



# What Now?

## Sub-prime Mortgage Repurchasing Demands Likely to Spur Litigation

**T**he collapse of the sub-prime residential real estate mortgage market has had significant economic impact and is likely to spawn a litigation tsunami. Some of the most severe impacts have arisen from demands that sellers of sub-prime loans repurchase them after they have lost their value.

While many contracts give purchasers an apparent right to demand loans be repurchased under certain conditions, there is a significant question as to whether a purchaser who relaxed guidelines to the point of eliminating any verification of a borrower's financial condition can nevertheless insist on repurchase when the borrowers' representations of their financial conditions turn out to be untrue.

According to the *Wall Street Journal*, more than 80 sub-prime mortgage companies have gone out of business since the end of 2006. The same article reports MortgageIT Holdings, Inc., based in New York, is being sued for \$70 million for an alleged failure to repurchase 587 sub-prime loans. ResMae Mortgage Corp. declared bankruptcy after a \$300 million repurchase demand from Merrill Lynch.

Morgan Stanley Mortgage Capital Holdings, LLC, filed a lawsuit in New York against Fremont General Corp. for an alleged failure to repurchase \$10 million in residential loans. Residential Pacific Mortgage (RPM), one of the largest privately held mortgage banks in California, has been sued by SunTrust Mortgage Inc. after SunTrust demanded RPM repurchase loans in excess of \$2 million, even though all of the loans are fully performing. This is just a small sample of the repurchase demands being made across the country.

A significant amount of future litigation arising from repurchase demands seems very likely. Some law firms have already created "sub-prime loan" task forces to garner litigation, transactional and regulatory matters. Perhaps most foretelling, professional liability insurers recently excluded coverage to mortgage brokers for losses arising from repurchase demands.

Not all sellers will accede to the repurchase demands, and in the ensuing litigation that is sure to follow, courts will no doubt be asked to assess whether changes in underwriting guidelines reallocated the risk after

the original purchase and sale contract became effective.

### The Rise and Fall Of Sub-prime Loans

Fueled by the packaging and resale of sub-prime loans as "mortgage-backed securities," the demand for sub-prime loans grew tremendously, reaching its peak in late 2006. Hedge funds and other investment vehicles, which marketed the sub-prime loans, became more valuable as housing prices rose because the risk associated with the mortgages in their portfolios dropped. More and more players jumped into the sub-prime market, creating more demand for loans they were previously reluctant to touch.

Many lending institutions, anxious to reap the benefits of a burgeoning market, relaxed their underwriting guidelines, accepting greater risk in exchange for higher profits. Borrowers who had once been required to provide detailed proof of their income, source of down payment, credit history, debt, and the value of the secured property, suddenly qualified for loans by simply telling the lenders they were credit-worthy, with little or no verification at all. Mortgage brokerage houses expanded rapidly to accommodate the flood of applications, and originated and sold loans to lenders who often resold them in an investment portfolio.

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Then the bottom fell out from underneath them. Interest rates began climbing, lowering the demand for refinancing and lessening the pool of qualified homebuyers. Housing sales slowed, prices dropped and inventory, once scarce as potential sellers waited for the market to peak, suddenly increased.

Many borrowers who entered into adjustable loans could no longer avoid foreclosure by simply selling or refinancing the home. The number of foreclosed properties dramatically increased, placing additional price pressures on the already depressed housing market. Lending institutions sharply tightened their lending guidelines. Even qualified buyers began having difficulty closing escrow, as their lenders scrutinized appraisals and demanded more verification of income and assets to cover their risk.

Potential buyers, who previously had to place non-contingent offers over the asking price just to be considered, elected to see how low the market might drop, and made more judicious offers. A sub-prime loan, which previously could be resold at a profit, was suddenly worth far less than the cost of acquiring it and sometimes could not be resold at all.

### The Repurchase Demands

A residential mortgage bank or broker will often sell loans to a wholesale lender, who will resell them in large portfolios. The sales are pursuant to contracts, which typically demand the selling party make certain warranties and representations concerning the loans being sold. The contracts require sellers to have performed varying levels of due diligence to satisfy the buyer's underwriting guidelines.

Since all mortgage brokers sell a variety of products, the underwriting guidelines invariably change over time. These contracts generally contain repurchase clauses by which the seller promises to reacquire a loan if, for example, information provided by the borrower turns out to be false, misleading or incomplete.

During the height of the sub-prime boom, repurchase demands were relatively rare. Not only were sub-prime loans in great demand, there were also few foreclosures because property values kept rising and interest rates were low enough for homeowners to avoid a default through refinancing. However, when the bubble burst, many loan purchasers found they had paid far more for the loans than they were worth just a very short time earlier. As rating companies dramatically revised their opinions as to the value of mortgage-backed securities, the holders of the sub-prime loans began to try to push them back to the companies that originated them. The results, obviously, have been devastating for residential mortgage brokers across the country.

### Were The Contracts Modified?

Though sub-prime mortgage purchasers aggressively pursued their contractual remedies in requiring originating brokers to repurchase loans, it is not clear all of the purchasers retained that right. Many of the contracts incorporate a handbook or manual that is updated periodically to reflect new products the purchaser is willing to buy.

During the boom, when sub-prime loans were in unprecedented demand, many purchasers relaxed their guidelines. For example, "stated income/stated asset" (SISA) loans became commonplace, in which income, assets, and source of down payment were not verified. SISA loans morphed into "no income/no asset" or NINA loans in which the borrower would not even disclose their income or assets, and "no doc" loans in which little if any information was provided at all. Mortgage brokers, who were instructed to verify nothing other than a credit report, no longer were performing the due diligence required under the original contract.

Courts likely will be asked to decide whether the change in purchasing and underwriting guidelines effected a contract modification. The question is whether purchasers who accept-

ed greater risk for greater profits (which mortgage brokers also enjoyed), instructing sellers not to verify information, may nevertheless require repurchase when the borrower's information turns out to be incorrect or incomplete, or when a loan goes into foreclosure.

Few published decisions have addressed the sub-prime repurchase issue yet. In *Trustcorp Mortg. Co. v. Metro Mortg. Co., Inc.* (2007) 867 N.E.2d 203, the contract provided the seller would provide loans that would "qualify for" Fannie Mae and other investors. The borrower eventually defaulted, and Fannie Mae found alleged deficiencies in the original appraisal. Fannie Mae required Trustcorp to repurchase, and Trustcorp sought to force Metro to repurchase from Trustcorp.

The appellate court held that "the 'qualified for' language contained in the Buy/Sell Agreement did not impose a duty on Metro to provide a flawless appraisal in its origination documents, but that it simply required Metro to comply with all of Trustcorp's requirements in obtaining the appraisal." (Id. at 214.)

As purchasers attempt to shift the risk of loans they no longer want and sellers in a distressed market desperately resist those attempts, courts will likely have to undergo similar contractual analyses. The Courts will have to determine what the parties intended, both at contract formation and as additional loan products were created, to decide which party ultimately bears the risk of the market they surely knew had to fall. •

*Sources: Associated Press, "Credit Suisse to buy U.S. sub-prime lender ResMae for \$19.1 million" (Feb. 13, 2007); Civils & Gongloff, Wall Street Journal Online, Sub-prime Shakeout (undated;online.wsj.com/public/resources/documents/info-subprime-loans0706-sort.html); Bansal, Reuters, "Morgan Stanley unit sues Fremont for \$10 mln," (Oct. 24, 2007.)*