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THE SUBPRIME MORTGAGE CRISIS: SECURITIES LITIGATION

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I. INTRODUCTION

The crash of the subprime lending market and the resulting credit crisis are now leading to the biggest wave of financial litigation since the savings and loan debacle of the early 1990s. Securities litigation accounts for a significant percentage of the subprime cases filed to date. This paper will describe the alphabet soup of complex securities involved in subprime litigation; chart the evolution of subprime mortgage financing and the current crisis; examine the emerging claims and theories of liability in subprime securities litigation; and consider several early subprime securities decisions.

II. SECURITIZATION 101 – MBSs, CDOs, AND SIVs

The securitized instruments involved in the subprime crisis seem befuddling and ominous. In a recent installment of "Dear Science" in *The Stranger*, the question posed to Science asked: "What in the hell is going on in the financial markets? The guy on CNBC looks like his head is going to explode." Science responded by comparing securitized financial instruments to junk food:

> Many modern financial investments – whose number and amount of money invested within increased dramatically after depression-era financial controls were dismantled in the 1990s – are more like processed foods than produce. Investors just figured this out. **And they've started to get nervous about where their cash has gone.**
>
> Take the mortgage-backed securities at the center of this crisis – in which thousands of mortgages were blended together, sliced into pieces, and then sold to millions of investors. Compared to the traditional mortgage lent out by a single bank to a single investor, these are the pizza-flavored low-fat Pringles to a baked potato.[1]

Science's answer provides an apt image of the process (and the quality of at least a good portion of the product) of blending and slicing that is the essence of securitization. Securitization is the process by which individual debt obligations like mortgages are combined, then packaged and sold to investors.[2] Thirty years ago, if a home buyer got a loan from a bank, it was very likely that the bank would keep the loan on its balance sheet until the loan was repaid.[3] Today, most loans are sold to third parties in a complex chain. Starting in the early 1980s, the

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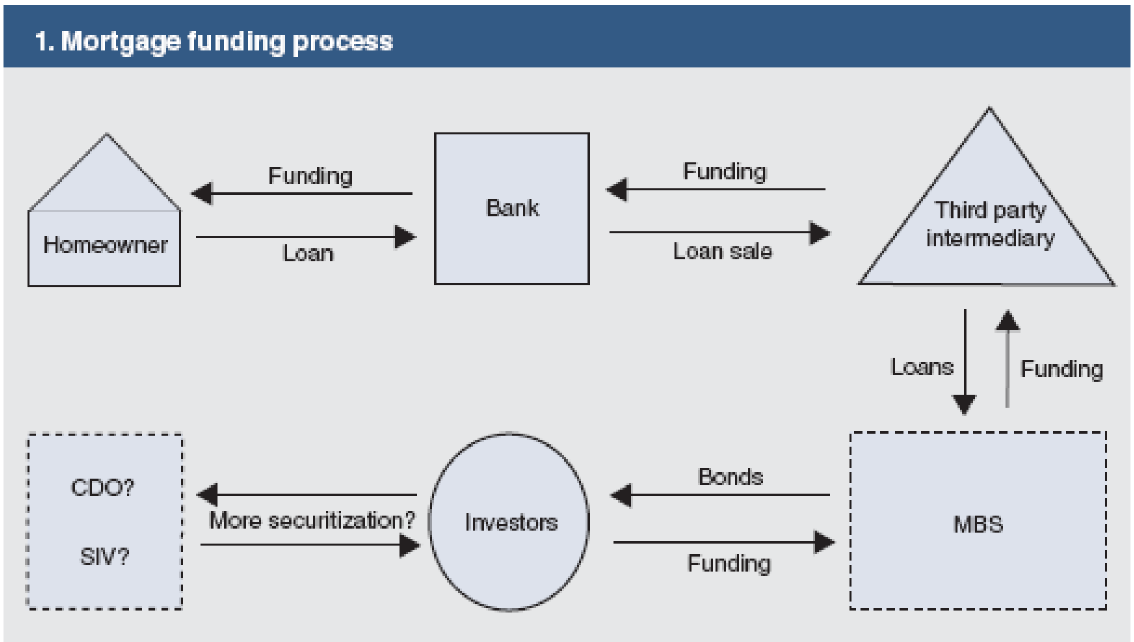
[1] Jonathan Golob, *Dear Science*, THE STRANGER, Apr. 24, 2008, at 103 (emphasis in original).

[2] Other types of debt obligations that are commonly securitized (and that have also been swept up in the subprime crisis) include credit card debt and student loans.

[3] Richard J. Rosen, *The Role of Securitization in Mortgage Lending*, CHI. FED LETTER, Nov. 2007.

percentage of mortgage debt sold down the chain has increased from about 10 percent to over 60 percent.[4]

Securitization converts mortgages into mortgage-backed securities – MBSs. Sometimes MBSs are resecuritized into instruments known as collateralized debt obligations (CDOs) or structured investment vehicles (SIVs). The chain of mortgage funding made from these links looks like this:



NOTES: MBS means mortgage-backed security. CDO means collateralized debt obligation. SIV means structured investment vehicle.

FIGURE 1.[5]

A. PARTICIPANTS IN SECURITIZATION

The major third-party intermediaries who purchase loans and then issue MBSs are two government-sponsored entities (GSEs), Fannie Mae and Freddie Mac; and private sector firms, such as Countrywide Financial, Lehman Brothers, and Wells Fargo. In 2006, the two GSEs accounted for 40 percent of MBSs issued, and private entities issued 56 percent of MBSs that year.[6]

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[4] *Id.*

[5] *Id.*

[6] The remaining 4 percent were MBSs guaranteed by Ginnie Mae, a federal government agency that insures loans issued by the Federal Housing Administration or the Department of Veteran's Affairs. *Id.*

The MBSs issued by the private firms include securities backed by high-quality prime loans, and lesser-quality subprime loans and "Alt-A" loans. A subprime borrower has a lower credit rating than the prime "A" rating. Alt-A loans are issued to borrowers who appear to have good credit, but whose loan application cannot meet the definition of a prime or conforming loan. In recent years, Alt-A loans have increasingly included loans issued to borrowers with limited or no income, no asset or income verification, and loans for which the loan-to-value ratio was too high.[7]

B. STRUCTURES OF SECURITIZATION

The basic structure of MBSs involves a pass-through of principal and interest payments. Interest payments on the underlying mortgages are used to pay interest on the bonds, and principal payments on the loans goes to pay down the principal on the bonds. The complexity of MBSs comes from complicated structures designed to allocate payments of interest and principal, and to manage the risk of default.

In most MBSs, default risk is distributed through subordination of classes of bonds issued. Senior bonds are placed in the A class, and have priority in bankruptcy – the first losses are taken by the subordinated classes. For example, some MBSs backed by jumbo loans use a "six-pack" structure, with six layers of subordination – described as bond classes B1 through B6. The first default losses are allocated to the most junior class (B6) until that class is exhausted. The losses then move up the ladder, and the A class does not incur default losses until all the B classes have been completely written down. The favored status of the A class is further enhanced by prepayments. Early payments are allocated to the A class, which serves to keep the other classes around as loss buffers.[8]

Bond ratings are assigned by the major bond rating agencies (Standard & Poor's and Moody's) to each of the classes issued. The highest rating (AAA) goes to the senior class of A bonds, signifying a lower risk. As the risk increases going down the bond ladder, the rating decreases (for example, B1=AA, B2=A, B3=BBB, B4=BB, B5=B, and B6 might be unrated due to its high risk.) In keeping with the risk/reward characteristics of capital markets, bonds with a higher credit rating typically receive a lower interest rate than bonds with lower credit ratings.

MBSs can also be structured to allocate the timing of payments. In such a case, the MBS would be sliced into "tranches," distinguished by the order in which they are repaid. This type of MBS is known as a collateralized mortgage obligation (CMO). In the simplest form of CMO, tranches are paid sequentially. All tranches receive interest payments, but the first tranche receives all principal payments until it is retired. Then the second tranche starts receiving principal payments, and so on, until the last tranche is paid off.

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[7] *Id.*

[8] *Id.*

C. RESECURITIZATION

Securitized investments can themselves be pooled and resecuritized. Bonds that are pools of MBSs are known as collateralized debt obligations (CDOs). In 2006, the issuers of CDOs were the major buyers of the low-rated classes (i.e. the B classes described above) of subprime MBSs. Like the MBSs within their pools, CDOs are issued as different classes of bonds, with different risk and payment characteristics.[9]

Structured investment vehicles (SIVs) are similar to CDOs. SIVs are structures backed by pools of assets, such as MBSs and CDOs. But the SIVs issue short- and medium-term debt rather than the longer-term debt of most CDOs.[10]

III. THE EVOLUTION OF THE SUBPRIME MARKET AND THE EMERGING CRISIS

Subprime lending first emerged following the deregulatory measures adopted in the early 1980s. This early Reagan-era legislation preempted state interest rate caps and permitted the use of variable interest rates and balloon payments. In the mid-to-late 1990s, the subprime mortgage market grew significantly, sustained by the increased issuance of MBSs.[11] Between 1990 and 2006, the percentage of loans securitized doubled. By 2006, the total volume of outstanding securitized loans had reached $28 trillion.[12]

The securitized subprime mortgage market has grown markedly in recent years. Subprime mortgages constituted 13 percent of all mortgage securities issued in 2003; by 2006 the subprime category constituted 35 percent of all mortgage securities. Much of this growth was fueled by new types of mortgages – known as "affordability products." These products required little or no downpayment, and little or no documentation of a borrower's income, and were sometimes derisively referred to as "liar loans." Other attributes of the growing class of "affordable" subprime loans included loans with 40- or 50-year terms, and low "teaser" rates that moved up quickly in later years.[13]

A recent Deutsche Bank report states that liar loans constituted 40 percent of the subprime loans issued in 2006, up from 25 percent in 2001. The Mortgage Asset Research Institute analyzed 100 of these loans, in which borrowers stated their income but provided no verification. The Institute compared the borrowers' stated income with their tax returns. In

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[9] *Id.*

[10] *Id.*

[11] Souphala Chomsisengphet and Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FED. RES. OF ST. LOUIS REV., Jan.-Feb. 2006, at 37-38.

[12] *Fear and Loathing, and a Hint of Hope*, THE ECONOMIST, Feb. 14, 2008.

[13] Gretchen Morgenson, *Crisis Looms in Market for Mortgages*, N.Y. TIMES, Mar. 11, 2007.

90 percent of the loans, the borrowers overstated their income by 5 percent or more. In a startling 60 percent of the cases, the borrowers inflated their incomes by more than half.[14]

The market for securities backed by subprime loans expanded during this same time period, attracting investors as prevailing interest rates remained low. By 2006, Wall Street's share of the mortgage financing market had grown to 60 percent, surpassing commercial and savings banks. Investors in the MBSs were typically pension funds, insurance companies, hedge funds, and other institutions. At the same time, trading emerged as a growing feature of the market. In 2006, the average daily trading volume of government-issued MBSs exceeded $250 billion, up from $60 billion in 2000.[15]

In 2007, signs of trouble first appeared. On March 1, 2007, a Bear Stearns analyst wrote a positive report about a subprime mortgage company, New Century Financial. New Century had already disclosed that a growing number of borrowers were defaulting, and its stock had lost half its value in three weeks. A week after the Bear Stearns report, New Century announced it would stop making loans, and needed emergency financing. Its stock collapsed from around $15 a share to $3.21.[16]

A number of other subprime firms buckled in 2007. Despite the spread of the crisis, Standard & Poor's and Moody's were slow to downgrade their ratings of MBSs. Some observers suggested that the rating agencies resisted downgrading the securities because many institutions – the major buyers of MBSs – cannot hold securities rated below investment grade. Others noted that profits were a consideration for the rating bureaus. Approximately 6.5 percent of Moody's revenue in 2006 was related to the subprime market.[17]

In February 2007, analyzing the collapse of the subprime market, two Drexel University researchers made a prescient prediction: "Decreased funding for RMBS [residential MBSs] could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy."[18] By August 2007, the subprime problems spread into the market for commercial loans, adversely affecting money market funds for which commercial paper was a favored investment to enhance yields.[19] In February 2008, the trouble expanded to securities tied to credit card debt, student loans, and car loans, when auctions for the bonds backed by these loans (known as auction-rate securities) began to fail in large numbers.[20]

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[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] Joseph R. Mason and Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?*, Hudson Inst., Feb. 15, 2007, at 33.

[19] Gretchen Morgenson and Jenny Anderson, *Subprime Problems Spread Into Commercial Loans*, N.Y. TIMES, Aug. 15, 2007.

[20] *Fear and Loathing, and a Hint of Hope*, THE ECONOMIST, Feb. 14, 2008.

In March 2008, the President's Working Group on Financial Markets, led by the Secretary of the Treasury and including the chairmen of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, issued a policy statement to present the Group's findings on the causes of the market turmoil experienced since mid-2007. They found as the principal causes:

- a breakdown in underwriting standards for subprime mortgages;
- a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;
- flaws in credit rating agencies' ratings of MBSs and other complex structured credit products, especially collateralized debt obligations (CDOs) that held MBSs and other asset-backed securities (CDOs of ABSs);
- risk management weaknesses at some large U.S. and European financial institutions; and
- regulatory policies, including capital and disclosure requirements, that failed to mitigate risk management weaknesses.[21]

In early 2008, the chairman of the Securities and Exchange Commission identified the fallout from the subprime mortgage crisis as the SEC's top priority. By February 2008, the SEC's Division of Enforcement had more than three dozen subprime-related investigations underway.[22] The issues under investigation by the SEC included: (1) whether bank holding companies and securities firms made proper disclosures in their filings and public statements of what they knew about their CDO portfolios and their valuations; (2) whether brokers followed suitability requirements when they sold complex debt-related derivatives that went bad shortly afterward; and (3) whether insiders unlawfully used non-public information to bail out of subprime securities or to sell them short.[23]

The SEC has also formed an agency-wide Subprime Task Force. The Task Force is charged with investigating: (1) the quality of risk controls and liquidity at the level of the holding companies of major Wall Street firms (which hold unregulated affiliates of the regulated broker-dealers); (2) the strength of investment banks' risk management systems; (3) the role of credit-rating agencies in the subprime crisis; (4) significant accounting questions in the subprime area,

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[21] President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments*, Mar. 2008.

[22] Christopher Cox, Chairman, U.S. Securities & Exchange Commission, Testimony: The State of the United States Economy and Financial Markets, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Feb. 14, 2008).

[23] Christopher Cox, Chairman, U.S. Securities & Exchange Commission,The SEC Agenda for 2008, remarks to the *SEC Speaks in 2008* Program of the Practising Law Institute (Feb. 18, 2008).

such as when off-balance sheet CDO-related liabilities should be forced back on to a sponsor's balance sheet; and (5) the adequacy of public company disclosures relating to subprime investments.[24]

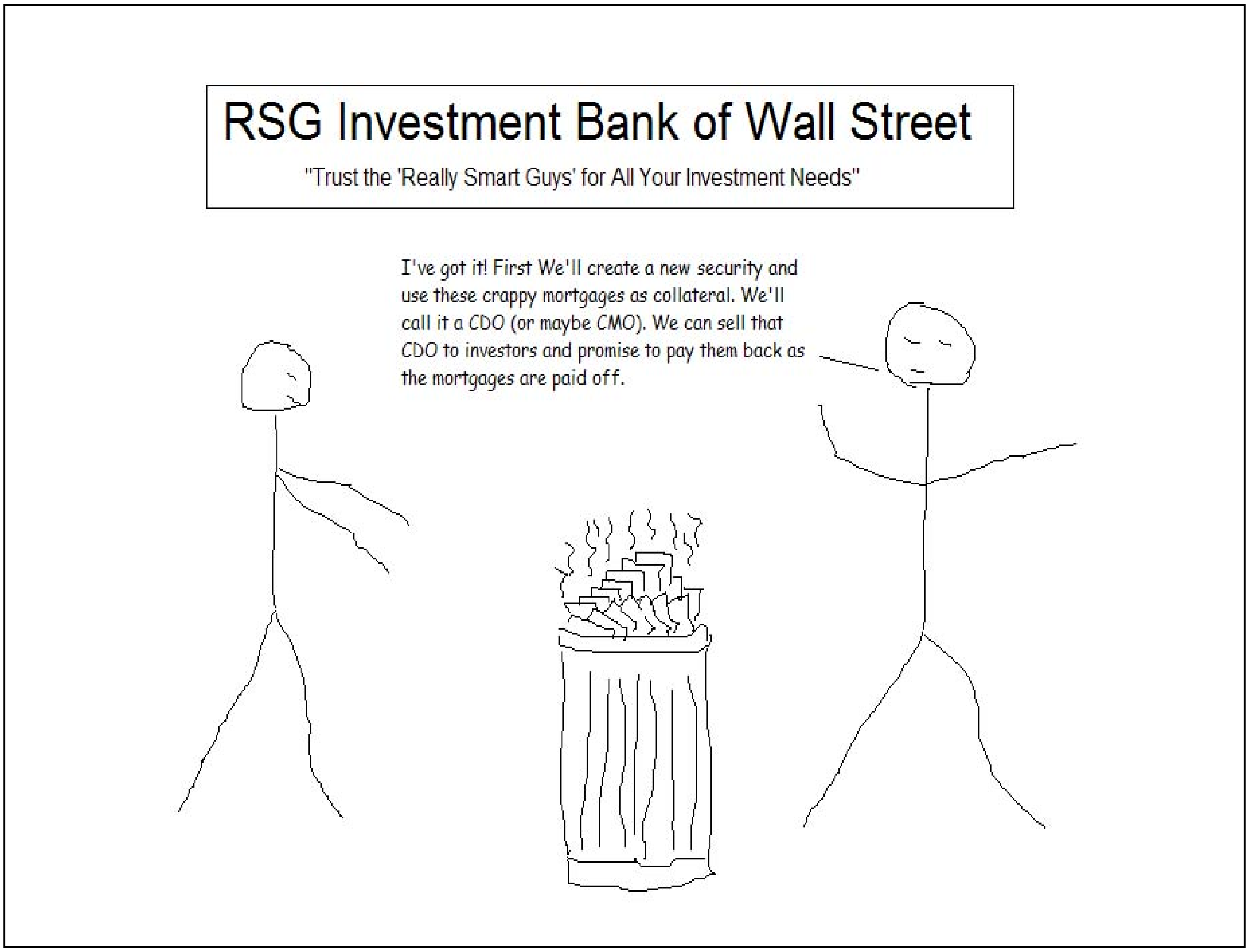

FIGURE 2.[25]

IV. DEVELOPING THEORIES OF SUBPRIME SECURITIES LIABILITY

The subprime crisis has generated an enormous wave of litigation, ranging from individual borrower actions to shareholder class actions. The first subprime-related shareholder class action was filed on February 8, 2007. By December 15, 2007, the total number of

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[24] *Id.*

[25] From "How Subprime Really Works," an anonymous and humorous PowerPoint presentation that circulated across Wall Street trading desks and the blogosphere. Available at: http://bigpicture.typepad.com/comments/2008/02/how-subprime-re.html.

subprime shareholder class actions had more than quadrupled compared to the number filed in the first half of 2007.[26] By the end of 2007, the number of subprime-related cases filed in federal court totaled 278.[27] In the first quarter of 2008, another 170 cases were filed, bringing the total to 448. Analysts have predicted that the total would soon surpass the 559 savings-and-loan cases of the early 1990s.[28]

These subprime cases fall largely into five major categories: (1) borrower class actions, (2) securities cases, (3) commercial contract disputes, (4) employment class actions, and (5) bankruptcy-related cases.[29] Virtually every party in the mortgage origination and securitization process is represented among defendants: mortgage brokers, lenders, appraisers, title companies, homebuilders, servicers, issuers, underwriting firms, securitization trustees, bond insurers, rating agencies, money managers, public accounting firms, and company officers and directors.[30]

Securities cases account for 26 percent of the total subprime filings in federal court through March 31, 2008. Of the securities cases, 57 percent are class actions.[31] The following table shows the different claims alleged in all subprime securities cases, and in the subcategory of subprime securities class actions, for 2007 and the first quarter of 2008:

Claims	**Percent of All Subprime Securities Cases 2007/Q1 2008**	**Percent of All Subprime Securities Class Actions 2007/Q1 2008**
Securities and Exchange Act of 1934, § 10(b) & Rule 10b-5 (Manipulative and Deceptive Acts and Practices)	59/58	84/87
Securities and Exchange Act of 1934, § 20(a) (Joint and Several Liability)	50/49	80/87
Breach of Fiduciary Duty	39/28	12/7
Securities Act of 1933, § 15 (Liability of Controlling Persons)	9/16	8/26

[26] Stephanie Plancich, Ph.D., Brian Saxton, and Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High*, Dec. 2007, at 2.

[27] Jeff Nielsen, Scott Paczosa, and William Schoeffler, Navigant Consulting, *Subprime Mortgage and Related Litigation 2007: Looking Back at What's Ahead* (2008) ("Navigant I"), at 2.

[28] Jeff Nielsen,, Scott Paczosa, and William Schoeffler, Navigant Consulting, *Subprime Mortgage and Related Litigation First Quarter 2008 Update: Reaching New Heights* (2008) ("Navigant II"), at 1.

[29] Navigant I at 2.

[30] *Id.* at 5.

[31] Navigant II at 2.

Claims	Percent of All Subprime Securities Cases 2007/Q1 2008	Percent of All Subprime Securities Class Actions 2007/Q1 2008
Securities Act of 1933, §§ 11, 12 (False Registration Statement)		8/26

FIGURE 3.[32]

The general theories pursued against the major players in the subprime lending chain include:

- ***Suits Against Subprime Loan Originators***. Shareholders have alleged that lenders: used inappropriate underwriting standards and failed to disclose the material facts surrounding their underwriting practices; made inadequate disclosures regarding the quality of loans; failed to disclose the actual conditions and deteriorating values of subprime loan portfolios; failed to disclose that reserves were inadequate; misrepresented the lender's internal controls and risk management practices.

- ***Suits Against Issuers of Securitized Products.*** Purchasers of securitized instruments have alleged that issuers: made improper disclosures in prospectuses regarding the initial loan portfolios, including asset pool characteristics, underwriting standards, quality of assets, source of loans, and credit enhancement arrangements; failed to adequately disclose the risks relating to investments in securities backed by subprime loans; failed to follow standard risk management procedures and did not disclose these failures; and failed to conduct adequate due diligence.

- ***Suits Against Underwriters and Brokers of Securitized Products.*** Purchasers have alleged that underwriters and brokers: recommended unsuitable or imprudent investments; misrepresented the value and quality of loan portfolios backing the securities; failed to disclose the risks of investing in subprime securities.

- ***Suits Against Credit Rating Agencies.*** Shareholders of Standard & Poor's and Moody's have asserted claims that these rating agencies misrepresented or failed to disclose that the companies assigned excessively high ratings to MBSs and CDOs.

[32] *Id.* at 6-7.

V. REVIEW OF EARLY SUBPRIME SECURITIES DECISIONS

The subprime securities cases are all in the very early stages of litigation. However, in four cases, courts have ruled on motions to dismiss. Although it is too early to detect any pattern or direction, a review of these cases is helpful to gain an understanding of the legal theories asserted by plaintiffs and defendants in subprime securities cases.

A. *TRIPP V. INDYMAC BANCORP, INC.*

The plaintiff investors sued IndyMac Bancorp, Inc. for violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. IndyMac was described as a "hybrid thrift / mortgage banker, which both invests in and originates loans." Also named as defendants were the senior executives of the bank. Plaintiffs filed an amended complaint containing 199 paragraphs, which the district court characterized as "overwhelming" in length.

The court distilled the plaintiffs' claims as follows:

> [D]espite the onset of the downturn in the national housing and mortgage markets, Defendants maintained that they were well-positioned, contrary to the 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."[33]

The district court granted defendants' motion to dismiss on November 29, 2007, holding that: "At least thus far . . . Plaintiffs have failed to allege sufficient facts giving rise to a 'strong inference' of scienter under *Tellabs*."[34] Plaintiffs' complaint cited the beliefs and opinions of confidential witnesses with respect to the allegedly problematic areas of Indymac's operations, but the Court held that plaintiffs failed to allege that the individual defendants shared those beliefs and opinions, or that they were aware of them and found them to be reliable and justified.

Plaintiffs also pointed to a press release and conference call that marked the end of the class period to support their complaint. The court held that: "Those statements certainly admit mistakes, but this is a fraud case, not a mismanagement case."[35] The court dismissed reliance on financial statements showing increases in loan loss provisions and charge-offs, which plaintiffs

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[33] *Tripp v. Indymac Bancorp, Inc.*, No. CV 07-1635-GW, slip op. at 4 (C.D. Cal. Nov. 29, 2007).

[34] *Id.* (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007)).

[35] *Id.* at 5.

had cited as evidence of both IndyMac's internal control problems and the defendants' knowledge that a significant portion of the loans they had sold were troubled. The court found this evidence insufficient to establish scienter, concluding that "an 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." The court further observed that the individual defendants had "retained such a large percentage of their stock that an inference of scienter is functionally negated . . . ."[36]

The court granted leave to amend the complaint, but required that "any further amendment greatly simplify the operative pleading by clearly identifying only those statements that are alleged to be false or misleading and (briefly, but specifically), stating why."[37]

B. *ATLAS V. ACCREDITED HOME LENDERS HOLDING CO.*

Lead plaintiff Arkansas Teacher Retirement System filed a class action against Accredited Home Lenders Holding Co. and its indirect subsidiary, Accredited Mortgage Loan REIT Trust, as well as individual officer and director defendants of the two entities. The complaint alleged that defendants concealed Accredited's true financial condition and made materially false and misleading statements regarding the company's operations and income, which had the result of artificially inflating the price of Accredited's stock during the class period. Prior to the class period, defendants allegedly represented that Accredited was focused more on credit quality than merely increasing the volume of loans that it originated, and that Accredited's underwriting procedures were better and more conservative than those of other sub-prime mortgage lenders. Plaintiffs' complaint asserted that by the beginning of the class period, defendants caused Accredited's employees to disregard the company's stated underwriting guidelines in an effort to increase the volume of loans originated.[38]

The complaint relied on the statements of several confidential witnesses, who detailed pervasive, widespread exceptions to the company's underwriting policies and substantial pressures to approve loans at the end of reporting periods in an effort to meet financial projections. The complaint also alleged that the defendants manipulated Accredited's earnings, inadequately reserving for defaults on portfolio loans, in violation of generally accepted accounting principles (GAAP). Plaintiffs asserted claims for violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, as well as claims for violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933.[39]

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[36] *Id.* at 6.

[37] *Id.* at 8.

[38] *Atlas v. Accredited Home Lenders Holding Co.*, No. 07-CV-488 H (RBB), slip op. (S.D. Cal. Jan. 4, 2008) (order dealing with various motions to dismiss and a motion to strike).

[39] *Id.*

With a few minor exceptions, the district court denied defendants' motions to dismiss. The court concluded that plaintiffs had adequately alleged that the defendants had manipulated Accredited's reserves such that its financial results and projections were false and misleading, and had also sufficiently pleaded that defendants' statements regarding Accredited's underwriting practices were false and misleading. The court found that an inference of scienter was adequately supported by allegations regarding the frequency with which defendants interfered with underwriters' decisions, and decreased Accredited's reserves compared to historic levels at a time when according to generally accepted accounting principles the reserves should have been increased. Citing *In re Daou Sys.*, 411 F.3d 1006, 1016 (9th Cir. 2005), the Court concluded that the allegations of significant violations of GAAP accounting standards provided evidence of scienter. The court also held that reliance and causation were established by adequate allegations that the plaintiffs had paid an artificially inflated price for the company's stock, and that the stock fell "after the truth became known" regarding the defendants' misrepresentations (citing *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346 (2005)).[40]

C. *GOLD V. MORRICE*

This case, filed by lead plaintiff New York State Teachers' Retirement System, stems from the collapse of New Century Financial Corporation. On January 31, 2008, the district court granted defendants' motion to dismiss.[41]

Prior to its demise, New Century had grown to become one of the nation's largest mortgage finance companies by focusing on subprime lending. The complaint alleged that starting in February 2007, New Century made several disclosures regarding errors in its previously reported financial statements, and that after these disclosures, New Century stock experienced a 97 percent decline in value. Plaintiffs asserted violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Sections 11 and 12(a) of the Securities Exchange Act of 1933.

In a blunt opinion, the court held, "In its current form, Plaintiffs' Complaint lacks clarity in articulating the grounds for its claims." The court found that the complaint did not clearly identify the allegedly false statements, nor did the allegations support an inference that particular statements were false or misleading. However, the court went on to state its belief that the deficiencies were "largely due to a lack of organization and somewhat unclear presentation of the allegations" in the Complaint.[42] The court noted that "Plaintiffs may be able to resolve deficiencies in the complaint by simple reorganization, revision, and clarification of the currently long and at times, meandering set of allegations." Accordingly, the court granted dismissal without prejudice, and granted plaintiffs' leave to amend their complaint, recommending that plaintiffs be "clear and concise": "For each allegedly false or misleading statement, the

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[40] *Id.*

[41] *Gold v. Morrice*, No. CV 07-00931 DDP (JTLx), slip op. (C.D. Cal. Jan. 31, 2008) (order granting motions to dismiss with leave to amend).

[42] *Id.* at 6.

Complaint should identify some facts suggesting that the statement is false or misleading, and preferably in the same or a paragraph following the statement."[43] Additionally, the Court instructed the plaintiffs to attach a chart as an exhibit to its amended complaint, to set forth for each claim: (a) the alleged false or misleading statements, including the source of the statement in a registration statement; (b) the supporting factual allegations; and (c) the ultimate conclusion.[44]

D. *GRAND LODGE OF PENNSYLVANIA V. PETERS*

Although not strictly a subprime case, this class action securities case involves issues closely related to the subprime crisis. The court's decision on defendants' motions to dismiss is instructive as to securities claims against third parties – here, underwriters and auditors. Securities claims against third parties may be significant in subprime cases, because a number of companies have gone out of business, leaving individual defendants and third parties as the only potentially viable defendants.

Defendant Coast Financial Holdings, Inc. ("CFHI") was the parent company of Coast Bank of Florida. Coast Bank opened for business in 2000 in the Tampa, Florida area. The case arises from Coast Bank's real estate loan portfolio, and specifically its "construction-to-permanent" loans. The complaint alleges that sometime after 2002, when CFHI began pursuing an aggressive growth strategy, CFHI approached a local builder, and hatched a scheme in which CFHI would attract investors to lend their credit to finance the construction of single-family homes without intending to occupy the homes, but rather to "flip" them for a profit. As the alleged scheme continued, defendants falsely claimed that CFHI practiced conservative lending, minimized higher risk lending, and maintained a high quality asset portfolio. Furthermore, according to the complaint, defendants falsely touted that Coast Bank's residential construction loans were made to individuals and not real estate investors. The defendants also allegedly represented that the bank's loan portfolio would be diversified so that no more than 10 percent of loans would be issued to any one group of customers, and that internal controls and underwriting standards would be used to manage credit risk.[45]

Plaintiffs claim that CFHI did not perform due diligence on the financial condition of the builder involved in the scheme. Furthermore, CFHI loosened its lending standards by making risky loans to the builder's customers, many of whom were investors located outside Florida. CFHI failed to diversity, and the percentage of its loans made for the one builder's construction increased to 25 percent by the end of the class period. To avoid detection, CFHI asked the

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[43] *Id.* at 7.

[44] *Id.*

[45] *Grand Lodge of Pennsylvania v. Peters,* No. 8:07-CV-479-T-26EAJ, slip op. (M.D. Fla. Mar. 13, 2008) (order).

builder to build homes in the names of affiliated companies, to give the appearance of a diversified portfolio.[46]

On January 19, 2007, defendants filed a Form 8-K revealing that CFHI's concentration of loans and loan portfolio value was far riskier than previously represented. CFHI's stock plummeted 25 percent, to $12.10 per share. Just three days later, CFHI issued a press release clarifying the Form 8-K, and stating that CFHI was having financial difficulty. The price of CFHI's shares dropped to $8.68 per share. Following several other disclosures to the public, CFHI announced on May 24, 2007, that the Federal Deposit Insurance Corporation (FDIC) and the Florida Office of Financial Regulation had issued a cease and desist order. Three months later, CFHI was acquired by another bank for a price of $3.40 per share.[47]

Soon thereafter, this class action was filed, asserting claims under Section 10(b) and Rule 10b-5 against CFHI, several of its officers and directors (collectively, the "Coast defendants"), as well as its auditor and two underwriters for CFHI's secondary public offering in 2005. The complaint also asserted claims against the Coast defendants and two underwriter defendants under Section 11 of the 1933 Act.

The district court found the allegations of misrepresentations and omissions by the Coast defendants adequate to withstand a motion to dismiss the Section 10(b) and Rule 10b-5 claims. Statements attributed to confidential witnesses were sufficiently detailed to suggest reliability, and to support an inference of scienter. The claims were further supported by the allegations of GAAP violations.[48]

Plaintiffs' claims against CFHI's auditor, however, were not sustained. Plaintiffs asserted that the auditor "turned a blind eye to each of numerous violations of GAAP, GAAS [generally accepted accounting standards], SEC, SOX [Sarbanes-Oxley], and PCAOB [Public Company Accounting Oversight Board] standards," falsely claimed that its audit complied with these standards, and thereby participated in the fraud.[49] The district court noted that under 11th Circuit authority, a plaintiff "must offer specific factual allegations that are sufficient to support the 'strong inference that the audit was so deficient that it amounted to no audit at all.'"[50] The court found that plaintiffs' allegations of violations of GAAP amounted to "mere negligence," and failed to rise to the level of "severe recklessness necessary to meet the pleading requirements of scienter on the part of an independent auditor."[51] Claims against the auditor were dismissed without prejudice.

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[46] *Id.*

[47] *Id.*

[48] *Id.* at 11-15.

[49] *Id.* at 15.

[50] *Id.* at 16.

[51] *Id.* at 18-19

The Section 11 claim against the Coast defendants and the underwriter defendants was also dismissed. The district court found that plaintiffs did not have standing to assert the Section 11 claim because they had not pleaded facts sufficient to show that their purchases of shares of CFHI in the aftermarket could be traced to the allegedly misleading registration statement filed in connection with CFHI's secondary public offering ("SPO"). Plaintiffs argued that whether or not they could trace their aftermarket purchases to the SPO was inappropriate for decision on a motion to dismiss. The district court, relying on its own independent research, found no 11th Circuit guidance for the determination of standing at the pre-discovery stage of a securities class action. Finding the cases at the district court level in irreconcilable conflict, the court chose to follow those cases requiring more than a mere allegation that the plaintiffs' purchases of stock were traceable to the tainted registration statement.[52]

VI. CONCLUSION

The tidal wave of subprime securities cases is still swelling. The decisions that have come down on early motions to dismiss are too few in number to draw any firm conclusions. However, it is safe to predict that the pro-defendant body of case law that has developed since the Private Securities Litigation Reform Act of 1995, and that has led to the early dismissal of many claims, will come under close scrutiny. In view of serious flaws in the regulation of the subprime mortgage and securities markets, courts may not be as amenable to early dismissal of claims, and may rein in the case law favoring defendants. Given the increasingly well-documented abuses by many participants in the subprime mortgage origination and securitization process, and the widespread and enormous losses (including many incurred by sympathetic parties such as pension funds), plaintiffs may succeed in pleading securities fraud allegations that meet the *Tellabs* standard. It seems likely that there will be a number of subprime cases where a "reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[53]

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[52] *Id.* at 23-25.

[53] *Tellabs*, 127 S. Ct. at 2510.