

Seeking Subprime Solutions

Fed action, legislation and litigation address the subprime mess

By Vincent R. Cappucci and Michael H. Rosner

WITH SUBPRIME LOSSES and foreclosures mounting and credit and financial markets remaining under considerable stress, policy makers and regulators are searching

for ways to limit the damage and contain serious risks to the economy. Though fundamental solutions appear far off, the most concrete measures to date have come from the Federal Reserve. Meanwhile, a growing wave of litigation related to the subprime crisis continues to accelerate, as market participants battle over who should bear the massive losses

Purchasers of collateralized debt obligations (CDOs) and mortgage-backed securities (MBS) with subprime exposure are pursuing claims against the investment banks that marketed, sold and managed these instruments. And holders of junior/mezzanine tranches of troubled CDOs and other securitizations are seeking ways to limit their losses, such as by arguing that the terms of the indenture agreement entitle them to a portion of the CDO proceeds.

Class actions on behalf of investors, including widely followed cases concerning the implosions of Countrywide Financial Corporation and Bear Stearns, also are progressing. Countrywide, one of the nation's largest mortgage banking conglomerates, is accused of (among other things) deceiving the marketplace as to the quality of its lending and underwriting practices in connection with aggressively marketed mortgage loans that were then passed on as premier credit in secondary market securitizations.

Federal Reserve

Notably, new rules proposed by the Federal Reserve would prohibit certain of the allegedly undisclosed lending practices that contributed to Countrywide's downfall. The new rules would substantially amend Regulation Z (under the Truth in Lending Act and the Home Ownership and Equity Protection Act) so as to bar, among other things, the practice of extending credit without regard to borrowers' ability to repay and would require creditors to verify the borrower's income and assets in making mortgage loans.

Industry groups have expressed qualified support for most of the new rules (subject to certain revisions), commenting that they "generally represent a workable regulatory regime for subprime mortgage lending." The groups are urging the Fed to adopt Regulation Z as a nationwide standard by revising it to preempt more stringent state requirements.

The Fed also has been at the forefront of recent regulatory efforts to restore liquidity to U.S. credit markets. In March, the Fed used its 'lender of last resort' powers under Section 13(3) of the Federal Reserve Act for the first time since the Great Depression to make an emergency \$30 billion loan to facilitate JP Morgan's takeover of a Bear Stearns on the brink of collapse. Given the array of lawsuits against Bear and its substantial holdings of subprime paper, JP Morgan has set aside \$6 billion largely to cover litigation costs and the de-leveraging of Bear's balance sheet.

The Fed's extraordinary involvement in the Bear acquisition was followed by its unprecedented decision to allow large investment banks to borrow from the Fed at the discount rate through the creation of the Primary Dealer Credit Facility. Until now, only depository institutions had access to Fed cash at wholesale rates.

Significantly, both the Bear loan and credit extended under the Fed's new lending facility may be secured by a broad range of collateral – including otherwise illiquid mortgage-backed assets.

Expect to see an increasingly active and muscular Fed, especially so long as primary dealers continue to have access to the Fed's liquidity facilities (and thus are subject to its supervision). It remains to be seen whether the Fed will have the sophistication and wherewithal to reign in the excesses of a 'shadow' banking industry created by Wall Street securitizations that has been, heretofore, largely unregulated and which dwarfs in size and exposure the traditional commercial banking markets.

Legislation

Congress is actively considering numerous proposals seeking to stem rising foreclosures and restore liquidity to the mortgage markets. Among the leading bills is H.R. 5830, the FHA Housing Stabilization and Homeowner Retention Act of 2008, which provides for up to \$300 billion in new guarantees by the Federal Housing Administration to help refinance at-risk borrowers into viable mortgages.

Generating perhaps the most opposition from market participants is H.R. 5679, The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008. The bill would establish a new federal duty for servicers and mortgagees to, upon a default, "engage in reasonable loss mitigation activities that provide for (1) the long-term affordability of the loan and (2) maximum retention of home equity." Foreclosure would be prohibited if required loss mitigation steps were not taken.

Industry groups are concerned that H.R. 5679 would fundamentally alter existing contractual standards by requiring servicers to be

the agent of the borrower rather than MBS institutional investors, as is the case now.

Credit Rating Agencies

Credit rating agencies are finding themselves under particular scrutiny for their role in the credit market turmoil, especially their granting of triple-A ratings to tranches of CDOs backed by mortgage loans that have since proved toxic. Many question the extent to which ratings were influenced by conflicts of interest and why the agencies waited until July 2007 – more than a year after the agencies themselves were warning of deterioration in the subprime market – before finally starting to downgrade troubled exposures en masse.

The SEC currently is completing examinations of the agencies, focused on whether they diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings and whether they followed their stated procedures for managing conflicts of interest.

By late June, the SEC expects to issue new rule proposals designed to make rating agencies more accountable and to increase transparency and competition. Enhanced disclosures about ratings performance and methodology are likely to be included. Disclosure of the role of third-party due diligence in assigning ratings also may be required, as well as the information used to rate structured finance products. It remains to be seen whether conflicts of interest will meaningfully be addressed.

Damaged investors are not waiting. Lawsuits against rating agencies, as well as monoline bond insurers, have been filed and many more are expected. The credit enhancements provided by these insurers were heavily relied upon by the rating agencies to justify triple-A ratings of CDOs with subprime

exposure, notwithstanding the enormous size of the obligations underwritten by these insurers.

Some market participants are concerned that major monoline insurers are undercapitalized and that the ‘protection’ they sold against default on risk-intensive MBS and CDOs is serving to mask the true extent of losses in these securities.

For more information, we invite you to contact us.

About the Authors:

Vincent R. Cappucci is a founding partner and head of the Securities Litigation Department at Entwistle & Cappucci. Throughout the years, he has served as lead counsel in many high-profile securities class action and derivative litigations, as well as individual actions representing some of the nation's largest public pension systems, financial institutions, money managers and wealthy individuals.

Michael H. Rosner is a senior litigation associate at Entwistle & Cappucci. His practice focuses on complex securities litigation, representing private and public institutions in direct, derivative and class actions.

About the Firm:

Entwistle & Cappucci LLP is a full-service law firm that represents the largest U.S. public pension funds and private institutional investors in significant securities litigation, including direct, class and derivative actions as well as actions alleging breach of fiduciary duty, corporate waste, appraisal proceedings and actions challenging corporate transactions on fairness and other grounds. In addition to securities litigation, the firm has an active practice in the areas of complex business and commercial litigation, business transactions, employment and bankruptcy litigation, among other areas. For more information, please visit www.entwistle-law.com.

ENTWISTLE & CAPPUCCI LLP

Counselors at Law

SECURITIES LITIGATION AND CORPORATE GOVERNANCE • COMPLEX BUSINESS AND COMMERCIAL LITIGATION
 BUSINESS TRANSACTIONS • EMPLOYMENT AND LABOR • EXECUTIVE COMPENSATION
 GOVERNMENT AFFAIRS AND ADMINISTRATIVE LAW • INSURANCE AND REINSURANCE
 INTELLECTUAL PROPERTY AND CYBERLAW • TRUST AND ESTATE LITIGATION, PLANNING AND ADMINISTRATION
 ALTERNATE DISPUTE RESOLUTION • WORKOUTS, REORGANIZATIONS AND BANKRUPTCY LITIGATION

Please direct all inquiries to:

Vincent R. Cappucci, Esq.
Senior Partner
 280 Park Avenue, 26th Floor West
 New York, New York 10017
 (212) 894-7200
vcappucci@entwistle-law.com
www.entwistle-law.com

ARMONK • AUSTIN • CHICAGO • FLORHAM PARK, NJ • NEW YORK • TALLAHASSEE • WASHINGTON, DC