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Institutional Investors From Around the World Turn to Direct Suits in U.S.

Recent Developments In Mortgage-Backed Securities Litigation

By Jeroen van Kwawegen

Over the last few months, several large institutional investors and banks — including several based in Europe and Asia — have taken the lead in the latest wave of mortgage-related lawsuits in the United States against some of the largest Wall Street banks. These investors have decided to assert their own direct, individual claims, alleging violations of federal and state law in connection with the banks' creation, issuance, and sale of billions of dollars of mortgage-backed securities. Recent examples of direct action suits include complaints filed by Dexia SA/NV, China Development Industrial Bank, and Allstate Insurance. As discussed below, this trend of filing direct actions to recover significant losses is particularly important for institutional investors, including European and Asian investors, who suffered substantial losses in their mortgage-backed securities portfolios and who may not be able to recover through pending class actions.

These complaints can be viewed as part of the third wave of mortgage-related suits filed as a result of the financial crisis. Each wave of litigation has targeted different sorts of misrepresentation and fraud in connection with the mortgage market. First, investors targeted false statements regarding the quality of loan originations and loan portfolios made by certain mortgage originators like Countrywide and New Century Financial. Second, investors sought recourse for the failure by certain banks — like Citigroup — to disclose that they had massive

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Goldman Sachs

In the most recent wave of mortgage crisis-related suits, investors are beginning to assert claims against investment banks like Goldman Sachs, Merrill Lynch, and Deutsche Bank, which created, issued, and sold mortgage-backed securities, all while knowing that the loans supporting the securities were much riskier than represented.

exposure to toxic mortgage-related assets on their balance sheet. And most recently, in the third wave of suits, investors are beginning to assert claims against investment banks like Goldman Sachs, Merrill Lynch, and Deutsche Bank, which created, issued, and sold mortgage-backed securities, all while knowing that the securities were supported by loans that were much riskier than represented.

In fact, a number of governmental investigations, including by the Financial Crisis Inquiry Commission ("FCIC") and a U.S. Senate Subcommittee, recently began to reveal that a number of investment banks created, issued, and sold mortgage-backed securities knowing that the supporting loans were originated in violation of underwriting guidelines and were destined to fail. In some cases, banks were more concerned with pushing the bad loans off their books and into offerings of mortgage-backed securities than they were with fairly disclosing the nature of the loans or the true risks of the securities. A number of investment banks also used their superior knowledge of high-risk loan pools to help certain of their clients bet against the offerings, generating enormous profits at the expense of other investors when the loan pools failed as expected.

This third wave of suits has taken longer to unfold. Investors frequently purchased AAA-rated mortgage-backed securities believing that the investment banks would act as gatekeepers to weed out bad loans from the pools of mortgage loans underlying the securities. Many of these AAA-rated securities were not downgraded below investment grade until fairly recently — in some cases many years after the offerings. Put another way, many investors only learned recently that banks had failed to carry out their gatekeeping role with respect to the mortgage-backed securities that the investors purchased.

As the truth about these practices comes to light, investors have brought class actions against certain banks that issued and sold mortgage-backed securities. For example, investors recently settled a class action against Wells Fargo for $125 million, and a federal district court in New York recently certified a class in a mortgage-backed securities action asserting claims against Merrill Lynch.

In these types of class actions, the plaintiff investors initially brought claims on behalf of all investors who purchased mortgage-backed securities pursuant to the offering documents. Some courts, however, have ruled that the plaintiffs could only bring claims with respect to the specific offerings in which they purchased securities — not all offerings covered by the offering documents — thereby narrowing the scope of those class actions significantly. Investors who were passive class members were negatively affected by these decisions. In many cases, their claims were either lost entirely or will only be partially covered by the pending class action.

As a result of these developments, a number of institutional investors, including large European and Asian entities, are now proactively seeking recovery on an individual basis. Bringing individual actions offers these institutions several advantages. First, institutional investors are often able to assert state law (as opposed to federal law) claims, which may have more favorable pleadings standards. Second, institutional investors may be able to bring individual actions in state courts, where proceedings sometimes move quicker than in federal court. Third, bringing individual actions gives the institution exclusive control over the prosecution and potential settlement of its claims.

There are several significant examples of this trend. For example, based in part on the investigations by the FCIC and U.S. Senate Subcommittee, as well as a recent investigation by the U.K.'s Financial Services Authority, the Belgian bank Dexia recently filed suit against Deutsche Bank in New York Supreme Court, alleging that Deutsche Bank allowed into the pools of mortgages backing its securities more than 50 percent of loans that were identified by an independent third party as defective. Moreover, the complaint contains detailed allegations explaining how Deutsche Bank made sure to profit from its knowledge of the quality of the loan pools by betting against offerings with loans that Deutsche Bank expected to default.

Similarly, the China Development Industrial Bank ("CDIB") recently brought fraud claims in New York State Court against Morgan Stanley after the investment bank promoted collateralized debt obligations ("CDOs") based on overstated and misleading credit ratings. According to the CDIB, Morgan Stanley knew that the CDOs were riskier than represented — at the same time that Morgan Stanley sold the CDOs to the CDIB, Morgan Stanley's own emails showed that it was quickly trying to dispose of troubled residential mortgage-backed securities forming the collateral for the CDOs.

Critically, many international investors purchased securities from U.S.-based banks, and thus, the U.S. Supreme Court's 2010 decision in* Morrison v. National Australia Bank*, which limits the rights of foreign investors to sue in the U.S., does not apply.

Deutsche Bank

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Allstate Insurance also has brought suit against Morgan Stanley, filing state law claims in New York state court based in part on newly discovered information by the FCIC and an investigation by the Massachusetts Attorney General. The complaint alleges that Morgan Stanley controlled every aspect of the creation, issuance, and sale of the mortgage-backed securities and knowingly or recklessly included poorly originated mortgages in the loan pools. According to the complaint, Morgan Stanley waived in 56 percent of the loans that an external due diligence firm had identified as defective, and Morgan Stanley purposefully included defective loans into offerings of mortgage-backed securities to get them off their books and reduce its own risk should those loans default.

Demonstrating the scope of this most recent wave of mortgage-related litigation, an agency of the U.S. government recently filed civil suits against numerous large banks. On September 2, 2011, the Federal Housing Finance Agency filed

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Morgan Stanley

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complaints against seventeen banks, including Goldman Sachs, Bank of America, Citigroup, Deutsche Bank, the Royal Bank of Scotland, and Société Générale in the United States District Court for the Southern District of New York (a federal court). According to the complaints, these investment banks violated state laws and federal securities laws when they created, issued and sold mortgage-backed securities to government housing authorities Fannie Mae and Freddie Mac.

In sum, the fallout from the financial crisis continues to expand and implicate more and more wrongdoers for increasingly egregious misconduct. As a result, large institutional investors from around the world are bringing direct actions to seek redress for the wrongdoing and the losses inflicted on them. We expect these trends to continue as more information about certain Wall Street banks' improper practices becomes known and available.

Full disclosure: BLB&G is Lead Counsel on behalf of the shareholder class in the above-referenced Wells Fargo class action, and is representing Dexia in its litigation against Deutsche Bank as well as Allstate in its action against Morgan Stanley.

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