

The Snowball Effect

A Brief Review of Subprime Securities Litigation

The International Monetary Fund estimates that the credit crisis will cost about \$945 billion dollars. No one knows the ultimate cost of the crisis, but it will certainly exceed the costs of the last major financial crisis of the savings and loans industry. The problem started in the subprime mortgage market and then quickly spilled over into other areas of the mortgage industry and corporate world, culminating in a liquidity and credit crisis that we are still in the process of sorting out. Unsurprisingly, litigation has quickly started to accumulate.

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This article briefly examines the subprime securities litigation to assess the trends, major players and issues. Some allegations are familiar from other types of disputes, yet others are somewhat novel. This is not meant to be a comprehensive account of all the cases and we do not report on commercial disputes or borrowers' predatory lending suits. We report the types of allegations brought by and against the various market players. We searched for suits alleging wrongdoings associated with subprime assets – mortgages, mortgage-backed securities, collateralized debt obligations (CDOs), etc. We compiled the data from various news sources including *Bloomberg*, *Factiva*, *Business Week*, *The Wall Street Journal*, and others from January 2007 to April 2008.

Exhibit 1

Subprime home equity ABS deals from the second half of 2006 (January 19, 2007 to May 8, 2008)



Just like the credit crisis, the lawsuits initially started in the mortgage industry. Subprime borrowers – those with poor credit history – were at the forefront of the meltdown as several economic factors, including the decline in national housing prices, caused the credit boom to stop and a reversal to begin. Lawsuits began against mortgage lenders, then moved to issuers and underwriters of securities backed by subprime mortgage payments, and then to investors who either purchased these securities or packaged them into other securities. As the liquidity crisis intensified, sectors not directly related to subprime started to suffer losses, including commercial paper, leveraged buyouts and auction-rate securities. Lawsuits followed shortly thereafter.

The 2007 fourth-quarter delinquency rate for subprime loans is 17.31%, the highest in the last eight years, and prime loans and credit cards have also started experiencing delinquencies. Not surprisingly, the value of asset-backed securities (ABS) backed by subprime products has fallen as the performance of the subprime loans has continued to worsen. Exhibit 1 shows the value of two indices tracking BBB rated and BBB(-) rated subprime home equity deals based on loans from the last six months of 2006. An initial investment of \$100 (on January 19, 2007) in the BBB index would have been worth only \$5.46 by May 8, 2008; both indices show a decline of almost 95% as of May 8, 2008.

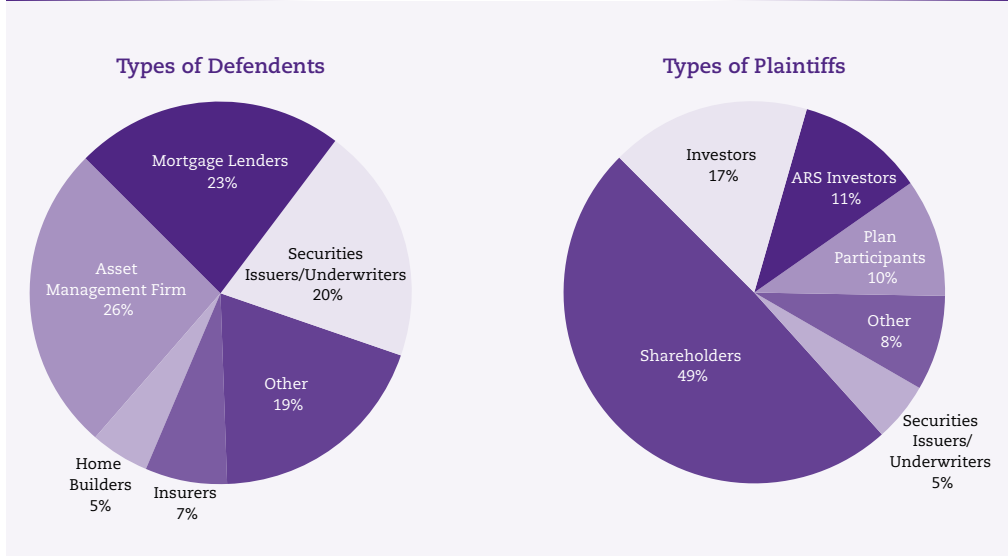
Securities subprime lawsuits

Almost every market participant in the securitization process – the process of turning illiquid financial assets such as mortgages, auto loans and student loans into securities – has been named a defendant. The list of defendants includes lenders, issuers, underwriters, rating agencies, accounting firms, bond insurers, hedge funds, collateralized debt obligation trusts and many more.

As of April 2008, there have been more than 132 securities lawsuits related to subprime and credit issues, of which 56 lawsuits were filed since January 2008. New York has the most filings – 48% – while California follows with 14% and Florida wraps up the top three with 7%. Filings in other states range between 1% and 5%. This is consistent with recent trends in shareholder class actions.

The majority of the early lawsuits have been against mortgage lenders. As various participants revealed the extent of their exposure and losses, securities defendants began to include others. The plaintiffs include

Exhibit 2 The Players: Plaintiffs and Defendants (through April 21, 2008)



shareholders, investors, issuers and underwriters of securities, plan participants and others. See the breakdown in exhibit 2.

Law suits against lenders

Subprime mortgage lenders face securities lawsuits from shareholders, borrowers, and issuers/underwriters. What complicates matters is that many of the lenders have filed for bankruptcy or have closed down. The allegations are mostly similar to suits filed in previous crises.

One of the earliest subprime shareholder class action cases was filed in February 2007 against New Century Financial and alleged a failure to disclose and properly account for the surge in forced repurchases of subprime loans. Other cases allege that the lenders concealed the size of, and failed to adequately reserve for, their subprime risk

exposure. Shareholder class actions comprise almost half of the lawsuits thus far and the allegations are all very similar.

Various mortgage lenders, such as Countrywide and Fremont Mortgage Corp., also face Employee Retirement Income Security Act (“ERISA”) lawsuits where plaintiffs allege that management’s fraudulent actions caused the company’s stock to collapse and thereby negatively affected employee contribution plans. There are also ERISA/401(k) lawsuits pending against asset management firms, home builders, and securities issuers.

In addition, lenders are facing lawsuits from issuers for failure to buyback loans. The plaintiffs allege negligence as well as lack of due diligence on, and misrepresentations about, the quality of the underlying mortgages.

Lawsuits against issuers

Securities issuers have also begun receiving an increasing number of securities lawsuits filed by lenders, shareholders, mortgage-backed securities investors, and their own employees. The list of issuers who are named defendants include Credit Suisse, HSBC, Lehman Brothers, Merrill Lynch, Citigroup, Washington Mutual, Bear Stearns, UBS, Morgan Stanley, Bank of America, and others.

In suits by lenders against issuers and underwriters, allegations include “exploiting an aberrational market as a pretext to unreasonably mark down the purported value of the bonds.”

Shareholder lawsuits again comprise the majority of cases against issuers. Cases such as the suit against Citigroup focus on charges of misrepresentation of exposure to the

subprime sector and allegations of failure to write down impaired securities backed by subprime loans. As companies disclose their losses, derivative products such as CDOs have become the centerpiece in many cases. CDOs highlight the pending suit against Merrill Lynch, as well.

Along with shareholders, investors have pursued litigation against issuers, as well. Banker's Life Insurance Company filed suit in April 2007 regarding asset-backed securities purchased from Credit Suisse. It alleges that Credit Suisse misrepresented the true value of some of its investment products and the underlying collateral, the majority of which were allegedly "shoddy, inferior mortgage loans."

Lawsuits against ratings agencies

Ratings agencies are being accused of assigning excessively high ratings to bonds backed by risky subprime mortgages. Both Moody's and Standard & Poor's (McGraw-Hill is the parent company) face lawsuits alleging that despite worsening conditions, the ratings agencies maintained the high ratings on subprime-backed instruments and failed to disclose key information regarding the market conditions and their effects on company profitability.



Lawsuits against bond insurers

Charges of failure to disclose subprime exposure are not limited to lenders and issuers. Separate class action suits were brought against bond insurers MBIA and Ambac in January 2008. The allegations include misrepresentation of purported risk exposure and inadequate internal underwriting and ratings systems for products such as CDOs.

Lawsuits against asset management companies

With complex derivatives securities like CDOs in the midst of the crisis, several asset management companies are now facing lawsuits after experiencing losses in subprime-related securities. One example is the suit by the German state-owned HSH Nordbank, which is suing UBS over its investment in a UBS-managed CDO. HSH Nordbank alleges that UBS misrepresented the credit quality of the investment and its underlying pool, causing a loss in excess of \$275 million on its investment.

Other lawsuits are calling upon the courts to determine the respective interests of the defendants and other related parties in the distribution of interest and principal proceeds of a CDO.

In an ERISA lawsuit, State Street faces allegations that it violated its fiduciary duties and “abandoned [its bond] funds’ conservative investment profile to speculate in high-risk mortgage backed investments,” including subprime-backed CDOs.

As the losses mount and markets for products such as CDOs continue to unravel, some expect more suits involving these complex securities.

Beyond subprime: The credit crunch

So far, the lawsuits described above focus on market participants who are somewhat related to the subprime mortgage industry. Events started to happen fast as investors fled to quality and write-downs spiked.



July 2007 started with an increase in spreads on the iTraxx Crossover index, which measures the cost of credit derivatives and is often regarded as a “barometer of investor appetite for corporate credit crisis.” The index crossed 3%; in mid-June, it was below 2%. Signs of concern over credit quality became apparent as buyout firm KKR’s banks failed to find investors for \$10 billion worth of loans and banks for the Chrysler Group decided to delay the sale of \$12 billion in debt due to the strained markets.



Various hedge funds began reporting losses due to the subprime meltdown and the ensuing turmoil in the credit markets. In August 2007, Sowood Capital Management announced that it was facing heavy losses of about 50% of its value and would shut down.

The crunch was not just a U.S. phenomenon. In the first week of August, Australia’s Macquarie Bank announced that two of its funds may lose as much as 25% of their value due to subprime loans. In Germany, banks banded together to provide €3.5 billion to cover potential subprime-related losses for German lender IKB. News also broke of the collapse of two Bear Stearns hedge funds. In the days following, alarm over BNP Paribas halting withdrawals from three investment funds, and a disclosure from Countrywide regarding short-term liquidity concerns due to “unprecedented” conditions in the credit markets, culminated in a 3% drop in the U.S. markets on August 9.

The market for commercial paper and commercial paper backed by securities seized up in that same week. Investors became increasingly nervous about the financial viability of their counterparties and lending almost came to a halt. By August 10, the Federal Reserve had announced that it was “providing liquidity to facilitate the orderly

functioning of financial markets.” In the two-day period of August 9 and 10, the Federal Reserve and other central banks injected \$290 billion into the financial markets as a stabilizing measure. The subprime issue had evolved into a credit crunch affecting the larger, global economy. As deleveraging continued, other sectors began to experience losses and receive lawsuits.

Lawsuits related to asset-backed commercial papers

A Canadian unit of HSBC Holdings is facing a lawsuit by Aastra Technologies in Ontario. Aastra is alleging that HSBC gave bad investment recommendations in suggesting asset-backed commercial paper investments that were frozen soon after. HSBC is the first financial adviser to face a lawsuit over investments in asset-backed commercial paper.

Lawsuits related to failed deals

As investors’ aversion to risk continued, the cost of borrowing increased and several merger deals fell through due to lack of funding. For example, in New York, Bain Capital and Thomas Lee Partners sued a group of banks including Citigroup, Morgan Stanley and Credit Suisse that were to finance the plaintiffs’ buyout of Clear Channel. The plaintiffs allege that the banks “balked” at their obligations due to the worsening credit conditions in mid-2007 even though the commitment was not subject to market conditions.



Lawsuits related to corporate debt losses

Various investors have even experienced losses on corporate debt and were sued. For example, iStar Financial is being sued for allegedly failing to recognize more than \$200 million in losses on its corporate loan and debt

portfolio in its registration statement for its secondary offering. The complaint alleges that the company's continuing operations were negatively impacted by the adverse conditions in the credit markets at the time of the secondary offering.

Lawsuits related to auction-rate securities

Auction-rate securities (ARS) – long-term variable-rate instruments (usually municipal or corporate bonds) whose interest rates are reset through auctions – were also affected. ARS are generally a main source of funding for municipalities. As a result of the credit crisis, many auctions have begun to fail. These failures are causing serious repercussions for municipalities like Jefferson County, Alabama, which is now facing rising interest rates on its bonds and demands for penalty payments as it struggles to avoid what would be the largest-ever bankruptcy of a U.S. county.



The ARS market problems have led to various lawsuits against broker-dealers such as Wachovia, Goldman Sachs, Wells Fargo, UBS, JP Morgan, Merrill Lynch, Morgan Stanley, TD Ameritrade and others. They all face allegations that they misrepresented the risk-level and liquidity of ARS they sold. In addition, plaintiffs claim that defendants “failed to disclose that auction-rate securities were only liquid at the time of sale because the auction market was artificially supported and manipulated by various broker-dealers to maintain the appearance of liquidity and stability.”

There are now up to 15 lawsuits related to auction-rate securities filed mostly in March and April 2008.

Too early to tell

Most of the lawsuits are still in the first stages and it is too early to tell the outcomes. The first class-action subprime-related lawsuit against New Century Financial Corporation was dismissed in January 2008 without prejudice. Earlier in November 2007, IndyMac Bank's motion for dismissal, from the second amended complaint, was granted but with leave to amend after the judge ruled against a "strong inference" of scienter. Given the continuing turmoil in the financial markets, the mounting losses, and the growing list of lawsuits, this story is far from over.

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