

THE COUNSELOR

SIROTE & PERMUTT'S STATEWIDE LEGAL NEWSLETTER

SUMMER 2007

BIRMINGHAM

HUNTSVILLE

MOBILE



MORTGAGE MARKET MELTDOWN AND ITS CONSEQUENCES



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Subprime real estate mortgage lending has seen as many ups and downs over the years as some elevators. Many changes and challenges have affected this industry over its 30 years, including Congressional scrutiny, 20+% interest rates, double digit inflation, development of ARMs, passage of HOEPA, the demise of the Savings & Loan industry, the application of RESPA and HMDA, the joinder of prime lenders into the marketplace, the advent of securitizations, the infusion of Wall Street capital, and the withdrawal of Wall Street capital. The one characteristic of the subprime industry that has enabled it to withstand the many challenges has been the entrepreneurial approach of subprime lenders. The one thing of which I am certain, is that subprime lending is not going away despite today's gloomy forecast.

With each waive of challenges, there have been significant repercussions, often led by the plaintiffs' trial bar. I saw first hand in Alabama in the mid-1990's what damage can be done by an aggressive plaintiffs' bar in a lax regulatory environment. When you add that aggressiveness and creativity to the lack of clarity of law and regulation, the result is a "perfect storm." Unfortunately, storm clouds are on the horizon once again; and those clouds look ominous.

Within the past 6 months, we have seen nothing short of a meltdown in the subprime real estate mortgage lending industry. Clearly, we've been here before. But, what makes

this time different is the sheer volume of lenders, loans and dollars involved. Subprime loan originations were over 25% of all mortgage loans made in the U.S. in 2006, totaling approximately \$640 billion. Subprime lenders were some of the hottest companies on Wall Street and were the growth stock of choice of many individual and institutional investors. Those companies' mantra was "We put people in homes." What was not said was "We put people in homes, whether they can afford them or not."

Subprime has been on a steep growth curve for several years, with an ever growing appetite for market share. This hunger led not only to the prevalence of teaser rates, but also to teaser rates available on non-traditional mortgage products, including Interest Only Loans and Payment Option ARMs. All of this worked well in a time of double digit growth in home values. After all, if the borrower

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couldn't make his mortgage payment, he could always sell the house and pay off even the most exotic of mortgages.

But what about when the music stopped, the economy faltered, and everyone had to scramble for a seat, or at least make their increasing monthly mortgage payments? That is exactly what has happened as the housing market has settled down, or in some areas, tumbled down. Where we find ourselves today is in a world of record delinquencies and foreclosures, particularly in the subprime world. Consumer advocates, regulators and legislators are looking for blood, and smell it.

SO, WHAT'S NEXT?



Consumer advocates are salivating and on the offensive. We will see a host of new laws and regulations from their concerted actions both on the national level and on the state level. For example, as recently as March 22nd, an extremely onerous bill was submitted to the North Carolina legislature, subjecting lenders to substantial penalties if they fail to pursue "all options" with a borrower before foreclosing. Trying to determine

precisely what "all options" are is a lender's nightmare and a consumer advocate's source of inspiration.

Plaintiffs' lawyers are attacking the mortgage loan products--particularly the exotic loans with teaser rates. We've already seen the filing and certification of class actions alleging that the ARM/teaser rate disclosures were not properly given. With HOEPA in play, we have seen a strong effort to argue that loans intended to be made outside of the boundaries of Section 32 of Regulation Z, actually fall within Section 32. In addition, we are seeing lawsuits in state courts in which claims are couched as fraud, breach of contract, and negligent supervision, but are really claims alleging that lenders made loans to borrowers which the borrowers could not afford--i.e., unsuitable loans. The result of such a successful attack would be startling to the mortgage holders, as they would see the value of their assets plummet.

Additionally, as the incidence of default and resulting foreclosures have taken center stage throughout the country, there has been incredible scrutiny given to mortgage loans by bankruptcy attorneys. Lenders often find themselves defending the loan terms before trustees and judges who are fairly sympathetic to the borrowers.

What all of this means is that we are seeing an up-tick in litigation and expect substantially more litigation to follow. We hope that our mortgage lending and servicing clients will weather the storm without incident; should one find oneself caught in the deluge, however, it is important to remember that there are aggressive defenses available.

MAURICE L. SHEVIN'S legal practice includes real estate, consumer finance, credit insurance, banking and general business. As corporate counsel for financial institutions and business clients, Shevin advises them with respect to regulatory matters and business and industry concerns and also advises numerous local, regional and national real estate, finance and consumer credit clients with respect to federal and state consumer credit protection laws, rules and regulations. Mr. Shevin serves as General Counsel to national and state trade associations. In addition, Shevin is a fellow of the American College of Consumer Financial Services Lawyers, and has authored many articles and lectures on the topics of consumer and real estate finance law.