'Dent' Sales Slow as Legal Risks Mount

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By Kate Berry

As distressed mortgage lenders and their creditors flood the "scratch-and-dent" market with discounted loans, the buyers of these assets are taking a much closer look at the legal and regulatory risks in portfolios.

Until recently, the buyers usually relied on sellers' representations and warranties to ensure that a loan complied with all applicable laws. But with many originators in bankruptcy or out of business, the investors have little recourse to cover any fines, penalties, or civil damages if the loans run afoul of state or federal laws.

Lawyers and mortgage specialists who conduct due diligence on pools of loans sold in this now-crowded market say they are finding that regulatory risk is not capped and could exceed the value of the loans.

Loans can end up in the scratch-and-dent market either because of a default, problems at the originator, or reduced liquidity in the regular secondary market.

The sellers are usually subprime originators or, in some cases, their creditors. (Morgan Stanley, Barclays PLC, and the French bank Natixis are trying to unload more than $4 billion of loans originated by the bankrupt New Century Financial Corp.) Buyers include the major Wall Street investment banks, most of which have scratch-and-dent trading desks, and private-equity firms and hedge funds that are hunting for bargains.

Louis Pizante, the chief executive of Mavent Inc. in Irvine, Calif., a provider of automated compliance software, said the purchasers face "huge risks." He characterized some of the loans as "grenades being passed around."

"With foreclosures spiking, there is a far greater likelihood that borrowers and their attorneys will scrutinize these loans for noncompliance issues that will enable them to defend foreclosure actions," said Mr. Pizante, a lawyer whose company reviews 500,000 loans a month.

While the credit risk on loan purchases is capped, so buyers will never lose more than what they paid, the penalties and fines associated with some regulatory violations "can well exceed the par value of the loan, let alone what you paid for it," Mr. Pizante said.

The most critical issue is "assignee liability," which allows a purchaser of mortgage loans to be held liable for faulty disclosures by the originator under the federal Truth in Lending Act. Laws in 28 states and the District of Columbia also have assignee-liability provisions that let borrowers recover damages from loan purchasers. And the federal Home Ownership and Equity Protection Act adds an extra set of compliance pressures and risk, lawyers say.

"The major issue is, can a borrower assert a fraud by the original lender against the secondary market?" said Tim Meredith, a partner at Hudson Cook LLP, a Hanover, Md., law firm that specializes in high-cost mortgage compliance. "These purchasers want to make sure they aren't buying something that the consumer could later hold them liable for."

Reps and warranties were once viewed as the solution to this problem. But Robert Cook, another Hudson

Cook partner, said: "We're in a situation where anyone buying a portfolio of loans in the distressed category is going to be left out in the cold. They will have no one to go back to after the sale to say, 'Take care of this loan, correct it, and get me off the hook.' "

Stephen Ornstein, a partner at the law firm Thacher Proffitt & Wood LLC, said that even if a seller is willing to provide a warranty, it may not be able to make good on the promise.

"The fact is that if you have a company that is in bankruptcy, the reps and warrants aren't worth much and it's going to be reflected in the ultimate purchase price," he said.

Mr. Cook said he has seen portfolios where "innocent mistakes were made by the originator" that created substantial assignee liability for loan purchasers.

Another potential problem with scratch-and-dent loans is that there is no guarantee that compliance standards were maintained on loans made last year, when underwriting standards "collapsed," he said.

Mr. Ornstein said buyers typically conduct due diligence on a sample pool of 10%-20% of the loans in a portfolio to ensure that the loans "don't look catastrophic."

But lately, he said, he has seen plenty of "fire sales" because buyers were not given time to perform due diligence on all the loans.

Observers said that scratch-and-dent buyers are generally paying 70 to 80 cents on the dollar for first-lien loans and 5 to 20 cents for second-liens.

Richard Gottlieb, the chairman of the consumer financial services group at the law firm Dykema Gossett PLLC in Chicago, said that "the fact that huge portfolios are selling in this nuclear-waste range is a scary prospect for those trying to unload large portfolios."

Due diligence experts said they have found problems in loans such as missing documentation, a lack of verification showing compliance with the Truth in Lending Act, or an inability to verify a "reasonable net tangible benefit" for the consumer, particularly for loans made last year.

In some cases the wrong index may have been used to calculate an adjustable rate, or the annual percentage rate was miscalculated.

"The trick for purchasers is to figure out if the loan has value, what it will take to get the consumer to pay on the loan, and then back that out of the purchase price," Mr. Meredith said.

Mr. Cook said some loan buyers may believe they don't need to conduct regulatory due diligence because they're getting the loans at a deep enough discount.

"These are the risk and reward decisions being made right now," he said. "The portfolios that are out there ... have higher interest rates and closing costs, and are the types of loans you worry about if somebody made a mistake." http://www.americanbanker.com/ http://www.sourcemedia.com/

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