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The Subprime Morass: Past, Present, and Future

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THE SUBPRIME MORASS: PAST, PRESENT, AND FUTURE

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I. INTRODUCTION

The subprime mortgage crisis is resulting in a sea of litigation presenting novel and significant legal problems. These issues will affect a universe of potential defendants including traditional lenders, investment banks, and investors. This article seeks to provide a practical understanding of how the subprime crisis occurred, and a synopsis of the legal ramifications and litigation trends associated with the fallout.

II. THE GENESIS OF THE QUAGMIRE

A. *The Development and Growth of Subprime Mortgage Loans*

The subprime mortgage is a relatively new product niche in the mortgage lending industry virtually unheard of prior to the mid-1990s.[1] A subprime mortgage loan is by definition a mortgage loan to a borrower with sub-standard credit.[2] In the decade since the subprime mortgage loan was first developed, it flourished as the vehicle by which lenders funded loans to borrowers who, for

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1. This article does not address issues presented by subprime lending in the auto finance or manufactured housing industries.

2. *See* Henry v. Lehman Commercial Paper, Inc., 471 F.3d 977, 984 (9th Cir. 2006); *see also* Chase Manhattan Mortgage Corp. v. Advanta Corp., No. Civ.A.01-507 KAJ, 2005 WL 2234608, at *1 (D. Del. Sept. 8, 2005).

various reasons ranging from poor credit histories to unstable income levels, would not generally qualify for traditional or prime rate loans.[3]

To compensate for the increased risk of making subprime loans, the upfront and continuing costs of a subprime loan are higher than that of a traditional loan.[4] For example, the average interest rate of a fixed-rate subprime loan at origination was over two percent higher than the rate of prime loans at origination, from 1995 to 2004.[5] However, as was all too often overlooked by the prospective subprime borrower, the majority of subprime loans tend to be adjustable-rate mortgages (ARMs).[6]

ARMs shift the risk of rate fluctuation from the lender to the borrower, which can present risks for consumer borrowers who may be forced to incur higher rates and greater payment obligations in the future.[7] Lenders generally charge lower initial interest rates for ARMs which result in less pressure on the borrower's pocketbook.[8] In some situations, such as when "discounted" or "teaser rates" are involved, the initial interest rate will be lower-than-market and will later adjust to a substantially higher prevailing market rate.[9] All types of ARMs present the risk that an increase in interest rates will lead to a significantly higher monthly payment.[10]

Many borrowers obtained ARMs under the impression that they would be able to refinance at favorable terms before rising interest rates triggered the ARMs to reset. In the subprime mortgage environment, ARMs could present significant and

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3. *See Henry*, 471 F.3d at 984.

4. *Id.*

5. Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK OF ST. LOUIS REV. 31, 34 (2006).

6. *See* FED. RES. BD., CONSUMER HANDBOOK ON ADJUSTABLE-RATE MORTGAGES (2007), http://www.federalreserve.gov/pubs/arms/arms_english.htm. ARMs are loans with interest rates that change. *Id.* The change is usually in relationship to an index. *Id.* The most common indexes are the rates on 1-year constant-maturity Treasury securities, the Cost of Funds Index, and the London Interbank Offered Rate (LIBOR). *Id.*

7. *See* GRANT NELSON & DALE A. WHITMAN, CASES AND MATERIALS ON REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT 935-38 (7th ed. 2006).

8. *See* FED. RES. BD., *supra* note 6.

9. *Id.*

10. *Id.*

widespread mortgage default risks because of the likelihood that subprime borrowers will be unable to service the debt after a rate adjustment.

The genesis of the subprime market began when Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA).[11] DIDMCA preempted state usury ceilings for most home mortgage loans.[12] Congress enacted DIDMCA during an era of record-high interest rates, in part to ensure that borrowers in states with low usury ceilings could obtain loans.[13] DIDMCA's deregulation not only permitted higher conventional mortgage rates in states with low usury ceilings, but also fostered the growth of the subprime market.[14]

The subprime lending spree hit its zenith between 2004 and 2006 in conjunction with the last and most furious phase of the U.S. housing boom. It is estimated that well over $2 trillion in ARMs were originated from 2004 to 2006.[15] A substantial portion of these ARMs were subprime loans, representing a historical departure from traditional prime loan underwriting requirements in favor of the origination of riskier loans. According to the Mortgage Bankers Association, approximately 13.1 percent of all outstanding mortgage indebtedness in the United States is subprime in nature.[16] For the reasons discussed in section II.B, *infra*, this departure was a direct function of the fundamentally different approach to the securitization of the subprime loan relative to the traditional prime home loan.

According to a study by First American CoreLogic, in 2007 and 2008, "trillions of dollars of adjustable-rate mortgages will

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11. *See* Chomsisengphet & Pennington-Cross, *supra* note 5, at 38; *see also* Pub. L. No. 96-221, 94 Stat. 132 (codified in various sections of 12 U.S.C.).

12. *See* Chomsisengphet & Pennington-Cross, *supra* note 5, at 38.

13. *See* Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. ON LEGIS. 167, 174-75 (2007).

14. *See id.* at 175.

15. Alistair Barr, *'Tsunami' of Adjustable-Rate Mortgage Resets Coming*, MARKETWATCH, Mar. 23, 2007, http://www.marketwatch.com/news/story/mortgage-reset-tsunami-could-end/story.aspx?guid=%7BECEE333A-22A2-4ECD-8C69-5ED431190A9E%7D.

16. *See* Press Release, Mortgage Bankers Ass'n, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey (Dec. 6, 2007), http://www.mbaa.org/NewsandMedia/PressCenter/58758.htm.

have their payments begin to reset."[17] If true, this spells exploding monthly payments for affected consumers just as the housing market continues to soften and the economic slow down reduces incomes. The negative impact of the subprime crisis on the cash-strapped homeowner, however, is just the tip of the iceberg.

B. *Funding of Subprime Mortgage Loans Through Securitization*

The growth of the subprime market was fueled by an influx of investment dollars into the mortgage market from non-traditional lending sources. This resulted in increased credit access for the subprime borrower through a financing vehicle for the securitization of subprime mortgage loans often referred to as mortgage backed securities (MBSs).[18] MBSs can take a variety of structures, but their principal purpose is to transfer the right to receive "the cash flow from pools of mortgage loans," as well as to transfer the related default risks, to third-party investors.[19]

In a typical "subprime mortgage securitization, a number of mortgage loans are pooled together and sold into a trust by an 'originator.'"[20] "Interests in the trust are in turn sold to investors," often known as certificateholders.[21] "The cash from the certificateholders goes to the originator, and the originator can then use that cash to originate more loans."[22] Some MBSs issue pass-through certificates in which the trust passes through principal and interest payments as they are received, minus certain servicing

17. CHRISTOPHER L. CAGAN, FIRST AMERICAN CORELOGIC, MORTGAGE PAYMENT RESET: THE ISSUE AND THE IMPACT 2 (2007), *available at* http://www.facorelogic.com/uploadedFiles/Newsroom/Studies_and_Briefs/Studies/20070048MortgagePaymentResetStudy_FINAL.pdf.

18. Ben Bernanke, Chairman, Fed. Res., Speech at the Economic Club of New York, New York: The Recent Financial Turmoil and its Economic and Policy Consequences (Oct. 15, 2007), http://www.federalreserve.gov/newsevents/speech/bernanke20071015a.htm.

19. U.S. Sec. and Exch. Comm'n, Mortgage-Backed Securities (June 25, 2007), http://www.sec.gov/answers/mortgagesecurities.htm.

20. Chase Manhattan Mortgage Corp. v. Advanta Corp., No. Civ.A.01-507 KAJ, 2005 WL 2234608, at *1 (D. Del. Sept. 8, 2005).

21. *Id.*; *see also* U.S. Sec. and Exch. Comm'n, *supra* note 19.

22. *Chase Manhattan Mortgage Corp.*, 2005 WL 2234608, at *1.

charges, to the investors on a pro rata basis.[23] Thus, if a loan in the pool is prepaid, the principal amount of that loan is repaid to the investor, requiring the investor to find another investment opportunity for that portion of the initial investment.[24]

A collateralized mortgage obligation (CMO) is also a pool of mortgage loans, but it issues different classes or tranches of securities.[25] The cash flows from each tranche are paid out in a predetermined order.[26] The tranches to receive payment first are the least risky, and accordingly, earn lower interest rates than the subordinate tranches which are lower in payment priority.[27] Subordinate tranches are often quite risky, and sometimes there is not a ready market for them.[28]

A collateralized debt obligation (CDO) was developed as a pool of securities issued in CMOs or MBSs.[29] Often the securities pooled were those that were otherwise rated the lowest by the credit rating agencies.[30] The securities issued by the CDO pools were also issued in tranches, and the credit rating agencies often gave a majority of the securities issued an investment grade rating, even though the pool backing the securities was below investment grade rated securities.[31] The theory was that the investment grade securities had the higher payment priority and that the likely losses from the pool would be adequately covered by the investors in the lowest tranches issued in the CDO.[32]

While the pooling of mortgage loans into trusts had long

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23. U.S. Sec. and Exch. Comm'n, *supra* note 19.

24. *Id.*

25. U.S. Sec. and Exch. Comm'n, Collateralized Mortgage Obligations (June 25, 2007), http://www.sec.gov/answers/tcmos.htm.

26. *See id.*

27. *See* Sec. Indus. and Fin. Markets Ass'n, Types of Bonds: The Effect of Interest Rates on CMO Values and Prepayment Rates, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=33 (last visited Jan. 30, 2007); *see also* U.S. Sec. and Exch. Comm'n, *supra* note 25.

28. *See* Sec. Indus. and Fin. Markets Ass'n, Types of Bonds: Minimum Investments, Transaction Costs, and Liquidity, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=36 (last visited Jan. 30, 2007).

29. *See* Bethany McLean, *The Dangers of Investing in Subprime Debt*, CNN, Mar. 19, 2007, http://money.cnn.com/magazines/fortune/fortune_archive/2007/04/02/8403416/index.htm.

30. *Id.*

31. *See id.*

32. *See id.*

been the practice of agencies like Fannie Mae and Freddie Mac, subject to certain limitations on the total value and credit-related quality loans eligible for bundling, never before had those on Wall Street been invested so heavily in securities backed by subprime loans. With rating institutions like Standard & Poor evaluating MBSs, CDOs, and CMOs in much the same way that commercial paper and other similar investments are rated in terms of credit risk of various levels of tranches,[33] these investment vehicles became highly sought after by pension funds, hedge funds, investment banks, insurers, and municipalities all over the world. In essence, this is how the American dream became underwritten by a cast of unlikely investors, including foreign commercial banks.

C. *The Current Crisis*

The crisis began with the bursting of the housing and financial bubbles in late 2006 and early 2007.[34] A report from the United States Government Accountability Office (GAO) found that "the rapid decline in the rate of home price appreciation throughout much of the nation beginning in 2005 may have reduced incentives for borrowers to keep current on their mortgages and made it more difficult for borrowers to refinance or sell their homes to avoid default or foreclosure."[35] Regional unemployment,[36] coupled with aggressive lending practices, made

33. *See, e.g.*, Sten Bergman, *CDO Evaluator Applies Correlation and Monte Carlo Simulation to the Art of Determining Portfolio Quality*, STANDARD & POOR'S, Nov. 12, 2001, http://www.standardandpoors.com/emarketing/structuredfinance/copy of111201_evaluator.html.

34. Justin Lahart, *Egg Cracks Differ in Housing, Finance Shells*, WALL ST. J., Dec. 24, 2007, at C1.

35. U. S. GOV'T ACCOUNTABILITY OFFICE, BRIEFING TO THE COMMITTEE ON FINANCIAL SERVICES, SUBJECT: INFORMATION ON RECENT DEFAULT AND FORECLOSURE TRENDS FOR HOME MORTGAGES AND ASSOCIATED ECONOMIC AND MARKET DEVELOPMENTS 4 (2007), *available at* http://www.gao.gov/new.items/d0878r .pdf.

36. *See* Randall S. Kroszner, Bd. of Governors of the Fed. Res. Sys., Speech at the Consumer Bankers Association 2007 Fair Lending Conference: The Challenges Facing Subprime Mortgage Borrowers (Nov. 5, 2007), http://www.bis.org/review/r071 107f.pdf. "The unemployment rate in an area can significantly undermine the ability of people in that area to repay their mortgages. States in the Midwest hit hardest by job cuts in the auto industry, such as Michigan and Ohio, are among the states with the highest rates of new foreclosures." *Id.*

it harder for borrowers to meet their mortgage repayment obligations and the emerging private MBS market lent support to such practices.[37] This combination forced more and more sub-prime borrowers into an unstable situation where loan default was the natural result. This precarious situation was solidified into a position of certain default for many borrowers when ARMs reset, increasing home mortgage interest rates, in the summer of 2007.[38] According to Federal Reserve Chairman Ben Bernanke, the rate of serious delinquencies for adjustable rate subprime mortgages has increased significantly, reaching nearly sixteen percent as of August 2007, almost three times the recent-low of 2005.[39]

D. *The Fallout*

The aggregation of delinquent payments from subprime borrowers resulted in MBSs losing some or all of their worth as the underlying assets lost value. Structured securities, CDOs and CMOs holding MBSs, likewise decreased in value.

The pressure of credit risks and illiquidity has forced many high profile banks, corporations, and hedge funds to take enormous write downs and, in some cases, has resulted in bankruptcy. In July of 2007, Bear Stearns informed investors that two of its hedge funds, together worth an estimated $1.5 billion in 2006, had nearly lost their entire value.[40] The funds, comprised of subprime MBSs and CDOs, reeled from "unprecedented declines in the valuations of a number of highly rated [] securities," according to the bank.[41] However, the funds' decline seems more closely tied to faltering mortgage securities. For the fourth quarter of 2007, Morgan Stanley took a $9.4 billion loss related to subprime-linked investments,[42] and in January of 2008, Citigroup announced it was writing down $22.2 billion due to "mortgage-

37. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 35, at 13.

38. *See* Les Christie, *When Bad Loans Get Worse*, CNNMONEY, June 21, 2007, http://64.236.22.104/2007/06/20/real_estate/when_ARMs_reset/index.htm.

39. *See* Bernanke, *supra* note 18.

40. Gretchen Morgenson, *Bear Sterns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, at C2.

41. *Id.*

42. Landon Thomas, Jr., *$9.4 Billion Write-Down at Morgan Stanley*, N.Y. TIMES, Dec. 20, 2007, at C1.

related investments and bad loans."[43]

Stock market declines among both depository and non-depository financial corporations were dramatic. Any investors owning subprime mortgage related financial instruments, which includes hedge funds, insurance companies, pension funds and commercial banks, were exposed to significant risk.

III. LITIGATION TRENDS

Not surprisingly, litigation arising from the subprime meltdown has begun to spread like wildfire in courthouses across the country. The suits implicate a wide array of issues and parties. At the most basic level, the subprime litigation involves suits brought by consumers against their mortgage originators.[44] This tier of consumer litigation involves mostly deceptive trade practices and unfair debt collection based claims.[45] The second tier of litigation involves alleged wrongs in the securitization process. To a large extent, the securitization litigation is primarily focused on the valuation of constituent pooled mortgages, mortgage backed securities, and their corresponding structured investments. Significant securities-related litigation is also arising out of the subprime rubble. In the securities litigation realm, the SEC has already started investigating investment banks, mutual fund managers, company executives and the like for possible securities fraud related to the subprime market. Lastly, in recent weeks the contours of subprime litigation have expanded into the unexpected realm of what can only be coined as "public interest litigation." This typifies just how far the subprime fallout extends. The following are examples from each emerging area of litigation.

A. Consumer Litigation – Novastar Mortgage Class Action

NovaStar Mortgage, a Missouri-based mortgage lender, settled a class action lawsuit brought on behalf of borrowers who

43. Eric Dash, *Citigroup Loses $9.8 Billion; Will Cut Jobs*, N.Y.TIMES, Jan. 15, 2008, at C1.

44. *See, e.g.*, Parker v. Long Beach Mortgage Co., No. 06-2002, 2008 WL 53276 (E.D. Pa. Jan. 3, 2008).

45. *Id.*

said they were overcharged in a yield-spread premium[46] scheme by lenders who put them into loans with higher interest rates than for which they qualified. A yield spread premium is the cash rebate paid to a mortgage broker based on selling an interest rate above the wholesale par rate for which the borrower qualifies.[47] A 2004 study by the Center for Responsible Lending, a nonprofit research and policy organization that advocates fair and responsible lending practices, found that yield spread premiums were included in eighty-five to ninety percent of all subprime mortgages, and that loans, which included yield spread premiums, cost borrowers an additional $800 to $3,000 more than loans that did not have yield spread premiums.[48] The $5.1 million NovaStar settlement came after a Washington judge ruled that the failure to disclose the payment of yield spread premiums was unfair or deceptive under Washington law.[49]

B. Securitization Litigation – Luminent Mortgage Capital v. HSBC Securities

Luminent's claim alleges that HSBC Securities breached repurchase agreements and wrongfully confiscated bonds posted as collateral for the repurchase agreements.[50] The agreements provided that two Luminent subsidiaries could execute repurchase transactions with HSBC whereby the subsidiaries would transfer securities to HSBC in exchange for payment, while HSBC simultaneously agreed to transfer back to the subsidiaries those securities at a certain date or on demand.[51] The agreements

46. *See* Elizabeth Rhodes, *NovaStar Mortgage Settles Class Action*, SEATTLE TIMES, June 22, 2007, at D2. A yield-spread premium is "a legal but controversial practice in which lenders pay independent mortgage brokers a premium to put borrowers into a loan with a higher interest rate than what they qualified for." *Id.*

47. *See* Press Release, Fed. Trade Comm'n, FTC Releases Staff Report on Mortgage Broker Compensation Disclosures, Feb. 27, 2004, http://www.ftc.gov/opa/2004/02/mortgagerpt.shtm.

48. *Yield Spread Premiums: A Powerful Incentive for Equity Theft*, CRL ISSUE BRIEF NO. 11 (Ctr. for Responsible Lending), June 18, 2004, *available at* http://www.responsiblelending.org/pdfs/ib011-YSP_Equity_Theft-0604.pdf.

49. *See* Rhodes, *supra* note 46.

50. Luminent Mortgage Capital v. HSBC Sec. Inc., No. 07-CIV-9340, 2007 WL 3092976, at *7 (S.D.N.Y. Oct. 18, 2007).

51. *Id.* at *13-16.

further provided HSBC could issue a margin call requiring the subsidiaries to post additional cash or collateral in the event the market value of the securities posted with HSBC fell below a certain level.[52] The repurchase agreements provided that the failure of the subsidiaries to meet a margin call would trigger an event of default, entitling HSBC to liquidate the collateral.[53]

In late July and early August of 2007, one Luminent subsidiary executed a total of eight repurchase trades with HSBC for bonds totaling over $24 million.[54] However, on the day the repurchase transactions were executed, the bond market "seized up" against the perceived crisis in the subprime mortgage loan market, causing the value of the bonds to drop and prompting HSBC to issue margin calls in the amount of $5.47 million to cover the decrease in value.[55] Luminent, as guarantor of the bonds for its subsidiaries, refused to pay the margin demand on the belief that the bonds were not accurately valued.[56] At the end of August, HSBC informed Luminent that it had already conducted an auction with respect to the bonds and had submitted the highest bid.[57]

Luminent's complaint alleges breach of contract, breach of the covenant of good faith and fair dealing, conversion, and unjust enrichment.[58] The specific allegations were that HSBC falsely discounted and misrepresented the true value of the bonds and conducted an inadequate bidding process that was not on par with standards of commercial reasonableness.[59] Knowing of the devaluation, the complaint continues, HSBC was able to "opportunistically and improperly misappropriate the securities,"[60] and in the eyes of Luminent, "was simply exploiting an aberrational market as a pretext to unreasonably mark down the purported value of the [b]onds, demand an unreasonable amount

52. *Id.* at *17.
53. *Id.* at *19.
54. *Id.* at *20-22.
55. *Id.* at *23-24.
56. *Luminent Mortgage Capital,* 2007 WL 3092976 at *25.
57. *Id.* at *26-28.
58. *Id.* at *35-53.
59. *Id.* at *28, *30.
60. *Id.* at *8.

of additional collateral from Plaintiffs, and then unilaterally confiscate the bonds for itself at an artificially steep discount."[61] The case is pending in the Southern District of New York.

C. *Securities Litigation*

1. Private Litigation – *Saltzman v. Citigroup*

Saltzman's complaint alleges that Citigroup, in violation of the Securities Exchange Act of 1934, issued false and misleading statements regarding the company's business and financial results and concealed the failure to write down impaired securities containing subprime debt.[62] Saltzman alleges that this false information and concealment artificially inflated the stock of Citigroup, and had Citigroup taken appropriate reserves for the large amount of CDOs both on and off its balance sheets, investors would have known this and could have taken appropriate action before the subprime mortgage meltdown.[63]

As of September 30, 2007, Citigroup's Securities and Banking (S&B) Business held approximately $55 billion in U.S. subprime direct exposure, $43 billion of which was due to exposures in the most super senior tranches of CDOs.[64] These tranches were collateralized by asset backed securities.[65] These super senior tranches, the complaint states, are not subject to valuation based on observable market conditions.[66] Due to rating agency downgrades and other market developments, changes to the discount rates applicable to these super senior tranches have resulted in significant declines in the estimates of the fair value of the S&B senior exposures.[67]

Saltzman claims that Citigroup knew of its exposure due to its S&B subprime holdings, but concealed such information from

61. *Id.* at *30.

62. Saltzman v. Citigroup Inc., No. 07 CIV 9901, 2007 WL 4189448, at *1, *3 (S.D.N.Y. Nov. 8, 2007).

63. *Id.* at *4.

64. *Id.* at *5.

65. *Id.*

66. *Id.*

67. *Id.*

the investing public.[68] Specifically, Citigroup concealed that its "portfolio of CDOs contained billions of dollars worth of impaired and risky securities, many of which were backed by subprime mortgage loans."[69] The complaint further alleges that Citigroup "failed to account for highly leveraged loans," and the company "failed to record impairment of debt securities which they knew or disregarded were impaired, causing the [c]ompany's results to be false and misleading."[70]

2. SEC Enforcement Efforts

As a result of the subprime crisis, some three dozen recent investigations by the SEC have focused on whether financial firms should have warned the public earlier about the declining value of securities sold to investors and how those firms valued those securities, especially in comparison to how they valued their own securities.[71] The Wall Street Journal reports that the SEC has set up a working group that is investigating whether firms selling securities outside of exchanges with readily available pricing information adequately warned investors of the risks of such investments.[72] The group is also investigating whether the firms timely informed investors of problems with their financial statements and how these firms account for off-balance sheet entities that hold MBSs.[73]

In December 2007, the SEC's Division of Corporation Finance sent a letter to a number of public companies identifying potential areas of disclosure that should be considered for upcoming annual filings in relation to off-balance sheet disclosure requirements.[74] The letter was sent to companies identifying

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68. *Saltzman*, 2007 WL 4189448 at *8.

69. *Id.* at *8(a).

70. *Id.* at *8(b)-(c).

71. *See* Susan Pulliam & Kara Scannell, *Pricing Probes on Wall Street Gather Steam*, WALL ST. J., Dec. 21, 2007, at C1. Firms mentioned as the targets for investigation include UBS's Dillon Read unit, Morgan Stanley, Merrill Lynch & Co., Bear Stearns, and the Royal Bank of Canada. *Id.*

72. *Id.*

73. *Id.*

74. U.S. Sec. and Exch. Comm'n, Sample Letter Sent to Public Companies that Have Identified Investments in Structured Investment Vehicles, Conduits, or

themselves as having been "involved with certain non-consolidated conduits, [structured investment vehicles], and collateralized debt obligations."[75] The specific disclosure issues to be considered include: categories and rating of assets the off-balance sheet entity holds; any material difficulties the off-balance sheet entity has experienced in issuing its commercial paper or other financing during the period; types of variable interests held in off-balance sheet entities; obligations under the liquidity facilities; and Item 303 known trends and uncertainties that could have a material effect on income, operations, or liquidity.[76] No doubt the increased scrutiny of the SEC will continue as more banks and financial institutions come under pressure from the subprime fallout and are made parties to litigation.

D. Public Interest Litigation – Lawsuits by the Cities of Baltimore and Cleveland

In an effort to curb the growing number of foreclosures, the City of Baltimore has filed a claim in United States District Court against California-based Wells Fargo Bank, who, the city alleges, violated fair housing laws by engaging in a practice of "reverse redlining" through selling high-interest, high priced subprime loans to African American residents at a disproportionately higher rate than they did to whites.[77] In 2005 and 2006, the complaint alleges, "two-thirds of the company's foreclosures were in census tracts where at least sixty percent of the residents were black."[78] "Wells Fargo," the complaint continues, "has been, and continues to be, engaged in a pattern or practice of unfair, deceptive and discriminatory lending activity in Baltimore's minority neighborhoods that have the effect and purpose of placing inexperienced and undeserved borrowers in loans they cannot

Collateralized Debt Obligations (Off-Balance Sheet Entities) (Dec. 11, 2007), http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm.

75. *Id.*

76. *Id.*

77. John Fritze, *Lawsuit by City Targets Lender*, BALTIMORE SUN, Jan. 8, 2008, at 1A.

78. *Id.*

afford."[79] The City of Baltimore is seeking recovery from "unrealized property tax revenue, added police and fire protection and legal costs – because of homes abandoned after foreclosure."[80]

The City of Cleveland has filed a similar suit against twenty-one banks, including Citigroup, Bank of America, Wells Fargo, and Countrywide Financial, although Cleveland's claim alleges the banks' lending practices violated public nuisance law and "led to widespread abandonment of homes."[81]

In 2007, the NAACP brought suit against twelve of the country's largest mortgage lenders, alleging that institutionalized racism in subprime mortgage lending resulted in African Americans being thirty percent more likely to be issued a loan with higher interest rates than whites with similar borrowing qualifications.[82]

While many areas of "public interest" litigation may be unlikely to withstand legal scrutiny, the mere existence of the lawsuits illustrates an undeniable truth: the wave of subprime litigation currently underway is only the beginning of what is to come. Inevitably, creative lawyering will result in a plethora of contentious litigation, especially given the fact that many of the potential defendants, in all categories of subprime litigation, are perceived as "deep pockets."

IV. CONCLUSION

The subprime crisis and its fallout are far from over. Indeed, the better assessment is perhaps that the precise contours are yet to be fully known. It is estimated that nearly $1 trillion in ARMs will reset in the next three years.[83] ARM resets combined with a weak housing market will fuel a continued liquidity crisis for the homeowner, the subprime investor, and the underwriting financial institution alike. The resulting pinch will ensure

79. *Id.*

80. *Id.*

81. Christopher Maag, *Cleveland Sues 21 Lenders Over Subprime Mortgages*, N.Y. TIMES, Jan. 12, 2008, at A9.

82. NAACP v. Ameriquest Mortgage Co., No. 07-CIV-00794 (C.D. Cal. July 11. 2007).

83. *See* Barr, *supra* note 15.

uncertainty in the capital markets and the perpetuation of subprime litigation for the foreseeable future.

In the meantime, regulators worldwide are devising efforts to curtail the growing crisis. In the United States, for example, President Bush announced on December 6, 2007, a plan to implement a moratorium on some upwardly adjusting subprime ARMs in an effort to prevent a further wave of foreclosures.[84] How and when this plan will become a reality remains to be seen.

One can only speculate when the subprime crisis will end. In late December 2007, Alan Greenspan, the former Chairman of the Federal Reserve, attempted to forecast the life-cycle of the crisis:

> The current credit crisis will come to an end when the overhang of inventories of newly built homes is largely liquidated, and home price deflation comes to an end. That will stabilize the now-uncertain value of the home equity that acts as a buffer for all home mortgages, but most importantly for those held as collateral for residential mortgage-backed securities. Very large losses will, no doubt, be taken as a consequence of the crisis. But after a period of protracted adjustment, the U.S. economy, and the world economy more generally, will be able to get back to business.[85]

According to this prediction, this is only the beginning.

84. Alison Vekshin, *Bush Aims to Prolong Expansion With Subprime Freeze*, BLOOMBERG, Dec. 6, 2007, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aUtXgB6b6ybU.

85. Alan Greenspan, *The Roots of the Mortgage Crisis*, WALL ST. J., Dec. 12, 2007, at A19.