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Sub-Prime Lending Leads the News: Investment Banks and Credit Rating Firms Are New Targets

Over the past few months, the business news media have saturated consumers with stories about sub-prime residential mortgage loans, "predatory" lending and the resulting "foreclosure crisis" in many states. Activist groups, such as the National Community Reinvestment Coalition, blame "a plethora of actors" including "brokers, appraisers, correspondents, depository lending institutions, loan [servicing companies], [securities companies] and Wall Street investors" for what they call an "epidemic of predatory lending" throughout the United States.

Federal and state government legislators and regulators have responded to this perceived lending crisis. In Washington D.C., both the House and Senate are considering new legislation that will set national guidelines on sub-prime mortgage lending, as well as expand the eligibility criteria for loans backed by the Federal Housing Association (FHA) to permit easier refinancing of high interest rate loans. Cleveland Congresswoman Stephanie Tubbs Jones recently reintroduced the Predatory Lending Practice Reduction Act of 2007. This proposed legislation would require federal regulation and certification of mortgage brokers and agents, as well as impose more severe penalties for violation of federal law. Additionally, the Tubbs Jones proposal would authorize federal funding for local community development corporations to provide training and education to consumers. The same legislation died during the previous Congress, but stands a much better chance of passing in the Democratic-led House.

On the regulatory side, the Office of the Comptroller of the Currency and the Federal Reserve Bank are currently requesting public comment on new guidelines for adjustable rate mortgages (a primary source of trouble for sub-prime borrowers), as well as disclosure of fees and pre-payment penalties that hinder repayment and refinancing.

On May 15, 2007, Ohio Attorney General (AG) Marc Dann announced that his office would begin pursuing investment banks and credit rating firms that aid sub-prime "predatory" lenders. This expands Ohio's efforts to punish entities involved in sub-prime lending, by going beyond the lenders and mortgage brokers previously in the AG's crosshairs. According to Attorney General Dann, "a lot of people profited handsomely" from the sub-prime lending boom. Those same non-lender players will now be targeted to provide disgruntled borrowers with "a big pot of money" as part compensation for the unscrupulous conduct of "predatory" lenders.

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In addition to Ohio's litigation strategy, Ohio Governor Ted Strickland has created a "Foreclosure Prevention Task Force" to provide assistance to troubled borrowers facing foreclosure due to problem sub-prime loans or "predatory" lending practices. This program, which began operating on April 2, 2007, will eventually include a $100 million "rescue fund" for refinancing loans, lender concessions and borrower counseling/education programs, all intended to help troubled borrowers keep their homes out of foreclosure.

The nationwide spate of state and local litigation and proposed law-making may run into barriers erected by a recent United States Supreme Court decision, *Watters v. Wachovia Bank,* 2007 U.S. LEXIS 4336 (U.S. No. 05-1342, April 17, 2007). In *Watters,* the Supreme Court determined that in areas where the National Bank Act authorizes national banks to operate, the federal government is the sole regulator of national bank subsidiaries, even when the subsidiaries are state-chartered.

The 5-3 opinion by Justice Ruth Bader Ginsburg held that the National Bank Act preempted the State of Michigan's efforts to regulate the real estate lending activities of a national bank's operating subsidiary, affirming an earlier decision of the Sixth Circuit Court of Appeals. The Court stated that because a "national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself," the operating subsidiary's activities "cannot be significantly impaired or impeded by state law." Since the state could not regulate the national bank's ability to engage in real estate lending directly, it could not regulate the bank indirectly by exercising visitorial powers over the operating subsidiary.

Watters clarifies the role and responsibilities of national banks conducting lending operations and other activities through its state-chartered operating subsidiaries. This decision may prove to be a useful precedent for banks and other financial services companies facing the threat of an increasingly tangled web of state and local laws and regulations meant to address the "predatory lending epidemic."

For mortgage brokers, lenders, realtors, title companies, and loan servicing companies – and now investment banks and credit rating firms as well – the current "crisis" in sub-prime lending dramatically increases the risk of litigation in the near future. State attorneys general, community activists, fair housing advocates and debtors' attorneys are becoming more aggressive in pursuing claims against any party connected with a troubled sub-prime loan. Yesterday's sub-prime loan can easily turn into tomorrow's "predatory loan." The result could client**alert**

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be a lawsuit which, like many Ulmer & Berne attorneys have seen recently, alleges common law fraud, racially targeted marketing or solicitation practices, "redlining" and/or race discrimination in lending, violations of the Fair Credit Reporting Act, and violations of the Fair Debt Collection Practices Act.