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## Subprime Litigation — Where Are We Now?

*Law360, New York (April 27, 2009)* -- The collapse of the housing market led to a rash of defaults on subprime mortgages. The implications of those defaults go well beyond just the lender and the mortgage holders.

In addition to their impact on the broader economy, the rash of defaults have triggered a wave of securities fraud litigation around the country, a wave that, despite its importance (and sheer size), has been as of yet little understood.

We offer some initial understanding and analysis here. First, we catalogue briefly the types of subprime-related suits that have been filed, finding that the cases fall into three rough categories: suits against loan originators, suits against issuers of mortgage backed securities and suits against banks.

From our review of these complaints (and from the handful of opinions that have been released to date), we conclude that, despite the predictions of many that we have entered a “brave new world” of subprime litigation, these cases actually look a lot like “classic” securities fraud suits.

However, courts today are better equipped to distinguish legitimate allegations of fraud from those suits brought simply to cash-in on investor hysteria, thanks to the Supreme Court’s landmark 2007 holding in *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308 (2007).

We have found that this case and its progeny hold very important lessons for any party involved in a subprime litigation, and they may offer some lessons for where, exactly, the subprime litigation wave as a whole will take us.

## **Background — The Subprime Meltdown, and the Litigation Wave that Followed**

During the housing boom, loan originators repackaged mortgages into various securities products, including mortgage backed securities (“MBSs”), collateralized debt obligations (“CDOs”) and collateralized mortgage obligations (“CMOs”).

The market’s desire for these products became so great that mortgage loan originators began issuing subprime mortgages, or mortgages to borrowers with credit scores typically lower than 640-660 on the FICO scale, and who were subject to a lower level of income verification.

By accessing the subprime market, loan originators were able to increase the pool of borrowers eligible to take out mortgages, in turn increasing the volume of mortgages available for securitization.

Typically, the originators would then sell these loans to firms that in turn would repackage them into securities to meet market demand. In some instances, originators would repackage the loans themselves. Banks lined up to partner with these issuers to sell the securitized loan products to investors.

As housing prices declined in late 2006, the equity underlying the mortgages was reduced, causing defaults. As the defaults increased, the value of these securitized products was called into question.

In late 2007, fears increased as a number of high-profile loan originators teetered on the verge of bankruptcy, including American Home Mortgage and Countrywide Financial.

By 2008, numerous financial institutions — who themselves had invested heavily in the mortgage-related products — began taking massive write-downs based on their exposure to these products.

Of course, as with previous major market phenomena (like the savings and loan collapse of the 1980s, or the turn-of-century accounting scandals like Enron), lawsuits alleging securities fraud were quick to follow.

As of this writing, several hundred subprime-related complaints have been filed in state and federal court, all essentially centered around one basic inquiry — whether institutions misrepresented their exposure to subprime risk.

### **A Taxonomy of Subprime Lawsuits**

#### *Suits Against Loan Originators*

In 2007, as more and more subprime borrowers defaulted on their mortgages, the value of investments in subprime loan originators began to decline. Soon thereafter, investors began filing suits alleging securities fraud against companies such as IndyMac, New Century and Countrywide.[1]

Complaints against originators were generally based on public statements regarding the companies' underwriting standards and business practices.

For example, in New Century, plaintiffs alleged that the company "misrepresented [its] ability to repurchase defaulted loans; overvalued its residual interests in securitizations; falsely certified the adequacy of its internal controls, loan origination standards and the quality of its loans; and failed to identify these problems in public statements." The complaints against IndyMac and Countrywide contained similar allegations.[2]

Many of these early suits against originators have, at this point, reached the dismissal stage, with decisions turning in large part on the strength of plaintiffs' allegations of scienter.

At present, outright dismissals outnumber all other outcomes nearly two-to-one, though courts have allowed plaintiffs to proceed with at least some claims in several prominent cases.

Courts have dismissed subprime complaints against IndyMac, Standard Pacific, Impac Mortgage Holdings, Novastar Financial, First Home Builders of Florida, Fremont General Corp. and BankAtlantic Bancorp.[3] However, at least some claims remain against New Century, Countrywide, Accredited Home Lenders and Toll Brothers.[4]

### *Suits Against MBS Issuers*

Similarly, investors suing issuers of now-worthless MBSs, CDOs and CMOs have alleged various forms of fraud. Most complaints revolve around alleged misstatements by issuers regarding the liquidity and value of the investments plaintiffs made.[5]

Because courts have only decided a handful of motions to dismiss (on a variety of grounds), few cognizable trends have emerged to date from this particular species of subprime litigation.[6]

### *Suits Against Banks*

In the most recent wave of complaints, plaintiffs have begun suing financial institutions, generally alleging three common causes of action: class action securities fraud brought by investors in bank securities; derivative claims of fraud brought by shareholders; and ERISA-based claims brought by current and former employees of the banks.[7]

The class action suits allege fraud based, fundamentally, on the banks' failure to disclose their exposure to subprime risk. The derivative claims allege breaches of

fiduciary duties by directors and officers for failure to disclose subprime risk, for allowing banks to take on risky subprime investments and for allowing inflated stock repurchases.

Finally, the ERISA suits allege that employee retirement programs permitting or requiring investment in company stock violated federal law, because the risk associated with those securities was too high in light of the banks' exposure to the subprime market.

Motions to dismiss have been filed in several of these cases, but none have, to date, been decided on the merits.[8]

At least one high profile case was settled recently. In late January, Merrill Lynch agreed to pay \$475 million to a class of plaintiffs alleging that the bank failed to disclose the full extent of its subprime exposure.

Merrill simultaneously settled ERISA claims brought by a class of former employees for \$75 million in cash, but did not admit wrongdoing in either matter.[9]

## **Early Lessons from the Subprime Wave**

So, what conclusions can be drawn from these cases? Is it in fact true that, as many predicted, subprime litigation represents uncharted waters for securities lawyers?[10]

While it is indeed still early on in this process, we think some initial observations can be made. At the highest level, predictions of a brave new subprime world appear to have been overstated.

Subprime litigation generally looks a lot like any wave of securities fraud litigation seen in the wake of major market phenomena: while each case presents its own issues, plaintiffs, often via class actions, are accusing directors and officers of making inaccurate or incomplete disclosures (in this case, about the quality of loan standards) which artificially inflated share prices.

What is different about the subprime cases so far is that courts are employing the Supreme Court's 2007 decision in *Tellabs v. Makor* to distinguish claims of actual fraud from lawsuits manufactured to cash in on investor hysteria.

*Tellabs* held that complaints alleging claims subject to the PSLRA must allege facts establishing an inference of scienter that is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."

We have found that courts are citing *Tellabs*' extensively in subprime cases, and some interesting indications of *Tellabs*' influence are discernable.

First, in the wake of Tellabs, establishing the identity and reliability of confidential witness statements in the complaint is critical,[11] and courts are willing to dismiss subprime complaints that fall short in that regard.

The issue of confidential informants in subprime litigation is crucial, given that subprime complaints often rely on allegations of nonpublic internal company procedures like lending practices or internal quality controls.

Courts will generally refuse to credit informant allegations when “[t]here is no specific information as to the [informants’] positions in the [c]ompany, [ ] employment duties, [and] the foundation or basis for their knowledge” Hubbard v. Bankatlantic Bancorp. Inc., Case No. 07-61542 (S.D. Fla. Dec. 11, 2008).[12]

In the post-Tellabs environment, subprime complaints relying on confidential informants are ripe for attack, especially if it can be shown that the informants are not adequately identified,[13] or that the informants’ statements do not closely tie a particular defendant to the alleged wrongdoing.

See, e.g., In re Downey Sec. Litig., No. 08-3261, 2009 WL 736802, \*3 (C.D. Cal. Mar. 18, 2009) (general job title not sufficient to identify confidential witnesses); In re 2007 Novastar Fin. Inc. Sec. Litig., No. 07-0139, 2008 WL 2354367 (W.D. Mo. June 04, 2008) (dismissing allegations; finding confidential informants not adequately identified).[14] This applies with special force to subprime complaints.

Second, courts seem skeptical of “mere puffery” defenses by subprime defendants, especially if plaintiffs adequately alleged that the purported fraud consisted of misrepresenting (or puffing up) the quality of loans or internal control standards.

See, e.g., In re Countrywide, 588 F.Supp.2d at 1144 (while “descriptions such as ‘high quality’ [loans] are generally not actionable [as mere puffery] ... the [complaint here] adequately allege[d] that Countrywide’s practices so departed from its public statements that even ‘high quality’ became materially false or misleading”).[15]

Third, some courts are apparently losing their patience with what has become a rash of extremely long subprime complaints. This may actually represent a backlash against one (unintended) consequence of the Tellabs holding.

Tellabs’ “holistic” approach incentivizes lengthy complaints containing many allegations which, standing alone, may not necessarily be indicative of scienter, but that might, in the aggregate, cohere into an culpable inference of intent.

However, in the face of three- and four-hundred page subprime complaints, courts appear to be growing weary, some even going so far as to threaten procedures outside normal motion practice to dispose of issues.

See, e.g., *In re New Century*, 2008 WL 5147991, at \*1 (C.D. Cal. Dec. 3, 2008) (denying dismissal, but warning that courts “will not hesitate to dismiss long, unwieldy pleadings” that have become “endemic”).[16]

Defendants might seek to use courts’ growing impatience to their advantage; arguments can likely be formulated that unreasonably long complaints belie weak scienter allegations. See *In re 2007 Novastar Fin., Inc. Sec. Litig.*, 2008 WL 2354367, at \*6 (dismissing 100-page subprime complaint).

## Conclusion

It seems as though we have reached the end of the beginning of the subprime wave.

While it is hard to discern trends from a fairly limited set of cases, we know at this point that subprime motion practice is largely operating on the familiar terrain of the securities statutes (especially the PSLRA), and that Tellabs — which was undoubtedly a major milestone in securities litigation generally — is making its presence heavily felt in subprime motion practice.

Litigants on both sides would do well to intimately familiarize themselves with Tellabs jurisprudence in order to best position themselves to confront this “new” subprime world.

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[1] *Tripp v. IndyMac Fin. Inc.*, No. 07-1635, 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007); *In re New Century*, No. 07-00931, 2008 WL 5147991 (C.D. Cal. 2008); *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132 (C.D. Cal. Dec. 1, 2008).

[2] See *IndyMac*, 2007 WL 4591930 at \*3 (alleging that IndyMac “inappropriately loosened its underwriting guidelines . . . inadequately hedge[d] against its risks . . . and . . . had inadequate ‘internal controls’”); *Countrywide*, 588 F. Supp. 2d at 1145 (alleging that Countrywide “loosened its underwriting guidelines to the point of nearly abandoning them” and “employed a misleading definition of ‘subprime’”).

[3] *IndyMac*, 2007 WL 4591930 at \*5; *Patel v. Parnes (Standard Pacific)*, 253 F.R.D. 531 (C.D. Cal. 2008); *In re Impac Mortgage Holdings, Inc. Sec. Litig.*, No. 07-0970, 2009 WL 648983 (C.D. Cal. March 9, 2009); *In re 2007 Novastar Fin. Inc. Sec. Litig.*, No. 07-0139, 2008 WL 2354367 (W.D. Mo. June 4, 2008); *Sewell v. D’Allesandro &*

Woodyard, Inc. (First Home Builders of Florida), No. 07-343, 2008 WL 4459260 (M.D. Fla. Sept. 29, 2008); New York State Teachers' Ret. Sys. v. Fremont Gen. Corp., No. 07-05756, 2008 WL 4812021 (C.D. Cal. Oct. 28, 2008); Hubbard v. BankAtlantic Bancorp Inc., No. 07- 61542 (S.D. Fla. Dec. 11, 2008).

[4] New Century, 2007 WL 5147991; Countrywide, 588 F. Supp. 2d at 1145; Atlas v. Accredited Home Lenders Holding Co., 556 F. Supp. 2d 1142 (S.D. Cal. Jan. 4, 2008); City of Hialeah Employees' Ret. Sys. and Laborers Pension Trust Fund for N. Ca. v. Toll Bros. Inc., No. 07-1513, 2008 WL 4058690 (E.D. Pa. Aug. 29, 2008).

[5] Edison Fund v. Cogent Inv. Strategies Fund, Ltd., 551 F. Supp. 2d 210 (S.D.N.Y. 2008) (suit against asset management company and issuer of securities backed by subprime auto loans "based on the inability of certain funds to redeem participants' investments after the market for managed portfolios of subprime automobile finance loans deteriorated"); Good Hill Partners LP v. WM Asset Holdings Corp., No. 08-3730, 2008 WL 4761921 (S.D.N.Y. 2008) (suit against issuer of subprime MBSs alleging that defendants failed to disclose intention to apply charge-off penalties for default loans to junior-lien mortgages before senior-lien mortgages, instead of applying the charge-offs across the board).

[6] Edison, 551 F. Supp. 2d 210 (dismissing complaint for failure to establish strong inference of scienter); Good Hill Partners, 2008 WL 4761921 (dismissing complaint for failure to show material misstatements).

[7] In re JP Morgan Chase & Co. S'holder Derivative Litig., No. 08-974, 2008 WL 4298588 (S.D.N.Y. Sept. 19, 2008); Lipetz v. Wachovia Corp., No. 08-6171 (S.D.N.Y.); Saltzman v. Citigroup Inc., No. 07-09901 (S.D.N.Y.); Staehr v. Mack (Morgan Stanley), No. 07-10368 (S.D.N.Y.); Carfagno v. Schnitzer (Centerline), No. 08-00912 (S.D.N.Y.); In re Washington Mutual Inc., Sec., Derivative and ERISA Litig., MDL No. 08-1919 (S.D.N.Y.); In re Merrill Lynch & Co. Inc., Sec., Derivative and ERISA Litig., MDL No. 08-1933 (S.D.N.Y.); In re Lehman Bros. Sec. Litig., No. MDL 09-2017 (S.D.N.Y.).

[8] Coupled with the claims against banks, investors have also alleged securities fraud by the auditors of these financial institutions. See, e.g., In re Merrill Lynch & Co. Inc. Sec., Derivative and ERISA Litig., No. 07-9633 (S.D.N.Y.); In re Lehman Bros. Sec. Litig., No. 09-MD-2017 (S.D.N.Y.); New Century 2007 WL 5147991; Countrywide, 588 F. Supp. 2d at 1144).

In addition, plaintiffs have sued ancillary financial service providers (such as home loan appraisers) for allowing lenders to inflate appraisal values; asset management companies for inappropriately investing in subprime assets; and bond issuers for misrepresenting exposure to subprime risk.

People of New York v. First Am. Corp., No. 07-10397 (S.D.N.Y.) (suit against home loan appraisers, alleging that appraiser allowed loan originator WaMu to handpick appraisers who provided inflated appraisal values); Reimer v. Ambac Fin. Group Inc., No. 08-411

(S.D.N.Y.) (alleging bond issuer fraudulently represented issuer's exposure to subprime mortgage market); *In re State Street Bank and Trust Co. Fixed Income Funds Inv. Litig.*, MDL No. 08-1945 (S.D.N.Y.) (alleging asset management company inappropriately invested fixed-income funds in risky subprime assets); *In re Am. Int'l Group Inc. 2007 Derivative Litig.*, No. 07-10464 (S.D.N.Y.) (insurer allegedly misrepresented exposure to subprime market).

[9] The derivative claims were separately dismissed. *In re Merrill Lynch & Co., Inc., Sec., Derivative and ERISA Litig.*, No. 07-9633, 2009 WL 367524 (S.D.N.Y. Feb. 17, 2009).

[10] Dickey, King and Shih, *Subprime-Related Securities Litigation: Where Do We Go From Here?*, *InSights*, Vol. 22, No. 4, at p.3 (April, 2008).

[11] Tellabs had an uncertain effect on courts' ability to credit allegations based on confidential informants ("CIs"). *Higginbotham v. Baxter*, 495 F.3d 753 (7th Cir. 2007), one of the earliest cases to apply Tellabs, was seen by many to essentially foreclose reliance on CIs. *Id.* at 757.

However, subsequent cases refused to go as far as the Higginbotham; many courts have interpreted Tellabs to require detailed allegations establishing that the CIs were in a position to have first-hand knowledge of the defendants' state of mind. *Malionek, et al., Tellabs v. Makor: One Year Later*, *Securities Law 360*, July 21, 2008; see also *City of Brockton Retirement System v. The Shaw Group*, 540 F. Supp. 2d 464 (S.D.N.Y. 2008).

[12] See also *Mizzaro v. Home Depot Inc.*, 544 F.3d 1230 (11th Cir. 2008) (dismissing complaint; "confidentiality [] should not eviscerate the weight given [to allegations] if the complaint [] fully describes the foundation or basis of the [CI's] knowledge, including the position(s) held, the proximity to the offending conduct, and the relevant time frame.").

[13] *Hubbard v. BankAtlantic Bancorp Inc.*, No. 07- 61542 (S.D. Fla. Dec. 11, 2008) (dismissing).

[14] See also *In re Impac Mortgage Holdings Inc. Sec. Litig.*, 2009 U.S. Dist. LEXIS 18213 (C.D. Cal. March 9, 2009) (dismissing complaint with prejudice where CI statements amounted to "vague accusations and conjecture"); but see *In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044 (C.D.Cal. 2008) (upholding subprime-related securities fraud complaint, finding CIs were adequately identified by employment status, and whose stories corroborated each other).

[15] But see *In re Impac Mortgage Holdings*, 554 F. Supp. 2d 1083, 1096-98 (dismissal in part based on statements that company foresaw "solid loan acquisitions and originations" constituted mere puffery); *In re Downey Sec. Litig.*, No. CV 08-3261, 2009 WL 736802, \*3 (C.D. Cal. Mar. 18, 2009) (finding terms like "strong" in describing capital position to be mere puffery).

[16] See also *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1205 (C.D.Cal. Dec. 01, 2008) (describing the over-800 paragraph complaint as “overlong” and noting that court’s opinion was therefore “regrettably long”); *Gold v. Morrice*, No. 07-00931, 2008 WL 467619, at \*3 (C.D.Cal. Jan. 31, 2008) (noting “long and at times meandering set of allegations” and noting that “[t]he court should not have to comb through the complaint to identify reasonable inferences from the factual allegations”).