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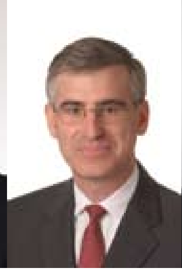


The nonprime mortgage slump has emboldened politicians to talk tough. Several have expressed a desire to expand liability for predatory and discriminatory lending to secondary mortgage market participants. But as our guest writers from Skadden, Arps, Slate, Meagher & Flom LLP describe, the risk of class-action lawsuits and government enforcement already exists.

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By Andrew L. Sandler, Benjamin B. Klubes, and Jonice Gray Tucker

The recent turmoil in the nonprime mortgage market has not just put lenders in the spotlight. It has also brought attention to the role that secondary mortgage market participants play. It remains to be seen whether the heightened interest that Congress and others are showing will lead to legislative or regulatory changes that would subject these players to increased liability for the business practices of the lenders. But several recent developments provide potential ways that secondary mortgage market participants may be held liable under existing laws that prohibit predatory and discriminatory lending origination practices.

Late last year the United States Court of Appeals for the Ninth Circuit took the unprecedented step of extending liability for the predatory lending practices of an originator to the secondary market under an aiding and abetting theory.

The case was brought by a class of California mortgagors who sued Lehman Brothers for fraudulent conduct perpetrated by bankrupt, non-prime mortgage lender First Alliance Mortgage. Over five years, Lehman provided the originator with a warehouse line of credit and co-managed four of its asset-backed securitizations. Over the years, Lehman allegedly became aware that First Alliance had been the subject of numerous allegations of fraudulent lending practices. Despite this, when other lenders withdrew funding because of concerns about First Alliance's business practices, Lehman increased First Alliance's line of credit to $150 million dollars, becoming its sole source of warehouse funding and underwriting.

After First Alliance declared bankruptcy, mortgagors alleged that Lehman was liable for aiding and abetting a uniform and systemic fraud in violation of California tort law and California's Unfair Competition Law because it provided First Alliance with financing knowing that its loans were originated through unfair and deceptive trade practices. Lehman defended on the grounds that it was not an active participant in the alleged fraudulent practices, but rather assisted First Alliance's business more generally.

Lehman's Liability

Following a jury verdict, the district court awarded the plaintiffs more than $5 million in damages, a decision upheld by the Ninth Circuit Court of Appeals. The Court held that Lehman's internal reports indicated it had direct knowledge of First Alliance's questionable business practices, and it rejected Lehman's claim that it assisted the business, not the fraud, holding that such a distinction is irrelevant when a company's entire business is "built like a house of cards on fraudulent enterprise."

Many states have similar laws on their statutes, so it its likely this case will be used as precedent by others seeking to hold secondary market purchasers liable for predatory conduct of originators. Interpretations may vary from state to state, however, as generally the defendant's aid must be to the person or entity who commits the wrongful act that caused the injury —and must be rendered knowingly and in substantial assistance of the principal violation.

State civil conspiracy laws may provide an alternative vehicle for holding secondary mortgage market participants liable, although they have not been used yet for this purpose. The allegations made against a loan purchaser likely would be similar to those in the aiding and abetting case. And the strength of a civil conspiracy claim would again turn, in large part, on how much the loan purchaser knew about the challenged lending practices, the timing of that knowledge, and whether it made an effort to address the challenged conduct.

First Alliance highlights the importance of understanding the practices of business partners, and taking timely and appropriate action based on that information. To reduce exposure to liability, secondary market participants should conduct appropriate due diligence before starting up a relationship with an originator. This may include a review of recent litigation, regulatory inquiries, mortgagor complaints, key lending policies, disclosures, and marketing materials, as well as analysis of a sample of loans originated by the lender.

Discriminatory Lending Liability

Secondary mortgage market participants may also face increased exposure to claims of discriminatory lending practices. In particular, the restrictions these players place on loans they are willing to purchase raises the possibility of being held liable for engaging in discriminatory practices under the expansive liability provisions of the Fair Housing Act of 1968 (FHA). The FHA, which prohibits discrimination against protected classes with respect to residential real estate-related transactions, defines a "residential real estate-related transaction" to include the "making or purchasing of loans or providing other financial assistance…secured by residential real estate."

The FHA's implementing regulations provide that it is unlawful for a person or entity engaged in the purchasing of loans, debts, or other securities, to "refuse to purchase such loans, debts, or securities, or to impose different terms or conditions for such purchases" because of the borrower's membership in a protected class. The statute identifies several types of discriminatory, and thus unlawful, activity within the secondary market, including: purchasing loans which are secured by dwellings in certain communities, but not others, because of a prohibited basis; pooling or packaging loans which are secured by dwellings differently because of a prohibited basis; and imposing, or using different terms or conditions, on the marketing or sale of securities issued in connection with residential real estate loans, because of a prohibited basis.

There is a safe-harbor provision, designed to make sure the regulations do not "prevent consideration, in the purchasing of loans, of factors justified by business necessity, including requirements of Federal law, relating to a transaction's financial security or to protection against default or reduction of the value of the security." So the regulations "would not preclude considerations employed in normal and prudent transactions," provided that no such factor relates to a prohibited basis.

The FHA may be enforced by the Department of Housing and Urban Development (HUD), the Department of Justice (DoJ), and private parties. Private parties and HUD may initiate administrative proceedings. In addition, both DoJ and private parties may commence civil litigation. The FHA provides for temporary or permanent injunctive relief, actual and punitive damages, civil penalties, and other orders deemed appropriate to address the discriminatory conduct.

The National Community Reinvestment Coalition (NCRC) has already filed complaints with HUD against five mortgage originators, claiming they violated the FHA in two ways. First, by refusing to make loans on homes valued under a specific dollar threshold of $75,000 to $100,000 — the "minimum value policy." Second, by requiring minimum home values for loans secured by row homes in certain neighborhoods or prohibiting loans secured by row homes altogether in other neighborhoods — the "no row house policy."

NCRC asserted that the minimum-value and no row house policies had a disparate impact on minorities in major metropolitan areas across the country because the homes at issue are located in predominantly minority communities. Some have suggested that these challenges to origination practices were precipitated by secondary market's limitations on the types of loans that it would purchase, and that these purchase practices could have had a disparate impact on minority borrowers.

Anticipated Allegations

Secondary mortgage market participants could be faced with claims that they violated the Fair Housing Act's general prohibition on discrimination by purchasing loans on the basis of race. In addition, a plaintiff may argue that the loan purchaser violated certain specific prohibitions on discrimination in the secondary market in the FHA implementing regulations — in particular, the prohibition on purchasing loans secured by dwellings in certain communities but not in others because of race-related factors, and its prohibition on pooling and packaging loans differently because of race-related factors.

The plaintiff would be required to make a prima facie showing that the challenged loan purchase practices had a disparate impact on minorities. The plaintiff might do so by alleging that the secondary market purchaser had a policy or practice of refraining from purchasing loans secured by properties with particular characteristics, and that these purchase restrictions then prompted originators to establish policies that would either deny loans secured by those property types, or offer loans on significantly less favorable terms.

The plaintiff might use census, Home Mortgage Disclosure Act and other data to show that minority borrowers have a higher likelihood of owning restricted property types than Caucasian borrowers. That might help support the argument that secondary mortgage market participants' purchase restrictions disproportionately affect minority borrowers.

If the plaintiff can establish a prima facie case, the burden of proof will shift to the secondary market purchaser to demonstrate either that it does not have such policies or practices or, if it does, to establish a non-discriminatory business justification for its loan purchase practices — for example, that they are necessary to guard against buying unprofitable loans.

To reduce exposure to litigation, secondary mortgage market participants should examine relevant demographic data to evaluate whether their loan purchase policies and restrictions could have an unintended, discriminatory impact on minority borrowers or members of other protected classes. If they do, the purchaser should evaluate the business justification for such restrictions and proactively make policy adjustments if a strong, non-discriminatory justification is lacking.

The onus now seems to be on secondary mortgage market participants to conduct proper due diligence to avoid such claims of discrimination, or of aiding and abetting unfair and deceptive practices of mortgage lenders. With the condition of the nonprime mortgage markets deteriorating, it is likely such players will face a new frontier of litigation in the months ahead.

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This is an edited version of the authors' article. The full version, complete with annotated references, can be found at www.skadden.com/consumerfinancialservices.