



message from partners in charge

It is our pleasure to introduce you to Pepper's first *Princeton Update*. Clients and friends of the firm often ask Pepper attorneys for advice and education on a range of subjects. We hope these quarterly updates provide you with insights to a wide variety of legal issues as well as the happenings in our office and the firm.

Our inaugural issue features an article about the effects of the recent decline in the subprime mortgage market. Like the savings and loan crisis in the 1980s, this decline may affect a variety of industries. Read more about the current debate and actions that may be taken by legislators and regulators to prevent future subprime lending problems.

We are excited to announce that the Princeton office continues to grow. Four attorneys have recently joined the firm, bringing with them experience in a variety of areas including tax, health effects litigation, private equity and commercial litigation. And several Princeton attorneys will be presenting at upcoming programs. Be sure to take a look at our new attorneys section and event listings.

We welcome your comments. Enjoy!

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The Decline of the Subprime Mortgage Market

The recent decline in the subprime mortgage market undoubtedly will have ripple effects throughout the economy. As the market declined, the perception that subprime loans are akin to predatory loans has grown.

Subprime lending came to life when investment bankers had the idea of purchasing mortgages from bank lenders, packaging them and issuing bonds to finance the purchases with the packaged mortgages as collateral. This practice of mortgage securitization has created enormous wealth for investors, but also has created an incentive structure that encourages originators to write riskier loans, collect fees and transfer the risk to investors.

The remarkable growth in the subprime market in the last 10 years is primarily the result of two distinct factors: investors' incessant search for higher yields, and ordinary Americans' pursuit of the American dream of homeownership – at whatever the cost or terms. Subprime loans grew rapidly in the late stages of the housing boom due to strong demand among households that were unable to acquire property in the housing market through traditional financing. Borrowers who cannot make the required downpayment, and who lack sufficient income to access traditional lenders, have flocked to subprime lenders.

Subprime loans are mortgages made to borrowers who generally have credit scores of 620 or below. Such scores often result from a record of paying debts late (or not at all) and other credit blemishes. Since these borrowers are viewed as high risk, their loans carry interest rates that are often at least 2 percent higher than those offered to traditional borrowers, and may contain risk compensating features, such as prepayment penalties. Examples of typical subprime mortgage products include:

- Balloon Mortgages – the borrower only pays interest for the first 10 or 15 years, after which a big lump-sum is due.

- “No Doc” or “Low Doc” Loans – the lender accepts the borrower’s stated income without any supporting documentation.
- Piggy-back Loans – the combination of a first and second mortgages eliminates the need for the typical 20 percent down-payment.
- Teaser Loans – the borrower may qualify for an artificially low interest rate for an initial term of, for example, three years, and then the rate adjusts – requiring higher payments that are less affordable for the borrower.
- Stretch Loans – the monthly payments represent more than 50 percent of the borrower’s gross income.
- 2/28 Loan – a type of teaser loan product that is nearly exclusive to the subprime market, 2/28 loans have an adjustable rate that is fixed for the first two years, and then adjusts to a rate index plus a margin.

To properly understand today’s problem, one must consider the current subprime environment in view of a nearly 20-year economic cycle. Following the recession of the early 1990’s, the country entered one of the longest periods of economic growth in the past 60 years. This environment allowed mortgage originations to hold steady at around \$1 trillion a year. Due to the stable environment, the Federal Reserve initiated interest rate reductions in 2001 that had an immediate impact on the mortgage market. As interest rates declined and home values increased, borrowers took advantage of the opportunity to refinance existing loans and cash-out equity. This also allowed increased opportunity for first-time home buyers. The result was a dramatic

expansion in the mortgage market from 2001 to 2004, peaking in 2003 at just under \$4 trillion in new originations. When demand for new loans slowed in 2004, the market was left with overcapacity, prompting originators, urged by investors hungry for increased yields, to shift to more “innovative” products. Accompanying these innovative products were relaxed underwriting standards and temporary payment reductions, increasing risk for both borrowers and lenders.

For the past two years, subprime lending has constituted approximately 20 percent of the mortgage loan market share. As an example of the current trend in subprime loan performance, a recent nationwide survey conducted by the Mortgage Bankers Association showed that 14.44 percent of subprime borrowers with Adjustable Rate Mortgage (ARM) loans were at least 60 days delinquent in their payments in the fourth quarter of 2006. This was a 122 basis point increase over the same rate from the previous quarter. Foreclosure rates for subprime loans also increased 18 basis points during the fourth quarter of 2006.

Similar to the savings and loan crisis of the 1980’s, the decline in the subprime market has the potential to affect a variety of industries. For example, real estate (increased foreclosures may cause lower overall sale prices and an oversupply of housing inventories), retailers (retail sales may decline as customers’ discretionary spending contracts, especially retailers that draw price-sensitive consumers), and home improvement companies (for consumers facing foreclosure, home improvement may become a



Peppercast: Mandatory Fee Arbitration Agreements

Michael Meeks, a partner in Pepper Hamilton’s Commercial Litigation practice group and a resident of our expanding Orange County California office, and **Eric Goldberg**, an associate with Pepper’s Philadelphia office who concentrates his practice in commercial litigation, discuss an interesting matter that arose out of the divorce proceedings between Bruce Springsteen’s keyboardist, Danny Federici, and his wife Kathlynn Federici.

The matter is *Federici v. Gursej Schneider and Company*. Federici raises the issue of the enforceability of a mandatory fee arbitration agreement between Kathlynn Federici and the accounting firm she retained during the divorce.

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low priority). The ripple effect of the subprime mortgage market downturn will be felt immediately for the investors who sought the opportunities for high yields available in mortgage securitized assets. Unlike the savings and loan industry, however, where the losses were born by individual banks and their owners, due to securitization of mortgage-backed assets traded in the secondary market, the subprime loan losses will be diluted among investors worldwide rather than concentrated in the institutions that originated the loans.

Members of Congress have called for a temporary moratorium on subprime loan foreclosures and greater regulatory controls. During this session, Congress may seek to modernize the Federal Housing Administration to enable it to attract many consumers who would otherwise be drawn to subprime lenders. Additionally, this legislative season may draw amendments to the Home Ownership Equity Protection Act (HOEPA) to broaden the scope of loans covered under the Act's protections.

Consumer advocates also are calling for a federally mandated home loan suitability rule, similar to what is currently in place for investment securities. As discussed in detail below, those who support such a measure argue that a federal suitability standard, and the enforcement of such a standard, would deter predatory lending practices that may exist in the subprime market, while permitting appropriate innovation of new products. Opponents of a suitability standard argue that it is ill-placed in a home mortgage market where affordability is key, and where such standards might lead to frivolous lawsuits. There are also different public policy considerations underlying homeownership that are absent in securities investments.

On the regulatory side, several federal agencies may take action to address subprime lending. The Federal Reserve Board may issue new regulations in an attempt to set uniform federal guidelines to replace the hodgepodge of federal and state laws and regulations affecting the subprime loan market. In 2006, more than half of the subprime loans originated were done subject to exclusive state regulation. There is still some question regarding whether the Federal Reserve can do this under its existing rules, or whether additional legislation is required to authorize such rulemaking. On June 29, 2007, the federal bank regulatory agencies issued final guidance on subprime mortgage lending ("Interagency Guidance"). The Interagency Guidance provides direction for banks, savings associations, and credit unions, and their subsidiaries, holding companies,

New Attorneys in Princeton

Pepper is pleased to welcome four new attorneys to the Princeton office.

Partner **Steven D. Bortnick** comes to Pepper from Dechert. As a member of the Tax Practice Group, Steve focuses his practice on domestic and international tax and private equity matters. He handles a broad range of cross-disciplinary transactions, including asset, stock, cross-border and domestic acquisitions, tax-free spinoffs, recapitalizations and reorganizations. Steve divides his time between our Princeton and New York offices. (609.951.4117/212.808.2715 or bortnicks@pepperlaw.com)

John F. Brenner joins the firm as a partner in Health Effects Litigation. John represents pharmaceutical and medical device manufacturers in the defense of complex liability and mass tort cases. His practice has included being a part of national counsel teams managing litigation for major pharmaceutical companies. He has handled cases involving a wide variety of prescription and over-the-counter pharmaceuticals as well as a variety of medical devices. He comes to Pepper from McCarter & English, LLP in Newark, NJ. (609.951.4193 or brennerj@pepperlaw.com)

Patricia A. Lauch is an associate in the Commercial Litigation Practice Group. Trish earned her J.D., *cum laude*, from Brooklyn Law School and her B.A., *summa cum laude*, in English from Seton Hall University. While in law school, she interned with the Honorable Conrad B. Duberstein, Chief Judge of the U.S. Bankruptcy Court for the Eastern District of New York in Brooklyn, NY. Trish practiced with Buchanan Ingersoll & Rooney PC in Princeton before coming to Pepper. (609.951.4139 or lauchp@pepperlaw.com)

Gregory S. Ricciardi was a summer associate at Pepper in 2006 and is now with us as a law clerk in the Real Estate Practice Group. Prior to joining the firm, Greg was a political intern to Senators Jon Corzine and Robert Menedez and a legal intern with the Office of the City Attorney in Ithaca, NY. He also was a policy analyst and consultant with the Ithaca Urban Renewal Agency. He is awaiting admittance to the bar. (609.951.4206 or ricciardig@pepperlaw.com)

Please join us in welcoming Steve, John, Trish and Greg to Pepper.

and nonbank subsidiaries of those holding companies, covering such areas as risk management practices, workout arrangements, consumer protection principles, control systems, and supervisory review.

Subprime loans are not intrinsically evil – quite the contrary – they have served the purposes for which they were designed: generating high investment yield and creating opportunities for home ownership. At the end of the day, this subprime experience has shown policymakers the need for greater consumer disclosure. Even before legislative and regulatory intervention, consumers can avoid some of the pitfalls of subprime lending by being aware of:

- potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires
- the existence of any prepayment penalties, how such will be calculated and when penalties may be imposed
- the existence of any balloon payment
- whether there is a cost premium attached to a reduced documentation or stated income program
- the requirement to make payments for real estate taxes and insurance, if not escrowed, in addition to loan payments, and the fact that taxes and insurance costs can be substantial.

Whether the current debate over subprime lending will result in fundamental change, for better or worse, to this market for those with limited access to banking services remains to be seen. However long the debate lasts, what is likely to result is a correction on the part of legislators, regulators, the courts, and the marketplace to make the subprime mortgage lending environment more transparent and more informed.

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Upcoming Events

Pepper lawyers **Leonard Schneidman**, **Julia D. Corelli** and **Steven D. Bortnick** will speak at the Institute for International Research's 6th Annual West Coast Program for Venture Capital and Private Equity Tax Practices at the Crowne Plaza Cabana in Palo Alto, California on October 22-24, 2007. Visit www.iirusa.com for more information and to register.

Pepper Hamilton is hosting a webinar "A Practical Guide to Dealing with Institutional Investors and Dissident Shareholders" on Thursday, November 8, beginning at 12 noon EST. The program will provide a practical "how to" approach to dealing with the legal and financial issues raised by investors in banking organizations. **Dennis R. Casale** will serve as moderator and **Angelo A. Stio** and **Donald R. Readlinger** as panelists. For more information or to register, contact Brian Dolan at 215.981.4568 or dolanb@pepperlaw.com.

On November 14-15, 2007, Pepper partner **Steven Bortnick** will be speaking at Financial Research Associates' "The Investor Forum on Private Equity Portfolio Management" at The 3 West Club in New York City. Visit www.frallc.com for more information.

Pepper Hamilton LLP

Attorneys at Law

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