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## Subprime – Law Firms

# A Group Approach To Coping With The Subprime Mortgage Crisis

*The Editor Interviews Joseph L. Buckley, Co-Chair, Litigation Department; Chair, Banking Litigation Practice Group, Sills Cummis & Gross P.C.*

**Editor:** When did your firm realize the magnitude of the subprime mortgage crisis and that something had to be done?

**Buckley:** The subprime mortgage meltdown and the crisis of public confidence that accompanied it began in the summer and fall of last year when the value of AAA rated CDO's and other financial instruments that included subprime mortgages fell precipitously and financial institutions started to announce large writedowns. The management of our Firm realized early on that these events would lead to widespread finger pointing and consequent litigation and that we had to gear up to serve clients who would be caught up in the litigation frenzy.

**Editor:** Which clients have been particularly affected?

**Buckley:** Our bank clients have been affected by the subprime mortgage crisis in many ways. It is also affecting other clients, like title insurers and mortgage brokers. Some clients often find themselves being sued and having to sue at the same time on the same transactions. The banks were in many cases the victims of unscrupulous mortgage originators and appraisers. Although our bank clients are really among the victims, they have nevertheless been sued by mortgage holders, both collectively and individually, as well as by those to whom the banks sold mortgages.



Joseph L. Buckley

**Editor:** Tell us about the firm's subprime loan group?

**Buckley:** It is cross disciplinary and draws upon the expertise of various practice groups. It includes white collar business crime practitioners and governmental affairs practitioners who work together in terms of dealing with the potential claims that may be made against our institutional clients by state attorneys general or U.S. attorneys in particular. Also included are securities, real estate, loan work out and bankruptcy practitioners.

**Editor:** Banks are very much involved in the subprime mortgage crisis. Are they important clients of the firm?

**Buckley:** Banks are among our largest block of clients. We represent banks in all

aspects of what they do – in lending, litigation, workouts, bankruptcies, real estate and dealing with regulators. Our experience before the current crisis enables us to meet its challenges. We had previously represented banks in a number of cases involving the sale or purchase of large pools of mortgages. In the early nineties crisis and later, we represented banks where claims were made, under contracts for the sale of pools of mortgages, that some of the mortgages were not as warranted. Although this was contractually based litigation, fraud and other tort claims were frequently included.

**Editor:** Let me ask about how you are involved in this.

**Buckley:** My own experience has been in representing banks. My clients find themselves in the dual role of plaintiffs and defendants in the current crisis. They are being hit by class action claims based on allegations by groups of home owners that they were misled. At the same time our bank clients are asserting claims against unscrupulous parties that helped put these packages together. Of course, many of the more unscrupulous parties that have caused these troubles are no longer to be found, having filed for bankruptcy or skipped town. It will be difficult to recover against many of the smaller title insurers and mortgage companies, because while they may have insurance, it almost certainly is not enough to cover substantial losses incurred by the banks.

**Editor:** Are cases being filed in both state and federal courts?

*Please email the interviewee at [jbuckley@sillscummis.com](mailto:jbuckley@sillscummis.com) with questions about this interview.*

**Buckley:** So far we have been seeing more of them in the state courts. Securities claims are being filed in the federal courts. As time goes on, we are going to be seeing more RICO claims brought in federal court. Complex multi-party litigation often is brought in state court because it is sometimes difficult to achieve diversity of citizenship, particularly where there are multiple plaintiffs.

In the case of class actions, plaintiffs' counsel strive to keep the litigation in the state courts. We usually try to remove them to the federal courts in order to get the benefit of the Class Action Fairness Act (CAFA).

**Editor: Is it likely that many of the cases spawned by the subprime mortgage crisis will be settled before trial?**

**Buckley:** It is our view that it is better to make an effort to settle as opposed to pursuing a scorched earth approach. Banks and other institutions are going to find themselves both plaintiffs and defendants. If you pursue a matter to judgment, even if you succeed, you could establish legal precedent that helps you in one way but hurts you in another.

Another consideration is that our institutional lending and financial clients are more diverse than ever and engaged in different businesses across the spectrum of finance. So, a legal decision that may be good for the client in one of its business areas may hurt it in another. I expect that there will be a lot of initial sword rattling, but prudent settlements will ultimately be reached.

**Editor: You mentioned class actions. Tell us about the types of class actions that you are seeing.**

**Buckley:** We are seeing class actions by clever plaintiffs' lawyers directed at attacking various aspects of the subprime lending operation, including claims that there was insufficient notice given the consumers about how the loans were priced. Ultimately we don't think that these claims have merit. More of them are being filed and my expectation is that the plaintiffs' lawyers believe that they have the right environment to have the claims given attention by the courts. Class actions are being brought in state courts that would not otherwise survive in a federal court. We have been representing bank clients in such cases, not just in New Jersey but in other states as well. One of my partners,

who was co-chairman of the ABA's Committee on Class Action Litigation, has been arguing in courts throughout the country.

**Editor: How important are lender liability cases?**

**Buckley:** Lender liability litigation was very common in the early nineties. Although the volume of these cases has greatly diminished, we have kept on top of it, which is fortunate because I expect there will be a resurgence of such cases in the next year.

**Editor: You mentioned bankruptcy; how does that come into play?**

**Buckley:** As the number of commercial and residential foreclosures increase, this will inevitably lead to a spike in the filing of bankruptcies. Traditionally there have been fewer commercial bankruptcies in the District of New Jersey than in the District of Delaware or the Southern District of New York. Based on what we are seeing in the pipeline with loan workouts going south, I would not be surprised to see a steep rise in New Jersey bankruptcies.

Under current bankruptcy law, a home mortgage loan can't in effect be crammed down. The one part of a bankruptcy that is not supposed to be restructured is a home mortgage. There is a bill that is gaining traction before Congress that would permit the home mortgage to be modified in bankruptcy.

**Editor: Has derivative litigation been brought?**

**Buckley:** We have not seen subprime derivative suits in New Jersey yet although it is coming. Derivative suits are also likely to be filed in New York and Delaware. We are certainly geared up in all three places.

**Editor: I understand that some of the investors are being sued.**

**Buckley:** Yes. Our clients include fund managers, hedge funds, and individual money managers. I don't think that there is any question that we are only seeing the beginning of litigation against them. Any such litigation is essentially contract-based and involves the interpretation of very complicated and well drafted agreements.

**Editor: Do you see suits against the rating agencies or against insurers of this**

**kind of debt being an important element.**

**Buckley:** Well, clearly the rating agencies are preparing for what I am sure will be the wave of litigation arising out of various types of mortgage backed securities. The insurance companies are also getting ready for all kinds of claims and I don't think that there is much doubt that there will be another wave of insurance company insolvencies at the state level.

**Editor: Do you see the possibility of litigation involving conventional businesses where the company invested its funds in subprime-tainted financial instruments?**

**Buckley:** Yes. Typically, the JC Penneys of the world will have investment guidelines stating that the majority of the investment portfolio must be invested in relatively liquid and conservative investments with say five to ten percent designated for so-called alternative investments that have the potential of a much higher rate of return, but with a much greater potential for risk. I think that what you are going to be seeing is litigation alleging that the portfolio managers failed either to properly assess the risk or ignored or misinterpreted the guidelines.

**Editor: Do you see your firm counseling directors who might want a second opinion?**

**Editor:** Certainly. Outside directors who normally rely on management for their advice sometimes want the comfort of a second opinion. This is particularly true of those who serve on an audit committee. In the last credit crisis we spent a lot of time representing directors of troubled financial institutions. I have personally represented a number of inside and outside bank directors during that era.

**Editor: Do you have any final thoughts for our readers?**

**Buckley:** Based on the number and types of cases that we are seeing already, it is highly likely that most of the companies and institutions in the categories I mentioned will face litigation. I cannot stress too strongly the need to be prepared long before the first shot is fired. Our subprime group is available to provide counseling with respect to a wide spectrum of businesses to ensure that our clients are well prepared to respond to whatever challenge may face them.