Mortgage-Backed Securities Litigation

Litigation and Regulatory Trends

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ATTORNEYS

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Key Participants

- Securities Firms
- CDO Managers
- Rating Agencies
- Investors
- Guarantors
- Trustees

Civil Litigation

- Who are the Primary Defendants in MBS Litigation?
  - The Investment Banks who Underwrote the Offerings
    - Their related entities that served as sponsors sellers and depositors of the MBS Offerings

- Who are the Plaintiffs in MBS Litigation?
  - Insurers (monolines)
  - Private investors
  - Public investors – GSEs, FHFA
  - Trustees

- What Do MBS Plaintiffs Typically Allege?
  - The risks of MBS investments were not accurately disclosed
  - There was systematic disregard for underwriting guidelines
  - Failed (or no) due diligence
  - Ratings failed for the riskier types of mortgages being fed into the mortgage pools
  - Outdated ratings models assigned falsely inflated ratings

- Most Common Claims
  - Breach of Contract
  - Breach of Covenant of Good Faith and Fair Dealing
  - Fraudulent Inducement
  - Negligent Misrepresentation
  - Unjust Enrichment

- Generally subprime-related lawsuits filed since the credit crisis have fallen into discrete categories:
- Shareholder class actions
  - These comprise the majority of subprime-related suits
  - Typically allege violations of sections 10(b), 14(a), 20(a), and 20A of the SEA and/or §§ 11, 12(a)(2), and 15 of the Securities Act

- Typically claim that defendant company misled investors about their exposure to subprime mortgages through false statements and omissions about their internal controls and underwriting practices. See, e.g., In re Manulife Fin. Corp. Sec. Litig., 2011 WL 1990883 (S.D.N.Y. May, 23, 2011); Kuriakose v. Federal Home Loan Mortgage Corp., 2011 WL 1158028 (S.D.N.Y. 2011); Smit v. Charles Schwab & Co., Inc., 2011 WL 846697 (N.D. Cal. 2011).

- Shareholder class actions also have been brought against loan originators, alleging that the defendant companies misled investors about their underwriting practices and concealed information such as the LTV ratios of the mortgage portfolios and the types of mortgages they originate. See, e.g., In re BankAtlantic Bancorp, Inc., 2011 WL 1585605 (S.D. Fla. 2011); In re Wachovia Securities Litigation, 753 F. Supp. 2d 326 (S.D.N.Y. 2011); In re Franklin Bank Corp. Securities Litigation, 2011 WL 1100272 (S.D. Tex. 2011).

- Suits Brought by Purchasers of Mortgage-Backed Securities
  - Most of these plaintiffs assert claims under sections 11 and 12(a)(2) of the SEA, alleging misstatements or omissions in prospectuses and registration statements, as well as state law claims.

- These suits typically allege that the offering documents contained false statements, leading purchasers to believe that the security was backed by assets with smaller risks than was in fact the case. See, e.g., Emps. Ret. Sys. v. J.P. Morgan Chase & Co., 2011 WL 1796426 (S.D.N.Y. May 10, 2011); Me. State Ret. Sys. v. Countrywide Fin. Corp., 2011 WL 1765509 (C.D. Cal. Apr. 20, 2011); Oughtred v. E*Trade Fin. Corp., 2011 WL 1210198 (S.D.N.Y. Mar. 31, 2011).

- Rating agencies have also been named as defendants, facing allegations that they effectively acted as underwriters and are therefore liable for misstatements in the offering documents concerning the ratings assigned to mortgage-backed securities as well as the underwriting standards applicable to the loans in the mortgage pools backing the securities. See N.J. Carpenters Health Fund v. NovaStar Mortg. Inc., 2011 WL 1338195 (S.D.N.Y. Mar. 31, 2011).

- Monoline Suits
  - Monolines are entities that enter into a credit default swap with the Trust, by which they receive a stream of payments from the trust and in exchange promise to reimburse the trust for any losses it incurs on the RMBS tranches – they are essentially insurers of the Trust's risk on its investment in the RMBS.

- Purporting to stand in the shoes of investors whose losses the monolines have absorbed pursuant to the insurance policies, monolines have sued mortgage originators and issuers, and underwriters of mortgage-backed securities, claiming misrepresentations in the offering materials. See, e.g., MBIA Ins. Corp. v. IndyMac ABS, Inc., No. 2:09-cv-07737 (Cal. Super. Ct. 2009).

- Trustee Suits
  - Allege that Defendants made representations and warranties about the quality and documentation of the mortgage loans and that they promised that, if a breach of a representation or warranty materially and adversely affected the value of a mortgage loan, then they would cure the breach or replace or repurchase that loan.

- Representations and warranties have been breached and, as a result, the mortgage-loan pool has not generated sufficient funds for the Trust to make all scheduled principal and interest payments on the certificates.

- Repurchase Cases
  - In repurchase cases, investors seek to enforce repurchase obligations under the deal documents for mortgage-backed securities, which generally require the seller of the loans to the issuer to repurchase or substitute similar loans for any nonconforming loans in the pool.

- Civil Actions Brought By the Government
  - S.E.C. v. Goldman Sachs & Co., et al., Civ. Act. No. 10 Civ. 3229 (S.D.N.Y., filed Apr. 16, 2010.
  - Alleged that the defendants knowingly, recklessly, or negligently mislead investors into believing that a particular hedge fund was investing in the equity of the RMBS, when in fact it was taking a short position.

- Federal Housing Finance Agency (FHFA) Litigation
  - FHFA, as conservator for Fannie Mae and Freddie Mac, filed lawsuits against 17 major financial institutions and others, alleging violations of the federal securities laws and common law in the sale of private mortgage-backed securities to Fannie Mae and Freddie Mac.
    - See Federal Housing Finance Agency v. Ally Financial Inc., et al., (Sup. Ct. N.Y., filed Sept. 2, 2011).

- Common Defense Strategies
  - Lack of Standing
  - No Scienter
  - Showing No Reasonable Reliance

- Arguing that the overall economic downturn, housing price declines, and reduced liquidity – not the alleged untrue statements and omissions – were to blame for the decline in the certificates' value
- Plaintiffs failed to perform adequate due diligence before investing or otherwise becoming involved with RMBS

- Disclaimers in their MBS offering documents, arguing that the allegedly false statements are non-actionable opinions
  - In Lehman Bros. Sec. & ERISA Litig., 684 F. Supp. 2d 485 (S.D.N.Y. 2010), plaintiffs' underwriting claims survived a motion to dismiss despite defendants' cautionary disclosures. The court found that, while defendants had "disclosed that the loan originators had discretion to issue loans pursuant to exceptions to the guidelines," plaintiffs' claims "that the originators systematically failed to follow the underwriting guidelines" exceeded the scope of defendants' warnings.

- Lack of Causation
  - "[W]hen a plaintiff's loss coincides with a market-wide phenomenon causing comparable losses to other investors, the probability that the loss was caused by an alleged fraud decreases." Hampshire Equity Partners, II, L.P. v. Teradyne, Inc., No. 04-cv-3318, 2005 WL 736217, at *5 (S.D.N.Y. Mar. 30, 2005), aff'd, 159 F. Appx. 317 (2d Cir. 2005).

- For example, in State St. Bank & Trust Co. Fixed Income Funds Inv. Litig., 774 F. Supp. 2d 584, 585 (S.D.N.Y. 2011), the court found that defendants' statements regarding the composition of the fund had no bearing on the value of the securities in the fund and was therefore irrelevant to loss causation. While misrepresentations about the composition of the fund might have induced the plaintiffs to invest in the fund, that would only prove *transaction* causation. Although the plaintiffs offered alternative theories of loss causation, the court concluded that the statute "require[d] a connection between the alleged material misstatement and a diminution in the security's value" and granted defendants' motion to dismiss.

- No Actual Losses
  - Argument based upon the notion that investors haven't actually lost that much on their RMBS investments as many trusts that have been paying principal and interest more or less on schedule.

- Trends and Developments
  - While the number of new subprime-related filings has decreased, settlements of subprime cases have increased.
  - After only eleven settlements in 2009 and eight in 2010, fifteen lawsuits already have settled in 2011 through the end of July. Settlements have ranged in size from $4.0 million to $624 million, averaging $103.1 million, with a median value of $31.3 million.

- By comparison, the average settlement value for non-credit crisis-related securities class actions during the same period was $31.6 million, with a median value of $10 million.
- There are over 100 pending cases that have not yet been dismissed or resolved. Accordingly, the number of settlements may increase in the coming years, as previously filed cases mature.

Government Enforcement Activities

- Legislative Reform
  - U.S. Financial Crisis Inquiry Commission, The Final Crisis Inquiry Report (Jan. 2011)

- The Report contained several observations potentially relevant to establishing certain claims or defenses in mortgage-backed securities litigation:
  - Banks took low investment-grade tranches – largely rated BBB or A – from many mortgage-backed securities and repackaged them into new securities

- Approximately 80% of these CDO tranches would be rated AAA despite the fact that they generally comprised the lower-rated tranches of mortgage-backed securities.
- Banks assert that they thought CDOs would be safe because they were diversified – but this stated assumption proved untrue: the mortgage-backed securities turned out to be highly homogenous.

- The Report additionally drew a number of conclusions about the mortgage-backed securities market.
  - Certain products in particular, including CDOs Squared, Credit Default Swaps, Synthetic CDOs, and asset-backed commercial paper programs fueled demand for subprime mortgage securitization and contributed to the housing bubble.

- "The high ratings erroneously given to CDOs by credit rating agencies encouraged investors and financial institutions to purchase them and enabled the continuing securitization of nonprime mortgages."

- Regulatory Actions
  - In February 2012 the SEC issued Wells Notices to Goldman Sachs Group, Inc., Wells Fargo & Co., and JPMorgan Chase & Co. for their involvement in the sales of mortgage-backed securities

- SEC is looking for evidence that firms failed to disclose the underlying credit weaknesses in mortgage pools and delinquencies
- Institutions are being investigated to determine whether it properly described facts and risk in its offering documents as well as whether it may have violated fair-lending laws and other regulations tied to making home loans

- Financial Fraud Enforcement Task Force (www.stopfraud.com)
  - This organization was recently assembled under the Obama administration and is Chaired by Attorney General Eric Holder

- It is divided into several subgroups, the most notable for MBS purposes include:
  - The Residential Mortgage-Backed Securities Working Group
  - The Mortgage Fraud Working Group
  - The Securities & Commodities Fraud Working Group
- Other than to flag its existence, however, there has not been much to report regarding this organization