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Goliath versus Goliath in high-stakes MBS litigation

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The loan-origination and mortgage-securitization practices between 2000 and 2007 created the housing and mortgage-backed securities bubble that precipitated the 2008 economic crisis and ensuing recession. The mess that the loan-origination and mortgage-securitization practices caused is now playing out in courts around the world.

MBS investors are suing banks, MBS sponsors and underwriters for misrepresenting the quality of loans purportedly held in MBS pools and failing to properly transfer loan documents and mortgages to the pools, as required by the MBS pooling and servicing agreements. State and federal prosecutors have also filed claims against banks, underwriters and sponsors for the roles they played in creating defective MBS and for misrepresenting the quality of the assets purportedly held in MBS pools.

An Australian federal court ruled in favor of plaintiffs who sued Standard & Poor's for misrepresentations it made in its ratings of MBS.¹ The U.S. Department of Justice and California attorney general have since filed lawsuits against S&P.²

Finally, a line of cases against insurers of the mortgage notes is working through the court system. All of this litigation is in addition to litigation between banks and borrowers regarding the validity of mortgages and mortgage notes, as well as the standing

of banks to bring foreclosure actions or establish standing in bankruptcy cases.

The lawsuits by MBS investors and prosecutors (upstream litigation) and litigation involving borrowers (downstream litigation) has banks, sponsors, underwriters and ratings agencies in a vice. The amount of downstream and upstream litigation continues to grow.³ With downstream litigation cases being decided, the contours of the law regarding banks' standing to foreclose on defaulted loans and to join bankruptcy proceedings of borrowers are beginning to emerge.

On the other hand, the numerous upstream complaints filed and few published decisions (most regarding motions for summary judgment) provide just an outline of the claims investors and prosecutors are making against banks, promoters, underwriters and ratings agencies in upstream MBS litigation.

This commentary focuses on the state of this upstream litigation. It reviews claims of several complaints and discusses some decisions on motions for summary judgment in several of the cases. The commentary is

not a comprehensive review of all the activity in this area, but it does provide an overview of the issues at stake in this litigation. The litigation in this area is still relatively new, but with hundreds of billions of dollars at stake, it will likely last for years to come and should reshape the MBS landscape.

Even though the stakes are high for the litigants in this area, decisions in any of these cases should affect behavior and practices in the financial industry. If the decisions deter the type of activity and practices that precipitated the financial crises, they will add stability to the financial markets and the

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world economy. Thus, the stakes are much higher than the significant sums directly at controversy in these cases.

LAWSUITS AGAINST BANKS AND MBS SPONSORS

Numerous lawsuits against banks and MBS sponsors are winding their way through various state and federal courts.⁴

The allegations in lawsuits brought by investors and prosecutors are similar. Generally, the allegations focus on misrepresentations sponsors made in MBS offering materials. First, they say sponsors represented that securitized loans were originated in accordance with specified underwriting guidelines, and the sponsors engaged in due diligence to ensure the quality of the loans. The plaintiffs allege, however, that in MBS pools, the sponsors routinely included mortgages deviating from the stated loan origination and underwriting standards. They also allege sponsors knowingly securitized loans that a due diligence vendor deemed to be defectively underwritten, and they off-loaded the worse loans from their balance sheets.



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Second, plaintiffs claim that sponsors downplayed the risk of borrower default by presenting misleading borrower credit scores and overstating the number of loans secured by owner-occupied residences. Several alleged sponsor practices suggest that they knew loans were of poor quality but transferred them to the MBS trusts. For example, plaintiffs say sponsors expressly instructed due diligence vendors not to verify occupancy status or credit scores and to make up data. Allegedly, sponsors knew that originators purposefully steered borrowers to high-risk mortgages and granted loans without establishing credit scores. They also allegedly securitized loans before the expiration of the early payment default period because mortgages (despite the likelihood of default) are not technically in default before that time.

Third, complaints assert that sponsors knew the value of the property collateralizing the loans was much lower than what they represented in offering materials. The allegations claim originators blacklisted appraisers who refused to inflate collateral values, and sponsors instructed due diligence vendors not to review appraisals. They also claim sponsors falsely represented that loans with high loan-to-value ratios were restricted to particularly creditworthy borrowers. Complaints also allege that sponsors failed to disclose the deliberate effort to undermine the due diligence processes, resulting in false and misleading MBS ratings. The allegations also say sponsors further compromised the integrity of the credit ratings by pressuring rating agencies to provide the highest ratings for their MBS.

Fourth, complaints contend that executives aided and abetted fraud. The allegations say high-level executives helped create policies encouraging high-risk lending and reduced controls to increase profits by creating greater numbers of MBS regardless of quality. Finally, these complaints allege that sponsors negligently misrepresented information.

Defenses

Sponsors' primary defense to those allegations appears to be that they disclosed risks associated with purchasing MBS and that the downturn in the market caused the loss, not their wrongdoing. Sponsors also argue that the plaintiffs were highly sophisticated financial institutions with significant

experience in the mortgage industry, so their reliance on the representations in the offering documents was unjustified.

Status of lawsuits

Most lawsuits are still in the pre-trial phase, but several courts have published rulings on motions to dismiss. Some early rulings granted the motions,⁵ but more recent rulings allow lawsuits to proceed. For example, the U.S. District Court for the Southern District of New York denied the sponsor's motion to dismiss a claim on all grounds.⁶ The court held that the plaintiffs alleged facts that, if

that the plaintiffs had sufficiently alleged facts (such as the defendants pressuring the appraisers and rating agencies into increasing their evaluations) that call into question the factual bases for the appraisal and rating evaluations. The court also found that the plaintiffs presented sufficient facts to show that the defendant had the requisite motive (to obtain high credit ratings to sell the MBS certificates), the defendants knew or should have known that the loans violated underwriting standards, and the appraisals did not satisfy industry standards.

Generally, the allegations focus on misrepresentations sponsors made in MBS offering materials.

true, are sufficient to raise a right to relief above the speculative level, the standard that applies to motions to dismiss a claim in federal court.⁷ Thus, the court denied the sponsor's motion to dismiss state law claims of fraud, fraudulent inducement, aiding and abetting fraud, and negligent misrepresentation. The court found that disclaimers in offering documents regarding the possibility that some loans might fail to satisfy the underwriting requirements were insufficient to put the investors on notice that the sponsors generally did not follow the underwriting guidelines.

Offering documents also disclosed that some loans could not meet the definition of delinquent because they were transferred to the MBS pool before the due date of the first payment. The court found that disclosure was not sufficient to address the sponsor's policy of transferring mortgage notes before the early payment default period expired. The court determined that the language in fact suggested that the sponsor should have made a disclosure relating to the early payment default period. Apparently, the court believes the sponsor should have disclosed that the notes would not fall within the definition of delinquent because insufficient time had passed to test the borrowers.

Regarding the value of collateral, the sponsors claim that language in the offering materials specifically warned that the value of property could fluctuate, extraneous reports warned of possible fluctuations in property values and valuations of appraisers were merely opinions. The court found, however,

Finally, the court found that despite the plaintiff's sophistication in financial matters, it had adequately alleged that no outside information could have led to the discovery of the defendants' fraudulent practices. Consequently, the court denied the motion to dismiss.

LAWSUITS AGAINST RATING AGENCIES

Two lawsuits (one brought by the Department of Justice and the other by the California attorney general) in California against S&P illustrate the types of claims that credit ratings agencies face in the United States.

The DOJ's complaint alleges that S&P committed mail fraud, wire fraud and financial institution fraud.⁸ The premise of these allegations is that S&P presented itself as providing high-quality, objective, independent and rigorous analytical information to the marketplace. Allegedly, however, it was financially beholden to the sponsors of MBS and CDO securities (a collateral debt obligation is an interest in a pool of MBS), resulting in numerous bad actions. The DOJ claims that S&P ignored information about the underlying mortgages held in RMBS trusts and MBS tranches held by CDOs and that it intentionally failed to implement programs that would have returned more objective ratings.

The lawsuit alleges that S&P's desire to increase profit by satisfying sponsors of CDOs and MBS was its motive for ignoring information about the underlying assets and downplaying risk. The DOJ relies upon

S&P internal communications revealing a particular sensitivity to demands and input from sponsors who wanted favorable credit ratings. The DOJ said S&P lowered its criteria for rating CDOs of real estate assets to keep from losing deals.

The DOJ also claims that S&P did not update the model it used to analyze MBS because doing so would have led to lower ratings, which would have caused S&P to lose business. Internal documents also suggest S&P knew that mortgage loans underlying many MBS were underperforming, which should have adversely affected ratings, but S&P did not adjust the ratings to account for such underperformance. The complaint lists several CDOs that S&P rated at investment grade, which lost value and resulted in severe loss for several purchasers who fall within the jurisdiction of the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

Defenses

In support of its motion to dismiss, S&P argues first that the statements the DOJ relies upon cannot be the basis for a finding of fraud under federal law.⁹ Second, S&P argues that the complaint does not allege that S&P's opinions were false and fraudulent due to S&P believing them at the time they were made. S&P presents the internal communication as "robust internal debate." Third, S&P argues that the complaint fails to allege that it had the requisite intent to defraud the investors of CDOs. For instance, S&P argues that Citibank and Bank of America, which purchased CDOs, also created the very CDOs at issue. S&P also argues that the investors did not pay the ratings fees, but the sponsors did.

S&P asserts that its ratings were objective, independent and uninfluenced by conflicts of interest and that the DOJ's claims relate to subjective statements that are not actionable. First, S&P argues that general statements it made about its services, integrity, credibility and objectivity do not support a claim of fraud. Instead, S&P argues, such statements are non-actionable puffery. Second, S&P argues that statements about its mission are aspirational and non-actionable statements that are not representations of current activity. Third, S&P argues that statements it made regarding its policy and code of conduct are not actionable statements of objective facts. Finally, S&P argues that

information about its ratings processes are neither quantifiable nor substantive enough to offer any specific qualitative guidance and are too general to serve as a basis for a fraud claim.

S&P also argued that the DOJ failed to sufficiently plead that the credit ratings were objectively false or that S&P subjectively disbelieved them on the date of issue. S&P claims that the DOJ's failure to identify the true credit risk associated with any of the securities at issue was a failure to plead with sufficient particularity that the ratings were incorrect or misleading. S&P also claims that the DOJ failed to plead with sufficient particularity that the ratings did not reflect S&P's current opinion. Among other defenses on this point, S&P argues that the DOJ cannot know whether S&P took into account updated information about RMBS ratings when it rated CDOs.

Disclaimers in offering documents regarding the possibility that some loans might fail to satisfy the underwriting requirements were insufficient to put the investors on notice.

Status of lawsuits

The DOJ suit awaits the court's ruling on S&P's motion for summary judgment, but other courts have acted on other motions to dismiss in securities fraud suits against S&P. For example, the 2nd Circuit upheld the dismissal of a securities fraud lawsuit against S&P executives because the complaint failed to state a claim with sufficient particularity.¹⁰ The plaintiff shareholders in that case sued McGraw-Hill Cos (S&P's parent company), and two of its corporate officers for making false and misleading statements about the operations of S&P. The court held that statements about S&P's integrity, transparency and independence were puffery and did not support a securities fraud claim. The court also held that claims about S&P's surveillance practices did not come within the definition of misleading, and S&P's failure to disclose that accurately reported earnings were unsustainable is not securities fraud. The court also found that the plaintiffs had not presented facts supporting the inference

that the defendants knew of facts or had access to information that contradicted their statements.

The court also concluded that the statements the plaintiffs claimed were misleading were not material because they would not alter the decision to invest in the McGraw-Hill stock. The court took issue with the complaint because it consisted of large block quotations and italicized text with claims that statements in the text were materially false and misleading. The court held that such a presentation of material does not state with specificity how each statement is materially false or misleading. These findings led the court to dismiss the shareholder suit against S&P.

The complaints filed by the DOJ and California attorney general are distinguishable from this 2nd Circuit case as the DOJ and California cases are not securities fraud cases brought by S&P shareholders. It will be interesting to see if the courts in California reach a different result based upon different legal theories.

LAWSUITS BY MONOLINE INSURERS AGAINST SPONSORS

Monoline insurers evaluate the likelihood that an MBS trust will default on any of its obligations. They then acquire sufficient comfort from the sponsor and the strength of the collateral that the risk of default is manageable, given the premium they charge for the insurance. Monoline insurers, who effectively ensure that investors in MBS receive payments in a timely manner, have brought lawsuits against the MBS sponsors, claiming the sponsors committed fraud or made misrepresentations regarding the quality of mortgages underlying the MBS.

In one typical case (the EMC case), monoline insurer Assured Guaranty Corp. alleged "that Bear Stearns grossly misrepresented the risk of the underlying pooled loans" used as collateral in MBS deals that it had underwritten.¹¹ Assured alleged that loan warranties in nearly 90 percent of the loans in one of the pools at issue had been breached. As a result, Assured claimed that the defendants breached the representations and warranties and the agreement. The New York trial court said that more than half of the loans in that pool had either "defaulted or are seriously delinquent." Bear Stearns' successor-in-interest refused to re-purchase the breaching loans as required by their agreement.

In another typical case (the Flagstar case), Assured Guaranty Municipal Cor., another Assured subsidiary, alleged “that the loans underlying the securities were either materially fraudulent or were the product of material underwriting defects, in breach of Flagstar’s [the sponsor’s] express representations and warranties.”¹² Assured thus argued that it was “entitled to be reimbursed for its payment of insurance claims that arose when many of the underlying loans defaulted,” and Flagstar thereafter “refused to cure the defects or substitute eligible loans.”

Defenses

Sponsors argue that they have materially complied with the contractual representations and warranties as well as

The Justice Department said S&P lowered its criteria for rating CDOs of real estate assets to keep from losing deals.

their re-purchase or substitution obligations, and the ensuing litigation can focus on a loan by loan analysis to determine who is right.

Status of the lawsuits

In the EMC case, the court found that the deal documents make “clear that the parties intended to limit Assured’s remedies for breach of the representations and warranties relating to the quality and characteristics of the pooled loans to the re-purchase protocol.” The limited remedy was to compel EMC to re-purchase the loans that did not comply with the representations and warranties, and the court limited Assured’s remedies in that manner.

In reaching its result, the court relied on Judge Jed Rakoff’s opinion in the Flagstar case.¹³ There, the court ruled for Assured Guaranty against Flagstar and awarded Assured more than \$90 million. The court found that “a huge percentage of the loans in the two pools were defective,” and many of the loans had “blatant” defects. It also found that

the sponsor “was made aware of Assured’s claim of pervasive and material breaches of the representations and warranties and, therefore, had breached its contract with Assured by failing to ‘re-purchase or cure’ the materially defective loans,” as required by the agreement between the parties. Flagstar has since settled the case for over \$100 million.

In light of these cases, monoline insurers are expected to change deal documents going forward. Most likely, they will not be so willing to treat representations and warranties as mere risk allocation devices between the parties. As risk allocation devices, the representations and warranties typically make only limited remedies available. Monoline insurers may demand they be treated as something more—perhaps as actual representations and warranties about the underlying transaction that, if breached, could lead to an unwinding of the insurance policy.

CONCLUSION

The MBS upstream litigation is in its infancy. Claims that prosecutors and plaintiffs make are very serious. If banks, sponsors, underwriters, appraisers and credit rating agencies committed the purported wrongs, the world was duped and has paid a significant price for their wrongdoing. Many of the cases will likely settle without a full vetting of facts. If a few make it to trial, full discovery will help publicize important facts from the era preceding the financial crisis. Those facts can help elucidate bad behavior and perhaps point to a better way of monitoring large financial transactions. The decisions from courts can help discourage such behavior in the future.

NOTES

¹ See *Bathurst Reg’l Council v. Local Gov’t Fin. Servs. Pty. Ltd.*, (No. 5) [2012] FCA 1200 (Nov. 5, 2012).

² See Complaint for Civil Money Penalties and Demand for Jury Trial, *United States v. McGraw-Hill Cos.*, No. CV13-00779 (C.D. Cal. Feb. 4, 2013); Complaint for Treble Damages, Civil Penalties and Permanent Injunction for Violation of the California False Claims Act, Unfair Competition Law, and False Advertising Law, *People v. McGraw-Hill Cos.*, No. CGC-13-528491 (Cal. Super. Ct., S.F. County Feb. 5, 2013).

³ See REFinblog.com (tracking and summarizing upstream and downstream cases).

⁴ See, e.g., Complaint, *People v. JPMorgan Sec. LLC*, No. 451556/2012 (N.Y. Sup. Ct., N.Y. County Oct. 10, 2012); *Western & Southern Life Ins. Co. v. Countrywide Fin. Corp.*, No. 2:11-cv-07166-MRP (MANx) (C.D. Cal. June 29, 2012) (dismissing suits against RMBS organizers); Complaint, *Fed. Hous. Fin. Agency v. JPMorgan Chase & Co.*, No. 11 Civ. 6188 (DLC) (S.D.N.Y. June 13, 2012); *Western & Southern Life Ins. Co. v. Residential Funding Co.*, No. A1105042 (Ohio Ct. Com. Pl., Hamilton County June 6, 2012) (denying motions to dismiss claims against organizers of residential mortgage-backed securities); Consolidated Complaint at 20–22, *HSH Nordbank AG v. Barclays Bank PLC*, No. 652678/2011 (N.Y. Sup. Ct., N.Y. County Apr. 2, 2012); *Pa. Pub. Sch. Employees’ Ret. Sys. v. Bank of Am. Corp.*, 874 F. Supp. 2d 341, 2012 WL 2847732 (S.D.N.Y. 2012) (denying Bank of America’s motion to dismiss the Section 10(b) and Rule 10b-5 claim against it because the plaintiff’s allegations concerning Bank of America’s “misstatements and omissions concerning its reliance on MERS, vulnerability to re-purchase claims, internal controls, and compliance with GAAP and SEC regulations” satisfied the requisite standard to raise a strong inference of the bank’s misconduct and *scienter* regarding the misconduct).

⁵ See, e.g., *Western & Southern Life Ins. Co. v. Countrywide Fin. Corp.*, No. 2:11-cv-07166-MRP (MANx) (C.D. Cal. June 29, 2012) (dismissing suits against RMBS organizers).

⁶ See *Dexia SA/NV v. Bear, Stearns & Co.*, No. 12 Civ. 4761 (JSR) (S.D.N.Y. Feb. 27, 2013).

⁷ See *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

⁸ See Complaint, *United States v. McGraw-Hill Cos.*, No. CV13-00779-DOC-JCG (C.D. Cal. Feb. 4, 2013).

⁹ See Memorandum in Support of Defendant’s Motion to Dismiss the Complaint Pursuant to Fed. R. Civ. P. 9(b) and 12(b)(6), *United States v. McGraw-Hill Cos.*, No. CV 13-00779-DOC-JCG (C.D. Cal. Apr. 22, 2013).

¹⁰ See *Boca Raton Firefighters & Police Pension Fund v. Bahash*, 2012 WL 6621391 (2d Cir. 2012).

¹¹ *Assured Guar. Corp. v. EMC Mortgage LLC*, 2013 NY Slip Op. 50519(U) at 1 (N.Y. Sup. Ct., N.Y. County Apr. 4, 2013).

¹² *Assured Guar. Mun. Corp. v. Flagstar Bank FSB et al.*, No. 1:11-cv-02375 at 2 (S.D.N.Y. Feb. 6, 2013).

¹³ *Id.*, No. 1:11-cv-02375.