borrowers may be "house rich" but "cash poor," with equity in their homes but with few other assets. Some are first-time home buyers with no down payment but want to participate in the American dream of home ownership.

Both types of borrowers are persuaded that they can meet the monthly payments touted to them with no explanation that, while their incomes may not rise, their mortgage payments will rise. Some brokers and lenders peddled these predatory loans disguising them as great financial opportunities and claiming to help the borrower, when, in fact, the consequence was the loss of whatever equity the borrowers at one time had.

Lenders explain that the higher interest rates come as a consequence of increased risk associated with these loans. Together with the higher interest rates, however, come fees or closing costs that are higher than they should be in light of the borrower's circumstances.

Often the borrower is not sophisticated and can be persuaded by misleading sales schemes resulting in a large number of borrowers entering into agreements they would not have entered into if they understood the ultimate consequences of the loans.

The lenders, brokers, rating agencies and others who jumped on the subprime bandwagon relied on the assumption that there would continue to be record-level inflation of home prices into the foreseeable future.

Whatever the reasons and wherever the fault lies, most agree that we are in a financial crisis with the prospect of millions of families losing their homes and financial institutions writing off billions of dollars. The ultimate fallout, whether recession, depression, or bailout, is as yet unknown.

Some seek a bailout of the lending institutions or of those entities that purchased the loans, reasoning that anything less will result in economic consequences that are unacceptable. There is certainly precedent for government intervention when a financial crisis presents itself.

In 1971, an emergency loan guarantee act was passed by Congress to enable Lockheed to avert bankruptcy. Lockheed had poured about \$900 million into the development of a new passenger liner but ran into trouble when the proposed engine supplier, Rolls-Royce, failed.

In 1981, Chrysler received \$1.5 billion in loan guarantees to avoid bankruptcy.

In the 1980s and early 1990s, the government bailed out the savings and loan industry after a number of institutions failed after deregulation allowed them to enter into risky lending practices.

Today, there is considerable resistance to these types of bailouts. The argument is that subprime lenders knew, or should have known, the risks they were taking as did the hedge funds that bought these collateralized debt obligations based on subprime loans. Those opposed to a bailout argue that there is no good reason for the government to bail out businesses that made a bad bet.

Somewhat more likely is relief for the borrowers who were lured into the subprime loans. It is claimed that many of these borrowers often paid mortgage brokers' commissions much higher than those made on prime loans.

Congress is looking at a variety of fixes, including the imposition of future safeguards and voluntary adjustments by the lenders and encouragement to eliminate prepayment penalties or increased interest rates. Whether the industry can or will make such voluntary adjustments is open to question, but those who do may well avoid some of the litigation that has already commenced and is sure to heat up in the near future.

As always, when there is a financial crisis, the courthouse is a ready refuge. More than 50 lenders have filed for bankruptcy. Shareholders in bankrupt mortgage lending companies have filed lawsuits as have mortgage borrowers and investors in mortgage-backed securities. Warehouse lenders (which provide interim financing until a mortgage is sold) and investors in credit rating agencies have also filed lawsuits or made less formal claims.

Class actions have been filed in a number of jurisdictions. More can be anticipated. Targets of these class actions as well as individual lawsuits include lenders, mortgage brokers, rating agencies, lawyers, and accountants as aiders and abettors providing substantial assistance in claimed fraudulent practices.

Theories of recovery include violations of state or federal truth in lending acts, fraud, violations of federal and state securities laws, exploitation, misrepresentation, and numerous others. Whether courts will validate all or some of the theories for recovery is yet to be seen. While the United States Supreme Court has recently confirmed that liability cannot automatically be extended to include indirect participants in the subprime lending industry, several other federal and state courts have extended liability to those entities and individuals who have taken a more active role in misleading investors, industry participants, and home buyers.

This is a time for all those who may have claims or for those potentially at risk to prepare to pursue or defend such claims. The likely economic destruction caused by the lending practices of some will create a run on the courthouses around the nation, and it is crucial to be prepared

for the litigation, whichever side you happen to fall on.

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