

# A Note on the Subprime Litigation

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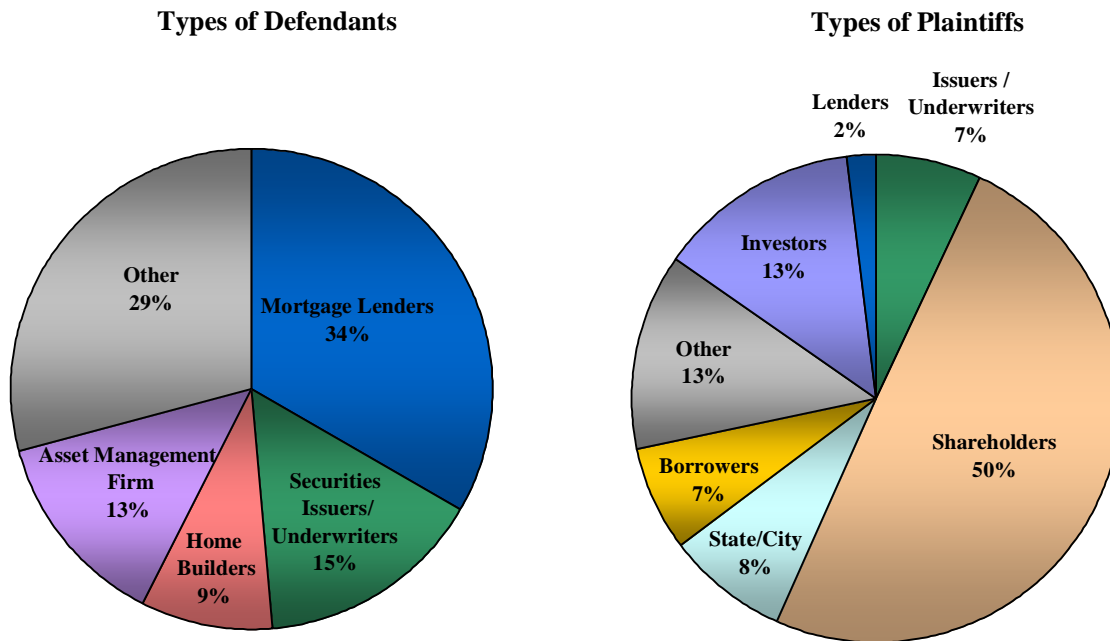
The subprime mortgage market—loans made to borrowers with poor credit records—has expanded rapidly in the last decade. However, several economic factors have caused the credit boom to stop and a reversal to begin. The problem appeared contained in the subprime market but quickly turned into a credit crisis. Unsurprisingly, lawsuits have started to accumulate.

This article briefly examines the emerging subprime 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 a comprehensive count of all the cases.

A study of about 100 subprime-related lawsuits from December 2006 to February 2008 shows a significant surge in filings in the second half of 2007.

New York has the most filings—39 percent—while California follows with 13 percent, and Florida wraps up the top three with 8 percent. Filings in other states range between 1 and 5 percent. This is consistent with recent trends in shareholder class actions, where the circuit courts encompassing New York (Second Circuit), California (Ninth Circuit), and Florida (Eleventh Circuit) have seen the most activity in recent years.

The majority of the early lawsuits have been against mortgage lenders. As various participants revealed the extent of their losses over time, defendants began to include issuers, underwriters, accounting firms, appraisers, rating agencies, insurance companies, investors, home builders, and others. See the breakdown in Figure 1.



**Notes & Sources:**

NERA collected lawsuits from various sources, including Factiva, Bloomberg, AP News, Securities Law360, Wall Street Journal, BusinessWeek, and others.

**Figure 1. The Players: Plaintiffs and Defendants (through February 7, 2008).**

### The Categories of Lawsuits

**Lawsuits against lenders.** Subprime mortgage lenders have faced lawsuits by shareholders, borrowers, and issuers/underwriters. What complicates matters is that many of them have filed for bankruptcy or gone out of business. Many of the allegations are similar to suits filed in prior crises.

One of the earlier subprime shareholder class action cases was filed in February 2007 against New Century Financial alleging failure to disclose and properly account for the surge in forced repurchases of subprime loans. Other cases such as *Robert Casey v. National City Corp.*, No. 08CV00209 (N.D. Ohio filed Jan. 24, 2008), 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.

Several cases have already been filed against mortgage lenders alleging predatory lending practices. The July 2007 case of *NAACP v. Ameriquest Mortgage Co.*, No. 8:2007CV00794-AG-AN (C.D. Cal. filed July 11, 2007), alleges that certain racial groups were offered a

disproportionate share of subprime loans (i.e., higher interest loans). Other cases, such as the suit pending against One Source Mortgage, allege misrepresentation of the nature of mortgage loans sold to consumers, the use of high-pressure sales tactics, and overstatement of homeowners' incomes to make them eligible for larger loans.

Various mortgage lenders, such as Countrywide and Freemont Mortgage Corp., are facing 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. These ERISA/401(k) lawsuits are also pending against some asset management firms, home builders, and securities issuers.

Netbank and New Century Mortgage Corporation, like other mortgage lenders, are facing suits with allegations of failure to repurchase underperforming loans.

**Lawsuits against issuers.** Securities issuers have also begun receiving an increasing number of lawsuits filed by lenders, shareholders, mortgage-backed securities investors, and even local governments.

In suits against issuers/underwriters, the allegations include "exploiting an aberrational market as a pretext to unreasonably mark down the purported value of the bonds." Complaint for Plaintiff at 7, *Luminent Mortgage Capital, Inc. v. HSBC Sec. (USA) Inc.*, No. 1:2007cv09340 (S.D.N.Y. filed Oct. 18, 2007).

Shareholder lawsuits again comprise the majority of cases against issuers. Cases such as those against Citigroup and Merrill Lynch 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 the extent of their subprime losses, derivative products such as collateralized debt obligations (CDOs) have become the centerpiece in many of these cases.

Along with shareholders, investors have pursued litigation as well. Banker's Life Insurance Company filed suit in April 2007 regarding asset-backed securities purchased from Credit Suisse. They allege 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." Complaint for Plaintiff at 12, *Bankers Life Ins. Co v. Credit Suisse First Boston Corp.*, No. 8:07-cv-00690-EAK-MSS (M.D. Fla. filed Apr. 20, 2007).

In one of the more novel lawsuits, the city of Cleveland is suing 21 investment banks under a “public nuisance” charge. The city claims that the banks are “liable to the City of Cleveland for public nuisance for their respective roles in proliferating toxic sub-prime mortgages within its border, under circumstances that made the resulting spike in foreclosures a foreseeable and inevitable result.” Complaint for Plaintiff at 26, *City of Cleveland v. Deutsche Bank Trust Co*, No. 1:08CV00139-DCN (N.D. Ohio filed Jan. 16, 2008).

**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 face lawsuits alleging that despite worsening conditions, the ratings agencies maintained the high ratings on subprime-backed instruments.

**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. Other lawsuits such as *Deutsche Bank Trust Co. Americas v. Lacrosse Fin. Prods, LLC.*, No. 1:08CV00955-LAK (S.D.N.Y. filed on Jan. 29, 2008), 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. As the losses mount and markets for products such as CDOs continue to unravel, some expect more suits involving complex securities products.

### **Recent Developments**

The first class action subprime-related lawsuit against New Century Financial Corporation was dismissed in January 2008 without prejudice. Earlier in November 2007, IndyMac was dismissed from the second amended complaint by the plaintiffs 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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