

SUBPRIME LITIGATION AGAINST ISSUERS AND UNDERWRITERS OF MORTGAGE-BACKED SECURITIES – WHERE ARE THE ACTUAL LOSSES?

Multi-billion dollar write-downs of mortgage-backed securities are spawning actions by allegedly defrauded investors against issuers and underwriters of financial institutions holding such securities. The authors review obstacles to such actions and argue that the write-downs may not necessarily reflect the type of “actual losses” that are necessary to support federal securities law claims.

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The current global financial crisis has brought to the forefront key issues concerning the appropriate “value” or “price” of residential mortgage-backed securities (“MBS”) that may be subject to purchase by the government as part of its proposed economic recovery plan. Specifically, the Emergency Economic Stabilization Act of 2008, better known as the “bailout bill” or the “Troubled Asset Relief Program,” vests the Treasury Department with, among other things, the authority to purchase MBS on the books of financial institutions on terms and conditions to be determined by the Secretary of the Treasury. This authority — whether or not it is eventually used for that purpose — has in turn prompted considerable debate concerning the price that the government should pay for these securities, particularly in light of the absence of a functioning secondary market for them.¹

¹ At the time of this writing, the Treasury Department has used the initial installment of funds authorized by the Stabilization Act to acquire equity stakes in various financial institutions. In mid-November 2008, Treasury Secretary Paulson indicated that he was abandoning his original plan to buy troubled assets (including MBS) and would instead focus on providing financial institutions with cash infusions and trying to increase the availability to consumers of student loans, auto loans, and credit cards. Given the state of flux with respect to the government’s response to the economic crisis and potential policy shifts that may be implemented by the Obama administration, it is unclear whether the proposed governmental purchase of mortgage-related assets will eventually come to pass. See *Bailout’s Next Phase: Consumers*, THE WALL STREET JOURNAL (Nov. 15, 2008).

Interestingly, the challenges faced by the government in determining how to value the MBS holdings of financial institutions, discussed below, underscore questions concerning the viability of class and individual actions that have been filed by MBS purchasers alleging misstatements and omissions by issuers and underwriters of MBS offerings.² These actions, more of which may be in the pipeline, have been brought primarily under Sections 11 and 12(a)(2) of the Securities Act of 1933, and allege that issuers and underwriters failed to disclose adequately the risks associated with the mortgages that were used to collateralize the MBS offerings and/or failed to conduct sufficient due diligence on those mortgages.³

² See Allen Ferrell, Jennifer E. Bethel and Gang Hu, *Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis*, HARVARD LAW AND ECONOMICS DISCUSSION PAPER NO. 612 (Nov. 17, 2008) (“Harvard Discussion Paper”), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096582; see also Jeff Nielsen, Scott Paczosa and William Schoeffler, *Subprime Mortgage and Related Litigation: First Quarter 2008 Update: Reaching New Heights*, NAVIGANT CONSULTING (April 2008).

³ E.g., *Luther v. Countrywide Home Loans Servicing L.P. et al.*, Case No. BC380698 (Calif. Super. Court, filed Nov. 17, 2007); *Luminent Mortgage Capital, Inc. et al. v. Merrill Lynch & Co., Inc. et al.*, Case No. 2:2007cv05423 (E.D.P.A., filed Dec. 24, 2007); *Plumbers’ Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp. et al.*, CA No. 08-0544 BLS (Mass. Super. Court, filed Jan. 31, 2008); *City of Ann Arbor Employees’ Retirement System v. Citigroup Mortgage Loan Trust, Inc., et al.*, 08-Civ-1418 (E.D.N.Y., filed March 19, 2008).

The theory of damages seemingly being advanced in these cases is that MBS purchasers have suffered compensable “losses” resulting from allegedly substantial declines in the market “value” or “price” of the purchased securities.⁴ This is premised on the notion that the “paper values” or “marks” assigned to mortgage-backed securities pursuant to generally accepted accounting principles (“GAAP”) can be properly construed as the “price” of the securities, and that declining GAAP “values” (which have resulted in write-downs on the books of MBS investors) reflect the type of “loss” necessary to support securities claims, with the only remaining question being how to quantify and attribute these losses. Under this theory, the massive write-downs in the values of MBS portfolios over the past year and a half suggests that potential damages in MBS cases might run to many billions of dollars.⁵

Embedded in all of this, however, is the relatively untested assumption that the appropriate reference point for determining whether an MBS purchaser has suffered a loss that is ripe for litigation (and the extent of any such loss) is the current “paper value” of the securities. The purpose of this article is to suggest that such a theory, which essentially applies to MBS cases the damages analyses found in traditional “stock drop” cases involving publicly traded equity securities, may not

provide an appropriate or legally viable framework for seeking relief under the securities laws. This is because unlike equities, the inherent value of an MBS may not be the price at which it can be sold, but rather the yield or income stream that it generates.⁶

THE NATURE OF MORTGAGE-BACKED SECURITIES

With respect to equity securities, courts and commentators have had many occasions to address when an investor has been injured for the purpose of asserting a securities claim. Other than dividends (which companies are not required to declare), equity investors make money by buying and selling securities at their trading prices. In other words, the value of an equity security (at least one that trades efficiently) is generally defined by the price at which it can be traded. The same may be true of corporate bonds, for which there are often liquid and stable secondary markets.

By contrast, mortgage-backed securities are not listed on exchanges — all trades are privately negotiated. Although a particular MBS offering may have many tranches that behave in very different ways (and have different payment and risk structures), each is in essence a contract that entitles its owner to certain portions of principal and interest from the pools of mortgages that serve as collateral for the offering.⁷ In this sense, mortgage-backed securities are arguably more akin to bank loans and other collateralized commercial contracts than to equity securities, a fact reflected in the fundamentally different ways that they are sold, traded, and valued.

⁴ For example, the complaint in *Luther* alleges that “[t]he delinquency rates of the underlying mortgages has gone up tremendously and Countrywide Financial has taken huge write-downs of its own residual interest in many of its Alt-A [a category of mortgages between prime and subprime] Trusts. As a result, the Certificates are no longer marketable at prices anywhere near the price paid by plaintiff and the Class, and the holders of the Certificates are exposed to much more risk than the Registration Statements/Prospectus Supplements represented.” *Luther* Complaint at p. 3. Similarly, the *Nomura* complaint alleges that “[b]y the summer of 2007, the truth about the performance of the mortgage loans that secured the certificates began to be revealed to the public. ... As a result, the Certificates should receive less absolute cash flow in the future and will not receive it on a timely basis. As an additional result, the Certificates are no longer marketable at prices anywhere near the price paid by plaintiff and the Class, and the holders of the Certificates are exposed to much more risk with respect to both the timing and the absolute cash flow to be received than the Registration Statements/Prospectus Supplements represented.” *Nomura* Complaint at p. 3.

⁵ As of August 27, 2008, over 100 institutions had announced write-downs totaling over \$506 billion, arising in part from estimated declines in the “value” of certain tranches of mortgage-backed securities. See Harvard Discussion paper, *supra* note 2 at 21.

⁶ As discussed below, even this is subject to disagreement because of the different pricing assumptions that MBS buyers and sellers may use.

⁷ For a detailed overview of the subprime mortgage securitization process and the “frictions” at the root of the subprime crisis, see Adam B. Ashcraft and Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, WHARTON FINANCIAL INSTITUTIONS CENTER WORKING PAPER NO. 07-43 (March 2008), available at http://www.newyorkfed.org/research/staff_reports/sr318.html. For a detailed overview of the rating process for mortgage-backed securities, see Staff of the Office of Compliance Inspections and Examinations, Division of Trading and Markets and Office of Economic Analysis, U.S. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies* (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (“OCIE Report”).

The tranches in an MBS issuance typically contain certain forms of credit enhancement, including, for example, subordination, over-collateralization, and excess spread, each of which is designed to shield the securities from loss of income due to mortgage defaults.⁸ Thus, the credit risk of many MBS tranches is controlled so that it is lower than the credit risk of the underlying mortgages serving as collateral. In other words, defaults on the mortgages underlying the bonds will not necessarily trigger a default of payment obligations on the bonds themselves. The structure of a typical MBS offering involves a payment “waterfall,” whereby holders of various MBS tranches are paid in order of seniority. Senior tranches — those with the highest credit rating and lowest rate of return — are entitled to receive accrued interest and principal payments before junior tranches. At the same time, any losses incurred based on the performance of the mortgages underlying the securities are borne first by holders of the more junior tranches. Thus, an increase in mortgage default rates leading to lower than expected cash flows may still allow for payment in full to holders of senior MBS tranches.

Accordingly, an investor could buy a mortgage-backed security, continue to receive all principal and interest payments called for by the offering documents on the schedule set out in those documents, and yet at some point be required by GAAP to mark down the value of the security on its balance sheet based on prevailing (and fluctuating) market conditions. The same investor might have to revalue the security up or down, from time to time, and may not yet know whether it will in fact suffer an actual loss on its investment. As it turns out, although there have been defaults on mortgages that collateralize MBS offerings, because of the credit enhancements built into the securities, there are mortgage-backed securities whose “book” “prices” or “values” are perceived to have declined — resulting in portfolio write-downs required by governing accounting standards — but which simultaneously continue to pay principal and interest in full.⁹ In such

⁸ See generally OCIE Report at 6, *supra* note 7 and Harvard Discussion Paper at 12, *supra* note 2.

⁹ Standard and Poor’s recently projected that in light of credit enhancements, AAA mortgage-backed securities will likely see write-downs of less than one percent despite the more significant losses on the underlying mortgages. See Michael Kling, *S&P: Subprime Losses Will Be Much Lower*, MONEYNEWS.COM (Nov. 17, 2008). JP Morgan Chase & Co. analysts have also noted that “the [recent] dips in prices for senior tranches overstate credit risk” and that “mortgage securities rated AAA or AA probably won’t lose principal in all

cases, the investor is holding a security that is providing 100% of the expected return, in precisely the form expected at the time of purchase.

Despite that fact, is the fear that certain tranches of MBS might not be paid in full in the future a sufficient basis for bringing a claim under the ‘33 Act? Is such a claim a ripe case or controversy for the courts? And is the fact that some “paper measure of price” for the MBS tranche has declined since the time of purchase enough to overcome these hurdles?¹⁰

MBS OFFERING DOCUMENTS: ENTITLEMENTS AND EXPECTATIONS

The tension of applying the loss standards articulated in equity securities cases to mortgage-backed securities is reflected in the expectations created by the terms and conditions of most MBS offering documents. These documents generally make clear that purchasers are buying interests in trusts whose assets consist of certain mortgage loans.¹¹ The investor is only entitled to the principal and interest payments from those mortgages, paid out at specified regular intervals in accordance with characteristics of the particular tranche purchased. Purchasers are also warned that a secondary market for the securities may not exist and that investors may not be able to sell the securities at the price they hope to obtain. For example, the list of risk factors in the prospectus

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but the most severe U.S. housing slump.” See Jody Shenn, *High-Rated Subprime-Mortgage Bonds Cheap Enough*, JPMorgan Says, BLOOMBERG NEWS (Aug. 13, 2007). It has also been noted that the senior tranches “virtually never suffer credit losses,” as only in the extremely unlikely event that losses exceed the amounts due to the holders of the junior tranches would the senior tranches absorb losses. See Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039, 2044, 2047 (2007).

¹⁰ For the reasons discussed below, even if a plaintiff can overcome the hurdle of showing that it has suffered a legally cognizable loss, these same issues may present significant obstacles to class treatment of claims.

¹¹ For example, the offering circular for one 2006 MBS issuance provided that the issued securities “[r]epresent obligations of and interests in a trust, whose assets consist of a pool comprised of closed-end fixed-rate mortgage loans and adjustable-rate, revolving home equity lines of credit mortgage loans, substantially all of which are secured by second liens on residential properties” and that these securities “[c]urrently have no trading market.”

supplement for a 2007 MBS issuance includes the following:

A secondary market for the offered certificates may not develop or, if it does develop, it may not provide you with liquidity of investment or continue while your certificates are outstanding. Lack of liquidity could result in a substantial decrease in the market value of your certificates. ... The secondary market for mortgage-backed securities has experienced periods of illiquidity and can be expected to do so in the future. Illiquidity means that there may not be any purchasers for your class of certificates. Although any class of certificates may experience illiquidity, it is more likely that classes of certificates that are more sensitive to prepayment, credit, or interest rate risk will experience illiquidity.¹²

Similarly, the offering circular for another issuance provided:

There is currently no market for the Offered Securities. The Initial Purchasers may make a market in the Offered Securities, but are not obligated to do so. There can be no assurance that a secondary market for the Offered Securities will develop or, if a secondary market does develop, that it will provide buyers of the Offered Securities with liquidity of investment or that it will continue for the life of the Offered Securities. If the Initial Purchasers are unable to sell all of the Offered Securities the Initial Purchasers have agreed to place, on the closing date, the Initial Purchasers have no obligation to purchase any Offered Securities. There have been times in the past where there have been very few buyers of similar asset-backed securities, and there may be similar times in the future. As a result, you may not be able to sell your Securities when you wish to do so or you may not be able to obtain the price you wish to receive.¹³

Disclosures of this type may make it difficult for MBS purchasers to argue that losses should be measured

by any decline in the “market value” of a particular mortgage-backed security. Because there can be no claimed expectation that the mortgage-backed security could be sold on the open market or that such a market even exists, the “market value” of any particular MBS may be irrelevant to whether a purchaser has suffered actual economic loss.

The standard terms of many MBS offering documents also disclose that intermittent losses and/or fluctuations in the value or performance of the underlying mortgages should be expected for a variety of possible reasons and that such losses, to the extent they are within a certain range, may not prevent payment in full to holders of some or all tranches. Indeed, as discussed above, mortgage-backed securities are structured to take this into account and allocate these risks to different tranches depending upon buyers’ different appetites for such risks. This is an important issue that does not yet seem to have filtered into the current discussion — anyone who reads a typical MBS prospectus knows that (i) losses are expected on the mortgage collateral and (ii) not all such losses will affect payment in full of each tranche in the issuance (let alone effect them in the same way or at the same time).

For example, one recent vintage prospectus supplement stated:

Risks Related to the Offered Certificates. A decline in real estate values or in economic conditions generally could increase the rates of delinquencies, foreclosures, and losses on the mortgage loans to a level that is significantly higher than those experienced currently. This in turn will reduce the yield on your certificates, particularly if the credit enhancement described in this prospectus supplement is not enough to protect your certificates from these losses.

* * *

The subordination, over-collateralization, and loss allocation features described in this prospectus supplement are intended to enhance the likelihood that holders of more senior classes of certificates will receive regular payments of interest and principal, but are limited in nature and may be

¹² Prospectus Supplement on file with authors.

¹³ Offering Circular on file with authors.

insufficient to cover all losses on the mortgage loans.¹⁴

Consequently, although an MBS purchaser can try to sell such a bond in a private transaction, many (if not most) MBS investors expect to make money by holding the bond through maturity and receiving the income stream they bargained for, not by trading on a secondary market or otherwise altering the type or nature of their holdings. In light of these provisions, it appears clear that an MBS investor's bargained-for entitlement is limited to anticipated principal and interest payments, which must include some tolerance for foreseeable losses on the underlying collateral. To the extent that these amounts — the consideration for the contract that a mortgage-backed security represents — continue to be paid and there is no default on the bond, MBS purchasers may face an uphill battle in convincing courts that they have suffered actual and actionable losses.

VALUING MORTGAGE-BACKED SECURITIES

Plaintiffs in MBS cases will undoubtedly argue that such cases are ripe for adjudication and/or otherwise sustainable because the deterioration in the “market value” of their MBS holdings is an appropriate proxy for actual losses suffered.¹⁵ But the manner in which investors are forced to value their MBS holdings under GAAP raises strong concerns about the reliability of

such values. Where a company buys mortgage-backed securities as an investment, GAAP requires the company to “mark” the securities for valuation purposes at certain regular intervals.¹⁶ Statement No. 157 of the Financial Accounting Standards Board (“FAS 157”) guides companies as to how they should measure the “fair value” of specific assets and liabilities (including instruments such as mortgage-backed securities) on their books in order to arrive at the appropriate marks. It provides that fair value should in the first instance be measured by the maximum price at which the asset could be sold in the principal market for the asset, or, where no principal market exists, the most advantageous market. Although FAS 157 favors valuations based on external, observable, and independent market participant assumptions, assumptions by companies themselves will suffice where there is minimal or no market activity from which to otherwise derive fair value measurements.¹⁷

Because mortgage-backed securities are not publicly traded and may experience periods of illiquidity, especially under current market conditions, fair value measurements must be obtained via a complex modeling process that takes into consideration predictions about the economy (such as short-term and long-term interest rates) and the expected performance (*e.g.* default and prepayment rates) of the particular mortgages underlying a given security.¹⁸ Thus, for purposes of valuing complex debt instruments like mortgage-backed securities, mark-to-market accounting is sometimes described as “mark-to-model” accounting.

A “mark-to-model” price may be theoretical and subjective, and may or may not represent (i) what

¹⁴ In the period after March 2007, many mortgage-backed security-offering documents also included additional disclosure such as “[i]n some areas of the United States, real estate values have fallen at a greater rate in recent years than in the past. In particular, mortgage loans with high principal balances or high loan-to-value ratios will be affected by any decline in real estate values. Real estate values in any area of the country may be affected by several factors, including population trends, mortgage interest rates, and the economic well-being of that area. Any decrease in the value of the mortgage loans may result in the allocation of losses which are not covered by credit enhancement to the offered certificates or notes.” Prospectus Supplement, *supra* note 12.

¹⁵ Interestingly, claims by MBS purchasers who are suing issuers and underwriters under the ‘33 Act may be at cross purposes with claims by shareholder plaintiffs bringing subprime-related “stock drop” cases against financial institutions. The former appear to be relying on “mark-to-model” prices as an accurate measure of accrued losses on their MBS portfolios. Conversely, shareholder suits challenging the integrity of a financial institution’s own financial statements have questioned whether the models (and their underlying assumptions) used by companies for fair value measurements under FAS 157 were reasonable and valid.

¹⁶ The Financial Standards Accounting Board (FASB) deems a mortgage-backed security to be “held for investment” where the investor intends to hold the loan until maturity. *See, e.g., FASB, Statement of Financial Accounting Standards No. 134, Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise — an amendment of FASB Statement No. 65* (Oct. 1998).

¹⁷ FAS 157 essentially ranks the quality and reliability of information used to determine fair values. Under the hierarchy it establishes, quoted prices are deemed the most reliable valuation indicators and model-generated values that rely on unobservable data are deemed the least reliable.

¹⁸ *See Jacob Boudoukh et al., The Pricing and Hedging of Mortgage-Backed Securities*, in *ADVANCED FIXED-INCOME VALUATION TOOLS* (Narasimhan Jegadeesh and Bruce Tuckman eds., 2000).

someone would actually pay for the security were it to be sold or (ii) whether it can be sold at all. Although the models used by many companies have in recent months resulted in decisions to significantly write down values of MBS portfolios, there is no guarantee of consistency or transparency from one company to the next. Some models may rely primarily on externally generated assumptions, whereas others may rely on internally generated assumptions. There may also be a lag time in the ability of some companies to adjust their models (or even create models) to take into account prevailing conditions. As a result, different investors (including plaintiffs or putative class members) could simultaneously carry the same or similar securities on their books while ascribing different values to them.

These concerns have been reinforced in recent months by Congress' passage of the Stabilization Act and the comments of various government officials. Earlier this year, federal regulators recognized that the extensive "paper losses" suffered on MBS portfolios held by credit unions — as a result of the application of GAAP — are likely to be reversed when the housing market stabilizes, and that at least one identified credit union had received all payments of principal and interest due to date on its senior tranche MBS holdings.¹⁹ This conclusion was buttressed by the Treasury Department's suggestion that it may conduct reverse auctions to establish market values for mortgage-related assets that it may choose to purchase from financial institutions.²⁰ Such contemplated auctions reflect the belief that the "marks" currently assigned by many entities to their MBS portfolios may be inaccurate in light of the income stream that the mortgages underlying these securities are

expected to generate.²¹ Indeed, Federal Reserve Chairman Bernanke and others have acknowledged that the "paper losses" ostensibly suffered by some MBS purchasers may reflect unrealistically low valuations of MBS based on market fears.²²

THE REQUIREMENT OF "ACTUAL LOSS" UNDER THE SECURITIES LAWS

The securities laws, and the '33 Act in particular, were designed for securities that trade on intermediated markets such as the NYSE and Nasdaq, not for asset-backed securities (such as MBS) whose inherent value is tied to contractual payment rights. Indeed, in cases involving equities, the question of whether an investor has suffered a loss is often a forgone conclusion. The existence of efficient and active markets for many equity securities means that the "price" of such a security at any given point in time can be determined quickly and reliably.

Because such equity "stock drop" cases make up the majority of securities fraud actions under both the '33 Act and '34 Act, judicial and academic treatment of damages issues has often assumed the existence of an economic loss (typically by reference to a prevailing "market" price) and focused exclusively on related questions of causation. In the context of securities fraud claims involving publicly traded securities, courts have long held that only actual damages, corresponding to the

¹⁹ See Mark Maremont, *Mortgage Market Trouble Reaches Big Credit Unions*, THE WALL STREET JOURNAL (Aug. 11, 2008). Acknowledging the discrepancy between GAAP-required "mark to market" values and the long-term value of mortgage-backed securities for which there is no discernible market, some lawmakers have lobbied the SEC to suspend the "mark to market" or "fair market value" rules and allow financial institutions to mark MBS portfolios based on long-term projections of their value. See Marcy Gordan and Stephen Bernard, *Banks Want to Suspend Accounting Rule in Bailout*, ASSOCIATED PRESS (Oct. 1, 2008).

²⁰ See Justin Lahart, *The Financial Crisis: Economists Look at Ways to Structure Auction – U.S. Seeks to Avoid Big Overpayments for Distressed Debt*, THE WALL STREET JOURNAL (Sept. 25, 2008), see also Chantale LaCasse, Marcia Kramer Mayer, Arun Sen, and Elaine Buckberg, *Buying the Bad Stuff: Implementation Consideration for the Paulson Plan*, NERA ECONOMIC CONSULTING (Sept. 27, 2008).

²¹ Some commentators have suggested that the Treasury (and accordingly, taxpayers) may even realize a profit on large-scale purchases of MBS because of the substantial difference between current "paper losses" on the securities and projected eventual losses on the underlying mortgages. See Jonathan R. Laing, *Making a Mint*, BARRON'S (Sept. 29, 2008).

²² Testifying before Congress on September 23, 2008, Chairman Bernanke suggested that the Treasury Department may be willing to pay as much as the "hold-to-maturity" price for troubled assets, including MBS, which is the price at which financial institutions value assets that they do not intend to sell or trade on secondary markets. This is as opposed to the "fire sale" prices that have been assigned to MBS and other mortgage-related assets in the absence of a functioning secondary market. Specifically, Chairman Bernanke stated: "If the Treasury bids for them and buys assets at a price close to the hold-to-maturity price, there will be substantial benefits. First, the banks will have a basis for valuing those assets and will not have to use fire-sale prices. Their capital will not be unreasonably marked down." See Jessica Holzer, *Bailout May Aid Bank Balance Sheets*, THE WALL STREET JOURNAL (Sept. 24, 2008); Vikas Bajaj, *Rescue Plan's Basic Mystery: What's All This Stuff Worth?*, NEW YORK TIMES (Sept. 25, 2008).

extent to which a plaintiff is damaged as a result of a defendant's fraudulent conduct, are recoverable.²³ The term "actual damages" has been interpreted to mean some reasonable form of economic loss — speculative losses are not compensable.²⁴

Because there is no functioning secondary market for most MBS offerings and trades are not publicly reported, proving that an MBS purchaser has suffered an actual economic loss may be more difficult. Indeed, even in cases involving publicly traded equities, courts have long recognized that "market prices" are not an appropriate determinant of "fair value" where equity securities are not actively traded or there is no "true" market.²⁵ The situation with respect to MBS is, if anything, worse. As discussed above, there is nothing to stop one MBS investor — who may be a named or unnamed plaintiff in a '33 Act class action — from taking a greater GAAP mark-down on a mortgage-backed security than other investors might deem necessary or even appropriate. In such a circumstance, it would seem illogical to allow that plaintiff to claim greater losses as a result. Similarly, after initially writing down the value of a particular MBS, an investor could decide (or feel compelled by GAAP) to later write up the value of a security as a result of changing market conditions or intervening events that affect the

performance of the underlying mortgages. In such a situation, would a plaintiff's losses be reduced accordingly, or its lawsuit rendered moot? What would happen if that write-up occurred post-judgment?

In light of this wrinkle, many MBS purchasers — particularly those who continue to hold the securities and have thus far been paid in full — may argue that sections 11 and 12 of the '33 Act (which also allow for rescission of securities purchases) do not require that they demonstrate any actual loss. At first glance, this argument might appear to have some merit. The applicable standard for claiming loss under the '33 Act is less clear than under the '34 Act. Sections 11 and 12 of the '33 Act are silent as to whether a plaintiff must prove that it has suffered an actual economic loss.²⁶ And no court seems to have directly opined on this issue. Yet there are good reasons to believe that MBS purchasers advancing '33 Act claims would still be subject to the requirement of proving actual economic loss. Both sections 11 and 12 provide for the defense of negative causation, whereby some or all of the damages claimed by a plaintiff may be disallowed if the defendant can prove that "any portion or all of such damages represents other than the depreciation of the value of the security" resulting from alleged misstatements or omissions. The negative causation provisions presume some showing by a plaintiff of a depreciation in the value of the underlying securities, or, put differently, that there has been some economic loss. Otherwise there would be no reason to have included them and/or they would not be considered affirmative defenses.²⁷ Indeed, these provisions provide a compelling basis for "reading in" a requirement of actual economic loss.

In addition, sections 11 and 12 provide that only misstatements and omissions concerning a "material fact" are actionable. In cases under the anti-fraud provisions of the securities laws, materiality has often been determined by reference to whether the market value of an efficiently traded security declined after the

²³ See, e.g., *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 343-44 (2005) (private securities fraud claims resemble common law deceit and misrepresentation claims, which require a plaintiff to show that it suffered an actual economic loss); *Pelletier v. Stuart-James Co., Inc.*, 863 F.2d 1550, 1557 (11th Cir. 1989) (citing and applying damages standard in 5 U.S.C. § 78bb(a)); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 (8th Cir. 1986) (same). Section 28(a) of the '34 Act provides, *inter alia*, that "no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of a judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."

²⁴ See *Pelletier*, 863 F.2d at 1557-58; see also *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 177-78 (3d Cir. 2001). The usual measure of damages in '34 Act cases is out-of-pocket losses — generally (i) the difference between the price paid for the security and what the fair value for the security would have been at the time of purchase absent the fraud or (ii) the difference between the purchase price and sale price, if the stock was sold after the alleged fraud was revealed. See *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128, 155 (1972); *Pelletier*, 863 F.2d at 1557-58.

²⁵ See Arnold S. Jacobs, 5E *Disclosure & Remedies under the Sec. Laws* § 20:64 (2008) (collecting cases).

²⁶ Section 11 assesses damages based on the value of a security at the time the suit is filed, rather than the value of the security at the time of purchase, whereas section 12 provides plaintiffs who have not sold their securities with the right to seek rescissory damages. Compare 15 U.S.C. § 77k(e) with 15 U.S.C. § 77l and *Randall v. Loftsgaarden*, 478 U.S. 647, 655-56 (1986).

²⁷ See generally *Sterten v. Option One Mortgage Corp.*, 479 F. Supp. 2d 479, 482 (E.D. Pa. 2007) (affirmative defenses raise new facts that, if proven, defeat a plaintiff's claim even if the allegations in his or her complaint are true).

revelation of the allegedly fraudulent conduct.²⁸ In the case of MBS, however, there is likely to be no discernible secondary market that can serve as an objective indicator of the “market value” of a particular MBS tranche. In this circumstance, courts might well find that a determination of “materiality” must be predicated on the existence of an actual economic loss resulting from the alleged fraudulent and/or negligent conduct. And, importantly, courts might go a step further and conclude that whether a misstatement or omission in an MBS offering document is material can only be determined based on whether the alleged conduct has resulted in a failure to make continued payments of principal and interest, as opposed to whether a subjective “market value” assigned to the security has declined. Beyond the problem of allowing the basis of a claim to be a plaintiff’s own determination of the “value” of an asset, the fact that that subjective value can change or even increase while an action is pending — or even later — is an additional reason for caution.

Finally, to the extent that MBS purchasers have received all payments currently due to them, any claim of actual damage would appear to be based solely on the theory that the security’s price was inflated at the time of purchase. But the Supreme Court has rejected such a “price inflation theory” in connection with claims under the ’34 Act and ruled that the existence of an artificially inflated price does not in itself constitute economic loss sufficient to state a claim under the securities laws.²⁹ Although *Dura* was a fraud-on-the-market case involving publicly traded securities, there is no reason to believe that the Court would adopt a different standard for the more complex MBS sector. Indeed, the *Dura* Court relied on both the policies behind the securities laws and the common law of deceit and misrepresentation in arriving at its decision, both of which should apply with equal force to claims by MBS purchasers under the ’33 Act.

All of this further confirms that reliance by plaintiffs on “mark-to-model” or “paper” valuations as a basis for claiming actual economic losses raises serious concerns that should be on the minds of counsel representing defendants in section 11 and 12 cases. This, of course,

leads to the broader question, discussed below, of whether plaintiffs’ claims are even ripe for adjudication where they continue to receive timely principal and interest payments on their MBS holdings.

RIPENESS CONSIDERATIONS

To date, no reported securities fraud case seems to have addressed the issue of whether an MBS holder who continues to be paid in full can claim an actual loss based solely on the deterioration of “market prices” for the bond. The above considerations, however, suggest that counsel for issuers or underwriters in ’33 Act subprime cases should step back and evaluate whether plaintiffs — including each member of a putative class — have to date been paid in full. If so, such actions may potentially be subject to dismissal on ripeness grounds, notwithstanding any asserted decline in the “prices” for the securities.³⁰

In order for a federal court to have subject matter jurisdiction over a claim under Article III of the Constitution, the claim must present a controversy that is ripe for adjudication. The underlying purpose of the ripeness doctrine “is to prevent the courts, through avoidance of premature adjudication, from entangling themselves in abstract disagreements.”³¹ Whether a claim is ripe for adjudication depends on whether a matter involves uncertain or “contingent future events that may not occur as anticipated, or indeed may not occur at all.”³² Although there is a scarcity of securities law decisions addressing ripeness issues, in other contexts courts have routinely dismissed tort claims as unripe where plaintiffs had not yet suffered any injury or accrued actual damages.³³

³⁰ The discussion that follows assumes that ripeness considerations are addressed under the federal constitution. It is beyond the scope of this article to address whether ripeness would be a state or federal constitutional issue were ’33 Act claims to be pursued in state courts.

³¹ *Pacific Gas & Elec. Co. v. State Energy Resources Comm.*, 461 U.S. 190, 200-01 (1983) (quoting *Abbott Laboratories v. Gardner*, 387 U.S. 136, 148-149 (1967)).

³² *Texas v. U.S.*, 523 U.S. 296, 300 (1998) (quoting 13A Charles A. Wright, Arthur R. Miller, & Edward H. Cooper, *Federal Practice and Procedure* § 3532, p. 112 (1984)).

³³ *See, e.g., Midwest Commerce Banking Co. v. Elkhart City Center*, 4 F.3d 521, 526 (7th Cir. 1993) (Posner, J.) (“Damages are for people who have been harmed. You cannot seek an award of damages for a fraud, therefore, before the fraud has harmed you. Even if there has been harm, if it cannot yet be

²⁸ *See generally Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (“when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock”).

²⁹ *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. at 342-44 (2005).

In this regard, cases brought under the Racketeer Influenced and Corrupt Organizations Act involving loans are particularly instructive.³⁴ For example, in *First Nationwide Bank v. Gelt Funding Corp.*,³⁵ the Second Circuit considered whether First Nationwide Bank (“FNB”) could state a fraud-based RICO claim before it had realized any actual loss as a result of the allegedly fraudulent conduct.³⁶ FNB alleged that it was fraudulently induced to make certain nonrecourse loans to defendants based on misrepresentations concerning the value of properties pledged as collateral to secure the loans.³⁷ FNB argued that its fraud claims were ripe for adjudication because it had suffered “immediate quantifiable injury when the loans were made because the loans were undersecured” and “FNB assumed additional risk of loss.”³⁸ It contended that these claims were ripe regardless of whether the borrowers were yet in default or whether FNB had completed proceedings to foreclose on the properties pledged as collateral.³⁹

The Second Circuit found these arguments unpersuasive, noting that “as a general rule, a cause of action does not accrue under RICO until the amount of damages becomes clear and definite.”⁴⁰ The court

reasoned that any amounts potentially recovered by FNB from defendants or through foreclosure on the collateral would serve to reduce the amount of damages to which it was entitled, and accordingly, “the amount of loss cannot be established until it is finally determined whether the collateral is sufficient to make the plaintiff whole, and if so, by how much.”⁴¹ Thus, the court rejected “FNB’s novel theory that it was damaged simply by being undersecured, when, with respect to those loans not yet foreclosed, the actual damages it will suffer, if any, are yet to be determined.”⁴² It further held that “to the extent FNB’s complaint is predicated on loans that have not been foreclosed, its claims are not ripe for adjudication because it is uncertain whether FNB will sustain any injury cognizable under RICO.”⁴³

In another RICO case before the Second Circuit, *Motorola Credit Corporation v. Uzan*,⁴⁴ the plaintiffs sought to recover for a third-party’s failure to repay loans and for actions to dilute the value of stock securing those loans.⁴⁵ Relying heavily on *First Nationwide Bank*, the court concluded that the plaintiffs lacked standing to assert RICO claims because their claims were not ripe insofar as plaintiffs had not yet foreclosed on the loans at issue.⁴⁶ Thus, the court found that “a plaintiff who claims that a debt is uncollectible because of the defendant’s conduct can only pursue the RICO treble damages remedy after his contractual rights to payment have been frustrated.”⁴⁷

Similarly, in *American Home Mortgage Corp. v. UM Securities Corp.*,⁴⁸ a plaintiff mortgage lender sued a mortgage broker and other related parties under RICO for conspiring to fraudulently obtain loans to purchase nine residential properties. The defendants allegedly accomplished the fraud by, among other things, misrepresenting the market value of the subject properties and submitting fraudulent appraisals,

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quantified, a damages suit may be premature.”); *Plummer v. Abbott Laboratories*, 568 F. Supp. 920, 922 (D.R.I. 1983) (“It is an abecedarian principle of tort law that an individual must be injured to recover for the negligent acts of another.”); *see also* CJS FRAUD § 70 (“A contingent injury, where loss may or may not occur, is insufficient to support a recovery for fraud.”).

³⁴ To have standing to bring a private fraud action under RICO, a plaintiff must demonstrate: “(1) a violation of section 1962 [of RICO]; (2) injury to business or property; and (3) causation of the injury by the violation.” *Motorola Credit Corp. v. Uzan*, 322 F.3d 130, 135 (2d Cir. 2003) (quoting *Hecht v. Commerce Clearing House, Inc.*, 897 F.2d 21, 23 (2d. Cir. 1990)).

³⁵ 27 F.3d 763 (2d Cir. 1994).

³⁶ Actual losses for the purposes of RICO means financial losses. *See Berg v. First State Ins. Co.*, 915 F.2d 460, 464 (9th Cir. 1990).

³⁷ *First Nationwide Bank*, 27 F.3d at 764-67.

³⁸ *Id.* at 767-68.

³⁹ *Id.* at 767.

⁴⁰ *Id.*; *see also Cruden v. Bank of New York*, 957 F.2d 961, 978 (2d Cir. 1992) (holding that debenture holder plaintiffs were injured within meaning of RICO only when companies which guaranteed principal and interest on debentures defaulted).

⁴¹ *Id.*

⁴² *Id.* at 768.

⁴³ *Id.* at 767. It should be noted that establishing standing under RICO is a “more rigorous matter” than establishing standing under Article III. *Denney v. Deutsche Bank AG*, 443 F.3d 253, 266 (2d Cir. 2006) (citation omitted).

⁴⁴ 322 F.3d 130, *supra note* 34.

⁴⁵ *Id.* at 132.

⁴⁶ *Id.* at 135.

⁴⁷ *Id.* at 136 (quoting *First Nationwide Bank*, 27 F.3d at 768).

⁴⁸ 2007 WL 1074837 (S.D.N.Y. April 9, 2007).

disclosure statements and other documentation.⁴⁹ Plaintiff argued that it had suffered compensable damages because the market value of the loans it issued had substantially diminished and that it would not have issued the loans had it known the true market value of the properties in question.⁵⁰ The court disagreed and concluded, following *First Nationwide Bank*, that the plaintiff's claims concerning unrefinanced loans and properties were not ripe because the scope of any actual damages that may be suffered in the future had not yet been determined.⁵¹

The fact patterns in these RICO cases are analogous to the scenario of an MBS purchaser who, despite receiving all payments to which it is entitled, nevertheless claims to have suffered damages as a result of alleged misrepresentations that caused it to assume additional risk of loss. These cases make clear that the speculative fear that a party might suffer a loss — from a deterioration in the value of mortgage collateral in particular — is not sufficient for a tort claim to become ripe. Nor is there generally a basis in law for seeking tort damages where such damages cannot be quantified and may never come to pass.

Tort litigation in other areas provides good examples of how these rules have developed. In cases filed against insurers under the Employee Retirement Income Security Act, courts have held that plaintiffs asserting tort (typically fraudulent inducement) or contract claims

do not have standing under Article III until they have sought and been denied benefits.⁵² More specifically, the fear that an insurer may deny benefits in the future based on an improper reading of an insurance policy, thus diminishing the policy's "market value," has been rejected as insufficient to show actual injury from fraud.⁵³ In the context of asbestos-related litigation, courts have held that damages cannot be awarded based on the fear of future illness; there must be a physical manifestation of asbestos-related disease before a plaintiff can bring suit.⁵⁴ Similar reasoning would suggest that the types of market-indicator revisions that drive mark-to-market price decreases — essentially fear

⁴⁹ *Id.* at *1.

⁵⁰ *Id.*

⁵¹ *Id.* at *4. Numerous other RICO cases are to the same effect. See, e.g., *Lincoln House, Inc. v. Dupre*, 903 F.2d 845, 847 (1st Cir. 1990) (fraud claim under RICO was not ripe for adjudication because "alleged injury [wa]s clearly contingent on events that may not occur as anticipated or may not occur at all."); *Cruden*, 957 F.2d at 978 ("defendants' RICO violations did not give rise to a claim for relief under § 1964(c) until those violations resulted in an injury to plaintiffs' business or property — when Computer and International defaulted on their principal and/or interest payments"); *Harbinger Capital Partners Master Fund I, Ltd.*, 2008 WL 3925175 at * 4-5 (S.D.N.Y. Aug. 26, 2008) (damages claims of holders of bank debt were unripe because ongoing bankruptcy proceedings may allow for recovery that would offset alleged losses); *Anitora Travel, Inc. v. Lopian*, 677 F.Supp. 209, 216 (S.D.N.Y. 1988) ("a party must actually have been injured — that is, subject to injury or inevitably to be subject to a future injury — in order to have standing to bring a civil RICO claim. Mere speculation that some injury might occur . . . is insufficient to state a civil RICO claim").

⁵² See *Impress Communications v. Unumprovident Corp.*, 335 F. Supp. 2d 1053, 1061 (C.D. Cal 2003) ("In short, whether [p]laintiffs have alleged fraudulent inducement or breach of contract, they have not established injury under Article III. Plaintiffs have never made a claim for benefits that [d]efendants have failed to honor. Thus, [d]efendants have not failed to perform, and there can be no breach of contract. Nor have [p]laintiffs suffered injury that could support a claim of fraud."); *Doe v. Blue Cross Blue Shield, of Maryland*, 173 F. Supp. 2d 398, 407 (D.Md. 2001) (dismissing fraud claim against insurer because "promisee does not suffer an injury necessary to trigger a fraud claim based on fraudulent inducement unless and until the promisor actually breaches the contract by failing to perform"); see also *Horvath v. Keystone Health Plan East, Inc.*, 333 F.3d 450, 456-57 (3d Cir. 2003) (denying plaintiff's standing to pursue restitution and disgorgement claims where benefits were not diminished or compromised by defendant's management of healthcare plan and no economic harm had been suffered).

⁵³ *Impress Communications*, 335 F. Supp. 2d at 1059 (allegation that defendant's administration of disability insurance plan might result in denial of future benefits was "purely speculative" and insufficient to confer Article III standing); *Doe*, 173 F. Supp. 2d at 406-07 (rejecting theory that present value of insurance policy was diminished because insurer may at some indefinite point in the future deny benefits based upon a restrictive reading of the policy).

⁵⁴ See *Berneir v Raymark Indus, Inc.*, 516 A2d 534, 543 (Me 1986) (under "generally applicable principles of tort law . . . a judicially recognizable claim does not arise until there has been a manifestation of physical injury to a person, sufficient to cause him actual loss, damage, or suffering"); *Temple-Inland Prods Corp v Carter*, 993 SW2d 88, 91-95 (Tex 1999) (damages for fear of future asbestos-related disease are not recoverable absent a present bodily injury); *Metro-North Commuter R.R. Co. v. Buckley*, 521 U.S. 424, 429 (1997); *Schweitzer v. Consolidated Rail Corp.*, 758 F.2d 936, 942 (3d Cir. 1985); *Gideon v. Johns-Manville Sales Corp.*, 761 F.2d 1129, 1136 (5th Cir. 1985).

of the results of current or future economic conditions — ought not be a basis for '33 Act claims.

There is yet another aspect of the ripeness issue that may be unique to the ongoing financial crisis: the possibility that further legislative action and policy choices (beyond the Stabilization Act, discussed above) may ameliorate some or all of the bases for fears that defaults and foreclosures will increase. For example, in late July 2008, Congress passed and the President signed into law the American Housing Rescue and Foreclosure Prevention Act,⁵⁵ which aims, through a variety of mechanisms, to help borrowers who are at risk of defaulting on their residential mortgages by allowing them to refinance with a loan guarantee from the government. Moreover, as of this writing, it is unclear what policy steps the Obama administration may take to address the current economic situation. To the extent that government action, whether at the federal or state level, reduces foreclosure rates or causes homes to retain or even increase in value, the collateral underlying many mortgage-backed securities may be more valuable. For example, one suggestion has been to have the government buy the underlying loans and renegotiate them with the borrowers; the argument is that increasing the values of the underlying loans will cause mortgage-backed securities based on those loans to increase in value.⁵⁶ Ideas like this would have a significant impact on the quantum of losses, if any, that might be suffered by holders of some MBS tranches. At the very least, such events (if they come to pass) will have to be reflected in valuations of MBS portfolios, just as markets often “price in” views regarding anticipated monetary policies.

Accordingly, defendants in pending or future securities cases brought by MBS purchasers might consider whether the legal principles articulated in tort ripeness cases can be extended to '33 Act claims. If they can, MBS purchasers who continue to be paid the full amount of any principal and interest payments due to them may have little choice but to “wait and see” whether feared, modeled, or projected losses on their MBS portfolios come to fruition (*i.e.*, become “clear and definite”) before being able to state claims under the securities laws.⁵⁷ This is especially true where, as here, intervening events such as legislative or executive action directed at curbing mortgage default rates, changes in prevailing interest rates, or other macroeconomic events (domestic or global) could drastically alter the future payment outlook for many mortgage-backed securities.

CONCLUSION

Assessing whether MBS purchasers who continue to be paid in full have suffered loss for the purposes of the securities laws, and the '33 Act in particular, will likely present thorny questions for litigants and the courts. Ultimately, application of the securities laws when “market” prices are absent may be deeply problematic. In the first instance, courts may need to grapple with whether (and if so, how) it makes sense to apply the '33 Act to securities that are not publicly traded and whose value is not defined by easily ascertainable public sale prices.

As discussed above, an MBS is in essence a contractual interest in a share of the income stream from the mortgages collateralizing the security, and this

⁵⁵ H.R. 3221.

⁵⁶ See Frank Partnoy, *Buy the Loans*, NEW YORK TIMES [op ed] (Sept. 26, 2008). At the same time, the legality of large-scale loan modifications to prevent defaults on troubled loans is itself an issue that may be decided by the courts. See *Greenwich Financial Svcs. Distressed Mortgage Fund 3, LLC et ano. v. Countrywide Fin. Corp.*, Index No. 650474/2008 (Sup. Ct. N.Y. County, filed Dec. 1, 2008) (seeking classwide declaration that any modified loans must be repurchased). Other broad economic initiatives aimed at expanding access to consumer credit may also impact the ability of borrowers to make timely mortgage payments and avoid foreclosure. See, e.g., Jon Hilsenrath and Deborah Solomon, *Mortgage Rates Fall as U.S. Expands Rescue – Government Vows \$800 Billion for Credit Markets in Fresh Salvo on Recession; Could Aid Students, Car Buyers, Small Businesses*, THE WALL STREET JOURNAL (Nov. 26, 2008).

⁵⁷ Plaintiffs faced with ripeness challenges will likely be concerned with the applicable statute of limitations (two years from discovery of the violation or a maximum of five years from the violation, as amended by the Sarbanes-Oxley Act), which could potentially expire before the extent of actual MBS losses, if any, are determined. Although this topic is beyond the scope of this article, the constitutional requirement that a federal court may only exercise subject matter jurisdiction over a claim that is ripe for adjudication cannot be relaxed to accommodate a statutory limitations period (which was presumably enacted with the constitutional restrictions in mind). Assuming that the claims of some MBS purchasers are deemed to have not ripened within the statute of limitations period, such claims may arguably be lost. See *MSI Pillars, Ltd. v. City Commission of Springfield, Ohio*, 2008 WL 4449273 at *3 (S.D. Ohio Sept. 30, 2008) (federal court may not create exception to ripeness doctrine in order to prevent statute of limitations from running).

contractual interest is fundamentally different from the interest an investor has in an equity security or even many corporate bonds. Accordingly, the key question is whether it makes sense to allow a party that is still getting exactly what it paid for under a contract to sue under the securities laws because of a change in the risks associated with the likelihood of future contractual performance. Indeed, as with any contract suit, it may well be that an MBS purchaser suffers a “loss” only when there has been a failure to perform (*i.e.*, by failing to make the requisite payments of principal and interest) and that the consideration one might receive from a hypothetical third party for selling or assigning one’s contractual rights is irrelevant to whether a claim can be pleaded under the securities laws.■

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