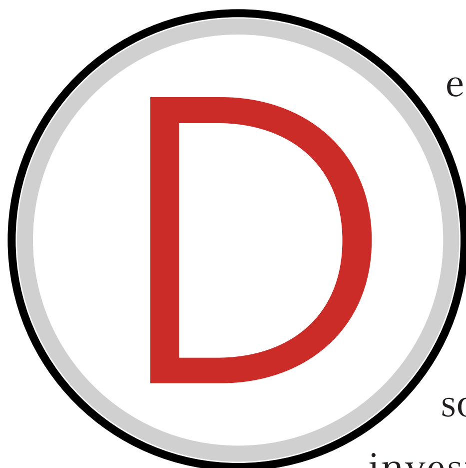
NOTEBOOK ON
MBS Litigation

BY PRAVIN RAO AND SULEEN LEE

The Securities and Exchange Commission could be going to school on private litigation being brought against MBS issuers.



espite recent statistics showing an overall decline in securities lawsuits stemming from the subprime mortgage crisis, civil claims against the banking industry for losses related to mortgage-backed securities (MBS) do not appear to be slowing anytime soon.

Plaintiffs in these cases—mostly institutional investors—have alleged that banks misrepresented the underwriting standards used to evaluate the borrowers' ability to repay the loans underlying the securities. For instance, in February, Massachusetts Mutual Life Insurance Co., Springfield, Massachusetts, filed a lawsuit against Deutsche Bank Securities Inc., an indirect subsidiary of Frankfurt, Germany–based Deutsche Bank AG, alleging that the bank had misrepresented certain characteristics of loans backing its MBS and disregarded or abandoned underwriting guidelines.

The Allstate Corporation, Northbrook, Illinois, has filed similar suits against JPMorgan Chase & Co., New York, and Countrywide Financial (now Bank of America, Charlotte, North Carolina), seeking damages related to its purchases of nearly $1.5 billion in MBS from these banks. Even before the Allstate suit was filed, Bank of America disclosed in its Securities and Exchange Commission (SEC) quarterly 10-Q report for the third quarter of 2010 that it was facing multiple lawsuits alleging misstatements or omissions in the issuance of $375 billion in MBS.

Citigroup Inc., New York, similarly disclosed in its fourth-quarter 10-Q that it was facing at least five investor lawsuits involving billions of dollars more of these same securities.

In terms of actual recovery, however, the investors filing these suits have faced a number of

challenges—including stringent pleading standards and statutes of limitation. Yet, the uncertain track record resulting from civil litigation over MBS will not necessarily translate to similar outcomes in potential enforcement actions pursued by the SEC.

For one thing, procedural technicalities such as pleading standards and statutes of limitation that have hampered civil suits will not impede an SEC action. In fact, it appears that the SEC has already begun focusing its investigative resources on MBS-related improprieties; sources have confirmed that an SEC investigation was well under way as of December 2010.

This article discusses how MBS have become a significant priority for the SEC's investigative resources, describes what might constitute a potential SEC action against banks, and suggests proactive measures banks should take to ensure they do not become ensnared by regulatory or private litigants.

Background

MBS emerged from a small niche in the bond market to a multi-trillion-dollar segment in the years leading up to the subprime mortgage meltdown. Large banks (mostly Wall Street firms) quickly learned that individual mortgage loans could be transformed into financial commodities. Thus, the banks (called depositors in this process) began purchasing loans from smaller lenders (also called originators), pooling residential real estate mortgages together, and then transferring these assets into the possession of trusts created by the depositors.

The assets then were securitized and partitioned off as MBS, being sold to institutional investors who would receive cash flows generated from the underlying mortgages in exchange for their purchase of these securities.

In the years leading to the housing collapse in 2007, smaller lenders became increasingly willing to lend money to borrowers with little documented ability to repay the loans, then reselling these loans to larger banks. Some of the larger banks buying up the loans appeared to become lax in their own securities underwriting, having underwriters (charged with the task of evaluating the pool of mortgages) accept the entire pool—even if the pool included borrowers who were likely to default.

Once the mortgage crisis hit, investors realized that their purchases of MBS were not as safe as they initially appeared. Shortly thereafter, investors began filing suits in both state and federal courts alleging misstatements and omissions in connection with the purchase of these mortgage-backed securities.

Not only have private suits against banks proliferated, but it has also become increasingly apparent that the SEC is focused on investigating any misconduct surrounding the mortgage securitization process.

> Speculation swirls as to whether the SEC will pursue enforcement actions against banks that played a large role in securitizing the MBS.

SEC enforcement priority

As investors attempt to seek remedies through private class-action suits, speculation swirls as to whether the SEC will pursue enforcement actions against banks that played a large role in securitizing the MBS. It appears likely that the SEC could pursue fraud claims questioning the truthfulness of disclosures made in selling the MBS.

SEC Chairman Mary L. Schapiro has stated, "Whenever there are suggestions that there may have been any kind of issues with respect to disclosure, misrepresentations or omissions, we are always looking at that kind of conduct."

Schapiro's statement was made on Oct. 19, 2010—around the same time that a state court dismissed a suit against Countrywide Financial for its MBS due to procedural technicalities. The SEC has already shown a fairly aggressive stance against Wall Street fraud through its action against Goldman Sachs Group Inc., New York, for disclosures related to collateralized debt obligations (CDOs).

CDOs are slightly more complex than MBS in that they involve an additional layer of securities; instead of being backed by the actual mortgages themselves, CDOs are backed by securities that are in turn backed by mortgages. Although the SEC eventually settled with Goldman Sachs for $550 million, the Goldman Sachs action could serve as a template for cases against MBS-issuing banks.

In its enforcement action against Goldman Sachs, the SEC alleged that the bank had defrauded investors by not disclosing that a large hedge fund, Paulson & Co. Inc., New York, played a significant role in selecting the underlying bonds within a CDO. Paulson, a client of Goldman Sachs, essentially wanted to bet against the housing market.

Paulson discussed with Goldman Sachs the idea of putting together a CDO full of mortgage-related assets that Paulson believed were likely to lose value. Goldman Sachs knew that the CDO would be a difficult sell if investors were aware that Paulson had input in deciding what went into the CDO and then bet against it; thus, Goldman Sachs brought in a third-party company, ACA Management LLC, New York, to select assets for the CDO. ACA, which was allegedly misled into thinking that Paulson was investing in the CDO, worked with Paulson to select assets going into the CDO. Ultimately, when the CDO lost value, Paulson paid Goldman Sachs a $15 million fee but profited to the tune of $1 billion.

Although misrepresentation about mortgage-backed securities appears less deliberately crafted than the plan between Goldman Sachs and Paulson, the SEC could view the banks' assurances about the quality control of the underlying mortgages as "misleading" or a "misrepresentation" in the same vein as the alleged scheme in the Goldman Sachs case. Moreover, since MBS transactions are not as difficult to unravel and explain as CDOs, the SEC may be more apt to bring an enforcement action

against the banks—especially if there are fewer investigative resources required.

According to press reports, the SEC has been expanding its probe of the mortgage industry, launching a new phase of its investigation by sending out a fresh round of subpoenas to banks including Bank of America, Citigroup, JPMorgan Chase and San Francisco–based Wells Fargo & Co.

The SEC had already been looking into foreclosure practices, investigating allegations that mortgage servicers were using subpar paperwork to process foreclosures against borrowers who had defaulted. Although the SEC initially probed the role of these servicers, the SEC is now asking banks about the early stages of the mortgage securitization process.

SEC Director of Enforcement Robert Khuzami, when announcing the Goldman Sachs action, stated, "We're looking at a wide range of products. If we see securities with similar profiles, we'll look at them more closely." This, in conjunction with Chairman Schapiro's Oct. 19, 2010, statement, makes it seem plausible that the SEC may turn its investigation of the MBS arena into an enforcement action if sufficient evidence is uncovered. Furthermore, political pressure to hold Wall Street accountable for the mortgage meltdown has intensified, so the SEC may have added motivation to restore its credibility as a capable watchdog in the wake of the financial crisis.

Model for SEC action

The securities laws that apply to misstatements and omissions involved in issuing MBS are rule 10b-5 of section 10b of the Securities Exchange Act of 1934 (the Exchange Act) and sections 11 and 12(a)(2) of the Securities Act of 1933 (the Securities Act). Section 10b of the Exchange Act is a vehicle for alleging fraud in general, while sections 11 and 12(a)(2) of the Securities Act apply to disclosures made in connection with registration statements and prospectuses, respectively.

The litigation trend since 2009 seems to be that a greater portion of MBS-related claims have involved sections 11 and 12(a)(2).

This increase may be due to the fact that plaintiffs bringing claims under sections 11 or 12(a)(2) do not have to plead and show knowledge of the fraud on the part of the bank, which is a difficult, necessary showing for a rule 10b-5 action. This knowledge requirement of rule 10b-5 is often a tough hurdle for private litigants to overcome.

Furthermore, in all class-action suits brought under rule 10b-5, strict requirements for stating facts in a complaint apply through the Private Securities Litigation Reform Act (PSLRA). Since its enactment in 1995, Congress has tried to curb lawsuits brought by individuals intent on extracting a settlement prior to going to court. There was a sense that these were baseless suits filed to merely initiate discovery to dig for ammunition.

By imposing more stringent standards in stating facts at the early complaint stage, the PSLRA requires plaintiffs in a securities class action to allege facts with particularity that give rise to a strong probability of defendant's knowledge of the fraud on the part of the defendant before pre-trial discovery can begin. Otherwise, the plaintiff's complaint will be dismissed. This heightened pleading standard requires plaintiffs to present factual allegations based on items such as confidential witness statements and the bank's awareness of the decline in the origination standards in subprime lending.

Given this tough standard, plaintiffs in private suits against banks have gravitated toward sections 11 and 12(a)(2) rather than tackle the more particularized pleading of a rule 10b-5 action.

As the trend with private litigants continues, we may also see the SEC looking to this framework for its own investigations. Although the PSLRA's stringent pleading requirements do not apply to an SEC action under rule 10b-5, it seems likely that the SEC would at least explore using sections 11 and 12(a)(2) as its statutory framework.

To understand how the SEC may bring a potential enforcement action under these sections, two putative class-action suits brought under sections 11 and 12(a)(2) and one recent state law filing may serve as a model for SEC cases in this area.

Example: **Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corporation**

In *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corporation* (U.S. Court of Appeals for the First Circuit, 2011), institutional investors filed a class-action suit under section 11 and section 12(a)(2) against eight trusts and the bank that organized the trusts. The suit alleged that the registration statements and prospectus supplements (together, the offering documents) for the mortgage-backed securities contained false and misleading statements as to the underwriting standards used.

The plaintiffs argued that as a result of these false and misleading statements, the securities' true value when purchased was less than what they paid. The district court ruled that the plaintiffs had not adequately alleged that the offering documents contained false and misleading statements with respect to the underwriting standards under section 11 and section 12(a)(2).

The appellate court, however, disagreed with the district court, pointing to representations in the offering documents that the originators had used lending guidelines to determine the borrower's creditworthiness and ability to repay the loans.

One statement in particular found in the prospectus supplement stated that one of the larger loan originators of the trusts, First National Bank of Nevada (FNBN), Las Vegas, used "underwriting guidelines [that] are primarily intended to evaluate the prospective borrower's credit standing and ability to repay the loan, as well as the value and adequacy of the proposed mortgage property as collateral."

Plaintiffs had argued that FNBN routinely violated the lending guidelines, approving as many loans as possible and even "scrubbing" loan applications of potentially disqualifying material. Throughout this process, plaintiffs claimed borrowers never had to show an established ability

to repay indebtedness in a timely fashion or verify their employment history. Plaintiffs allege this absence of verification was part of FNBN's business model, and that the bank misrepresented the standards used by these originators.

In its January 2011 ruling, the appellate court agreed with the plaintiffs, and emphasized that the "less stringent" and "limited documentation" wording was not sufficient to warrant dismissal of the plaintiffs' claim at this stage of the action. Furthermore, the appellate court noted that the bank's argument that no detailed factual support was provided to support the plaintiffs' allegation was invalid, as the sharp drop in the credit ratings after the sale of the MBS and the specificity as to FNBN's practices offered enough of a basis to initiate discovery aimed at the allegations.

Thus, the use of sections 11 and 12(a)(2) by the plaintiffs allowed them to withstand challenges that normally would have signaled defeat had they relied on rule 10b-5 to bring their claims.

***Example:* In re Wells Fargo Mortgage-Backed Certificates Litigation**

Similarly, in *In re Wells Fargo Mortgage-Backed Certificates Litigation,* (U.S. District Court for the Northern District of California, 2010), plaintiffs brought an action against Wells Fargo also under sections 11 and 12(a)(2) for misrepresentations of its underwriting standards. Here, the district court held in April 2010 that the plaintiffs' allegations were sufficient to state a claim, as the plaintiffs presented statements from confidential witnesses who asserted that Wells Fargo (here, both the originator and depositor of the pooled loans) placed "intense pressure" on its loan officers to close loans.

This alleged pressure came in the form of coaching borrowers to provide qualifying income information and accepting implausible or falsified income information. Although Wells Fargo argued that the plaintiffs' allegations were insufficiently linked to the types of mortgages that were packaged into the securities at issue, the court agreed with the plaintiffs' argument that this type of conduct systematically infected the entire underwriting process, and thus made it unnecessary to distinguish between those that were packaged and others that were not.

Furthermore, the court determined that the plaintiffs had also stated a claim for misstatements and omissions concerning the appraisal value and loan-to-value (LTV) ratio of the underlying mortgaged properties. While the prospectuses for the mortgage-backed securities stated that "mortgage loans will not generally have had at origination a loan-to-value ratio in excess of 95 percent," the plaintiffs alleged that this statement was misleading because the home's value calculation was often based on an inflated appraisal.

Like their prior claim, the plaintiffs supported this allegation through confidential witnesses, who maintained that Wells Fargo representatives would push appraisers they worked with to inflate the value of the real estate underlying the mortgage loans. One confidential witness believed that more than 70 percent of the loans he had worked with had an LTV higher than 95 percent.

Finally, the court also held that the plaintiffs provided sufficient support for their allegations of misstatements concerning the high investment rating awarded to the MBS, as the plaintiffs presented statements by executives at rating agencies who admitted that they were aware the rating models were outdated at the time the subject ratings were made.

Once again, sections 11 and 12(a)(2) served as a vehicle for bringing suit against the banks where rule 10b-5 would not.

This latest filing, in the authors' view, seems to illustrate an emerging trend of relying on sections 11 and 12(a)(2) to bring cases against banks for their MBS.

***Example:* Massachusetts Mutual Life Insurance Co. v. Deutsche Bank**

As one of the most recently filed suits in the realm of MBS litigation, Massachusetts Mutual Life Insurance Co.'s (MassMutual's) complaint filed in February 2011 against Deutsche Bank and other defendants in the U.S. District Court for the District of Massachusetts may be a harbinger of the shift to sections 11 and 12(a)(2) type claims.

Although the plaintiff here brought its action under the Massachusetts Uniform Securities Act, Chapter 110A, section 410, this action is analogous to a sections 11 and 12(a)(2) action, as the plaintiff frames its allegations with respect to misrepresentations found in the offering materials of the MBS.

While the state law here does not impose strict liability like sections 11 and 12(a)(2) of federal securities law, it does allow for plaintiffs to prevail on claims arising in connection with a prospectus if they can show the defendant's negligence with respect to the misstatement or omission. Like the cases discussed earlier, MassMutual similarly alleges that the statements in the offering materials were materially false and misleading, as they misrepresented underwriting standards applied to the loans backing the MBS and appraisal information.

Although the prospectus supplements of the MBS stated that conservative underwriting guidelines were followed, the plaintiff claims that the defendants made no attempt to verify any information in the loan files, showing the defendants' "disregard and abandonment" of underwriting guidelines.

This latest filing, in the authors' view, seems to illustrate an emerging trend of relying on sections 11 and 12(a)(2) to bring cases against banks for their MBS. Often, claims under sections 11 and 12(a)(2) will be brought in conjunction with a rule 10b-5 claim (see, for example, *Putnam Bank v. Countrywide Financial Corporation, [2011]*).

Although MBS litigation in general has also been brought pursuant to rule 10b-5, these plaintiffs often find themselves unable to surpass the initial hurdle of showing the defendant's knowledge (see Security Capital Assurance Ltd. Sec. Litig., 729 F. Supp. 2d 569 [2010], in which the investors' putative class action against financial guaranty insurance providers was dismissed due to the investors' failure to sufficiently allege the defendant's knowledge; and *Ellington Management Group LLC v. Ameriquest Mortgage Co. [2009]*, in which investors failed to allege that mortgage company representatives acted with the requisite knowledge). Thus, the SEC may decide to shift its focus away from its commonly used rule 10b-5, and use sections 11 and 12(a)(2) to avoid running into a potential problem with proving knowledge. Although the aforementioned model cases brought under sections 11 and 12(a)(2) were still pending as of March 2011, one might glean from their facts that the SEC may craft a potential enforcement action against banks using these sections.

As the SEC looks deeper into the securitization process, it is likely examining statements contained in offering documents as they relate to the underwriting standards, the LTV and the investment ratings of the MBS. Because sections 11 and 12(a)(2) do not require showing that banks knew of any misrepresentations, the SEC can argue that banks are strictly liable for material misstatements in their registration statements and prospectuses.

Proactive measures

While as of early March, it remains to be seen whether any enforcement actions against banks will result from the SEC investigations currently under way, banks may want to consider the following proactive measures to prepare for this possibility:

- Stay updated on pending private litigation involving MBS. The SEC will likely frame its investigation based on the allegations found in the plaintiffs' complaints.
- Gather documentation on communications between bank personnel and underwriters. Flag communications that would negate the idea that bank personnel exerted pressure on underwriters charged with the task of evaluating the pool of loans for securitization.
- Understand that certain hurdles facing private litigants do not apply to actions brought by the SEC. For example, the statute of limitations for claims under sections 11 and 12(a)(2) do not apply to actions brought by a government agency like the SEC; be prepared to make alternative arguments in favor of dismissal.
- Be cognizant that private litigation involving a bank's MBS could morph into an SEC investigation, and later an SEC enforcement action; the plaintiff's attorneys regularly share their allegations with the SEC. **MB**

Pravin B. Rao is a litigation partner in the Chicago office of Perkins Coie LLP, where his practice focuses on white-collar and securities enforcement defense. Suleen Lee is a real estate associate in the Chicago office at Perkins Coie. They can be reached at prao@perkinscoie.com and slee@perkinscoie.com.

REPRINTED WITH PERMISSION FROM THE MORTGAGE BANKERS ASSOCIATION (MBA)