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New Century Financial Discloses Federal Criminal Investigation: Is a New Wave of Corporate Fraud Investigations Breaking Over the Mortgage Lending Industry?

The recent industry-wide economic downturn in the mortgage, and especially the subprime mortgage lending market, has sparked the interest of law enforcement and regulators. As the stock options backdating scandals begin to wind down, and as speculation grows that a recession may be looming, the financial media has begun to raise questions about the subprime mortgage market. Indeed, the media has speculated that weakness in the subprime market has helped fuel the decline in the stock market over the past week. At the same time, federal regulators and law enforcement agents are shifting their sights to the subprime market. Last Friday's announcement of a criminal investigation of a major subprime lender may be the first in a long series of inquiries into one of the largest and most complex financial markets.

New Century Financial Corp. ("New Century" or the "Company"), a leading subprime mortgage lender, announced last Friday, March 3, 2007, that it had learned of a federal criminal investigation into both trading in New Century securities and into certain New Century accounting errors, and that it has received inquiries from the Securities and Exchange Commission ("SEC") and the New York Stock Exchange ("NYSE") in connection with the events leading up to New Century's February 7, 2007 announcement that it would restate its financial results for the first three quarters of 2006.

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Since 1995, the mortgage market has been the fastest growing securitization debt market, larger in fact than the market for U.S. Treasury bonds and notes. Currently, the very same factors that appear to have fueled the growth of this market, demand in the debt securities markets and weak underwriting standards, have led to an economic downturn in the subprime market, as the ripple effects of the highest mortgage default rates in six years are starting to take their toll on lenders. Indeed, in recent months, the financial troubles plaguing the mortgage market – more numerous, and earlier, defaults by borrowers – have claimed the first financial services victims of the housing recession, as numerous mortgage lenders have filed for bankruptcy protection or declared significant losses.

The driving force for these filings and losses has been essentially the same: the higher levels of defaults in lower credit quality and “option-pay” mortgage loans have triggered provisions in whole-loan sale agreements as well as credit lines made by so-called warehouse lenders to lenders to fund their mortgage originations, which require the mortgage lenders to repurchase mortgage loans that have defaulted. Specifically, most loan purchase agreements and warehouse lines contain standard industry representations and warranties regarding borrowers’ payments on the mortgage loans, which allow the purchasers and lenders to review the payment performance of the mortgage loans and require lenders to repurchase the loans if the borrowers are in payment default early in the term of the mortgages. The recent slowing of the housing market and the resulting lack of property appreciation, coupled with weak underwriting standards for loan originations, has led to sudden increases of early payment defaults and stricter scrutiny by purchasers and lenders looking to offload bad mortgage loans. The resulting high level of repurchase obligations incurred by the lenders has led to unforeseen obligations that have been financially crippling for some subprime lenders in particular.

New Century has been no exception to this industry-wide trend. During the first nine months of 2006, New Century has been forced by its whole loan purchasers to repurchase hundreds of millions of dollars of mortgage loans. However, the Company's reaction to these required repurchases has generated particular interest among regulators and law enforcement officials. On February 7, 2007, the Company announced that it would restate its earnings for the first three quarters of 2006 due to accounting errors. Specifically, New Century stated that it did not properly estimate its allowance for loan repurchase losses and did not consider the increased volume of repurchase claims in estimating the volume of repurchase claims to be included in the repurchase reserve calculation. Almost one month later, on March 3, 2007, New Century announced that the United States Attorney's Office for the Central District of California had commenced a criminal investigation in connection with the trading of New Century securities prior to the February 7, 2007 restatement announcement and into accounting errors regarding the Company's allowance for repurchase losses. New Century also announced that the NYSE was in the process of reviewing the securities transactions occurring prior to its restatement announcement and that the SEC had requested a meeting with New Century to discuss the actions leading up to the restatement announcement.

The investigations into New Century's practices in the midst of an industry-wide downturn is not entirely unexpected. When there is a significant downturn in business, regulators and law enforcement will often closely scrutinize companies that are suffering setbacks to determine whether such setbacks are a result of simple misfortune or the result of criminal wrongdoing. Therefore, companies that are experiencing significant financial difficulties should anticipate being placed under heightened scrutiny and proceed accordingly. Such companies should be scrupulously careful in their business transactions and their dealings with the public in anticipation of having these actions explored in depth by law enforcement or regulatory agencies. That caution can be the critical difference in keeping a business problem from exploding into a criminal one.

For example, when a company in a troubled industry experiences financial setbacks, individual employees at that company may feel increasing pressure to present a positive picture of the company's current financial situation and future prospects. This pressure may come not only from others within the organization, but also from simple human nature. The tendency to answer inquiries in a time of crisis with a reassurance that "everything is all right" is understandable and, indeed, almost reflexive. However, while there is nothing wrong with honest optimism, employees must be careful not to present a rosier picture of the company's financial situation than the facts allow. This is true not only for statements included in regulatory filings, but also for all public statements made regarding the company. Often, it is not the underlying actions causing the setback that lead to an adverse response by law enforcement and regulatory agencies, but the failure to acknowledge such setbacks or to report on them candidly.

The recent trial and conviction of former Enron CEO Kenneth Lay is one recent example of how an improper response to a crisis can lead to criminal prosecution. In Lay's case, the evidence of his involvement in the initial fraud at Enron was inconclusive at best. However, when Lay resumed his position as CEO in the midst of Enron's meltdown, he made a series of optimistic public statements that starkly contrasted with the truth about the company's deteriorating condition, and those false statements provided the foundation for the fraud charges of which he was convicted.

Enron is obviously an extreme case, but the lesson from Lay's prosecution has broad applicability. When there are high-profile business failures, prosecutors will scrutinize executive conduct carefully. As a result, companies and executives should take particular care to ensure the accuracy and candor of all their public statements.

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