AMERICAN BAR ASSOCIATION

SECTION OF LITIGATION

VOL. 10 NO. 1 FALL 2008

■ Trends and Strategies in CDO Litigation

BY ANGELO A. STIO III AND TRAVIS P. NELSON

n no other context in recent memory do we encounter a product market characterized by falling prices and expanded opportunity for entry by first-time consumers, and yet label such market a "crisis." The distinction is that in subprime, we are not dealing with just any other product. At issue is the bedrock of the American dream—home ownership. The subprime crisis has resulted in headaches not only for the homeowners that are losing their homes (or seeing the home values fall) but also for a variety of other market participants who have, or will become, defendants in the continuing subprime fallout. Some

of these potential defendants include traditional banks, investment banks, and investors. One of the most prevalent issues in subprime litigation is litigation over collateralized debt obligations (CDOs). This article will examine the history and current issues surrounding CDOs.

Origins of CDOs

The growth in the subprime market was supported in part by an influx of funding from nontraditional funding sources. Subprime borrowers were able to gain access to credit due to a creative funding vehicle that securitized mortgage loans, known as mortgage-backed securities (MBSs). The chief function of MBSs is to transfer the right to receive the cash flow from pools of mortgage loans. MBSs also served to transfer the risks of the loans to third-party investors. In a typical mortgage

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■ Reducing Litigation Risk from New Accounting Pronouncements

BY C. SHAWN CLEVELAND

n important role of the general counsel is to reduce litigation risk by focusing the attention of board members and senior management on issues that are likely to lead to litigation. This article discusses how in-house counsel can help mitigate the significant litigation risk often associated with new accounting pronouncements. This is particularly important in view of two recent significant accounting pronouncements—SFAS 157, regarding fair value accounting, and SFAS 161, governing disclosures about derivatives—and the less certain but more sweeping shift to international accounting principles that has been proposed by the SEC.

How New Accounting Pronouncements Can Drive Litigation

Implementation of new accounting pronouncements can drive litigation in several ways. Recognition of losses pursuant to new rules may cause a drop in stock price that generates shareholder suits. Plaintiffs or regulators may allege that a company engaged in manipulation in implementing the new pronouncements in order to artificially minimize resulting write-offs, to inflate losses so they can be attributed merely to "accounting changes," or to create cookie jar reserves that can be used to smooth earnings. Plaintiffs may also claim that information disclosed pursuant to new accounting pronouncements should have been previously disclosed under existing rules. In-house

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Letter from the Chairs

he new bar year begins in the shadow of a major financial crisis. The 2008 credit contraction will likely impact the practices of all Commercial & Business Litigation Committee members in the months to come. We hope that the committee and the Section of Litigation can serve as a valuable resource in these challenging times.

Towards that end, this issue focuses on litigation about subprime lending. The article by Garrett W. Wotkyns addresses federal preemption of state law claims—a central topic in much financial services litigation. Federal preemption will be hotly contested in many upcoming cases about the credit crunch. Two cases on the Supreme Court's docket this term bear particular attention: Wyeth v. Levine, No. 06-1249, about the preemptive effect of FDA labeling rules; and Altria v. Good, No. 07-562, about preemption of a state deceptive trade practices action. The treatment of preemption issues by courts in finance cases will determine not only the controlling law for those disputes, but will also likely influence where the cases are resolved. The committee will keep a close eye on the preemption issue during the year and welcomes submissions for the newsletter and website about it.

Lamont and I welcome Barb Dawson, from Phoenix, as a third cochair for our committee. Barb joins our committee leadership in time to participate in the "AP Leadership" project, a new initiative of the Section to help committees develop strong strategies for growth, and in turn establish best practices for all the committees in the Section. The Commercial & Business Litigation Committee was honored to be one of only three committees chosen to participate in this exciting program this year. We hope the project will produce new benefits for committee members as early as this bar year.

We are always on the lookout for new subcommittee chairs, especially on substantive and procedural topics relating to the kind of litigation that the sputtering economy is likely to produce. Please take a look at the list of subcommittees on the website (www.abanet.org/litigation/committees/commercial) and let us know if you are interested in those or in starting a new one. The committee has over 3,000 members now, and the subcommittees are the foundation of its programming and networking opportunities.

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Letter from the Editor

his issue of Commercial & Business Litigation focuses on financial services litigation, which is a hot topic in light of the recent credit crisis that our nation is facing. This issue contains articles dealing with collateralized debt obligation litigation, reducing litigation risks associated with new accounting pronouncements, an overview of the subprime crisis, class action litigation arising from the subprime crisis, and federal preemption of state consumer protection law class actions. We are grateful to all the contributors who have made this a highly informative issue.

If you have any comments about this issue or if you wish to contribute articles to future issues of *Commercial & Business Litigation*, please contact me at stioa@pepperlaw.com. Upcoming newsletter themes and the submission dates for articles are as follows:

- Spring 2009—Alternate Dispute Resolution Submission Deadline: February 1, 2009
- Summer 2009—Energy
 Submission Deadline: May 1, 2009

A standard article is roughly 1,500 words, with all citations in the form of endnotes. The article should be written in MS Word and may be submitted to my attention by email. You will be notified shortly after your submission if your article was selected for publication.

As always, thank you for your interest in the ABA and the Committee on Commercial & Business Litigation.

Angelo A. Stio III



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FOR THE YOUNG LAWER **Summary of Subprime Litigations**

BY MADDALENA ZEFFERINO

he United States is often described as a "litigious society," but the recent subprime circus has certainly taken this characterization to an entirely different level. In 2006–2007, lawsuits, particularly class actions between loan originators and subprime homeowners, began to trickle down in federal and state courts nationwide. The difference now is that current mortgage brokers have company as other parties are now becoming major ingredients in this explosive litigation cocktail. Just how explosive? A recent Navigant Consulting study cited 278 total subprime-related litigation cases were filed in 2007 and almost all of them are still active; borrower class actions led the way, comprising 43 percent of the total. Corporate securities also made up a nice chunk of the litigation with 22 percent of the filings. Between 1994 and 2005, the subprime mortgage market increased from \$35 to \$665 billion dollars. To top that off, at the end of 2006, it was determined that 23 percent of America's mortgages were subprime. Borrowers, shareholders, and investment banks are now defendants, and in some cases plaintiffs, in the lawsuits inundating the courts.

A phenomenon known as information asymmetry is sparking this litigation. According to a New York University Finance professor, Otto Van Hemert, "Loans change hands several times along the chain, and each time there is an exchange, one side has more information than the others."² This legal frenzy has pushed some firms to create their own subprime practice groups. This article will examine how each of these vantage points affects litigation and may force attorneys to muster new creative theories and subprime task forces for their clients in the midst of the subprime debacle.

Where It Began: The Borrower

The story is becoming all too familiar. Individuals trying to pursue the American Dream are swayed by "creative financing products" to buy their homes. This primarily was done by introductory Adjustable Rates Mortgages (ARM). These are loans whose interest rates adjust periodically. Generally, initial rates are fixed for about two years. Such loans are tempting because the starter rates are more affordable and allow borrowers to qualify for larger loans. The issue arises when unpaid interest is tacked onto the principal, leaving borrowers owing more money than what they originally opted for. Some of these creative financing packages give payment options only, which means borrowers can select to pay interest or only the principal. To the confused or less savvy reader, options like these ultimately lead to risky consequences. Most, if not all, subprime loans are filled with these risky terms or options. Some subprime loans also call for "low documentation." This suggests that very little

information is needed from potential borrowers to see if they could actually afford the loan. According to the First American Loan Performance, 58 percent of all loans were comprised of this type.³ The failure to properly disclose information to the borrower, or even make an adequate attempt to properly assess if such loans could be paid off, may even constitute predatory lending.

What does this mean for borrowers? Well, what they thought they would be paying monthly has suddenly skyrocketed. Borrowers would sit down with brokers agreeing to one term at closing, and then, unbeknownst to the borrower, these terms would change. In chronicling foreclosures, The New York Times reported an example in which a homeowner agreed to an 8 percent fixed rate, but instead, according to her interview, the rate jumped to 12.514 percent with penalties and balloon payments. 4 These last-minute additions were clearly not disclosed to the borrower. In some instances, these brokers are committing fraud by cushioning the value of real estate and other assets. In New Jersey, one homeowner paid \$272,000 for a property that was actually appraised for \$127,000. Unfortunately, New Jersey homeowners are not the only ones plagued by such practices. The Attorney General of Connecticut stated that Royal Financial, LLC, and Elisabeth Athan Real Estate, LLC, two defendants named in lawsuits, were misleading consumers and even mortgage lenders into property purchases that "[were and are] financially destroying dozens of home buyers . . . "5 Connecticut is currently seeking civil penalties under the Unfair Practices and Trade Act for this case.

So, who is now helping these potentially destitute homeowners? Attorneys general nationwide are actually forming coalitions to rescue homeowners from these situations. Attorney General of Iowa, Tom Miller, stated that he is touching base with other state attorneys general to see how they could consolidate their efforts to eliminate this subprime mess. He has worked actively in his involvement with Ameriquest, a well-known subprime lender who has been accused by state prosecutors of predatory lending. The company has faced a class action lawsuit in which Miller was able to net millions in settlements nationwide. He believes that attorneys general "understand the value of that, and it is never far from our minds that we can accomplish things together that we can't individually." Furthermore, Marc Dann is another attorney general who will not let foreclosure consume his state; he sued 10 mortgage lenders who have pressured real estate appraisers to inflate home values. He states, "Predatory lending is driving Ohio's shameful home foreclosure rate," and he has also accused some lenders of violating the state's Consumer Sales

Practice Act,⁷ citing Apex Mortgage, First Ohio Banc, and Island Financial. These cases are all being heard in Ohio Superior Courts. In addition, Ohio currently has the third largest number of foreclosure filings in the nation, at 11,431 (mostly based on complaints from borrowers).⁸

Expectedly, these attorney general suits are not the only ones that have emerged. NovaStar Home Mortgage Inc. was faced with a heavy class action in late 2005. Essentially, the company "pushed clients into paying higher interest rates due to hidden fees." The suit alleged that the broker/lender did not disclose the additional payments to the borrowers until closing time. The class action finally settled and NovaStar agreed to pay \$5.1 million—\$3.3 million to cover the 1,600 consumers in the class action, and \$1.8 million to cover plaintiff attorney fees. The suit also alleged that the broker/lender did not disclose the additional payments to the borrowers until closing.

It does not end with NovaStar; CountryWide has also paid heavily. There was a class action filed last September in the Federal District Court of Los Angeles stating that unwary borrowers could have qualified for lower-cost prime loans, and thus the company violated the Federal Racketeer Influenced and Corrupt Organization Act. Not accurately assessing borrowers' needs ultimately leads to such corruption charges. Moreover, CountryWide continues to be targeted in court, but for discriminatory issues as well. In Boston, the company was charged with violating federal housing discrimination laws. It was found that African-Americans paid higher fees to CountryWide agents than other racial groups who applied for loans. This prosecutor's suit seeks \$100 million in reimbursements.

Securities

As previously illustrated, the subprime crisis began with borrowers and loan originators, and now more parties have entered the mix, even those entities involved in securitization. As a whole, securities litigation rose 43 percent in 2007, according to the Stanford Law School Class Action Clearinghouse Study. Filings against companies in the finance industry rose from 11 to 47. From this end, plaintiffs contend that senior executives sold off securities without disclosing the inherent risks. In some instances, they insist that the "companies inflated share prices by providing positive business assessments, while failing to disclose facts the executives knew, or should have known, about exposure to huge losses with subprime mortgages and their securitization."¹³

So, who has been sued thus far for artificially inflating stock? Freddie Mac was charged in the Northern District of Ohio because it denied it had any substantial investment in, or exposure to, the subprime financing of U.S. housing; however, in the fall of 2007, Freddie Mac revealed that \$150 billion of its portfolio was riskier than initially thought, and they also conveyed to investors that they incurred a \$2 billion loss. 14 Prior to 2007, Freddie Mac apparently did not disclose its subprime lending exposure. Compared to its

rival, Fannie Mae, which regularly files voluntarily with the SEC, Freddie Mac has kept those involved in subprime deals in the dark, and in turn, at risk. Freddie Mac is now being sued by Ohio Public Employee Retirement System for unspecified damages.

Another securities litigation case that also made headlines was JDS Uniphase securities class action litigation, in which the defendants prevailed. The case alleged that the company's former officers sold hundreds of stocks for personal profit and made misleading statements about the company's financial performance. The company wrote down over \$40 billion dollars in inventory, making it the largest write-off in corporate history. Some legal experts claim that the JDS trial is an important landmark in modern securities litigation. Professor Grundfest of Stanford law school stated, "These cases rarely go to trial, and for defendants to win a total victory in a

case that claims \$20 billion in damage demonstrates that not every case that makes it past summary judgment ha[s] merit."15

Another similar case, in which a company's condition was misrepresented, was with American Home Mortgage Investment Corporation. ¹⁶ Apparently, "defendants continued to conceal financial determination of the company and its

Attorney
General Marc
Dann states,
"Predatory
lending is
driving Ohio's
shameful home
foreclosure rate."

liquidity."¹⁷ Attorneys in the case are citing violations of the Securities Exchange Act as well.

Shareholders/Investors

As illustrated, even in the securities fraud suits, individuals, underwriters, and executives are being named as defendants. Now it is time to examine suits brought by investors and shareholders. Most of the complaints brought by shareholders clearly state that these executives had knowledge of negative company conditions, but nevertheless allowed false public statements to be made anyway. For example, Angelo Mozilo, CEO of CountryWide, was charged with breaching his fiduciary duty by not properly disclosing the company's lending practices. The complaint alleges that management knew about the dire conditions of the company but unloaded shares of stock to themselves before financial woes could be revealed. It does not end here. The International Brotherhood of Electrical Workers Local 98 also filed a shareholder derivative against CountryWide, alleging that Mozilo and others provided

false and misleading statements. Unfortunately, Bank of America, with its recent \$4 billion acquisition of CountryWide, will inevitably inherit all of these subprime litigation suits.

Other investors are also suing. Employees of Freemont General Corporation are "suing the struggling mortgage lender, claming its directors should have cited to prevent the loss of millions of dollars from retirement and stock ownership plans."18 This was a class action filed in Los Angeles on April 26, 2007, and it is still pending, with 3,300 people in retirement plans and 1,700 employees in stock option plans being involved. The company is accused of engaging in unsafe lending practices in order to increase stock price; this so-called strategy ended in catastrophe and struck when subprime borrowers defaulted on loans.

In addition, investors in securities class action fraud against American Business Financial Services, Inc., et al., (ABFS), also made headlines. The company was charged with making loans to credit-impaired and subprime borrowers considered unqualified by other financial institutions. Specifically, plaintiffs stated that material omissions were made in various prospectuses since 2002.19 ABFS also understated their delinquency of loans, thus creating securities fraud under the Securities Act of 1933.

Investment Banks

The litigation chain does not end with shareholders. Once again, attorneys general are asserting their role and are also listing banks as defendants, including, but not limited to Bear Stearns and Co., Inc.; Deutsche Banc Securities Inc.; and Roth Capital Partners, LLC. These entities are liable for including misleading statements in prospectuses and other offering documents. According to partners at Mayer Brown LLP, they believe that such cases can be categorized in four groups:20 class actions involving securities fraud by banking shareholders;²¹ banks that securitized groups of subprime mortgages and sold securities; claims alleging that investment banks and hedge funds aided and abetted fraud;²² and customer suits insisting that banks invested their funds too heavily in securities that were based on subprime mortgages.²³

State entities and regulatory agencies are also examining Wall Street firms, based on their involvement in mortgage finance practices. For instance, state regulators "have fired the opening shots with lawsuits trying to prove that investment banks and big lenders are guilty of more than just bad business decisions and failing to foresee looming mortgage troubles."24 Even the FBI is targeting Wall Street for possible criminal action of investment banks. Focusing on whether firms hide risks from investors and other investigations, Massachusetts top securities regulator and Secretary of Sate, William Galvin, accused Bear Stearns mortgage unit for conflict of interest in trading between hedge funds. Furthermore, Merrill Lynch was also accused of fraud and misrepresentation. Apparently, Merrill Lynch invested the City of Springfield's funds too arbitrarily and carelessly, which, as a result, generated a great loss for the state.

Furthermore, in New York, Attorney General Andrew Cuomo continues his investigation of a real estate appraisal firm that colluded with Washington Mutual, Inc. to inflate home values. Ultimately, it appears that such close examination of these Wall Street and other prestigious firms could lead to acknowledgment of dubious practices that would not have otherwise been brought to light.

Legal S.W.A.T. Teams?

The lawsuits being filed from all of these perspectives lead to more work for attorneys. Although the potential litigation appears to be overwhelming, most firms are already well prepared to dive in. In the last four months, 20 law firms have constructed subprime crisis response teams and task forces, consisting of roughly 500 attorneys. According to one partner at Duane Morris, LLP, "These problems are going to expand to such a dimension that it will consume vast amounts of lawyers' time."25 To truly tackle these cases, there needs to be great emphasis on the architecture of the legal team, with key considerations being the composition of the team and the role each advocate will play. These teams not only require litigators but also individuals with different types of expertise, from bankruptcy to white-collar crime. There also needs to be a systematic way to delegate the responsibility to all the agents involved, and this requires different perspectives. However, the construction of the team is not the only critical factor; the defenses the team asserts are paramount to their success. New, creative approaches may be necessary to determine the degree of liability of participating agents. In fact, recent cases look at how deeply entities are involved, what roles certain businesses assume, and if such involvement is sufficient to make them liable. In other words, did these entities assert some form of "scheme liability?" 26 With all of this in mind, exercising vigilance with regard to recent arguments brought before the Supreme Court is crucial, but it is only when coupled with a true comprehension of the involved entities' positions that legal teams will be able to posture effective arguments.

Conclusion

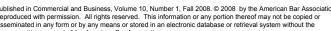
By chronicling the subprime-oriented litigation lawsuits from each of these vantage points, attorneys involved must brace and truly organize themselves as this legal tidal wave will certainly not ebb anytime soon. ■

Maddalena Zefferino is a paralegal with Pepper Hamilton LLP in Princeton, New Jersey.

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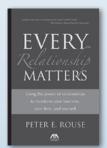
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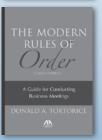
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Class Action and Related Litigation Arising from the Subprime Crisis

BY JAMES A. KING, ANTHONY R. MCCLURE, AND LINDSAY M. SESTILE

rom 1994 to 2005, the percentage of mortgages in the United States that were subprime more than quadrupled. Many of those mortgages were packaged into mortgage-backed securities. By 2006, mortgage interest rates reached four-year highs while home values plummeted. As a result, approximately 80,000 of those mortgages fell into delinquency, and by mid-2007, dozens of lenders participating in the subprime mortgage business had gone out of business. The resulting subprime lending crisis set off a wave of class action litigation in 2007. Borrowers, investors, and other plaintiffs filed 278 civil lawsuits in federal courts relating to subprime lending in 2007, with 65 percent of those cases filed in the latter half of the year. Many types of cases have arisen out of the subprime lending crisis, including borrower class actions, shareholder class actions, ERISA class actions, and shareholder derivative suits. This article discusses examples of the various types of cases that have been filed.

Borrower Class Actions

In Andrews v. Chevy Chase, a Wisconsin couple filed a class action suit against Chevy Chase Bank, a mortgage lender, for violations of the Truth in Lending Act (TILA), 15 U.S.C. § 1601, and Regulation Z, 12 C.F.R. § 226.20. In 2004, the Andrews received an advertising mailer that offered "Cashflow 5-Year Fixed; Note Interest Rate; 1.95 percent." Since the interest rate on their current mortgage was 5.75 percent, the Andrews signed with Chevy Chase, only to discover later that the loan actually allowed the interest rate to rise and that the advertised 1.95 percent rate lasted only one month. The rate quickly reached more than 8 percent.

In 2005, the Andrews filed their lawsuit in the Eastern District of Wisconsin, seeking rescission for each class member, as well as compensatory damages and injunctive and other relief. The Andrews defined the class as any person who entered into a mortgage with Chevy Chase since April 20, 2004, where the loan contained a monthly adjustable rate but the disclosure statement contained the word "fixed" or failed to fully disclose the principal, interest, and other charges.

In January 2007, the district court held that Chevy Chase violated TILA in several respects, and extended by three years the time that the aggrieved borrowers had to exercise their right of rescission under the act. Interestingly, on October 17, 2007, the Seventh Circuit apparently agreed in part with the district court's substantive decision and held that the failure to specify a payment interval is a violation of TILA.²

On the issue of rescission for all class members, the district court in *Andrews* observed that, "[t]here is no reason why a plaintiff who alleges that a defendant has violated TILA and caused widespread injuries should not be able to bring a class action.

Denial of class action status would reward defendants who may have committed wrongs and leave victims who may have been wronged uncompensated." Chevy Chase appealed the decision certifying the class, and pursuant to Rule 23(f), the district court stayed the proceedings pending appeal. Both the appeal and the lawsuit remain pending.

Shareholder Class Actions

As with the Merrill Lynch litigation, several lawsuits also have been filed against NovaStar Financial, Inc., a real estate investment trust (REIT) in the Western District of Missouri. One example is *Owens v. NovaStar Fin. Inc.*, ⁴ a securities fraud class action on behalf of all investors in securities of NovaStar between May 4, 2006, and February 20, 2007, alleging violations of the Securities and Exchange Act of 1934 § 10(b) and Rule 10b-5.

According to the complaint, NovaStar originates, invests in, and services residential nonconforming (subprime) loans. On February 20, 2007, the company announced that its underwriting guidelines for 2006 were "inappropriate" and that it had suffered the loss of more than \$14 million for the fourth quarter 2006. The company further announced that it did not expect to make any REIT taxable income for the next four years, that it therefore would not pay dividends, and that it was evaluating whether it would retain REIT status. As a result, the stock dropped more than 30 percent.

The complaint estimated that there were hundreds, if not thousands, of class members owning the more than 24 million shares of stock. The plaintiff alleged that NovaStar reported falsely inflated financial results and misrepresented the quality of its mortgage loan portfolios, among other things. As a result, the plaintiff alleged that NovaStar's securities traded at artificially inflated or distorted levels. On July 9, 2007, the district court in Owens consolidated the case with seven other lawsuits pending against NovaStar and assigned lead plaintiffs and counsel. After the case was consolidated, an amended complaint was refiled on October 19, 2007, in *In re 2007 NovaStar Fin.* 6

In an interesting twist, in a recent decision the district court dismissed the entire lawsuit. Applying the Private Securities Litigation Reform Act (PSLRA), the court determined that the complaint did not satisfy the act's pleading requirements. "Ultimately, Plaintiff fails to identify a single false entry in the Company's financial statements, nor does not he identify the 'truth' that should have been disclosed." The court observed that the complaint "reads more like a cautionary tale from a treatise on business management than a charge of knowing misstatements and concealments. Plaintiff has not stated a claim because companies (and their management) are not expected to be clairvoyant,

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and bad decisions do not constitute securities fraud." In addition, the court held that the complaint did not present facts creating an inference of scienter, "and this failing constitutes an independent reason to dismiss the case."

ERISA Class Actions

Traditional ERISA class actions, often referred to as "stock concentration" or ERISA "breach of fiduciary duty" cases, concern breaches of fiduciary duties under ERISA relating to 401(k) and Employee Stock Ownership Plan (ESOP) investments in employer stock. Beginning in the summer of 2007 and continuing to the present, traditional ERISA class action claims have been joined by a new subclass of actions relating to the subprime mortgage crisis and the fall of the subprime lending industry. These ERISA stock concentration class actions allege that investment of company stock in plan assets was imprudent based upon the company's involvement in the subprime industry. For these cases, key issues will include what the defendant companies and fiduciaries are alleged to have known or should have known about the risks associated with subprime lending and investing. Those being sued under this theory include subprime mortgage originators, investment banks, and building companies and title agencies. Some of these new cases are discussed below.

Cases Against Subprime Mortgage Originators In In re Fremont Gen. Corp. Litig.,9 a consolidated class action was filed against Fremont General Corporation on behalf of all participants and beneficiaries of the Fremont Investment Incentive 401(k) Plan and the Fremont ESOP Plan as of January 2005. Fremont was, according to the complaint, the third-largest subprime mortgage lender in the U.S., with about half of its business focused on the subprime mortgage sector. The complaint alleges that Fremont's risky subprime lending practices and poor underwriting standards caused the company to bear the risk of hundreds of millions of dollars in uncollectible loans. Fremont stock, which represented more than 50 percent of the 401(k) Plan's net assets, fell from approximately \$25 per share in 2005 to its current trading level (as of June 11, 2008) of \$0.07 per share. According to the complaint, investment of Plan assets in company stock was imprudent based on the company's serious mismanagement and improper business practices. A motion to dismiss filed by Fremont, raising issues of a demonstrable link between the alleged misconduct and the harm suffered to the Plan, as well as the duty to disclose nonpublic information regarding the company to Plan participants, was recently denied by the district court on May 29, 2008, allowing the plaintiffs to continue to pursue their claims against Fremont.

Other instances of cases against subprime mortgage originators include *Alvidres v. Countrywide Fin. Corp.*, ¹⁰ (on March 17 and 18, 2008, and April 9, 2008, the district court denied various defendants' motions to dismiss, and on April 16, 2008, it granted plaintiffs' motion for class certification) and *Cedarleaf v. Huntington Bancshares*, *Inc.*, ¹¹ (in addition to claims relating the Huntington's lending practices, plaintiffs claim Huntington exposed

them to additional risk by acquiring Sky Financial in 2007, giving Huntington an additional \$1.5 billion of subprime exposure and not disclosing the full extent of risk from the acquisition).

Cases Against Investment Banks

Investment banks that invested in mortgage-backed securities have also been impacted by the subprime mortgage crisis as, beginning in the fall of 2007, they were forced to make downward adjustments in the accounting values of their assets based in the subprime market. As shares of company stock have declined in value due to the subprime crisis, so has the value of their employees' 401(k) Plan assets. The federal courts (particularly in the Southern District of New York) have begun to see filings of ERISA class actions against investment banks based on their investments in the subprime markets.

In In re Morgan Stanley ERISA Litig., 12 plaintiffs claim that

Morgan Stanley (and other named defendants) breached their fiduciary duties when they did not take steps to protect investors when ownership of company stock was no longer prudent based on Morgan Stanley's investment in the subprime market, and by not disclosing the risks of investing in Morgan Stanley. Plaintiffs also claim Morgan Stanley directors and officers made reassuring statements in press releases and conference calls even though they anticipated the subprime investment fallout. Morgan Stanley stock, which

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represented more than 50 percent of the 401(k) Plan's net assets, fell from approximately \$84 per share at the beginning of 2007 to its current trading level (as of June 11, 2008) of \$37.13 per share.

Other instances of cases against investment banks include *Alexander v. Washington Mutual, Inc.*¹³ (in which plaintiffs alleged that the directors failed to monitor the performance of co-fiduciaries and publicly made misleading statements to inflate the value of company stock while at the same time selling thousands of their own shares); and *Steven v. Citigroup*, *Inc.*¹⁴ (in which plaintiffs alleged that Citigroup's conduct was

improper, particularly its participation in investment vehicles that were off the balance sheet).

Cases Against Building Companies and Title Agencies In In re Beazer Homes USA, Inc. ERISA Litig. 15, defendant Beazer began reporting record earnings resulting from its strong inventory of homes and expectations of competitive advantages over other building companies in late 2005. Plaintiffs claim Beazer and other defendants breached their fiduciary duties to 401(k) Plan participants of the company by overstating its inventory, engaging in improper subprime lending practices, hiding account irregularities, and downplaying bankruptcy rumors. According to the complaint, this conduct resulted in the significant decline in the price of company stock by 2007, and plaintiffs filed suit

According to the complaint, Merrill Lynch CEO Stanley O'Neal committed several breaches of his fiduciary duties and was ultimately responsible for the company's massive downturn.

alleging Beazer failed to inform Plan participants of potential risks to their investments, which rendered company stock an imprudent choice for the Plan and caused the stock to be artificially inflated. On October 11, 2007, Beazer announced interim findings from an internal investigation and declared it would be necessary for the company to file restated financial statements for the past three years with the SEC. On May 12, 2008, Beazer refiled with the SEC, and on June 11, 2008, the parties entered into a consent order allowing plaintiffs until June 27, 2008, to file a consolidated complaint. Beazer is expected to file a

motion to dismiss once the consolidated complaint is filed.

In In re First Am. Corp. ERISA Litig., 16 plaintiffs allege that First American, the nation's largest title insurer, relied heavily on business generated by the subprime mortgage industry. In particular, plaintiffs allege that First American conspired with Washington Mutual to unlawfully inflate real estate appraisals, causing a boost in First American's stock price and profits. At the end of 2006, approximately 35 percent of First American's 401(k) Plan investments were in company stock. Plaintiffs allege that investment of those assets in company stock was imprudent because First American knew, or should have known, of the consequences to the company from its dealings in the failing subprime mortgage market and of the eventual decline of artificially inflated company stock. On May 5, 2008, First American filed a motion to dismiss for failure to state a

claim and plaintiffs opposed on June 4, 2008. That motion remains pending.

At the present time, it is too early to know if this trend of subprime class action filings will continue. As the various federal district courts begin to rule on motions to dismiss and other dispositive motions, and as the jurisprudence for these types of claims develops, it will become clearer whether this type of litigation is a flash in the pan with little practical effect, or whether it will result in massive overhaul to corporate policies relating to subprime lending and investments.

Shareholder Derivative Lawsuits

In 2007 and 2008, several lawsuits related to the subprime mortgage crisis were filed against Merrill Lynch in the Southern District of New York, including shareholder derivative actions. For instance, in Arthur v. O'Neal, 17 the plaintiff filed a shareholder derivative action, claiming that Merrill Lynch had become one of the largest victims of the crisis, and placing the blame on its former CEO, Stanley O'Neal, as well as other officers and directors. The plaintiff claims that by 2007, Merrill Lynch became the world's leading underwriter of collateralized debt offerings (CDOs), which are essentially mutual funds that buy securities backed by things such as mortgages, auto loans, and corporate bonds. About 40 percent of CDO collateral is residential mortgage-backed securities, secured by risky subprime mortgages.

According to the complaint, O'Neal committed several breaches of his fiduciary duties in his pursuit of CDOs and was ultimately responsible for the company's massive downturn in 2007, causing stocks to fall by \$3.80, or 5.7 percent. The plaintiff also claims that the other officers and directors "turned a blind eye" to O'Neal's breaches while some intentionally caused Merrill Lynch to issue financial statements that concealed the dangers of the CDOs. On October 24, 2007, O'Neal announced that Merrill Lynch would write-down more than \$8 billion in the value of its CDOs and other investments, and would suffer a \$2.2 billion loss in the third quarter of the fiscal year 2007 which, according to the complaint, is the largest quarterly loss in the 93-year history of the company.

In support of the derivative nature of the lawsuit, the plaintiff claims that making a demand to the board of directors would be futile, as they are named defendants. The complaint raises four claims: (1) breach of the fiduciary duties of care, loyalty, and good faith; (2) corporate waste; (3) abuse of control; and (4) gross mismanagement. The plaintiff seeks, on behalf of Merrill Lynch as the nominal Defendant, damages of \$8 billion as well as an order directing the company to take all necessary actions to reform and/or improve corporate governance.

In March 2008, the district court observed that there are 19 lawsuits pending before it against Merrill Lynch: five putative securities class actions, three shareholder derivative actions (including Arthur), and 11 ERISA actions. After a hearing, the court consolidated the cases and appointed lead counsel in each of the three categories. In compliance with that order, an amended complaint was filed in the consolidated cases. That lawsuit is still pending.

Conclusion

The subprime mortgage crisis does not appear to be slowing. The number and types of subprime-related class actions and lawsuits are likely to increase as the crisis unfolds. As many of these lawsuits are still in their infancy with no real standard having been set, courts will be on their own to determine a multitude of procedural issues, such as class certification, motions to dismiss, and consolidation in this subprime context, as well as issues arising under the various substantive laws discussed in this article. Time will ultimately tell whether this litigation will produce any meaningful precedent.

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- 1. Andrews v. Chevy Chase, 240 F.R.D. 612 (E.D. Wis. 2007).
- 2. Hamm v. Ameriquest Mortgage Co., No. 05-3984 (7th Cir. Oct. 17, 2007).
- 3. Andrews, 240 F.R.D. at 621; see also In re Ameriquest Mortgage Co., No. 05-CV-7097 (N.D. Ill. 2007) ("While we recognize that actual rescission is a personal remedy, we find nothing in TILA precluding declaratory relief authorizing class members to individually request rescission where they are legally entitled to do so."); but

- see McKenna v. First Horizon Home Loan Corp., 474 F.3d 418 (1st Cir. 2007) (holding that an action for class-wide declaratory relief stating a right to rescission is not permissible under TILA).
- 4. Owens v. NovaStar Fin. Inc., No. 07-cv-0166 (W.D. Mo. Mar. 1, 2007).
- 5. See also Teamsters Local 282 Pension Trust Fund v. Moody's Corp., No. 07-cv-8375 (S.D.N.Y. Sept. 26, 2007) (complaining of Moody's investments in CDOs and invoking the fraud-on-the-market doctrine).
- 6. *In re* 2007 *NovaStar Fin.*, *Inc.* Sec. Litig., No. 07-cv-0139 (W.D. Mo. Feb. 23, 2007).
- 7. *In re* 2007 *NovaStar Fin.*, No. 07-cv-0139, slip op. at 6 (W.D. Mo. June 4, 2008).
 - 8. *Id.* at 7.
- 9. *In re* Fremont Gen. Corp. Litig., No. 07-cv-02693 (C.D. Cal. Consol. Compl. Oct. 25, 2007).
- 10. Alvidres v. Countrywide Fin. Corp., No. 07-cv-05810 (C.D. Cal. Sept. 6, 2007).
- 11. Cedarleaf v. Huntington Bancshares, Inc., No. 08-cv-0175 (S.D. Ohio Feb. 25, 2008).
- 12. *In re* Morgan Stanley ERISA Litig., No. 07-cv-11285 (S.D.N.Y. Dec. 14, 2007).
- 13. Alexander v. Washington Mutual, Inc., No. 07-cv-01906 (W.D. Wa. Nov. 19, 2007).
- 14. Steven v. Citigroup, Inc., No. 07-cv-11156 (S.D.N.Y. Dec. 11, 2007).
- 15. *In re* Beazer Homes USA, Inc. ERISA Litig., No. 07-cv-0952 (N.D. Ga. Apr. 30, 2007).
- 16. *In re* First Am. Corp. ERISA Litig., No. 07-cv-1357 (C.D. Cal. Nov. 16, 2007).
 - 17. Arthur v. O'Neal, No. 07-cv-9696 (S.D.N.Y. Nov. 1, 2007).

Silvas and Subprime Class Actions: Another Brick in the Federal Preemption Wall

BY GARRETT W. WOTKYNS

ontesquieu held that every man invested with power is apt to carry his authority as far as he can. Today's American federal banking regulators do not disprove that maxim. Coincident with America's recent boom in subprime mortgage lending, the federal Office of the Comptroller of the Currency (OCC) and the federal Office of Thrift Supervision (OTS) asserted sweeping claims of authority to preempt a broad array of state laws, including consumer protection laws. Such initiatives carried these executive branch administrative agencies—which, respectively, regulate America's federally chartered national banks and savings banks—to the *ne plus ultra* of their lawful authority. They also disrupted state efforts to combat abusive subprime mortgage lending during the recent housing frenzy.¹ Whether that is a good or bad thing or

even matters much to the still-being-written history of American subprime mortgage lending is the subject of robust debate.²

More directly relevant to class action litigators handling subprime lending cases is the superstructure of federal law and regulation undergirding these recent acts of preemption. For those very same laws and regulations reliably are invoked in dismissal bids by federally chartered bank defendants when such banks are sued by subprime borrowers under state law-based theories. When one considers that these laws, therefore, both largely give federal regulators a free hand to regulate (or not) America's largest mortgage lenders as they see fit, and simultaneously provide those lenders with matter-of-law immunity from many state law-based complaints filed against

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them, then federal preemption looks quite important, indeed, to the story of American subprime mortgage lending.

The subject of this article is a striking recent chapter in that story. In January 2008, the United States Court of Appeals for the Ninth Circuit—widely supposed to be America's "most liberal circuit court"—declared a wide range of state law-based claims against federal savings banks to be broadly preempted by federal law. In Silvas v. E*Trade Mortgage Corp.,3 the Ninth Circuit held that state law-based causes of action against federal savings banks are preempted by federal law even where those state law claims seek relief for alleged violations of federal banking rules. This article contends that Silvas effectively will eliminate certain long-established rights of federal savings bank mortgage borrowers, and thus undermine the aims of the federal banking regulations it ostensibly enforces.

Basic Preemption Rules for Federal Savings Banks

The Home Owners Loan Act (HOLA), 12 U.S.C. §§ 1461, et seq., and its implementing regulations comprehensively govern the lending activities of federal savings banks. Enacted in 1933,

State law-based claims against federal savings banks may vanish altogether in the Ninth Circuit in the wake of Silvas. HOLA is "a product of the Great Depression of the 1930s, [and] was intended 'to provide emergency relief with respect to home mortgage indebtedness' at a time when as many as half of all home loans in the country were in default."4 HOLA empowered what is now the OTS to authorize the creation of federal savings banks, to regulate them, and to preempt conflicting state law with its regulations in some situations.

One of the HOLA's implementing regulations

permits federal savings banks to "extend credit as authorized under federal law . . . without regard to state laws purporting to regulate or otherwise affect their credit activities." The regulation goes on to supply "[i]llustrative examples" of the kinds of state laws that are preempted by HOLA.6 Among them are state laws "purporting to impose requirements" regarding "[t]he terms of credit," "loan-related fees," "[d]isclosure and advertising," and the "[p]rocessing, origination, servicing, sale, or purchase of, or investment or participation in, mortgages[.]"7 The regulation also supplies examples of state laws applying to federal savings banks that are not preempted by HOLA. State "contract and commercial law[s]," "real property law[s]," and "tort law[s]" are not preempted "to the extent that they only incidentally affect the lending operations of Federal savings associations or are otherwise consistent with the purposes" of the HOLA regulations.8

While the HOLA preemption rules, then, are complex and nuanced, last year Judge Posner summarized them concisely in another important federal banking preemption decision. The OTS's "assertion of plenary regulatory authority" over federal savings banks' lending activities, he wrote for the Seventh Circuit, "does not deprive persons harmed by the wrongful acts of savings and loan associations of their basic state common-law-type remedies" when they assert claims for relief concerning subjects not included in the above-described laundry list codified at 12 C.F.R. § 560.2(b).9 He stated that such remedies include, but are not limited to, tort remedies. Judge Posner also noted that sometimes enforcement of such state law-created remedies against federal savings banks will "complement rather than substitute for the federal [HOLA] regulatory scheme."10

Silvas

To read the Ninth Circuit's decision in Silvas, one would scarcely guess that Silvas applied the same preemption regulations as the Seventh Circuit did in Ocwen. For even though negligence liability is a "basic state common-law-type remed[y]," and allowing mortgage consumers to pursue negligence per se claims founded on predicate federal banking law violations would seem to "complement rather than substitute for the federal [banking] regulatory scheme," the Ninth Circuit in Silvas nonetheless affirmed the preemption-based dismissal of negligence per se-type consumer class claims against a federal savings bank in emphatic terms. 11 Silvas leaves serious doubt about whether such claims are ever viable against federally chartered financial institutions in the Ninth Circuit.

Silvas concerned a mortgage loan that was issued by a federal savings bank member of the E*Trade family of companies. 12 The Silvas plaintiffs advanced class action claims against their lender under California's Unfair Competition Law (UCL), California Business and Professions Code Section 17200 et seq., which, like the negligence per se doctrine, allows plaintiffs to "borrow" violations of other laws and seek recovery for those predicate violations under the UCL.13 The Silvas plaintiffs alleged that their lender violated California's UCL by making misrepresentations concerning the plaintiffs' rescission rights under the federal Truth in Lending Act, 15 U.S.C. § 1601 et seq. (TILA), and by failing to provide a refund of the plaintiffs' deposit as required by TILA.

In other words, the Silvas plaintiffs sought to hold their lender liable under California consumer law for predicate violations of federal banking rules—a negligence per se-type claim (albeit one explicitly asserted in UCL terms). 14 Notably, the Silvas plaintiffs stood on these predicate federal law violations as a basis for their UCL allegations, even though TILA claims are subject to a one year statute of limitations15 and the plaintiffs waited almost four years to file their TILA-centric UCL case. The district court granted the bank's motion to dismiss the plaintiffs' claims as preempted, and the Ninth Circuit affirmed that dismissal.

In its opinion, the Ninth Circuit seized on the *Silvas* plaintiffs' attempt to circumvent TILA's limitations period, noting acidly that "[t]heir end run will not do." Because HOLA directs the OTS to occupy the "entire field of lending regulation for federal savings associations," the court wrote, a state like California may not use its law to "add a damages remedy unavailable under [a] federal law" like TILA that concededly otherwise applies to federal savings banks and is used as a predicate for California-law claims. The court contended that this was so because "[a]n integral part of any regulatory scheme is the remedy available against those who violate the regulations."

Life after Silvas for Subprime Class Action Litigants in the Ninth Circuit

After Silvas, what becomes of state law-based claims against federal savings banks founded on predicate violations of federal law? To begin with, Silvas's sweeping language suggests that all mortgage-related state law claims based on violations of federal consumer protection regulations (which typically feature no private right of action) are per se preempted because those underlying regulations supply no private right of action against banks that violate them.¹⁹ Silvas also appears to bar state lawbased consumer mortgage claims predicated on violations of federal remedial statutes like TILA when such state law claims would trigger remedies in any way differing from those offered by TILA. It does so, of course, despite that negligence per se liability is "a basic state common-law-type" cause of action other courts believe is not categorically foreclosed by the HOLA/ OTS regulatory scheme—and despite that "[t]he underlying idea [behind negligence per se doctrine] is that it is beneficial that statutory norms find their way into tort law to ensure that common law adjudication reinforces legislative priorities."20

A recent federal district court ruling in a subprime mortgage class action against a federal savings bank suggests the courts will (for better or worse) apply *Silvas* in exactly this broad-brush fashion going forward. In *Reyes v. Downey Savings and Loan Ass'n, F.A.*,²¹ the court dismissed UCL claims against a federal savings bank where the UCL claims were founded on alleged predicate TILA violations but apparently *not* otherwise barred by TILA's one-year limitations period. Citing *Silvas*, the court dismissed the UCL claims out of hand—observing that *Silvas* "explicitly held that HOLA preempt[s] claims under the UCL if the UCL claims [are] predicated on TILA."²² Even though the short TILA limitations period did not appear to afflict the actual claims advanced by the *Reyes* plaintiffs, the court nonetheless cited the difference in the limitations periods of TILA and the UCL as a basis for dismissing the plaintiffs' TILA-based UCL claims as preempted by HOLA:

While TILA only provides for a one-year statute of limitations period, the UCL provides for a four-year statute of limitations period. . . . This procedural difference amounts to state regulation of savings associations since it alters the rules controlling how the associations operate. Plaintiffs' use of the UCL as predicated on TILA is preempted.²³

While at press time only one other reported federal decision aside from *Reyes* has followed *Silvas*, the court in that case again invoked *Silvas* in dismissing state law-based claims founded on predicate alleged TILA violations.²⁴ To date, no reported decision has construed *Silvas* to permit state law-based consumer claims to proceed against a federal savings bank defendant.

Conclusion

In short, Silvas deepens the difficulties faced by those mortgage borrowers who secured loans from federal savings banks during the recent subprime lending boom and who wish to obtain relief from onerous loan terms in the courts. Given the short limitations periods attached to the federal laws most often used by consumers in consumer mortgage cases (TILA and the Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 et seq.), and the difficulties even savvy consumers face in discovering and understanding mortgagerelated wrongdoing by lenders, such borrowers often turn of necessity to state law regimes in hopes of recovering their losses. While basic state law-based claims (such as for negligence or fraud) against federal savings banks have always been difficult for consumers to pursue, given the way HOLA governs the "powers and operations of every federal savings and loan association from its cradle to its corporate grave,"25 they may vanish altogether in the Ninth Circuit in the wake of Silvas. ■

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- 1. See Keith R. Fisher, Toward a Basal Tenth Amendment: A Riposte to National Bank Preemption of State Consumer Protection Laws, 29 HARV. J.L. & Pub. Pol. 981, 981 (2006).
- 2. See, e.g., Baher Amzy, Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation, 57 Fla. L. Rev. 295, 359–60 (2005) (noting that while only approximately ten percent of the lending institutions that primarily engage in subprime lending are federally chartered banks, nonbank subsidiaries of federally chartered national bank holding companies "originated nearly a quarter of the total subprime loans made by the top twenty-five subprime lenders in 2003").
- 3. Silvas v. E*Trade Mortgage Corp., 514 F.3d 1001 (9th Cir. 2008).
- 4. Fidelity Federal Savings & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 159 (1982) (citations omitted).
 - 5. 12 C.F.R. § 560.2(a).
 - 6. 12 C.F.R. § 560.2(b).
 - 7. 12 C.F.R. § 560.2(a), (b).
 - 8. 12 C.F.R. § 560.2(c).
 - 9. *In re* Ocwen Mortg. Servicing Litig., 491 F.3d 638, 643 (2007). 10. *Id*.
 - 11. Ocwen, 491 F.3d at 643.
 - 12. Id. at 1003.

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13. Id.; see also Cel-Tech Communications, Inc. v. Los Angeles Cellular Tel. Co., 20 Cal.4th 163, 195 (1999).

14. See, e.g., Gilmer v. Ellington, 159 Cal. App. 4th 190, 202-03 (Cal. Ct. App. 2008) (statutory violations are actionable in California as negligence per se when a defendant has violated a statute, ordinance, or regulation; the violation proximately caused an injury; the injury resulted from an event that the statute, ordinance, or regulation was designed to prevent; and the person suffering the injury was someone the statute, ordinance, or regulation was designed to protect).

15. See 15 U.S.C. § 1640(e). 16. 514 F.3d at 1004.

17. Id. at 1005, 1007 n.3.



Trends and Strategies in CDO Litigation

(Continued from page 1)

securitization, several mortgage loans are pooled together and sold into a trust by an originator. Interests in the trust are then sold to investors, sometimes referred to as certificate holders. The cash from the certificate holders is provided to the originator, and the originator uses that cash to originate more loans. Sometimes MBSs issue pass-through certificates, in which the trust passes through principal and interest payments as they are received to the certificate holders, less a servicing fee.

A CDO is a grouping of the securities issued in MBSs. Frequently, the securities pooled were those that were otherwise rated the lowest by the credit-rating agencies.² CDO notes are issued in a variety of "tranches" in various categories, such as senior, mezzanine, and subordinate, with an underlying equity tranche. Each tranche is assigned its own rating indicating its priority of payment. The more senior tranches have higher ratings but lower yields. Cash flows from mortgage portfolios are paid first to the more senior tranches, then to lesser ones.

The Fall of CDOs

The troubles for CDOs and their investors started to arise in late 2006 and early 2007. According to a report from the Government Accounting Office (GAO), "The rapid decline in the rate of home price appreciation throughout much of the nation, beginning in 2005, may have reduced incentives for borrowers to keep current on their mortgages, and made it more difficult for borrowers to refinance or sell their homes to avoid default or foreclosure." Unemployment, aggressive lending practices, stagnant or falling home sales prices, and a struggling economy made it more difficult for borrowers to meet their mortgage obligations. This confluence of variables frequently led to mortgage loan default. The series of

- 18. Id. at 1007 n.3.
- 19. See id. at 1005. 1007 n.3.
- 20. Martha Chamallas, Discrimination and Outrage: The Migration from Civil Rights to Tort Law, 48 Wm. & MARY L. Rev. 2115, 2183 (2007).
- 21. Reves v. Downey Savings & Loan Ass'n, F.A., No. SACV 07-0615-AG, 2008 WL 867722, at *6 (C.D. Cal. Mar. 29, 2008),
 - 22. Id. at *6 (citation omitted).
 - 23. Id.
- 24. See Kajitani v. Downey Savings & Loan Ass'n, F.A., No. 07-00398, 2008 WL 2164660, at *6 (D. Haw. May 22, 2008).
- 25. Fidelity Fed. Sav. & Loan v. de la Cuesta, 458 U.S. 141, 145 (1982).

defaulting borrowers and failed mortgage loans also resulted in MBSs losing their value, which consequently resulted in CDOs also losing their value.

Theories of Liability

Plaintiffs have argued that issuers failed to warn investors of the risks of the subprime downturn. For example, in suits against Countrywide, plaintiffs have argued that Countrywide "knew that the economy could not possibly support the historically high real estate prices," and therefore Countrywide should have taken steps to protect itself from the impending market collapse.

Plaintiffs have also alleged that institutional defendants have failed to disclose the extent to which its CDO portfolio "contained billions of dollars worth of impaired and risky securities, many of which were backed by subprime mortgage loans," and that the defendant "failed to properly account for highly leveraged loans such as mortgage securities."4

In March 2008, a Connecticut-based hedge fund sued an institutional defendant, alleging that the hedge fund made CDO investments last year based on "fraudulent concealment of material information." The suit alleged that the defendant had been in talks with Moody's, and as a result, knew that changes in the rating agency's methodology were imminent, yet the defendant continued to market the CDOs as if the change would not occur.

In March 2008, an investment fund manager filed suit against Bank of America and certain of its directors and officers, alleging that the company underwrote and invested in CDOs but failed to inform investors of the associated risks, and failed to set aside adequate reserves for possible losses. The complaint also alleged that the company issued misleading disclosures about its exposure to subprime-related losses, and that the defendants breached their fiduciary duties, engaged in reckless and gross mismanagement, and wasted corporate assets.

In 2007, Bankers Life Insurance filed suit claiming that Credit Suisse misrepresented the true value of some of its investment products and the underlying collateral, the majority of which were allegedly "shoddy, inferior mortgage loans." Bankers Life claimed that divisions of Credit Suisse caused it to lose money by overstating how much of a loss after foreclosures that the insurance on the

loans would recover. Bankers Life also alleged that the bank failed to buy back fraudulent loans, covered up delinquencies of homeowners, and that payments were being advanced on borrowers' behalf to "maintain the illusion" that defaults were not occurring.

Plaintiffs have also sued bond issuers, alleging misrepresentation of purported risk exposure and inadequate internal underwriting and ratings systems for CDOs, among other products.

Are Rating Agencies to Blame?

Abu Dhabi Commercial Bank (ADCB) recently filed a lawsuit against Morgan Stanley, the Bank of New York Mellon Corp., and rating agencies Moody's and S&P, accusing them of fraud in operating a fund that collapsed. ADCB brought the action on behalf of all investors who bought investment grade Mezzanine Capital Notes issued by Cheyne Finance PLC and its wholly owned subsidiary, Cheyne Finance Capital Notes, from October 2004 to October 2007.6 According to the suit, "The ratings agencies intentionally, recklessly, or negligently misled investors in Cheyne," and furthermore, "But for the ratings agencies' violations of law, the capital notes never would have been issued."7 The suit claims that Moody's and S&P were paid three times the fees they would get from typical corporate bond ratings; that they were paid only if they provided an investment grade rating and the deal closed with that rating; and that they earned success fees when the vehicle was launched and the fees increased in tandem with the growth of the structured investment vehicle.8

The ADCB and other suits filed against the rating agencies raise the long-standing question of whether rating agencies should be held liable for the opinions they provide. Historically, creditrating agencies have enjoyed immunity from civil liability under § 11 of the Securities Act of 1933, through the Securities Act Rule 436(g). Additionally, they have claimed even broader protection under the First Amendment as publishers of opinions. More recently, however, courts are becoming more willing to conclude that ratings are linked to clients' needs and that agencies play an active role in the transaction, and therefore may not be entitled to immunity. This was the result in the Second Circuit's permitting the enforcement of a subpoena against a rating agency in *In re Fitch*, where under the court's ruling the fact that Moody's and Fitch rate few, if any, unsolicited transactions will undermine their arguments that some measure of journalistic privilege applies.

The renewed focus on rating agencies is also due, in part, to a July report by the SEC, announcing the results of an investigation into the practices of rating agencies. Specifically, the report faulted the way that S&P, Fitch, and Moody's handle ratings for residential MBSs and CDOs. The SEC alleges that the three principal rating agencies failed to establish significant Chinese walls between structured finance rating activities and fee negotiations. Conflicts of interest eradicated essential separations between rating assessments and revenue negotiations. According to one email uncovered during the investigation, one analyst wrote: "I am trying to ascertain whether . . . we will suffer any loss of business because of our decision [to assign separate ratings

to a product's principal and interest]." Another email refers to a "paradigm shift in thinking" as to the new focus on competition for market share and closing deals."

The continued viability of the First Amendment as a defense for rating agencies that fail to maintain the appropriate degree of internal integrity is particularly questionable when the rating agencies rate only those securities they are hired to rate, 12 when the rating agencies participate in structuring the security, 13 and if the security was privately placed rather than offered to the public. 14 Further, with respect to the fact that rating agencies' recent conduct is making it more and more clear that they may not be entitled to the sort of First Amendment protections typically reserved for journalists, two authors have written:

In their traditional role of rating and writing for their subscribers about all debt securities offered and traded

publicly, the rating agencies may well have acted as members of the press. But in rating structured securities like CDOs, which the agencies normally rate only for a fee, often participate in the structuring of, and which are usually sold and traded privately, the reverse is true: The rating agencies are not journalists gathering information and reporting to the public, but rather participants in the transactions that they rate.15

Courts are becoming more willing to conclude that rating agencies may not be entitled to immunity from civil liability.

Thus, the rating agencies' close collaboration with their clients may cause them to share their clients' fate.

With the continuing failure of CDOs and investors looking to rating agencies to substantiate their opinions in the face of obvious and compelling conflicts of interest, we are likely to see additional litigation against rating agencies, and hopefully an authoritative delineation by the courts as to when rating agencies are entitled to immunity and when they are not.

What's Next?

There are a variety of issues that plaintiffs' counsel and the defense bar should consider when representing any entity involved in CDO litigation:

• Did the CDO portfolio investments conform to the investment guidelines represented in the marketing materials and set forth in the transactional documents?

- Was there adequate and timely disclosure by the manager of changes in the portfolio assets?
- Was the value of the portfolio inflated by the CDO sponsor or manager?
- Was the sponsor invested in the CDO? If so, was the sponsor's investment more senior than other tranches?
- Did the sponsor impermissibly withdraw its investment in the CDO?
- Is there any other evidence that suggests the sponsor held a more negative opinion of the CDO that it disclosed to purchasers?¹⁶

Is the issue of the defendant's intent relevant? If so, how can it be proven or rebutted? In fraud cases or other actions where intent is an issue, defendants will argue that if they were reckless, then so were the government regulators and others

Looking ahead, if there is one corrective measure that needs to be implemented in the near term, it is improved board and management oversight.

who gave encouraging remarks about the state of the subprime market. For example, Federal Reserve Vice-Chairman Donald Kohn has said that the Federal Reserve itself failed to fully appreciate the risks that financial institutions were taking, adding, "I'm not sure anybody did, to be perfectly honest."¹⁷

Were CDO prices already falling when "curative" information was disclosed? The timing of this may prove crucial to challenging a plaintiff's loss causations elements

under the Private Securities Litigation Reform Act.¹⁸

It's anybody's guess how long the subprime crisis will last and how far its ripples will spread. Some have argued that we have not seen the worst vet, and thus the light is not even in view. As part of effective litigation planning and management, counsel must not only effectively represent the client's interest in the current matter, but also advise clients as to a future course to avoid repeating past mistakes. Until the current wave of litigation has made its way through the courts and the assignment of fault process reaches some degree of certainty, we will not be able to point with confidence to what exactly went wrong. Looking ahead, however, if there is one corrective measure that is to be implemented in the near term, it is improved board and management oversight. With the assistance of counsel, other professional service providers, and a great degree of transparency in the reform process, institutions that have been tarnished by the current crisis will be able to avoid similar problems in the next evolution of innovative financial products.

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- 1. U.S. Securities and Exchange Commission, Mortgage-Backed Securities (June 25, 2007).
- 2. See The Dangers of Investing in Subprime Debt, CNN, Mar. 19, 2007.
- 3. U.S. GAO, Briefing to the Committee on Financial Services, Subject: Information on Recent Default and Foreclosure Trends for Home Mortgages and Associates Economic Market Developments 4 (2007), available at http://www.gao.gov/new.items/d0878r.pdf.
- 4. Saltzman v. Citigroup Inc., 07 Civ. 9901 (S.D.N.Y. Nov. 8, 2007).
- 5. Credit Suisse Is Sued Over Subprime Bond Issue, Inter't Herald Tribune, Apr. 30, 2007.
- 6. Abu Dhabi Bank Sues in U.S. Over Risky Investments, Reuters, Aug. 25, 2008.
 - 7. Id.
- 8. Abu Dhabi Law Suit Cuts to Heart of Credit Boom, Fin. Times, Sept. 9, 2008.
- 9. Mark P. Zimmett, A Primer on the ABC's of CDO Litigation, New York Law Journal, Vol. 239, No. 62, Apr. 1, 2008.
 - 10. 303 F.3d 104 (2d Cir. 2003).
- 11. Over Rated? The Subprime Fiasco Has Put Corporate Credit Ratings on Thin Ice, CFO MAGAZINE, Sept. 1, 2008.
- 12. Compare, e.g., In re Fitch, Inc., 330 F.3d 104, 109 (2d Cir. 2003) ("Fitch only 'covers' its own clients.") with In re Pan Am Corp., 161 B.R. 577, 583 (S.D.N.Y. 1993) ("S&P as a matter of policy and fact rates practically all public debt financings and preferred stock issues with or without a request or a fee from the issuer.") (quoting an affidavit submitted by S&P).
- 13. Compare, e.g., In re Fitch, Inc., 330 F.3d at 110–11 (finding that communications between rating agency and arranger "reveal a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports"), with Compuware Corp. v. Moody's Investors Servs., Inc., 222 F.R.D. at 131 ("Compuware has not alleged that Moody's was so involved with the companies here that it stepped outside newsgathering activities."). See also Compuware, 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004) ("[T]he most important factor in determining whether [Moody's] is qualified to assert the journalist's privilege is the nature of [Moody's] relationship with the alleged 'source.'"); Compuware, 371 F. Supp. 2d 898, 904 n.7 (E.D. Mich. 2005) ("Moody's was in the business of publishing ratings, not the business of advising the subjects of those ratings about how to obtain favorable publications.").
- 14. Compare, e.g., LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. at 1095 ("[T]he report at issue was not disseminated to the public at large. Rather, it was distributed to a select group of qualified investors."), and Nat'l Med. Care, Inc., with

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In re Pan Am Corp., 161 B.R. 577, *and In re* Scott Paper Co. Sec. Litig., 145 F.R.D. 366 (agencies successfully claimed journalist's privilege against subpoenas for information they gathered in rating publicly traded debt).

15. David J. Grais and Kostas D. Katsiris, Not "The World's Shortest Editorial": Why the First Amendment Does Not Shield the Rating Agencies From Liability for Over-Rating CDO's, BLOOMBERG LAW REPORTS, Nov. 2007.

16. Mark P. Zimmett, A Primer on the ABC's of CDO Litigation, New York Law Journal, Vol. 239, No. 62, Apr. 1, 2008.

17. D. Paletta, Fed Admits Missteps on Banks, Wall St. J. (Mar. 5, 2008). For a decision granting a motion to dismiss a mortgage lending related class action on intent grounds, see Tripp v. Indymac Financial Inc., et al., 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007).

18. 15 U.S.C. § 78u-4. In 60233 Trust v. Goldman, Sachs & Co., 2007 WL 4326730 (S.D.N.Y. Dec. 4, 2007), the court dismissed, on loss causation grounds, a suit by the shareholders of Exodus Corporation against Goldman Sachs and one of Goldman's analysts. With respect to the movement in Exodus's share price during the class period, the court noted: "The loss in value of the stock occurred gradually over the course of the entire class period, and the stock had lost most of its value before the June 14–21 events. This gradual loss of value occurred during the time when the alleged false and misleading statements were being issued. The complaint does not even refer to the phenomenon of the gradual loss of the stock's value, much less attempt to explain it as related to loss causation." *Id.* at *11.

Reducing Litigation Risk from New Accounting Pronouncements (Continued from page 1)

counsel can play a role in reducing these risks in ways that go beyond the normal legal review of public disclosures.

General counsel can minimize litigation risk by focusing management on the perils inherent in implementing new accounting pronouncements. Perhaps most importantly, senior management responsible for implementation of new accounting pronouncements should be conscious of the written record they are creating in that process. An example of how that record may be used against a corporate officer can be seen in the prosecution of Enron Chairman Ken Lay in the aftermath of the company's collapse. Government lawyers pointed to suspicious emails and memorandums circulated among Enron accountants (not to Mr. Lay) as evidence of a conspiracy to circumvent SFAS 142, an accounting rule that changed how companies account for goodwill. The documents reflected discussion about whether implementing a growth strategy in Enron's water business might result in avoiding a write-off under the new rule. One document included a particularly suspicious statement: "will require some optics that we are maintaining some minimum level of effort. . . . "1 Even in the absence of such a suspect statement, however, general discussion about whether it is possible to avoid a write-off may appear sinister to a jury even though such discussions are, in fact, commonplace and based on a legitimate duty to the company's shareholders to avoid a write-off when appropriate. Regardless of the actual intent, there is a significant possibility that these types of statements will be interpreted negatively after the fact. Accordingly, when company personnel are implementing a new accounting standard, they should be aware that their debates may later be interpreted as manipulation of accounting principles.

In-house counsel can also provide a valuable litigation perspective when management is exercising its judgment in selecting from a range of acceptable accounting treatments. Companies must often make difficult choices because the application of new accounting pronouncements requires subjective judgment and may result in a range of acceptable outcomes. Interpreting accounting rules either too conservatively or too aggressively may damage the company. When officers exercise accounting judgment, they must consider whether shareholders will be benefited by taking a very conservative approach that can result, for example, in recognizing losses that are unlikely to materialize. On the other hand, interpreting accounting principles more aggressively may subject the company to litigation risk. A company's in-house lawyers can provide valuable insight if they are involved when important decisions about accounting policy are made.

A company's general counsel can reduce litigation risk by having a basic understanding of new accounting pronouncements and by opening a dialogue with directors and senior management about avoiding behaviors that create litigation risk. The accounting changes discussed below are particularly worthy of such dialogue.

Recent Accounting Changes That Impact Litigation Risk

Significant accounting changes are taking place in the United States—both in the promulgation of new principles and in a potential shift to a completely different system of international accounting standards. The SEC recently proposed to allow some large public companies to adopt International Financial Reporting Standards (IFRS) for fiscal years ending after December 15, 2009, and to potentially require all registrants to shift to IFRS between 2014 and 2016. If these proposals are adopted, affected companies will make sweeping changes to their accounting policies. Furthermore, because IFRS are more "principles-based" compared to the existing "rules-based" approach under U.S. generally accepted accounting principles (GAAP), these changes will require more subjective decision making in some cases, and may call for increased consultation with counsel. In the meantime, U.S. GAAP continue

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to govern, and new GAAP pronouncements continue to be implemented. Two of the most significant recent pronouncements are discussed below.

SFAS 157: Fair Value Measurements

Fair value measurements, now governed by SFAS 157, have recently received much public scrutiny. The ongoing credit crisis and resulting fluctuation in the fair value of financial instruments, such as collateralized debt obligations (CDOs) and credit default swaps (CDSs), have drawn attention in the media and from plaintiffs' attorneys. Fair value accounting requires marking CDOs, CDSs, and many other financial instruments to market periodically and recognizing the resulting gains or losses in a company's financial statements. The fair value of such investments can be

The discretion management is afforded in valuing Level 3 assets has led some commentators to label the accounting for these assets "mark-to-myth."

significantly impacted by SFAS 157, a recently implemented accounting pronouncement governing fair value measurements for fiscal years beginning after November 15, 2007.

Although most companies implemented SFAS 157 earlier this year, the associated litigation risk is ongoing. The implementation of SFAS 157 consisted of allocating assets into one of three classes: valuing the assets; recognizing gains and losses; and making

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related disclosures. While that initial implementation may be complete, fair value assets will continue to be reallocated into different levels and revalued over time. As new valuations are disclosed and gains and losses recognized, today's fair value disclosures will become tomorrow's alleged misrepresentations. Accordingly, corporate personnel responsible for these areas must continue to be thoughtful about the actions they take and the record they create in the ongoing SFAS 157 valuation process.

SFAS 157 does not require any new fair value measurements. Rather, the new standard requires additional disclosures and provides a unified definition and framework for determining fair value for all assets that are subject to fair value accounting under existing accounting standards. Many assets such as trading securities, available-for-sale securities, and derivatives were already measured at fair value on a recurring basis under preexisting accounting pronouncements. Assets such as long-lived assets and goodwill are measured at fair value when dictated by accounting principles governing impairment.

SFAS 157 clarifies that the standard for determining an asset's fair value is an "exit price" in a hypothetical transaction—that is, "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This standard does not assume a forced transaction or distressed sale. The new standard also clarifies that the hypothetical transaction is assumed to occur in the "principal market," which is the market with the greatest volume or level of activity.4 In the absence of a "principal market," the "most advantageous market" for the asset or liability is used.5

SFAS 157 provides a three-level framework for determining fair value based on the type of information—termed "inputs"—available for assessing fair value. An asset is classified in the lowest of the three levels in which that type of input is significant in valuing the asset.

- Level 1 inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 inputs consist of information other than quoted prices for identical assets or liabilities that are observable for the asset or liability, either directly or indirectly. Examples of Level 2 inputs are interest rates, default rates, and quoted prices for similar assets.
- Level 3 inputs are "unobservable" inputs for an asset or liability that reflect a company's own assumptions, based on the best information available about the assumptions market participants would use in pricing the asset or liability.7 Level 3 inputs could include internal forecasts of earnings or cash flow from an asset, or forecasts regarding default rates on debt securities.

The discretion management is afforded in valuing Level 3 assets has led some commentators to label the accounting for these assets "mark-to-myth" or "mark-to-make-believe." Level 3 inputs are obviously the most subject to judgment and to manipulation, and accordingly, Level 3 assets are subject to heightened disclosure under the new standard.

For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, trading securities), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period.8

The potential for lawsuits alleging manipulation of Level 3 assets has increased as a result of the ongoing U.S. credit crisis. Trading in many financial instruments has slowed drastically or ceased altogether, and as a result, these assets may now be valued using Level 3 inputs. The increase in Level 3 assets, though required by SFAS 157, may result in claims of manipulation and fraud, that is, that a company has artificially increased its number of Level 3 assets in order to allow it greater discretion in valuing the assets, and thereby avoid write-downs. This presents an

ongoing danger as companies continue to reallocate assets among the three SFAS 157 levels based on changing availability of pricing inputs. Companies must, therefore, continue to be conscious to avoid not only manipulation in fact, but also in appearance, as they create a record of the ongoing valuation process.

Plaintiffs' attorneys have begun to base claims on improper application of SFAS 157. For example, in an ERISA suit filed in federal court in Seattle against Washington Mutual, Inc., plaintiffs complain that the company "recognized \$849.0 million in Level 3 gains on its MSRs [mortgage servicing rights]," despite the fact that it allegedly knew or should have known that "this amount was materially overstated given that these gains were reported during a period in which default and delinquency rates were rising. . . . "9

Interestingly, in March 2008, the SEC issued guidance about fair value disclosures to CFOs of public companies, stating, "Under SFAS 157, it is appropriate for you to consider actual market prices or observable inputs, even when the market is less liquid than historical market volumes, unless those prices are the result of a forced liquidation or distress sale."10 This guidance caused some commentators to note that the SEC appeared to be emphasizing companies' ability to classify assets as Level 3 assets without observable inputs (and thereby give companies more discretion to avoid write-downs) if the only observable inputs are based upon a forced liquidation or distressed sale. On the other hand, the SEC may have intended to emphasize the requirement to consider actual market prices or observable inputs, even when the market is less liquid than historical market volumes. One thing is certain—the SEC is concerned that companies adequately disclose the impact of fair value accounting in management's discussion and analysis provided to investors in public filings.

SFAS 161: Disclosures about Derivative Instruments and Hedging Activities

SFAS 161 requires increased disclosure about companies' use of derivatives that will provide investors additional insight into the risks companies are taking and the character and quality of their earnings. This increased disclosure may, in turn, impact company stock valuations and lead to litigation over the adequacy of prior disclosures.

Issued in March 2008, SFAS 161 is effective for fiscal years beginning after November 15, 2008. The new standard amends the existing guidance on accounting for derivatives, SFAS 133, to require disclosures about how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations; and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows.¹¹

These broad categories include many specific disclosures such as the following:

 Information about each derivative instrument's primary underlying risk exposure (e.g., interest rate, credit,

- foreign exchange rate, interest rate and foreign exchange rate, or overall price)
- Disclosures distinguishing between derivative instruments used for risk management purposes and those used for other purposes, such as speculation
- Information that would enable users of a company's financial statements to understand the volume of its derivative activity
- The location and fair value amounts of derivative instruments as well as associated gains and losses, with detailed disclosures as to various categories of derivatives
- Disclosures about credit-risk-related contingent features

The intent of these disclosures is to help investors better understand a company's use of derivatives and assess risk related to derivatives. However, an unintended consequence of the new disclosures may be a drop in stock price for some companies, and resulting litigation in which plaintiffs will claim that the failure to previously disclose the information constituted fraud. In-house counsel may want to highlight this risk for directors and senior management. This may lead to a beneficial dialogue on the necessity and prudence of their companies' use of derivatives and their exposure to derivative price risk in light of the coming implementation of SFAS 161.

Conclusion

The implementation of new accounting standards creates difficult decisions and significant litigation risk. Communication between accountants and in-house lawyers on these subjects reduces the risk of missteps that can result from keeping information compartmentalized. Litigation risk can be reduced when corporate counsel focus accounting personnel, as well as senior management and directors, on litigation risk arising from new rules and when accountants involve in-house counsel in important decisions on accounting policies.

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- 1. Government's Trial Exhibit 821 and Trial Testimony of J.R. Sult at 8503:13-8507:16, U.S. v. Jeffrey K. Skilling and Kenneth L. Lay (No. 4:04-cr-00025).
 - 2. SFAS 157 at ¶ 7.
 - 3. SFAS 157 at ¶ 5.
 - 4. SFAS 157 at ¶ 8.
 - 5. Id.
 - 6. SFAS 157 at ¶ 21.
 - 7. SFAS 157 at ¶ 30.
 - 8. SFAS 157 at ¶ 32.
- 9. Consolidated Amended Complaint in Case No. 2:08-md-01919-MJP, Aug. 5, 2008, at 198–202.
- 10. http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm.
 - 11. SFAS 161 at ¶ 1.



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