

# Securities Litigation & Regulation

COMMENTARY

REPRINTED FROM VOLUME 14, ISSUE 4 / JULY 1, 2008

## 'Industry-Wide Collapse' Defense Falls Flat In Recent Subprime-Related Securities Fraud Decisions

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The "subprime mortgage meltdown" has dominated the headlines for more than a year, and new reports of wrongdoing and blatantly fraudulent conduct underlying the collapse of the housing and credit markets appear daily. In response, numerous lawsuits have been filed arising from the widespread improper conduct that is now being revealed. In light of the transformation of mortgage lending from an originate-to-hold to an originate-to-securitize model, and in light of the packaging of mortgages into increasingly complex securities, the cast of characters involved in mortgage lending is immense, and the variety of people and entities appearing as plaintiffs and defendants in these subprime cases is quite diverse.

Out of this diverse universe of cases, this article focuses on a particular subset of cases: securities fraud suits in which the complaint's core allegations include some or all of the following actions by defendants:

- Loosening or disregarding underwriting standards to increase loan originations;
- Inadequately reserving for non-performing loans;
- Recognizing increased financial performance as a result of the increased originations and inadequate reserves; and
- Making false representations to the public regarding the company's lending standards and performance.

Given that many of the subprime cases were filed in mid-2007, the subprime litigation landscape is maturing, and several of the cases have now progressed to the motion-to-dismiss stage. Beyond arguments particular to the facts of each case, one common defense argument has emerged: Rather than committing fraud or acting recklessly, the defendants simply were unwitting victims of an industry-wide collapse of the housing and credit markets.

Defendants have put forward this argument in three of the first subprime securities fraud cases to reach decisions on the merits of dismissal motions. Each case contains similar allegations and each was decided by a court within the 9th U.S. Circuit Court of Appeals, but each court addressed this argument in a different way. As these cases demonstrate, while this "industry-wide collapse" argument met with some initial success, courts have recently rejected this defense at the motion-to-dismiss stage.

### Initial Success of the 'Industry-Wide Collapse' Defense

In the first subprime securities fraud case to reach the motion-to-dismiss stage, *Tripp v. IndyMac Financial Inc.*,<sup>1</sup> the court viewed favorably the defendants' contention that an industry-wide meltdown, rather than fraud, was to blame for the company's collapse. In a brief unpublished decision adopting the court's earlier tentative ruling, the court dismissed the complaint in its entirety with leave to amend.<sup>2</sup>

IndyMac was a hybrid thrift/mortgage banker that both originated and invested in mortgage loans.<sup>3</sup> The company's investors brought federal securities fraud claims against IndyMac and several of its officers and directors.<sup>4</sup> The court summarized the complaint's charges:

Plaintiffs' allegations ... are that, despite the onset of the downturn in the national housing and mortgage markets, defendants maintained that they were well-positioned, contrary to other players in the markets. Plaintiffs contend that this was misleading and untrue for three general reasons: 1) IndyMac had inappropriately loosened its underwriting guidelines such that it had extended far riskier loans that were going into default at an increasing rate; 2) IndyMac had inadequately hedged against its risks; and 3) IndyMac had inadequate "internal controls." In short, plaintiffs assert that defendants knew "both before and throughout the class period [that] IndyMac entered 2006 as a deeply troubled company that was plagued by profoundly flawed underwriting and hedging operations and [was] crippled by deficient and inadequate internal controls."<sup>5</sup>

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### ***Defendants argued they were taken by surprise by an unprecedented industry-wide meltdown.***

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In *IndyMac* the defendants' "industry-wide collapse" argument arose in the context of contending that the plaintiffs had not adequately alleged the defendants acted with *scienter*, or fraudulent intent. Under the Private Securities Litigation Reform Act of 1995 plaintiffs must allege facts giving rise to a strong inference that the defendants acted with *scienter*.<sup>6</sup> As the Supreme Court clarified in *Tellabs Inc. v. Makor Issues & Rights* however, in making this determination, the court also must consider plausible non-culpable inferences for the defendants' conduct that arise from the allegations.<sup>7</sup> In short, plaintiffs must allege facts giving rise to an inference of *scienter* that is at least as compelling as any opposing inference that could be drawn from the alleged facts.<sup>8</sup>

In addition to putting forth their argument in their briefing, the IndyMac defendants submitted materials purporting to demonstrate how widespread the downturn in the housing market was and how it had dramatically affected many companies.<sup>9</sup> Relying heavily upon the "competing inference" language from *Tellabs*, the court in *IndyMac* discounted the inference of *scienter* arising from confidential witness accounts, public statements, insider trading and violations of accounting standards.<sup>10</sup>

Instead, the court concluded that the competing non-culpable inference put forward by defendants — that they were victims of an industry-wide collapse — was more compelling: "[A]n even stronger inference is that defendants were simply unable to shield themselves as effectively as they anticipated from the drastic change in the housing and mortgage markets and, once that inability became evident, IndyMac's financials were changed accordingly."<sup>11</sup>

The plaintiffs have since filed an amended complaint, and the parties have completed briefing on the defense motion to dismiss the amended complaint.

Since the decision in *IndyMac* two courts have indicated that defendants' success in securing dismissal by pointing to an industry-wide collapse may have been short-lived.

### **Use of Extraneous 'Industry-Wide Collapse' Evidence to Support Dismissal Motions**

Shortly after the decision in *IndyMac* the defendants in *Atlas v. Accredited Home Lenders Holding Co.*<sup>12</sup> raised the same "industry-wide collapse" defense but with a dramatically different result. In *Accredited* U.S. District Judge Marilyn Huff of the Southern District of California sustained the majority of the complaint and did not even address this argument in her analysis.

Accredited Home Lenders is a mortgage banking company that "originates, finances, securitizes, services and sells subprime mortgage loans secured by residential real estate."<sup>13</sup> The plaintiffs made similar claims to the core allegations in *IndyMac*:

Defendants allegedly caused Accredited's employees to disregard the company's stated underwriting guidelines in an effort to increase the volume of loans originated by Accredited. The complaint contains the allegations of several confidential witnesses who detail pervasive, widespread exceptions to the company's underwriting policies and substantial pressures to approve such loans at the end of reporting periods in an effort to meet financial projections. According to the allegations of the complaint, the individual defendants were not only aware of these practices but affirmatively mandated and/or encouraged them. Publicly, however, defendants allegedly continued to represent that Accredited was committed to a disciplined approach that focused on credit quality even though defendants knew that they had caused the company to abandon adherence to its underwriting policies.<sup>14</sup>

In seeking dismissal the defendants argued extensively that they were taken by surprise by an unprecedented and unforeseeable industry-wide meltdown. Indeed, both the company and individual defendants began their dismissal briefs by referencing the subprime industry meltdown as the true cause of the problems at Accredited.<sup>15</sup> Specifically, the defendants raised this argument with regard to two elements of the plaintiffs' securities fraud claims; the defendants contended that their statements were not false and that they did not act with *scienter*.

In their reply papers the defendants relied heavily upon the "industry collapse" language from *IndyMac* to assert that they were similarly victims of external circumstances, which negated the plaintiffs' fraud claims.<sup>16</sup> In further support of their "industry-wide collapse" argument, the defendants not only submitted voluminous requests for judicial notice but also attached numerous other documents to their moving papers:

First, ... in support of the corporate defendants' motion to dismiss are (1) several newspaper articles regarding Accredited and/or the subprime mortgage market, (2) a transcript of remarks made by the chairman of the Federal Reserve Bank, and (3) various press releases and SEC filings of companies not defendants here. Second, the individual defendants' motion to dismiss includes three appendices: a newspaper article similar to those submitted by the corporate defendants, and two tables apparently created by counsel that purport to summarize "non-prime lending industry events" and to compare "forward-looking statements and risk disclosures."<sup>17</sup>

The parties vigorously contested whether the court could consider these materials at the motion-to-dismiss stage. Resolving this dispute, the court said "these extraneous documents are neither necessary nor appropriate on a motion to dismiss, and the court has not considered them."<sup>18</sup>

In contrast to the *IndyMac* court's reliance on the subprime industry meltdown in its decision dismissing the complaint, beyond refusing to consider many of the supporting materials, the court in *Accredited* did not even address this argument. Instead, the court methodically analyzed each element of the securities claims as pleaded in the complaint, determining that the plaintiffs had adequately pleaded the majority of the claims.<sup>19</sup>

The court's approach in *Accredited* is particularly noteworthy, given the defendants' heavy reliance upon *IndyMac*, a recent decision from within the 9th Circuit addressing similar issues, and their voluminous submission of materials to show an industry-wide collapse and problems faced by other lenders.

### 'Industry-Wide Collapse' Defense Expressly Rejected

Most recently this defense was put forward in *In re Countrywide Financial Corp. Derivative Litigation*<sup>20</sup> in the context of motions to dismiss a derivative lawsuit alleging securities fraud against Countrywide's officers and directors. In *Countrywide*, however, going beyond the approach in *Accredited*, U.S. District Judge Mariana Pfaelzer of the Central District of California explicitly addressed — and rejected — the defendants' arguments that an industry-wide downturn was to blame for Countrywide's financial collapse and that they were merely innocent victims of unforeseeable circumstances. As in *Accredited*, the defendants relied on *IndyMac* in support of this argument, and the parties vigorously contested the propriety of this defense at the motion-to-dismiss stage.

### The "industry-wide collapse" argument met with some initial success.

Similar to *IndyMac* and *Accredited*, Countrywide "originates home loans, retaining a portion of these loans on its balance sheet as investments, and securitizing and selling the remainder."<sup>21</sup> The plaintiffs alleged the defendants allowed Countrywide to originate loans in violation of its underwriting standards and issued false statements regarding its lending standards and financial performance.<sup>22</sup> Given that the securities fraud claims arose in the context of a derivative suit on behalf of the company, the complaint alleged the defendants defrauded Countrywide when they caused it to engage in a \$2.4 billion share repurchase program at inflated prices.<sup>23</sup>

The court conducted an extensive *scienter* analysis, highlighting the consistent confidential witness accounts from various Countrywide offices of widespread disregard for underwriting standards. The court explained that the defendants' memberships on various board committees required them to assess red flags and monitor underwriting practices and ruled that the allegations as a whole established a strong inference of *scienter*. As the court summarized, "Plaintiffs' allegations create a cogent and compelling inference that the individual defendants misled the public with regard to the rigor of Countrywide's loan origination process, the quality of its loans, and the company's financial situation — even as they realized that Countrywide had virtually abandoned its own loan underwriting practices."<sup>24</sup>

What is particularly noteworthy is that the court, in evaluating the strength of competing non-culpable inferences, directly addressed and rejected the defense argument based on an industry-wide collapse. The court succinctly described the argument and the defendants' reliance on *IndyMac*:

Here, the competing inference is that the board consciously adopted a risky — but publicly disclosed — strategy by shifting to [riskier loan products]. Under this theory, the defendants were unaware of any alleged employee wrongdoing at the lower levels, and Countrywide's misfortunes resulted not from the defendants' wrongdoing, but from an "unprecedented seizing up of the capital markets." The directors were "simply unable to shield themselves as effectively as they anticipated," *Tripp v. IndyMac Bancorp Inc.*, No. CV 07-1635, [2007 WL 4591930] (C.D. Cal. Nov. 29, 2007), when, caught by surprise, the secondary market demand for mortgage-backed securities issued by Countrywide and other lenders "suddenly evaporated" in August 2007.<sup>25</sup>

Expressly rejecting this line of argument, the court provided two reasons why the inference of *scienter* was at least as strong as the defendants' competing inference. First, the court explained that the individual defendants were tasked with monitoring Countrywide's operation, financial performance and risk position. "The idea that a company-wide culture that encouraged unchecked deviations from underwriting standards in a way which would fatally affect the company's continued financial performance went unnoticed by a board of directors simply does not square with the specific and comprehensive monitoring duties assigned to the members of the board."<sup>26</sup> Further, the court noted that the inference of *scienter* was even stronger as to the officers involved in the company's day-to-day operations.<sup>27</sup>

Second, the court refused to speculate as to the causes of the recent economic downturn, particularly where the complaint alleged actions by the individual defendants that would have caused significant financial troubles for Countrywide:

[W]hile the court will not engage in speculation as to the causes of the recent economic downturn, the company's own SEC filings recognize that ongoing access to the secondary mortgage market requires the consistent production of quality mortgages and servicing of those mortgages at levels that meet or exceed secondary mortgage market standards. Independent of any

turmoil in the capital markets, the widespread violations of underwriting standards, as alleged, would significantly raise the risk of loan default. When combined with what plaintiffs allege are misrepresentations concerning the quality of Countrywide's loans, these underwriting issues would ultimately undermine confidence in the secondary market for Countrywide products.<sup>28</sup>

Additionally, the court noted that Countrywide officers had publicly acknowledged the possibility of a housing downturn: "Based on public statements in early 2005 and 2006 [Countrywide CEO Angelo Mozilo] realized (i) the need for underwriting discipline in originating subprime mortgages and (ii) the possibility that the housing market might, in fact, decline in the near future."<sup>29</sup>

In sum, the *Countrywide* court conducted a detailed analysis and rejected the defendants' "industry collapse" arguments. In contrast to the *IndyMac* decision, the court in *Countrywide* expressly refused to speculate whether external factors (outside the allegations in the complaint) caused Countrywide's difficulties. Thus, like in *Accredited*, the court focused on the specific allegations in the complaint and determined whether they gave rise to an inference of *scienter* as strong as any competing inference that could be drawn from the facts alleged.

### Conclusion

Defendants in the initial subprime securities fraud cases to reach decision on motions to dismiss have relied on external market conditions in an attempt to preclude liability. Indeed, in *IndyMac*, *Accredited* and *Countrywide* they attempted to portray themselves as unsuspecting victims of an unprecedented industry collapse. While the court in *IndyMac* relied partly on this ground in dismissing the suit, it did not specifically address the propriety of relying upon information or materials extraneous to the complaint in conducting the *Tellabs* "competing inference" analysis. More recently, however, the lengthy analyses in *Accredited* and *Countrywide* indicate that this defense is not likely to be successful at the motion-to-dismiss stage, with courts focusing on inferences that may be drawn from the allegations pleaded in the complaint.

As the court explained in *Accredited*, outside of judicially noticeable materials, additional materials extraneous to the complaint are improper at the motion-to-dismiss stage. Moreover, the "competing inference" analysis set forth in *Tellabs* does not sanction consideration of information or materials outside the allegations in the complaint. Rather, *Tellabs* instructs that the court should consider competing inferences "rationally drawn from the facts alleged" in the complaint.<sup>30</sup>

As Judge Pfaelzer concluded in *Countrywide*, the “competing inference” inquiry does not condone speculation as to hypothetical innocent explanations based on external factors when the allegations in the complaint themselves present a cogent inference of *scienter*.

Thus, while defendants likely will continue to raise the “industry-wide collapse” defense, particularly in light of the decision in *IndyMac*, given the limitation on materials that courts may consider in ruling on a motion to dismiss, the defense will probably meet with limited, if any, success.

**Notes**

<sup>1</sup> 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007).  
<sup>2</sup> *Id.* at \*1.  
<sup>3</sup> *Id.*  
<sup>4</sup> Plaintiffs brought claims under Section 10(b) of the Securities Exchange Act of 1934 against all defendants and brought claims for control person liability against the individual defendants under Section 20(a) of the Exchange Act. *Id.*  
<sup>5</sup> *Id.* at \*3 (internal citations omitted).  
<sup>6</sup> 15 U.S.C. § 78u-4(b)(2).  
<sup>7</sup> 127 S. Ct. 2499, 2509-10 (2007).  
<sup>8</sup> *Id.* at 2510.  
<sup>9</sup> See, e.g., Defendants’ Memorandum of Points and Authorities in Support of Motion to Dismiss, 2007 WL 3193071.  
<sup>10</sup> 2007 WL 4591930, at \*3-\*5.  
<sup>11</sup> *Id.* at \*4, \*6.  
<sup>12</sup> 2008 WL 80949 (S.D. Cal. Jan. 4, 2008).  
<sup>13</sup> *Id.* at \*2.  
<sup>14</sup> *Id.* at \*4 (internal citations omitted).

<sup>15</sup> See Accredited’s Memorandum of Points and Authorities in Support of Motion to Dismiss, 2007 WL 4358042; Individual Defendants’ Memorandum of Points and Authorities in Support of Motion to Dismiss, 2007 WL 4358049.  
<sup>16</sup> Accredited’s Reply Brief, 2007 WL 4620826; Individual Defendants’ Reply Brief, 2007 WL 4620825.  
<sup>17</sup> 2008 WL 80949, at \*15 n.7.  
<sup>18</sup> *Id.*  
<sup>19</sup> See, e.g., *id.* at \*8-\*11.  
<sup>20</sup> 2008 WL 2064977 (C.D. Cal. May 14, 2008).  
<sup>21</sup> *Id.* at \*1.  
<sup>22</sup> *Id.* at \*2, \*5.  
<sup>23</sup> *Id.* at \*8.  
<sup>24</sup> *Id.* at \*9.  
<sup>25</sup> *Id.* at \*16 (internal citations omitted).  
<sup>26</sup> *Id.*  
<sup>27</sup> *Id.* at \*17.  
<sup>28</sup> *Id.* at \*16 (footnotes and internal citations omitted).  
<sup>29</sup> *Id.* at \*16 n.25.  
<sup>30</sup> 127 S. Ct. at 2504, 2510 (emphasis added).

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