



LITIGATION:

Safeguards, and Strategies

MORTGAGE BANKERS
COMMERCIAL BANKS
SAVINGS INSTITUTIONS
SECURITY BROKERS

agreements and credit default swaps, or allegations of firms taking advantage of the credit crunch and allegedly extorting value from counterparties facing severe liquidity pressures. Employment class actions comprise 9 percent of total cases with bankruptcy-related and other making up the remaining 4 percent. Approximately 90 percent of the 278 cases filed during 2007 remained active at year's end.

Who's Bringing the Lawsuits?

Seventy-three percent of the 251 lawsuits still active at the end of 2007 are class actions brought by borrowers, investors, or employees. Of the commercial entity plaintiffs, the single largest category by SIC code is "Mortgage Bankers & Loan Correspondents," which accounts for 28 percent of the commercial plaintiffs. This is explained, at least in part, by the large number of mortgage repurchase litigation cases described above. Notably, California and New York courts combine to account for approximately 50 percent of all cases filed.

Increases in the rates to be paid on ARMs will be shielded by the government or industry from foreclosure, the extent to which the bond insurers and other counterparties will make good on the credit insurance they sold, and additional revelations of subprime exposure/write-downs by financial institutions and other entities. In addition, actions (or inactions) by central banks and macroeconomic indicators generally, including consumer sentiment, will play a critical role in determining the extent of the market upheaval and related litigation. In any event, the explosion of litigation activity in 2007 is likely only the tip of the iceberg.

Safeguards and Strategies

As shown above, the subprime litigation ripple is spreading and there is no sure escape. We do believe, however, that certain steps to identify potential vulnerabilities, update practices, and prepare for litigation can significantly diminish both the likelihood of becoming a target of subprime litigation and the extent of the related exposure.

Assessing Risk

The first step in litigation preparedness is an accurate assessment of the financial institution's exposure to subprime litigation. Direct exposure analysis is rather evident and requires, at a minimum, examination of mortgage origination practices and loan underwriting policies and procedures, including quality control programs and active monitoring of default and foreclosure trends. The assessment should include a review of underwriting files for the following, among other things: (i) compliant documentation standards, including, when applicable, evidence of reliable third-party verifications of income and employment; (ii) determination whether ARM loans were underwritten to fully indexed rates; (iii) determination whether loans were underwritten to properly account for escrow for taxes and insurance; and (iv) evaluation of whether the underwriting criteria applied in assessing borrowers' repayment ability were realistic (and continue to be realistic in the current financial climate). Introspective assessments of compliance with fair lending requirements are likewise essential given the increased prominence of borrower class actions alleging discriminatory lending practices. Enlisting the assistance of qualified, independent experts to perform such audits can solve resource issues and, much more importantly, enhance credibility with regulators and other third parties. In the current climate, the decision to commission an independent compliance audit permits a full and candid assessment of exposure and also sends a clear signal that existing issues, if any, will be addressed proactively. In all cases, the financial institution should have counsel involved with self-critical evaluations—both to advise as to current legal issues and to preserve any applicable privileges that could apply to such evaluations.

The first step in litigation preparedness is an accurate assessment of the financial institution's exposure to subprime litigation.

Who's Being Sued?

Virtually no industry participants have been spared from the lawsuits. Defendants include mortgage brokers, lenders, appraisers, title companies, homebuilders, servicers, issuers, underwriting firms, bond insurers, money managers, public accounting firms, and company directors and officers. The group most commonly targeted (identified by SIC code) is "Mortgage Bankers & Loan Correspondents" at 32 percent. "National Commercial Banks" are second at 10 percent, with "Savings Institution, Federally Chartered," and "Security Brokers, Dealers & Flotation Companies" at 9 and 7 percent, respectively.

Fortune 1000 companies or their subsidiaries have been named in 56 percent of the 251 active cases at the end of 2007. *Fortune* 500, 100, and 50 companies have been named in 50, 32, and 22 percent of the lawsuits, respectively. When focusing on financial services-related companies comprising the *Fortune* 1000, just under 50 percent of these companies have been named as defendants in at least one case.

Looking Ahead

The ultimate volume of litigation activity during 2008 and beyond will be influenced by a variety of factors including, but not limited to, the course of regulatory investigations, the direction and velocity of changes in U.S. residential property values, the extent to which borrowers facing in-

Like a stone landing in the center of a still pond, the impact of subprime lending litigation on financial institutions has first reached those who originated subprime loans, and the ripples from the initial impact are expanding to reach numerous other financial institutions. Other forms of exposure analysis should include (i) review of whole loans purchased from other institutions; (ii) review of mortgages serviced but not originated by the institution with an emphasis on compliant documentation standards and anti-fraud protections, among other areas; (iii) examination of securities portfolios for bank-held mortgage-backed or collateralized debt obligations or other similar derivative investments linked to these assets; (iv) an assessment of counterparty risk, including that from arising from hedging activities using credit derivatives; and (v) off-balance-sheet-exposures.

Perhaps the most significant indirect or ripple effect from the subprime loan crisis is the general credibility decline that will be experienced by all financial institutions

Perhaps the most significant indirect or ripple effect from the subprime loan crisis is the general credibility decline that will be experienced by all financial institutions for an undetermined time.

for an undetermined time. Uncomfortable parallels are becoming apparent between the current credit crunch and the savings and loan crisis of the early 1990s. Total bank nonperforming asset-to-loan ratios have spiked dramatically over the last 12 months and are predicted to exceed the 4 to 6 percent ranges seen in 1990 to 1992. There is reason to believe that juror and public opinion studies documenting a significant decline from 1990 to 1993 in the public's perception of financial institutions are a reasonable barometer for forecasting the significant difficulties banks are likely to experience over the next several years in gaining the confidence of judges, juries, and regulators who are called upon to assess the appropriateness of bank activities. Prudent bankers will recognize this spillover phenomenon and adjust litigation success forecasts accordingly, evaluate ongoing litigation strategies to account for the perceived "credibility gap," and affirmatively address areas likely to be targeted in litigation (e.g., apply increased scrutiny in reviewing promotional materials and sales practices to curb what could be considered aggressive tactics).

Industry Strategies

What can the industry and its members do to mitigate the impact of the subprime lending litigation crisis? The

confluence of economic conditions that fueled the rapid appreciation in home prices and the loosening of credit standards, followed by the ensuing sharp declines in residential real estate values, likely will ultimately be resolved by the often-painful economic corrections that are playing out. Nonetheless, there are a number of business strategies that can and should be pursued to effectively steer through the current difficult conditions.

First, the industry and its members must clearly differentiate subprime lending from predatory lending. Subprime lending has met and can continue to meet an important need for households with problem credit. In contrast, predatory lending is an abusive practice that specifically targets lower income, minority, and elderly homeowners. Subprime lending generally is characterized by interest and fee charges that bear some rational relationship to the increased risk of the specific credit. Predatory lending, on the other hand, is designed to result in exorbitant interest and fees (in many cases at or even above the maximum allowed by the governing law) not justified by the risk presented. Subprime loan generation has generally been characterized by aggressive but legitimate tactics. Predatory loan generation often is the result of deceptive or even illegal tactics such as loan flipping, steering, and forged or fraudulent credit documentation. By properly distinguishing subprime lending from predatory lending, the industry can segregate practices that must be stopped from those that may continue subject to appropriate regulation.

Second, holders, investors, and servicers of subprime portfolios should be proactively anticipating and responding to the extreme difficulties faced by borrowers with ARMs resetting at rates that are significantly in excess of the initial "teaser" rate. As recommended by the Federal Reserve Board in its September 2007 *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*, servicers should be prepared to be more flexible in considering loan modifications such as payment deferrals, loan maturity extensions, or conversion of ARMs to fixed-rate loans, to name a few. In this difficult market, enhanced communication with borrowers is critical. Servicers should correspond with borrowers well in advance of scheduled ARM rate sets, communicate available alternative financing mechanisms, and document borrower responses to mitigation efforts. Servicers and mortgage holders must reevaluate their traditional foreclosure matrices and institute litigation only as a last resort.

Financial Institution Strategies

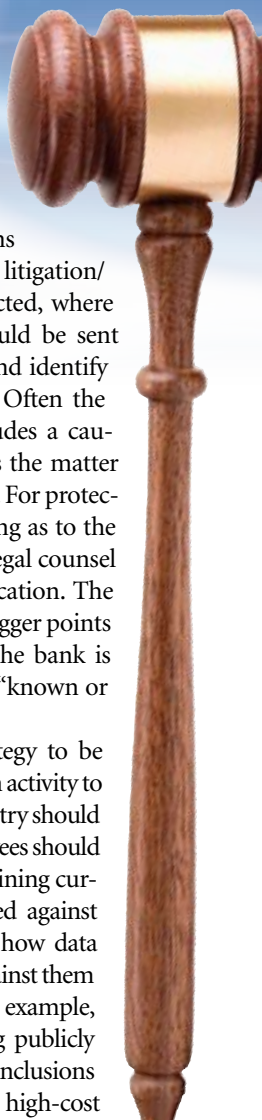
Successfully operating in an environment that is experiencing substantially increased regulatory and litigation risk requires that financial institutions be prepared to produce full documentation of their activities. As the business of banking has been revolutionized by the exponential growth in computing power, regulators and plaintiffs' lawyers have developed increasingly sophisticated means to understand,

collect, and efficiently review mind-boggling amounts of data stored in the systems that facilitate bank operations. Failure to maintain and produce critical data can be just as devastating in regulatory and civil actions as actually producing unfavorable data. All financial institutions should have document retention policies and methods to ensure compliance with them. These policies must take into account current and evolving electronic data formats and mapped data sources. The December 2006 amendments to Federal Rule of Civil Procedure 26 place the maintenance, collection, and sharing of electronic data maintained by litigants at issue in virtually every federal litigation now faced by financial institutions. Consequently, litigation counsel (in-house or outside counsel) are essential players in the creation and review of document retention policies.

Effective litigation preparedness programs necessarily include established evidence collection methodologies. Financial institutions should consider establishing a litigation discovery committee, staffed with representation from IT,

litigation hold communication (usually in memo format) should state in simple terms the nature of the issues involved in the litigation/inquiry, what should be saved and protected, where responsive electronic and hard data should be sent for protection, who should collect data, and identify a point person to respond to questions. Often the litigation hold communication also includes a caution to involved employees not to discuss the matter in controversy with coworkers or outsiders. For protection of privileges and to add understanding as to the legal ramifications of the litigation hold, legal counsel always should initiate the hold communication. The responsible counsel must determine the trigger points for the legal standards governing when the bank is “in anticipation of litigation” and what is “known or reasonably should be known.”

Finally, if there is one overriding strategy to be gleaned from the subprime lending litigation activity to date, it is that members of the financial industry should prepare to be informed litigants. Key employees should be charged with the responsibility for remaining current on the evolving legal theories asserted against banks. Banks should be acutely aware of how data that they produce can be used offensively against them (or defensively for them) in litigation. For example, plaintiffs’ lawyers in recent cases are using publicly available HMDA data to draw liability conclusions regarding alleged steering practices, alleged high-cost loan targeting, and alleged “reverse redlining” strategies. Banks should consider having established litigation response teams (including legal, compliance, IT, and records management personnel) designated to respond to specific subprime litigation theories.

The financial services industry must recognize the increased scrutiny that is a direct result of unfavorable public perceptions arising from the subprime lending crisis. The ripple effect of the subprime crisis has caused and will continue to result in negative press, pressure for new legislative initiatives, increased regulatory scrutiny, and a substantial increase in the number of lawsuits filed against all financial institutions. To prepare to meet this scrutiny banks should consider (i) revisiting existing compliance programs and identifying and redressing potential gaps, (ii) increasing the frequency of both internal and external compliance audits and fully documenting results, (iii) carefully screening external communications (e.g., marketing materials, public relations releases), (iv) monitoring and enforcing records retention policies, and (v) reviewing and strengthening policies for protecting self-critical or litigation-related communications. Said differently, for the foreseeable future, all financial institutions should anticipate increased regulatory and litigation activity, and prudent institutions will prepare accordingly. 

The ripple effect of the subprime crisis has caused and will continue to result in negative press, pressure for new legislative initiatives, increased regulatory scrutiny, and a substantial increase in the number of lawsuits filed against all financial institutions.

records management, compliance and legal, to periodically review document retention policies and to establish a collection methodology for responding to regulatory or litigation-driven inquiries. Banks should determine in advance what information can and should be collected and preserved quickly and what information is not reasonably accessible due to undue burden or cost. Collection methodologies should have safeguards built in to minimize the potential inadvertent production of privileged documents or information. When facing a particular regulatory or litigation request, the collection methodology must involve and be fully understood by outside counsel. Rapidly accumulating empirical evidence proving that established collection methodologies save litigants significant time and money because methodologies that are in place before the particular dispute du jour have more credibility.

The best retention and collection procedures quickly fail if the financial institution does not have an effective litigation hold procedure. Every bank must be able to communicate quickly and directly to key custodians, data stewards, and involved employees to hold important information and documents pending the outcome of the inquiry at issue. The

ABOUT THE AUTHORS

William J. Holley II, a partner in the Atlanta office of Parker Hudson, Rainer & Dobbs LLP, acts as regular litigation counsel for major national banking associations, regional banks, and community banks, in defense of class, mass, and individual actions alleging fraud, RICO, TILA, RESPA, FDCPA, FCRA, HOEPA, ERISA, and securities violations, state law violations, and numerous common law violations. In his 22 years of practice, he has tried more than fifty jury trials in various jurisdictions throughout the United States and practiced before the United States Supreme Court and numerous federal circuit courts, federal district courts, state appellate courts, and state trial courts. Mr. Holley has been recognized as a leading business litigator by Chambers USA, as a Georgia Super Lawyer by Law & Politics magazine and as one of Georgia's "legal elite" by Georgia Trend magazine. Mr. Holley received his A.B. degree, magna cum laude, from Duke University and his J.D. degree from Vanderbilt University where he served as editor-in-chief of the Vanderbilt Law Review. Reach him by telephone at (404) 420-5544 or via e-mail at wholley@phrd.com.

Jeff Nielsen is a managing director in the Washington, D.C., office of Navigant Consulting, Inc., and leads the firm's Financial Services Disputes & Investigations service line. For more than 15 years, Mr. Nielsen has advised clients on the financial, economic, accounting, and data management aspects of commercial disputes and regulatory investigations, specifically matters involving the financial services industry and real estate. He has been retained on more than 50 banking matters and has extensive knowledge of mortgage markets and products, including residential and commercial loans, as well as mortgage banking, securitizations, and servicing operations. Mr. Nielsen is currently leading a number of the firm's major subprime-related engagements. Mr. Nielsen is a frequent speaker on mortgage-related issues and has been quoted, or has had his work cited to, in publications such as American Banker, National Mortgage News, The Wall Street Journal, and National Law Journal. Reach him by telephone at (202) 973-4506 or via e-mail at jenielsen@navigantconsulting.com.

Endnotes

¹Nielsen, Jeff, with Scott Paczosa and Bill Schoeffler, "Subprime Mortgage and Related Litigation: 2007—Looking Back at What's Ahead," Navigant Consulting (February 2008). The subprime litigation figures presented in this article are based largely on the results of this study.