Subprime White Paper ***For Immediate Release***

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THE MORTGAGE LENDING MELTDOWN: PENDING LITIGATION AND INSURANCE ISSUES

The mortgage industry is undergoing a major financial meltdown…a serious issue for lenders and brokers alike. Whether this is a correction for mistakes of the past, part of a bigger picture of a widespread real estate market failure or even the beginning of a general business recession, the consequences are self evident: defaults, foreclosures, repurchase demands, layoffs, bankruptcies and general financial catastrophe.

A further consequence certain to ensue in the coming months and years from the mortgage lending morass is an avalanche of litigation. Consumers will sue lenders and brokers. Investors and repurchasers will sue loan originators. Stockholders will sue directors and officers. Government regulators will sue everyone. All will be looking for the magic "deep pocket" to recover their losses.

This financial catastrophe and resulting litigation scenario has been played out before. Remember the 1980's real estate crash, the S&L crisis and the dot com bust? Both led to years of contentious and expensive litigation.

This article, divided into two sections, discusses the key aspects of coming litigation. First we'll look at the various types of lawsuits that can be expected to arise, and second we'll focus on the critical role insurance can play in helping the mortgage lending businesses survive this litigation nightmare.

I. Litigation and the Mortgage Lending Meltdown

With the recent rise in defaults, many parties are looking for a scapegoat. There has been a significant new wave of litigation and heightened legislative scrutiny lodged against lenders. Plaintiffs' attorneys have started to sue on behalf of people who invested in the subprime lenders or the mortgage-backed securities that were issued, received home loans from them, or were fired by them under their financial stress. Shareholders of the subprime lenders, whose stock prices plummeted as their financial situations deteriorated, have already brought new lawsuits.

Class actions abound, with wide-ranging allegations of fraud, misrepresentation, non-disclosure of loan terms and broker kickbacks, unfair business practices, predatory lending, wrongful termination, employee pension claims, and director and officer liability. Federal agencies in at least six states have launched probes into the recent wake of foreclosures and investment losses. Congressional hearings, Attorney General investigations, State Regulatory Agency examinations and Federal banking regulatory examinations have already started.

The main types of lawsuits that we can expect are:

- **Early Payment Defaults and Buy Back Demands**
  Wall Street banks have filed numerous lawsuits against mortgage lenders to repurchase their loans. Investors who bought some of the mortgage-backed debt securities, which have also declined in value, may also have claims against lenders.

  These demands or lawsuits are often based on two types of representations and warranties given by the subprime lenders. The first provides that for a certain period from the date of sale (generally 90 days), the investor has the right to put the loan back to the originator if the loan goes delinquent. The other allows the buyer to put the loan back to the originator if the buyer finds an indication of fraud in the underlying origination of the loan.

  The reality is that it is virtually impossible for the seller to be aware of all misrepresentations. In the past, buyers of loans would not go looking for these errors until a loan stopped performing; sellers were only asked to repurchase those loans that actually became collection problems. Now investors have begun scrutinizing their portfolios for violations of representations and warranties before the loans default, so as to force a buy back while the mortgage company is still solvent.

- **Non-Disclosure Lawsuits**
  Another major area of potential liability concerns the disclosures made to the actual borrower. A lender may be liable for making misrepresentations and failing to disclose, based on principles of common law fraud and as required by various state and federal statutes. We are currently seeing a new wave of claims of non-disclosure or late disclosure of loan details such as ARM terms, interest rates, negative amortization, and more. The current trend in unlawful foreclosure litigation is shifting towards problems with the origination of a loan that made it "unsuitable" for the borrower in the first place. Class actions are pending against lenders on behalf of consumers who say they were duped by the loans' terms and ended up facing foreclosure or unexpectedly high mortgage payments.

- **Yield Spread Premium (YSP) Claims**
  A further area of litigation concerns so-called hidden fees and other dubious practices, all of which have contributed to the surge in delinquencies. One of the most controversial is the fee known as the yield spread premium (YSP) that mortgage brokers receive from lenders. One court has described this as "a bonus paid to a broker when it originates a loan at an interest rate higher than the minimum interest rate approved by the lender for a particular loan. The lender then rewards the broker by paying it a percentage of the 'yield spread' (i.e.,

the difference between the interest rate specified by the lender and the actual interest rate set by the broker at the time of origination) multiplied by the amount of the loan."[1]

- **Kickbacks and Secret Commissions**
  Sometimes the mortgage broker sends repeat business to one lender, which then pays it a secret commission or kickback. This is generally illegal. The Real Estate Settlement Procedures Act (RESPA) expressly forbids kickbacks in real estate settlements and services involving federally-related mortgage loans. Look for lawsuits alleging the illegal payment of kickbacks.[2]

- **Other Legal Challenges**
  Employees of the failing subprime lending companies may bring lawsuits based on wrongful termination due to lost compensation. In addition, employees' lawyers are finding additional ways to challenge the recent activity of mortgage lenders. For example, employees of Fremont General Corp. sued the company as well as the company's officers and directors, claiming they lost millions of dollars on company stock in their retirement plans when the company was forced out of the subprime loan business in March 2007 – losses that Fremont's board should have foreseen and prevented, according to the lawsuit, which alleged violations of ERISA, the Federal Pension Law. The complaint also alleges that Fremont engaged in unsafe lending practices beginning in 2003, which backfired when a large number of subprime borrowers began to default.

  In other scenarios, stockholders of subprime lenders are challenging the drop in stock value, whether in class actions or shareholder derivative lawsuits.

As you can see, there is no shortage of legal actions. The key is to determine your exposure.

II. Insurance Coverage and You

The fundamental nature of insurance in our society is to spread risk and provide peace of mind. Insurance provides protection for the proverbial rainy day, and there has never been a rainier day or a more pressing need for insurance in the mortgage lending business than the current financial catastrophe. It is certain that there will be thousands of lawsuits nationwide seeking billions of dollars from mortgage lending businesses and their principals, shareholders, officers and directors. Plaintiffs' attorneys will pull out all the stops and try every trick in the book in going after those they allege are "responsible" for the various financial problems of the mortgage lending business.

While there are many different types of insurance coverage that will ultimately apply to these lawsuits and claims, it is critical to understand that the insurance industry will contest virtually

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1 *Wolski v. Fremont Investment &* Loan (2005) 127 Cal.App.4th 347, 351, citing In *re Bell* (Bankr. E. D. Pa. 2004) 309 B.R. 139, 153

2 12 U.S.C.A. section 2607(a)

all of them. The authors have handled thousands of insurance disputes over the last 25 years and have recovered hundreds of millions of dollars of insurance proceeds. Virtually every dollar of insurance coverage obtained has been contested. That's why it's important that you understand general insurance principles and how your various coverages work.

General Insurance Principles

Every insurance contract contains an implied covenant of good faith and fair dealing that "neither party will do anything which injures the right of the other to receive the benefits of the agreement." [3] If an insurance company breaches this covenant of good faith, it will be liable for any contract damages as well as tort damages, including emotional distress, economic losses, attorneys' fees and punitive damages.[4] Policyholders therefore have significant leverage in negotiations with insurance companies.

Liability insurance provides two separate coverages. First, the insurance company has a duty to pay attorneys' fees for any lawsuit. This can either be the prospective payment of attorneys' fees through the duty to defend, or it can be through reimbursement of attorneys' fees paid, as many D&O policies provide. The duty to defend is the most powerful concept in insurance law. The fundamental principle is that an insurance company must defend a lawsuit if there is even a small probability that the claim may ultimately be covered.[5] Second, an insurance policy provides for indemnity for judgments and settlements.

It is imperative that counsel defending any mortgage lending claims understands the impact that these fundamental principles of duty to defend and indemnity have upon the litigation. The defense lawyer must first have the insurance expertise to trigger insurance coverage for the claim (so that the insurance company agrees to provide a defense), and must then understand the complex insurance coverage issues arising out of the duty to indemnify, in order to resolve the lawsuit with insurance company money.

The following provides an overview of the various insurance coverages available, and how these insurance policies apply to mortgage lending litigation.

- **Errors and Ommisions Insurance**
  Errors and Omissions (E&O) policies cover a mortgage lender for errors and omissions in connection with activities as a mortgage banker or mortgage broker. It has been the authors' experience that E&O policies frequently provide coverage for the early payment defaults (EPD), misrepresentation, yield spread premium and other claims discussed above.
  For example, EPD claims often involve errors and omissions in the processing of loan applications. Examples of errors and omissions that might be covered include accepting false or fraudulent appraisals, and false or fraudulent verifications of bank deposits, income,

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3 Comunale v. Traders & General Ins. Co. (1958) 50 Cal.2d 654, 658
4 See, Foley v. Interactive Data Corp. (1988) 47 Cal.3d 654, 684-685
5 Gray v. Zurich Ins. Co. (1966) 65 Cal.2d 263, 276

or employment.

Because E&O policies often are “burning limits” policies (i.e., defense costs erode the limits), with aggregate limits and large self-insured retentions or deductibles, it is important for the insured to develop evidence of potential negligence early on, to try to settle claims quickly with insurance money.

Critically, the principles of E&O insurance apply with equal, if not greater, force to mortgage brokers. In fact, the activities of mortgage brokers are the quintessential acts that are at the heart of E&O coverage: preparing applications, verifying income and deposits, handling appraisals, communicating with lenders and borrowers, etc. When the mortgage lending crisis reaches critical mass, plaintiffs will be suing everyone involved in the mortgage lending process, including brokers – whose E&O insurance should provide litigation protection.

- **Directors and Officers Insurance**
  The purpose of Directors & Officers’ liability (D&O) insurance is to provide protection of the corporate directors and officers for liabilities arising from activities connected with serving the corporation. D&O insurance policies generally pay for loss arising out of claims first made during the policy period against corporate directors and officers for “wrongful acts” committed in their corporate capacities. These policies typically contain two separate insuring agreements: direct coverage for the directors and officers individually, and “Corporate Reimbursement,” which provides reimbursement to the corporation for certain indemnification payments it makes to its officers and directors.

  Like E&O policies, D&O policies are generally written on a “claims made” basis. This means that coverage is generally provided if a claim is made and reported during the policy period, without regard to the date on which the wrongful acts occurred. If a claim is not reported to the insurance company by the expiration of the policy period, coverage for that claim is forever barred.

- **Business Liability Insurance**
  Virtually every business entity has a standard form Commercial General Liability (CGL) insurance policy, the standard “slip and fall” liability policy. However, what most business people and business litigators fail to appreciate is that these policies also provide insurance coverage for a wide spectrum of business litigation disputes. The standard CGL policy contains sections providing coverage for “advertising injury,” “personal injury” and other broad coverages. These boilerplate provisions, when properly handled by defense counsel with insurance expertise, trigger coverage for many different types of business litigation disputes.

  Over the last 20 years, the authors have obtained insurance coverage for hundreds of complex business litigation cases pursuant to CGL policies. These cases include trade secret misappropriation disputes, intellectual property claims, unfair competition, defamation, slander, libel, invasion of privacy, wrongful entry or eviction and numerous other complex business disputes. We believe that a significant number of the mortgage lending lawsuits and claims will potentially be covered by CGL policies, including both mortgage lenders and mortgage brokers. In fact, mortgage brokers should find a significant potential for coverage under their CGL policies, as their activities include a significant amount of interaction and communication with third parties, which typically form the predicate for the types of claims covered by business liability insurance.

- **First Party Property/Business Insurance**
  Fidelity bond policies may provide coverage for first party claims arising out of dishonest acts of employees or agents. The loss to the insured is usually based on the amount the insured has paid out or lost, less any amounts the insured has received in funds or property. This is first party insurance, and covers mortgage lenders for losses they have incurred themselves, by paying out for EPD or misrepresentation claims or other financial losses that are based on employee dishonesty. First party coverage can also be of benefit to mortgage brokers, for claims arising out of misappropriation of down payments, escrows, premiums or other cash or assets (including electronic transfers), as well as claims of illegal kickbacks, rebates, secret commissions or similar wrongful activities.

  Other examples of the type of fraudulent conduct covered by first party property/business insurance include wrongful acts with respect to real estate documents, such as mortgage, trust deed, note, title policy, deed, application for mortgage loan, verification of employment, escrow agreements, or underwriting documents including financial statements, appraisals and other related documents.

  Fidelity bond policies may exclude losses arising out of having repurchased or having been required to repurchase a real estate loan from an investor or secondary market institution, but this exclusion often does not apply to dishonest acts of employees or agents, or losses arising from a forged signature on or fraudulent alteration of real estate documents.

Summary: Are You Ready for the Coming Storm?
No questions there will be an avalanche of litigation involving mortgage lenders and brokers in the coming years...and that’s not good news for you. For those seeking to recover their damages, insurance can be the proverbial pot at the end of the rainbow. However, plaintiffs will need both a map to find the insurance pot and the key to unlock the fortune inside.

Conversely, for the parties who are the litigation targets, triggering insurance coverage for these claims can be their saving grace. Not only can insurance pay the attorneys’ fees and costs for defending the lawsuits, but insurance can also be responsible for paying any judgments or settlements.

Ultimately, successfully navigating this litigation minefield requires defense counsel who has expertise in both complex business litigation and insurance law. Counsel must understand and know how to navigate insurance coverage principles for the defense of these lawsuits. The ultimate goal is to use insurance money to protect the personal assets of the individuals and businesses being attacked.

About the Authors

Daniel J. Callahan is the founding partner of Callahan & Blaine, California's Premier Litigation Firm. Mr. Callahan specializes in the trial of complex business litigation cases. Edward Susolik is a senior partner at Callahan & Blaine and specializes in complex business litigation and representation of policyholders in complex insurance disputes. Both Mr. Callahan and Mr. Susolik have successfully represented many different mortgage lenders in a wide variety of litigation and insurance disputes.

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