DIRECTORS' AND OFFICERS' LIABILITY

SUBPRIME MORTGAGE REFORM LEGISLATION TAKES AN IMPORTANT STEP FORWARD

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The subprime mortgage crisis has escalated into a widespread and fast-evolving litigation and regulatory exposure for a host of participants in global financial markets. The scope and variety of the litigation initiated reflects the scale of the economic spillover from the problems of the $650 billion dollar subprime mortgage industry – approximately 25 percent of the national mortgage market. The magnitude of the problem has occasioned a startlingly swift legislative proposal that would significantly affect the origination and securitization of residential mortgage loans. By veto-proof vote of 291-127, the U.S. House of Representatives last month approved H.R. 3915 - the Mortgage Reform and Anti-Predatory Lending Act of 2007. The bill's stated objective is "to reform consumer mortgage practices and provide accountability for such practices, to establish licensing and registration requirements for residential mortgage originators, to provide certain minimum standards for consumer mortgage loans, and for other purposes." It is the "other purposes," which create exposure based on financial relationships created after the origination of the consumer loan, that warrant immediate understanding of the bill's provisions by directors and officers of any institution involved in the mortgage lending process or mortgage-backed securitizations. The bill overcame the opposition of numerous banking and lending groups and the Bush administration, and has a long way to go through the Senate. But its quick passage by the House with a decisive majority suggests that some form of federal mortgage reform legislation ultimately will be enacted, and it seems likely that many of the House bill's features will be part of any such legislation.

Anatomy of the Subprime Freefall

A mortgage is generally categorized as "subprime" on the basis of the borrower's financial circumstances, rather than any particular feature of the loan itself. Subprime borrowers generally lack solid credit histories or documented income, and may have records of late payments, delinquencies, bankruptcies and the like. Consequently, these consumers are

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unable to qualify for traditional loans, and may therefore be unable to purchase a home absent relaxed qualification requirements. Subprime loans typically offer a low introductory interest rate during the initial years on the note (usually two), which may dramatically increase when the rate resets thereafter, creating increased risk of default.

The ready availability of capital to fund these new mortgages is largely a function of innovations in the capital markets. In order to obtain funds to make loans to underlying consumers, subprime mortgage originators generally depend on revolving credit facilities from multiple warehouse lenders, secured by the mortgages. Most subprime lenders also sell the loans they originate to third party institutional investors, such as commercial and investment banks, which then package mortgage loans together in a special purpose entity, usually a trust, which issues and sells interests to hedge funds, pension funds and other investors as mortgaged-backed securities -- securities backed by specific mortgage loans, the payments under which are derived from cash flows produced by the underlying mortgage loans. The proceeds from the sale of the securities pay for the assets in the trust. Securitization is simply a type of funding in which illiquid balance sheet assets, such as mortgages, are converted into freely tradable securities.

But simple pass-through mortgage-backed securities are only part of the story. Banks, insurance companies and money managers also regularly issued investment-grade collateralized debt obligations, a fixed-income security backed by a portfolio of diverse fixed income assets, including subprime mortgages. The special purpose entity holding the CDO assets issues multiple classes of securities in “tranches” or groupings of mortgages with similar risk profiles. The tranches usually are classified as senior (least risky), mezzanine, or junior (riskiest), based on their priority in receiving interest payments from the underlying pool of assets. The senior tranche has the highest credit rating, often AAA, and receives a lower interest rate than riskier tranches. Losses are suffered from the bottom up, with the junior tranches, known as “equity,” taking all losses before the higher tranches suffer any loss.

The heterogeneous nature of the income-generating assets makes valuation of a CDO asset pool on the basis of historical default information challenging. In recent months, the level of subprime defaults swept away the computer models (based on historical rates of subprime loan delinquencies and foreclosures) relied on by the banks that package and market the tranches -- and the rating agencies that assigned rating to the securities. The resulting downgrades sparked an investor rush away from mortgage-backed securities, which quickly spilled into every corner of the securitized financial system. It is the steep decline in the values of CDO securities backed by subprime mortgage bonds that underlie the massive losses recently disclosed by many of the world's largest financial institutions.

The current credit crisis arose when the housing market cooled concurrently with increases in interest rates. Subprime borrowers who anticipated that housing prices would increase indefinitely and that low interest rates would be available to refinance or sell their home before their ARMs reset, were suddenly confronted with mortgage payments resetting to substantially higher amounts. So when a wave of adjustable rate subprime mortgages reset in

an environment of declining home values, the stage was set for widespread defaults by borrowers, which quickly rippled into the mortgage-backed securities tied to such mortgages.

The banks that securitize the loans usually contract for the right to require the subprime lender to repurchase any loans in which the borrower defaults within a prescribed time period. Because subprime originators depend on credit facilities and loan sales to make loans that are subsequently securitized for sale in the secondary market, termination of those credit facilities and a run of loan repurchase obligations virtually guarantees insolvency of the originators. New Century, for example, declared bankruptcy shortly after Morgan Stanley, Goldman Sachs and CSFB declared the company in violation of its lending agreements and cut off all financing.

On December 6, 2007, the Bush administration announced an important agreement with major loan servicers and investors that purchased subprime loans and mortgage-backed securities, which may help slow the rising number of foreclosures. The plan would facilitate a five-year freeze on the "starter" interest rate for certain loans originated between 2005, and July 31, 2007, and that reset between 2008 and July 31, 2010, and assist certain other borrowers in obtaining refinancing. It bears emphasis that the plan would only partially mitigate the flood of defaults; financial industry negotiators of the plan estimate that it would provide relief to no more than 20% of the 1.8 million borrowers whose loans will reset in the next 18 months.

The initial public and regulatory focus on the subprime lending crisis centered on the companies that originate mortgage loans. New Century Financial, for example, was pilloried as "a poster child for the lenders that rode [the subprime] boom to the top and are now in free fall" when its $8 billion portfolio of home loans lost hundreds of millions of dollars of value in a matter of days.[1] The initial wave of borrower and shareholder litigation against mortgage companies and loan originators has expanded to against suits against securities firms, credit rating agencies and even fiduciaries of retirement Plans who, in purported breach of their fiduciary duties to the participants of the Plans, allegedly allowed the imprudent investment of the Plans' assets in company common stock despite purported improper business practices that resulted in serious subprime-related loss exposure.

Mortgage Lending Reform Bill

While most of the nearly 200-page legislation passed by the House of Representatives focuses on entities that originate mortgage loans, participants in the secondary market must understand the controversial provisions designed to motivate financial institutions to ensure responsible lending. In order to do that, you must first understand the new minimum standards the bill would establish for all residential mortgage loans. In summary, Title II of the bill fixes minimum standards for residential mortgage loans and requires creditors to make a reasonable and good faith determination based on documented information that, at the time the mortgage is consummated, the consumer has a "reasonable ability to repay the loan," based on consideration of the consumer's credit history, current income, current obligations, debt-to-

income ratio and employment status. For the refinancing of a residential mortgage loan, the creditor must make a reasonable and good faith determination that the refinanced loan will provide a net tangible benefit to the consumer. There would be no tangible net benefit if the costs of the loan, including points and fees, exceed the amount of newly advanced principal. The OCC, OTS, and FDIC, in consultation with FTC, will jointly prescribe regulations further defining the term "net tangible benefit." Creditors and assignees may presume that the minimum standards (reasonable ability to repay and net tangible benefit) are met for "qualified mortgages" and "qualified safe harbor mortgages." This presumption may be rebutted only against creditors and only if the loan is a qualified safe harbor mortgage, as described below.

The proponents of the Act recognized that the modern mortgage market depends on the ability to package mortgage debt, then slice it into various risk segments through complex financial instruments, and then sell those segments. The Act seeks to thrust assignees and securitizers into the position of having to review not only the loan documents in a particular mortgage transaction, but also to evaluate the wherewithal of consumers. In order to motivate Wall Street oversight of lending practices, section 204 of the Act proposes to create for borrowers an individual private right of action in federal court under the Truth in Lending Act ("TILA"), for rescission and the consumer's additional costs incurred as a result of the violation against "assignees" and "securitizers," even if they acted in good faith, of loans that violate the minimum standards for reasonable ability to repay and net tangible benefit as defined by regulation. Importantly, the bill expressly disallows class action relief against assignees and securitizers. A "securitizer" is defined as "the person that transfers, conveys, or assigns, or causes the transfer, conveyance, or assignment of, residential mortgage loans, including through a special purpose vehicle, to any securitization vehicle, excluding any trustee that holds such loans solely for the benefit of the securitization vehicle." The bill expressly excludes from the definitions of "assignee" and securitizer" any securitization vehicle (usually a trust holding pools of mortgage loans), *i.e.,* the actual pool of loans or any investors in the securitization vehicle or an instrument representing an investment interest in the pool. The inclusion within the definition of "securitizer" of "the person that . . . causes" the assignment will likely result in efforts by borrowers to name as defendants directors and officers of institutions involved in the securitization process.

The proposed legislation provides two safe harbors for firms that securitize mortgage loans for sale in the secondary market. First, an assignee or securitizer of a mortgage loan may avoid liability by curing, within 90 days of notice from the borrower, any violation by the maker of the mortgage loan of the Act's reasonable ability to repay or net tangible benefit for refinancing standards, through modification of the loan terms. Alternatively, an assignee or securitizer would avoid liability by meeting three conditions: (1) it has a policy to purchase only qualified mortgages or qualified safe harbor mortgages, (as defined below); (2) it exercises reasonable due diligence to adhere to the policy concerning mortgages it purchases "through adequate, thorough, and consistently applied sampling procedures" in accordance with regulation prescribed jointly by federal banking agencies and the SEC; and (3) it receives representations and warranties from the seller or assignor of the loans that the loans sold or

assigned are all qualified mortgages or qualified safe harbor mortgages.

For a first lien on the home, a "qualified mortgage" is one with an interest rate either not more than three percent higher than Treasury securities bearing comparable maturity period, or more than 175 basis points higher than a conventional mortgage rate to be established by banking regulation. A "qualified safe harbor mortgage" generally is one for which the financial resources of the borrower are documented, the loan underwriting process is based on the fully indexed rate and takes into account real estate taxes and insurance premiums and has a repayment schedule that never results in negative amortization (the addition to principal owed of amounts by which a mortgage payment is less than interest due). The fully indexed rate -- usually the best predictor of the rate at an ARM's first rate adjustment – is the current value of the rate index used by the ARM (such as the cost of funds index or LIBOR), plus a margin which varies among loan transactions, but remains the same through the life of the particular ARM. A qualified safe harbor mortgage also must meet one of the three criteria: (i) feature a fixed interest rate for at least five years; (ii) for an adjustable rate mortgage, have a margin less than three percent over the interest rate index; or (iii) the consumer's monthly debts, including the mortgage, do not exceed a percentage prescribed by regulation of his or her monthly gross income.

For adjustable rate mortgages, the bill would impose a statute of limitations on claims against assignees or securitizers of the earlier of (a) the end of the one-year period beginning on the date of rate adjustment or (b) six-years from the date of the loan. The bill would provide limited preemption of state law remedies, such as consumer protection statutes, as against assignees, securitizers and securitization vehicles (but not as against creditors) concerning loans that violate the bill's standards for determination of ability to repay or net tangible benefit requirement.

The bill's proposal to create a private right of action for borrowers against assignees and securitizers continues an erosion of the concept of "holder in due course" which began with the Home Ownership and Equity Protection Act of 1994 ("HOEPA"), a prior amendment to TILA. Under New York law, a party is entitled to holder-in-due-course status if it takes an instrument for value, in good faith, and "without notice that it is overdue or has been dishonored or of any defense against it or claim to it on the part of any person."[2] A holder in due course "takes the instrument free from (1) all claims to it on the part of any person; and (2) all defenses of any party to the instrument with whom the holder has not dealt...."[3] The law has long been that whether or not a holder of a commercial instrument is a holder in due course depends on whether the holder has actual, subjective knowledge of a claim to or defense against payment of the instrument.

Since 1994, TILA has featured an exception to this principle, imposing two different standards of care for assignees. Pursuant to 15 U.S.C. § 1641(e), assignee liability regarding a non -"high cost" mortgage loan is limited to violations that are apparent on the face of the disclosure statement. That is, unless a loan qualifies as a "high cost" HOEPA loan, a holder-in-due-course is insulated from origination claims. HOEPA applies to any consumer

credit transaction that is secured by the consumer's principal dwelling, other than other than a transaction entered into to finance the original construction or acquisition of the dwelling, when either the annual percentage rate of the credit or the total points and fees charged exceed a "trigger" amount. In contrast to the "apparent on the face" standard, HOEPA introduced the notion of "assignee liability" for purchasers of these "high-cost" loans. Section 1641(d)(1) of HOEPA eliminates an assignee's holder in due course defense to all claims asserted by a consumer under TILA or other laws. An assignee of a HOEPA loan is subject to all claims and defenses, whether under TILA or other law, which could be raised against the original lender. Section 1641(d)(1) also makes clear that an assignee of a defective HOEPA loan has only one defense: that a reasonable person exercising ordinary due diligence could not determine at the time of assignment that the relevant loan was a HOEPA loan. The proposed 2007 Act, like HOEPA before it, sweeps aside the longstanding rule that a holder ordinarily has no duty to investigate the facts underlying an instrument it purchases "absent 'actual knowledge of some fact that would prevent a commercially honest individual from taking up the instrument."'[4] Unlike HOEPA, the proposed Act would apply to first-time residential mortgage transactions.

Other Provisions

In other noteworthy provisions, the Act would mandate the licensing and registration of all individual mortgage brokers and mortgage loan originators, including employees of state and federally-charted banks, the Act prohibits the receipt by mortgage originators (*i.e.*, brokers) of steering incentive compensation (including yield spread premiums) that is based on or varies with the terms of a mortgage loan. HOEPA currently applies only to closed end (or fixed amount) mortgage loans that meet one of two "high-cost" triggers -- one based on the annual percentage rate (APR) of the loan (the cost of credit expressed as a yearly percentage rate), and the other based on the total points and fees charged on the loan. Title Three of the Act expands the scope of HOEPA to encompass purchase money mortgage loans and open-end loans. It also would codify the existing Federal Reserve standard for HOEPA's APR trigger, which is set at 8% above comparable Treasury securities for first mortgages, and Treasuries plus 10% for subordinate mortgages, and lower the points and fee trigger from 8% to 5% for most loans. It also would establish a third APR trigger for loans with prepayment penalties that exceed 2% or 30 months duration. The definition of points and fees would be expanded to include all compensation paid directly or indirectly by a consumer or creditor to a mortgage broker from any source (including table-funded transactions), certain insurance premiums, prepayment penalty charges under the loan, and prepayment penalties actually charged in a refinance by the original lender or the original lender's affiliate.

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[1] Julie Creswell & Vikas Bajaj, *A Mortgage Crisis Begins to Spiral, and the Casualties Mount*, *N.Y. Times* (Mar. 5, 2007); *see* Gregory Zuckerman, *How Street Hit Lender*, WALL ST. JOURNAL (Mar. 29, 2007).

[2] N.Y. U.C.C. § 3-302(1).

[3] N.Y. U.C.C. § 3-305.

[4] *National Union Fire Ins. Co. v. Woodhead*, 917 F.2d 752, 756 (2d Cir. 1990).