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Sub-Prime Litigation Update

Emerging Originator Liability Issues

James L. Thompson
Megan B. Poetzel
Jenner & Block LLP

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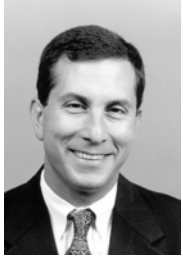
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Speaker Biographies



James L. Thompson is a partner in Jenner & Block's Chicago office, where he is a member of the firm's Sub-Prime Litigation Task Force, as well a member of the firm's Business Litigation, Securities Litigation, and Class Action practice groups. Jim's diverse practice focuses on complex business litigation, with emphasis on litigation under the federal securities laws (including the 1933 Act, the 1934 Act, and the Investment Company Act of 1940). He also has substantial experience representing banks and finance companies facing class actions based on their secured and unsecured lending practices, account handling, and/or collection practices. Mr. Thompson has experience with state consumer protection laws, predatory lending statutes, credit counseling or debt consolidation laws, and with the federal statutes relevant to consumer credit transactions.



Megan B. Poetzel is a partner in Jenner & Block's Chicago office. She is a member of the Firm's Litigation Department and Business Litigation, Securities Litigation, and Reinsurance Practices. Megan focuses her practice in the commercial litigation area, representing clients in a wide range of matters before federal and state courts, and has been involved in a number of insurance and reinsurance disputes. Ms. Poetzel also has worked on cases involving securities and consumer class actions, as well as patent infringement, breach of contract and fraud claims.

Since the onset of litigation arising out of the sub-prime mortgage crisis, Mr. Thompson and Ms. Poetzel have been actively involved in representing and counseling clients threatened with liability related to their involvement in the sub-prime mortgage industry.



Sub-Prime Mortgage Basics

Definition: Generally, subprime mortgages are for borrowers with credit scores under 620. Credit scores range from about 300 to about 900, with most consumers landing in the 600's and 700's. Bankrate.com

Common Features:

- High LTV ratio
- Adjustable interest rates – ARM's and Option ARM's
- Alternative income/asset verification and documentation programs
- No escrow for insurance or taxes
- Pre-payment penalties are common



Scope of the Problem

Large volume:

- sub-prime loans make up 20% of originations in 05-06 (Alt-A another 13%)
- 26% of '06 sub-primes were interest only or Option ARMs

Delinquencies:

- 13% of sub-prime mortgages seriously delinquent as of October 2007
- 16-19% of adjustable rate sub-prime loans

ARM's Resetting:

- 374,000 loans, with value of \$170 billion, scheduled to re-set in each quarter of 08
- \$229 billion in Option ARMs re-set in 09-11



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Sub-Prime Market Participants – Path of a Loan

Borrower

Mortgage Broker: 60% of originations; 50,000 brokerage companies

Settlement Service Providers: Appraiser; Closing Agent; Title Insurer

Loan Originator: Lending arms of national banks; large lenders geared towards sub-prime market in particular; smaller, independent mortgage companies

Issuer: National/international financial services companies who purchase bundles of sub-prime mortgages from Originators

Trust

Servicer

Purchasers of mortgage-backed securities

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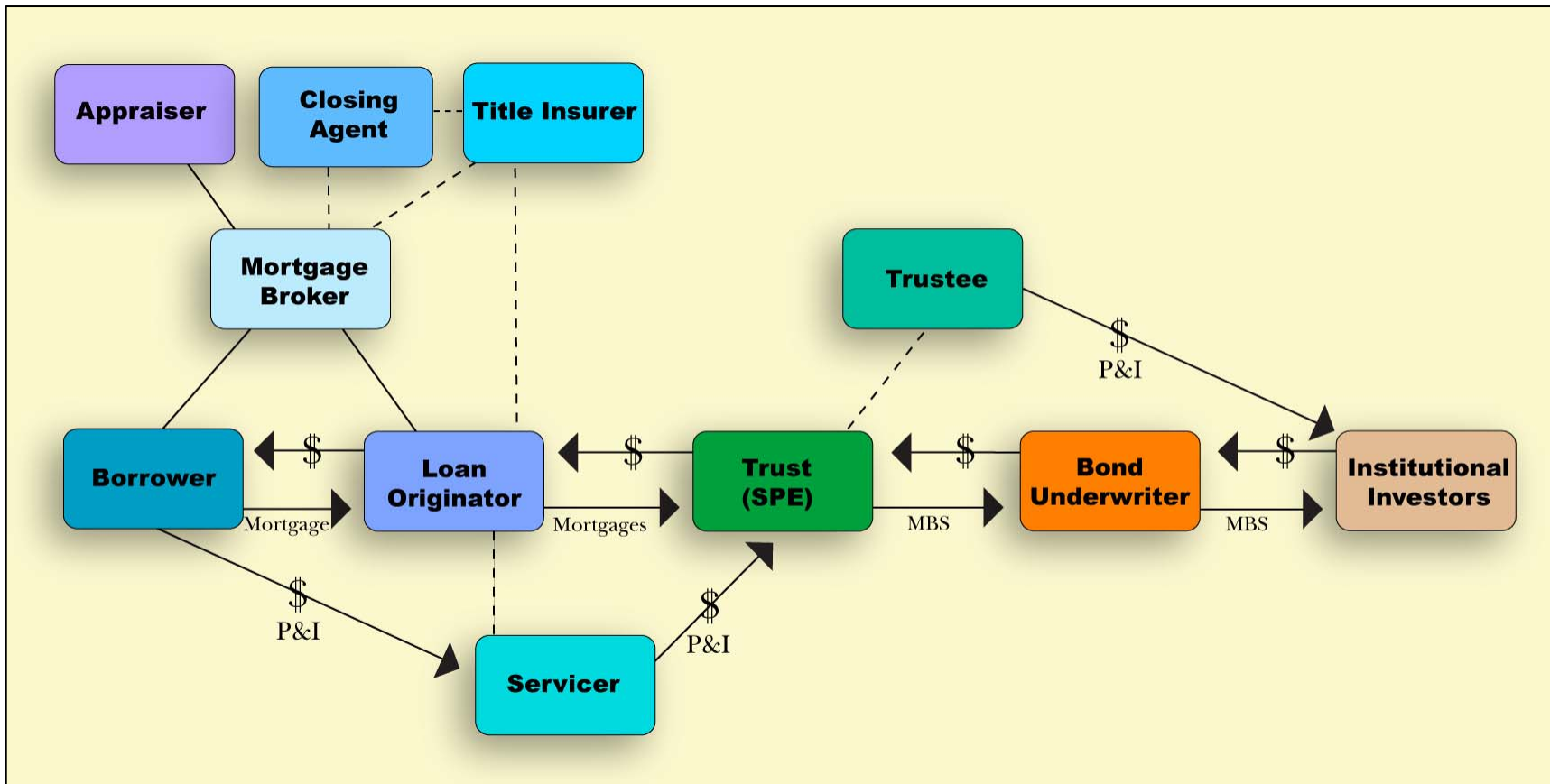
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Sub-Prime: Market Mechanics and Participants





Course of Sub-Prime Litigation

- First wave of suits against Originators – borrowers and shareholders
- Suits against Issuers – shareholders, Issuer 401(k) plans
- Claims against firms investing in mortgage-backed obligations – investment professionals, funds
- Suits against other participants – ratings agencies; bond insurers; home builders
- Governmental investigations – across the market, by DOJ, state AGs, and federal agencies



Suits Against Originators – Wave Two

Suits by Issuers/Servicers/Trustees:

Contract Theories

- Based on mortgage purchase agreements
- Individual, loan-by-loan repurchase requests
 - First payment/early payment defaults
 - Breach of Originator representations and warranties
 - No inaccuracies or misrepresentations in loan origination
 - Typical allegations – misstatements as to income, employment and/or occupancy; inflated appraisal
 - Actions may relate to a single loan or multiple loans that can be shown to suffer from the same defect(s).



Suits Against Originators – Wave Two

Investigations/Actions by state AGs

- Conspiracy – NY AG against WaMu, First American
- Other ongoing investigations

Actions by local municipalities

- Recent actions by Baltimore, Cleveland

Potential actions by other market participants

- Private mortgage insurers
- Bond insurers
- Investors in mortgage-backed obligations
- Such claims attenuated, remote from origination



Originator Efforts to Transfer Liability

Most Common Theory – Breach of Contract:

Against Mortgage Brokers – based on broker agreements

- No untrue statements – typically objective
- All mortgage loans are “acceptable investments”
- No reason to believe loan would become delinquent – subjective
- Indemnification provisions – access to attorney fees

Against Title Insurers – based on ICPLs issued by insurers

Against Closing Agents – based on lender’s closing instructions

Against Appraisers – based on appraiser contract with broker

Tort Theories Being Advanced:

- Fraud, negligent misrepresentation, conspiracy, breach of fiduciary duty are most common



Originator Efforts to Transfer Liability

Typical Defenses Asserted Against Originators

General Defenses

- Equitable defenses – unclean hands, equitable estoppel; contributory negligence; assumption of the risk.
- Others responsible – intervening cause, failure to add necessary party.
- Miscellaneous – failure to mitigate, statutes of limitation.

Contract Defenses

- Originator breached – failure of due diligence, underwriting.
- Lack of privity

Tort Defenses

- Lack of duty owing to Originator
- Economic loss doctrine (gist of the action doctrine)



Originator Efforts to Transfer Liability

Other practical limitations impacting originator efforts to transfer liability:

- Concern that claims will delay or complicate action -- suits commenced originally against Originators
- Identification and viability of defendants
 - Multiple brokers often used – 50,000 brokerages in market
 - Brokers insolvent or dissolved or in jail
 - Possibility of insurance
 - Closing agents
- Fraud starts with borrowers



Conclusion

- After initial focus on Originators, attention shifted to Issuers
- As pressure on Issuers mounts, and possible exposure grows, expect renewed focus on role of loan origination
- For Originators (and their creditors and investors) key issue will be whether lenders can push liability back down the transactional trail



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Contact Information

James L. Thompson

Tel: 312 923-2944

E-Mail: jthompson@jenner.com

Megan B. Poetzel

Tel: 312 923-2823

E-Mail: mpoetzel@jenner.com

Jenner & Block
330 N. Wabash
Chicago, IL 60611

www.jenner.com

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