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The Subprime Mortgage Market: Its Broad Impact and the Initial Hurdle for Securities Class Actions

In the past year, we have watched the scope of the subprime lending crisis grow practically every week. Home foreclosures have spiked to historic levels. Fortune 500 companies have announced write-downs or losses. Consumer confidence has plunged. Investors have suffered losses in the stock market. Plaintiffs in class action suits, as expected, have begun lining up to pursue securities fraud class actions against a broad variety of corporations and individuals connected to the decline in the subprime mortgage market. Despite the nonstop news coverage and the filing of lawsuits, important questions remain unanswered: How does the decline of the subprime mortgage market have such a broad impact? And how will practitioners deal with the recent U.S. Supreme Court decision regarding what plaintiffs are required to plead and prove in securities fraud cases?

Reasons for the Wide-Ranging Impact of the Subprime Mortgage Market

Little doubt exists that the decline of the subprime mortgage market has had an enormous impact on the economy. To many, the breadth of the impact is surprisingly expansive and the decline in the subprime market arrived abruptly. Certainly, subprime lending cannot account for a significant portion of outstanding loans, right? Well, it turns out that subprime loans do. Before the current crisis, the subprime market grew at a prodigious clip for more than a decade. For example, although subprime loans accounted for only 5 percent of loans granted in the late 1990s, by the end of 2005 subprime loans had jumped to 20 percent of all loans.

Similarly, the value of subprime loans also grew at an astonishing rate over the last decade. One recent estimate put the value of outstanding subprime loans at $1.3 trillion. The rapid decline of any large segment of the financial world would obviously have a serious impact on other sectors of the economy. And there is no exception here. But the subprime market also has unique features that help explain why this particular crisis has broader and more far-reaching consequences for many individuals and major corporations.

Expectations About the Rise in Housing Prices

In large part, the growth of subprime lending can be attributed to the unprecedented and prolonged increase in home prices across the country for much of the last decade. During that period, it became conventional wisdom that home prices could only go up. As long as home prices rose, borrowers with little or no equity could easily pay off their mortgage by selling their homes at a price exceeding the amount of their mortgage. For purchasers in that climate, borrowing more money to purchase a bigger and more expensive home was an easy and seemingly safe decision. Similarly, given the unprecedented rise in the price of homes, lenders became increasingly willing to lend more money to subprime borrowers—that is, individuals who had lower credit scores and were subject to a lower level of income verification.

At the same time, exotic lending vehicles proliferated. Lenders began offering adjustable rate mortgages with hybrid features, negatively amortizing loans, and making interest-only loans to many subprime borrowers. For subprime borrowers, the more exotic lending vehicles were attractive because of the low initial interest rate. Over time, lenders' underwriting standards became more relaxed, and it has been reported that many lenders began to obscure the weaknesses of their underwriting standards through the use of loans that required little or no documentation.

When home prices leveled off, interest rates rose, and the nationwide housing market cooled; however, many subprime borrowers lost the ability to sell their homes at a price that exceeded their mortgages. In addition, because many of those subprime borrowers had received more exotic loans, the amount of their monthly payments began to rise with the expiration of the period during which the initial interest rate was in effect. This combination of factors helped fuel the collapse of the subprime market. Of course, the breadth of the subprime crisis cannot be attributed solely to this unexpected downturn in the housing market.[1]

Increased Securitization

The securitization of subprime loans—the process by which banks and lenders pool mortgages with similar characteristics together, package the loans into bonds, and ultimately sell them to investors as securities—also helps to explain why this crisis has such a far-reaching impact. Mortgages were traditionally a simple relationship between a bank and a borrower. The bank held the mortgage, received principal and interest, and could foreclose if the borrower did not pay. As a result, in the good old days, a major decline in the housing market would have a much more limited impact on the overall economy. The traditional model does not reflect modern-day mortgage lending, however.

In addition, during the period in which home prices could only go up, securitization of subprime loans became standard practice. The increase in securitization of subprime loans made the expansion of subprime lending possible throughout the past decade.

The securitization process is complex. Moreover, even though the general structure of the securitization of mortgages generally follows a common pattern, the precise details of the securitization of any individual mortgage-backed security will vary. The following general structure was commonly used in many securitizations in the past decade:

1. After making a loan to a borrower, it became common for banks and lenders to pool mortgages and transfer them to a trust entity or to a special-purpose vehicle. It bears mentioning, however, that banks and lenders did not necessarily transfer and securitize all mortgages or otherwise eliminate their own liability for bad loans. Many of the largest lenders kept a substantial portion of such loans on their books. In addition, most transfers of subprime mortgage pools included "repurchase agreements," according to which the lender agreed to repurchase loans if default rates reached a certain threshold. To account for this possibility, lenders were expected to set up repurchase reserves.
2. Within the pool of loans for the mortgage-backed security, it became common for loans to be grouped into senior and subordinate tranches. The most senior tranches were made up of less risky loans, they were intended to receive a slightly lower return, and their investors were to be paid first. The most subordinate tranches were made up of more risky loans, they were intended to receive a higher return, and their investors were to be paid only to the extent that repayment was possible. Many times there were multiple levels of tranches.
3. Before the securitized mortgages were sold to investors, rating agencies would typically rate these investments in the double-A or triple-A range. By using the tranche system, the mortgage-backed securities obtained higher credit ratings before they were sold to investors.
4. The mortgage-backed securities were sold to investors, some of the largest of which were mutual funds, hedge funds, and insurance companies. Indeed, while housing prices were rising, mortgage-backed securities were regarded as fairly attractive investments. Many investors in mortgage-backed securities were large corporations that had nothing to do with the subprime mortgage market itself.[2]

When the housing decline began, many subprime borrowers lost the ability to sell their homes and pay off their debt. This inability, in turn, caused a substantial drop in the value of mortgage-backed securities and triggered repurchase obligations for lenders. The decline in the subprime mortgage market obviously had a major impact on investors in the banks and the lenders who actively participated in the subprime mortgage market. However, because of the ubiquitous nature of the mortgage-backed securities and the nature of the investors in mortgage-backed securities, the impact of the subprime decline is not limited to borrowers and banks. In fact, virtually any entity invested mortgage-backed securities will be affected by the current crisis and is likely to play some role in the subsequent subprime litigation.

The Onset of the "Wave" of Litigation

Even at this relatively early stage, it is clear that the subprime lending market will be a major source of litigation for years to come. Just between January 2007 and March 2008, for example, 448 cases arising out of the subprime market were filed, and the pace appears to be increasing. During the first quarter of 2008, approximately 170 subprime cases were filed—an increase of more than 85 percent over the number filed in the fourth quarter of 2007—and the pace has not slowed in the second quarter of 2008. A significant portion of these subprime-related filings—approximately 22 percent at one point—are securities class actions.[3]

Subprime Securities Class Actions

The securities class actions arising out of the subprime lending market generally allege that the risks of the mortgage-backed securities (or a company's investment in the mortgage business) were not properly disclosed to stockholders. In short, these cases allege that there were misrepresentations or misstatements regarding the risks of the mortgage-backed securities and that material information was not properly and timely disclosed to the investing public. The subprime securities class actions also generally allege internal controls regarding underwriting or other corporate policies were lacking, accounting by lenders were improper, and therefore false or misleading representations in public filings were made. Some subprime securities class actions also allege that individual officers or directors failed to oversee the quality of the origination programs properly, to oversee the company's investment in subprime loans properly, and to react to the effects of the housing market decline effectively. As one would expect, the actual claims asserted in subprime securities class actions include virtually every type of claim available under the Securities Act of 1933 and the Securities Exchange Act of 1934. A recent U.S. Supreme Court decision in the securities arena will help district courts separate the meritorious actions from those that are not meritorious.[4]

Scienter: One Initial Hurdle for Subprime Securities Class Actions

Heightened pleading requirements apply in all pri-

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vate claims of federal securities fraud. Obviously, these requirements will also apply to subprime securities class actions. In addition to the particularity requirement for fraud claims under Rule 9 of the Federal Rules of Civil Procedure, a plaintiff in a securities fraud suit must satisfy the requirements of the Private Securities Litigation Reform Act (PSLRA). Congress enacted the PSLRA in 1995 in an effort to reduce baseless securities fraud strike actions. A number of procedural and substantive limitations under the PSLRA apply when a plaintiff seeks to bring securities fraud actions. Among other requirements of the act, a plaintiff in a securities fraud case alleging material misstatements or omissions must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[5] In other words, securities fraud plaintiffs must allege facts that give rise to a "strong inference" of scienter. Congress, however, did not define what qualified as a "strong inference" and in subsequent years it became a hotly contested issue. Over time, a clear split among the circuit courts of appeals developed regarding what plaintiffs needed to plead and prove to satisfy the PSLRA standard. Ultimately, in 2007, the U.S. Supreme Court clarified what constitutes a strong inference of scienter in *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007).

In *Tellabs*, the U.S. Supreme Court made it clear that plaintiffs must "plead facts rendering an inference of scienter at least as likely as any plausible opposing inference." Following the *Tellabs* ruling, district courts are now required to conduct a comparative inquiry regarding whether the plaintiff has sufficiently alleged scienter. Courts must review the plaintiffs' factual allegations and weigh them against plausible innocent explanations for the defendant's conduct. According to the Supreme Court, a complaint will survive "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[6]

Given this recent pronouncement, what will plaintiffs set forth to show that the allegation meets the requirement of a strong inference of scienter in subprime securities class actions, and will this be enough? To attempt to meet the strong inference standard, plaintiffs are likely to offer factual allegations based on (1) statements from confidential witnesses, (2) the defendant's awareness of the deterioration of origination standards in subprime lending, (3) corporate executives' stock transactions, (4) the fact that a corporation was heavily invested in mortgage-backed securities, (5) a lack of sufficient loan-loss reserves, (6) improper accounting regarding subprime losses, and (7) purposeful delays in disclosing the drop in portfolio values. Plaintiffs are likely to point to a combination of these and other factual allegations in their attempts to plead a strong inference of scienter. Defendants, on the other hand, are likely to dispute outright some of the factual allegations and argue that a variety of plausible innocent explanations for the alleged conduct exists. In particular, in the subprime context, defendants are likely to argue that the market collapse was unforeseeable and that their conduct was consistent with business standards.

It remains to be seen what type of allegations will be sufficient for subprime securities class actions that arise from the subprime mortgage meltdown. Many subprime securities class action complaints are voluminous. But one thing is already clear: length is no guarantee that a court will be persuaded that plaintiffs' inference of scienter is at least as compelling as any opposing inference is. One court has already remarked that "one might be tempted to think that a complaint spanning more than 100 pages and consisting of more than 200 paragraphs could not fail to be specific. The temptation is dangerous and must be resisted."[7] After making that assessment, the court reviewed the plaintiffs' allegations, considered the requirements of the PSLRA and the *Tellabs* decision, and dismissed the case with prejudice.

Notwithstanding the U.S. Supreme Court's decision in *Tellabs*, one must wonder whether the crisis atmosphere surrounding the subprime lending market may result in district courts' attempts to loosen the pleading requirements as a way to ensure that subprime plaintiffs have an opportunity to seek redress. It seems much more likely that subprime securities class actions will be resolved on the very specific factual allegations asserted by plaintiffs, the innocent explanations proffered by defendants, and the comparative strength of each of those positions. Over the coming years, the impact of the collapse in the subprime mortgage market will undoubtedly continue to generate significant levels of litigation and is likely to result in further elaboration by the courts about what parties must plead in order to allege securities fraud sufficiently. **TFL**

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Endnotes

[1]*See*, generally, Dr. Faten Sabry and Dr. Thomas Schopflocher, *The Subprime Meltdown: A Primer,* NERA Economic Consulting, June 21, 2007.

[2]*Id.*

[3]*See*, generally, Jeff Nielsen, *Subprime Mortgage and Related Litigation: First Quarter 2008 Update*, Navigant Consulting, April 2008.

[4]*Id.*

[5]15 U.S.C. § 78u-4(b)(2).

[6]*Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499, 2506–2513 (2007).

[7]*In re 2007 Novastar Financial Inc., Securities Litig.*, 2008 WL 2354367, *2 (W.D. Mo. June 4, 2008).