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Let the Lawsuits Begin: Banks Brace for a Storm of Litigation

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In an article in *The San Francisco Chronicle* in December 2007, attorney Sean Olender suggested that the real reason for the subprime bailout schemes being proposed by the U.S. Treasury Department was not to keep strapped borrowers in their homes so much as to stave off a spate of lawsuits against the banks. The plan then on the table was an interest rate freeze on a limited number of subprime loans. Olender wrote:

"The sole goal of the freeze is to prevent owners of mortgage-backed securities, many of them foreigners, from suing U.S. banks and forcing them to buy back worthless mortgage securities at face value – right now almost 10 times their market worth. The ticking time bomb in the U.S. banking system is not resetting subprime mortgage rates. *The real problem is the contractual ability of investors in mortgage bonds to require banks to buy back the loans at face value if there was fraud in the origination process.*

". . . The catastrophic consequences of bond investors forcing originators to buy back loans at face value are beyond the current media discussion. *The loans at issue dwarf the capital available at the largest U.S. banks combined, and investor lawsuits would raise stunning liability sufficient to cause even the largest U.S. banks to fail*, resulting in massive taxpayer-funded bailouts of Fannie and Freddie, and even FDIC . . . .

"What would be prudent and logical is for the banks that sold this toxic waste to buy it back and for a lot of people to go to prison. *If they knew about the fraud, they should have to buy the bonds back*."1

The thought could send a chill through even the most powerful of investment bankers, including Treasury Secretary Henry Paulson himself, who was head of Goldman Sachs during the heyday of toxic subprime paper-writing from 2004 to 2006. Mortgage fraud has not been limited to the representations made to borrowers or on loan documents but is in the design of the banks' "financial products" themselves. Among other design flaws is that securitized mortgage debt has become so complex that ownership of the underlying security has often been lost in the shuffle; and without a legal owner, there is no one with standing to foreclose. That was the procedural problem prompting Federal District Judge Christopher Boyko to rule in October 2007 that Deutsche Bank did not have standing to foreclose on 14 mortgage loans held in trust for a pool of mortgage-backed securities holders.2 If large numbers of defaulting homeowners were to contest their foreclosures on the ground that the plaintiffs lacked standing to sue, trillions of dollars in mortgage-backed securities (MBS) could be at risk. Irate securities holders might then respond with litigation that could indeed threaten the existence of the banking Goliaths.

States Leading the Charge

MBS investors with the power to bring major lawsuits include state and local governments, which hold substantial portions of their assets in MBS and similar investments. A harbinger of things to come was a complaint filed on February 1, 2008, by the State of Massachusetts against investment bank Merrill Lynch, for fraud and misrepresentation concerning about $14 million worth of subprime securities sold to the city of Springfield. The complaint focused on the sale of "certain esoteric financial instruments known as collateralized debt obligations (CDOs) . . . which were unsuitable for the city and which, within months after the sale, became illiquid and lost almost all of their market value."3

The previous month, the city of Baltimore sued Wells Fargo Bank for damages from the subprime debacle, alleging that Wells Fargo had intentionally discriminated in selling high-interest mortgages more frequently to blacks than to whites, in violation of federal law.4

Another innovative suit filed in January 2008 was brought by Cleveland Mayor Frank Jackson against 21 major investment banks, for enabling the subprime lending and foreclosure crisis in his city. The suit targeted the investment banks that fed off the mortgage market by buying subprime mortgages from lenders and then "securitizing" them and selling them to investors. City officials said they hoped to recover hundreds of millions of dollars in damages from the banks, including lost taxes from devalued property and money spent demolishing and boarding up thousands of abandoned houses. The defendants included banking giants Deutsche Bank, Goldman Sachs, Merrill Lynch, Wells Fargo, Bank of America and Citigroup. They were charged with creating a "public nuisance" by irresponsibly buying and selling high-interest home loans, causing widespread defaults that depleted the city's tax base and left neighborhoods in ruins.

"To me, this is no different than organized crime or drugs," Jackson told the Cleveland newspaper The Plain Dealer. "It has the same effect as drug activity in neighborhoods. It's a form of organized crime that happens to be legal in many respects." He added in a videotaped interview, "This lawsuit said, *'You're not going to do this to us anymore.'*"5

The Plain Dealer also interviewed Ohio Attorney General Marc Dann, who was considering a state lawsuit against some of the same investment banks. "There's clearly been a wrong done," he said, "and the source is Wall Street. I'm glad to have some company on my hunt."

However, a funny thing happened on the way to the courthouse. Like New York Governor Eliot Spitzer, Attorney General Dann wound up resigning from his post in May 2008 after a sexual harassment investigation in his office.6 Before they were forced to resign, both prosecutors were hot on the tail of the banks, attempting to impose liability for the destructive wave of home foreclosures in their jurisdictions.

But the hits keep on coming. In June 2008, California Attorney General Jerry Brown sued Countrywide Financial Corporation, the nation's largest mortgage lender, for causing thousands of foreclosures by deceptively marketing risky loans to borrowers. Among other things, the 46-page complaint alleged that:

"'Defendants viewed borrowers as nothing more than the means for producing more loans, originating loans with little or no regard to borrowers' long-term ability to afford them and to sustain homeownership' . . .

"The company routinely . . . 'turned a blind eye' to deceptive practices by brokers and its own loan agents despite 'numerous complaints from borrowers claiming that they did not understand their loan terms.'

". . . Underwriters who confirmed information on mortgage applications were 'under intense pressure . . . to process 60 to 70 loans per day, making careful consideration of borrowers' financial circumstances and the suitability of the loan product for them nearly impossible.'

"'Countrywide's high-pressure sales environment and compensation system encouraged serial refinancing of Countrywide loans.'"7

Similar suits against Countrywide and its CEO have been filed by the states of Illinois and Florida. These suits seek not only damages but rescission of the loans, creating a potential nightmare for the banks.

An Avalanche of Class Actions?

Massive class action lawsuits by defrauded borrowers may also be in the works. In a 2007 ruling in Wisconsin that is now on appeal, U.S. District Judge Lynn Adelman held that Chevy Chase Bank had violated the Truth in Lending Act by hiding the terms of an adjustable rate loan, and that *thousands of other Chevy Chase borrowers could join the plaintiffs in a class action on that ground*. According to a June 30, 2008 report in Reuters:

"The judge transformed the case from a run-of-the-mill class action to a potential nightmare for the U.S. banking industry by also finding that the borrowers could force the bank to cancel, or rescind, their loans. That decision was stayed pending an appeal to the 7th U.S. Circuit Court of Appeals, which is expected to rule any day.

"The idea of canceling tainted loans to stem a tide of foreclosures has caught hold in other quarters; a lawsuit filed last week by the Illinois attorney general asks a court to rescind or reform Countrywide Financial mortgages originated under 'unfair or deceptive practices.'

". . . The mortgage banking industry already faces pressure from state and federal regulators, who have accused banks of lowering underwriting standards and forcing some borrowers, through fraud, into costly adjustable loans that the banks later bundled and sold as high-interest investment vehicles."

The Truth in Lending Act (TILA) is a 1968 federal law designed to protect consumers against lending fraud by requiring clear disclosure of loan terms and costs. It lets consumers seek rescission or termination of a loan and the return of all interest and fees when a lender is found to be in violation. The beauty of the statute, says California bankruptcy attorney Cathy Moran, is that it provides for strict liability: the aggrieved borrowers don't have to prove they were personally defrauded or misled, or that they had actual damages. Just the fact that the disclosures were defective gives them the right to rescind and deprives the lenders of interest. In Moran's small sample, at least half of the loans reviewed contained TILA violations.8 If class actions are found to be available for rescission of loans based on fraud in the disclosure process, the result could be a flood of class suits against banks all over the country.9

Shifting the Loss Back to the Banks

Rescission may be a remedy available not only for borrowers but for MBS investors. Many loan sale contracts provide by their terms that lenders must take back loans that default unusually quickly or that contain mistakes or fraud. An avalanche of rescissions could be catastrophic for the banks. Banks were moving loans off their books and selling them to investors in order to allow many more loans to be made than would otherwise have been allowed under banking regulations. The banking rules are complex, but for every dollar of shareholder capital a bank has on its balance sheet, it is supposed to be limited to about $10 in loans. The problem for the banks is that when the process is reversed, the 10 to 1 rule can work the other way: taking a dollar of bad debt *back* on a bank's books can *reduce* its lending ability by a factor of 10. As explained in a BBC News story citing Prof. Nouriel Roubini for authority:

"[S]ecuritisation was key to helping banks avoid the regulators' 10:1 rule. To make their risky loans appear attractive to buyers, banks used complex financial engineering to repackage them so they looked super-safe and paid returns well above what equivalent super-safe investments offered. Banks even found ways to get loans off their balance sheets without selling them at all. They devised bizarre new financial entities – called Special Investment Vehicles or SIVs – in which loans could be held technically and legally off balance sheet, out of sight, and beyond the scope of regulators' rules. So, once again, SIVs made room on balance sheets for banks to go on lending.

"Banks had got round regulators' rules by selling off their risky loans, but because so many of the securitised loans were bought by other banks, the losses were still inside the banking system. Loans held in SIVs were technically off banks' balance sheets, but when the value of the loans inside SIVs started to collapse, the banks which set them up found that they were still responsible for them. So losses from investments which might have appeared outside the scope of the regulators' 10:1 rule, suddenly started turning up on bank balance sheets. . . . The problem now facing many of the biggest lenders is that when losses appear on banks' balance sheets, *the regulator's 10:1 rule comes back into play because losses reduce a banks' shareholder capital*. 'If you have a $200bn loss, that reduced your capital by $200bn, you have to reduce your lending by 10 times as much,' [Prof. Roubini] explains. *'So you could have a reduction of total credit to the economy of two trillion dollars.'*"10

You could also have some very bankrupt banks. The total equity of the top 100 U.S. banks stood at $800 billion at the end of the third quarter of 2007. Banking losses are currently expected to rise by as much as $450 billion, enough to wipe out more than half of the banks' capital bases and leave many of them insolvent.11 If debtors were to deluge the courts with viable defenses to their debts and mortgage-backed securities holders were to challenge their securities, the result could be even worse.

Putting the Genie Back in the Bottle

So what would happen if the mega-banks engaging in these irresponsible practices actually went bankrupt? These banks are widely acknowledged to be at fault, but they expect to be bailed out by the Federal Reserve or the taxpayers because they are "too big to fail." The argument is that if they were allowed to collapse, they would take the economy down with them. That is the fear, but it is not actually true. We *do* need a ready source of credit, so we need banks; but we don't need *private* banks. It is a little-known, well-concealed fact that banks do not lend their own money or even their depositors' money. They actually *create* the money they lend; and creating money is properly a public, not a private, function. The Constitution delegates the power to create money to Congress and only to Congress.12 In making loans, banks are merely extending credit; and the proper agency for extending "the full faith and credit of the United States" is the United States itself.

There is more at stake here than just the equitable treatment of injured homeowners and investors in mortgage-backed securities. Banks and investment houses are now squeezing the last drops of blood from the U.S. government's credit rating, "borrowing" money and unloading worthless paper on the government and the taxpayers. When the dust settles, it will be the banks, investment brokerages and hedge funds for wealthy investors that will be saved. The repossessed will become the dispossessed; and unless your pension fund has invested in politically well-connected hedge funds, you can probably kiss it goodbye, as teachers in Florida already have.

But the banking genie is a creature of the law, and the law can put it back in the bottle. The imminent failure of some very big banks could provide the government with an opportunity to regain control of its finances. More than that, it could provide the funds for tackling otherwise unsolvable problems now threatening to destroy our standard of living and our standing in the world. The only solution that will be more than a temporary fix is to take the power to create money away from private bankers and return it to the people collectively. That is how it should have been all along, and how it was in our early history; but we are so used to banks being private corporations that we have forgotten the public banks of our forebears. The best of the colonial American banking models was developed in Benjamin Franklin's province of Pennsylvania, where a government-owned bank issued money and lent it to farmers at 5 percent interest. *The interest was returned to the government, replacing taxes*. During the decades that that system was in operation, *the province of Pennsylvania operated without taxes, inflation or debt*.

Rather than bailing out bankrupt banks and sending them on their merry way, the Federal Deposit Insurance Corporation (FDIC) needs to take a close look at the banks' books and put any banks found to be insolvent into receivership. The FDIC (unlike the Federal Reserve) is actually a federal agency, and it has the option of taking a bank's stock in return for bailing it out, effectively nationalizing it. This is done in Europe with bankrupt banks, and it was done in the United States with Continental Illinois, the country's fourth largest bank, when it went bankrupt in the 1990s.

A system of truly "national" banks could issue "the full faith and credit of the United States" for public purposes, including funding infrastructure, sustainable energy development and health care.13 Publicly-issued credit could also be used to relieve the subprime crisis. Local governments could use it to buy up mortgages in default, compensating the MBS investors and freeing the real estate for public disposal. The properties could then be rented back to their occupants at reasonable rates, leaving people in their homes without the windfall of acquiring a house without paying for it. A program of lease-purchase might also be instituted. The proceeds would be applied toward repaying the credit advanced to buy the mortgages, balancing the money supply and preventing inflation.

Local and Private Solutions

While we are waiting for the federal government to act, there are also private and local possibilities for relieving the subprime crisis. Chris Cook is a British strategic market consultant and the former Compliance Director for the International Petroleum Exchange. He recommends getting all the parties to settle by forming a pool constituted as an LLC (limited liability company), in a partnership framework that brings together occupiers and financiers as co-owners under a neutral custodian. The original owners would pay an affordable rental, and the resulting pool of rentals would be "unitized" (divided into unit interests, similar to a REIT or real estate investment trust). Among other advantages over the usual mortgage-backed security, there would be no loans at interest, since the property would be owned outright by the LLC. Eliminating interest substantially reduces costs. The former owners would be able to occupy the property at an affordable rental, with the option to buy an equity stake in it. For the banks, the advantage would be that they would be able to find investors again, since the risk would have been taken out of the investment by insuring full occupancy at affordable rates; and for the investors, the advantage would be a secure investment with a dependable return.14

Carolyn Betts is an Ohio attorney who served in Washington as issuer's counsel for MBS trusts formed by various federal governmental entities, and represented Resolution Trust Corporation in its auction of defaulted commercial mortgage loans during the last real estate crisis. She proposes a squeeze play by the states, in the style of that brought against the tobacco companies by a consortium of state attorneys general in the 1990s. She notes that at the end of 2007, at least 20% of the funds held by the Ohio Public Employees' Retirement System (PERS) were in mortgage backed securities and similar investments. That makes Ohio public money a major investor in these mortgage-related securities. Ohio governments have an interest in not having homes foreclosed upon, since foreclosures destroy local real estate markets, contribute to lower tax revenues and losses on PERS investments, and cause a strain on state and local affordable housing systems. A coordinated series of actions brought by state attorneys general could eliminate the culpable banker middlemen and return the properties to local ownership and control.

Andrew Jackson reportedly told Congress in 1829, "If the American people only understood the rank injustice of our money and banking system, there would be a revolution before morning." A wave of private actions, class actions and government lawsuits aimed at redressing injurious banking practices could spark a revolution in banking, returning the power to advance "the full faith and credit of the United States" to the United States, and returning community assets to local ownership and control.

Ellen Brown, J.D., developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves and how we the people can get it back. Her websites are www.webofdebt.com and www.ellenbrown.com.

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