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FEDERAL COURT DISMISSES MORTGAGE-BACKED SECURITIES INVESTORS' SECTION 11 CLAIM FOR LACK OF COGNIZABLE INJURY

In a recent decision with significant implications for issuers and underwriters of mortgage-backed securities—and potentially other forms of asset-backed securities—Judge Miriam G. Cedarbaum of the United States District Court for the Southern District of New York dismissed a claim under Section 11 of the Securities Act of 1933 (the "'33 Act") because the plaintiff purchasers of mortgage-backed securities ("MBS") failed to allege any diminution of cash flow payments arising from the MBS they had purchased, and thus could not show any cognizable injury. The decision, *NECA-IBEW Health and Welfare Fund v. Goldman, Sachs & Co., et al.*,[1] embraces arguments first raised in an article published by Milbank in January 2009 regarding the viability of damages claims in some MBS cases.[2]

NECA-IBEW Health & Welfare Fund ("NECA") purchased MBS certificates (the "Certificates") in two offerings underwritten by Goldman, Sachs & Co. ("Goldman"). As is standard in MBS offerings, the Certificates entitled NECA only to monthly distributions of principal and interest flowing from the underlying loans.[3] The Prospectus Supplement also contained an express statement advising investors that the Certificates may not be liquid:

> Your Investment May Not Be Liquid. The underwriter intends to make a secondary market in the offered certificates, but it will have no obligation to do so. We cannot assure you that such a secondary market will develop or, if it develops, that it will continue. Consequently, you may not be able to sell your certificates readily or at prices that will enable you to realize your desired yield.[4]

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1 *NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co. et al.*, No. 08-cv-10783, 2010 WL 4054149 (S.D.N.Y. October 15, 2010) ("NECA-IBEW").

2 Douglas W. Henkin & Tawfiq S. Rangwala, Subprime Litigation Against Issuers and Underwriters of Mortgage-Backed Securities – Where are the Losses?, THE REVIEW OF BANKING AND FINANCIAL SERVICES, v. 25 no. 1 (January 2009); *see also* updated version, Douglas W. Henkin & Tawfiq S. Rangwala, Subprime Litigation: Where Are the Actual Losses? An Update, JOURNAL OF REINSURANCE, v. 17 no. 1, (Winter 2010).

3 *NECA-IBEW*, 2010 WL 4054149, at *1.

4 *Id.*

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NECA sued Goldman, certain Goldman affiliates, and three individuals under Sections 11, 12(a)(2), and 15 of '33 Act, alleging that the offering documents for the Certificates contained false and misleading information concerning the risks associated with the underlying mortgages. NECA continued to hold the Certificates and did not allege—in its initial or amended complaints—that it had failed to receive any distributions to which it was entitled under the terms of the Certificates. Nevertheless, in its Third Amended Complaint, NECA asserted that it had suffered compensable losses because a secondary market for securities "like" the Certificates existed since at least 2007, but "the value of the Certificates has diminished greatly since their original offering, as has the price at which members of the Class can dispose of them in the secondary market for these Certificates."[5] NECA further alleged that the value of the Certificates declined because of diminished expectations concerning future cash flows, and that this exposed NECA to "much more risk than the Offering Documents represented with respect to both the timing and absolute cash flow to be received."[6]

The defendants moved to dismiss the case in its entirety, arguing, among other things, that NECA had not suffered a cognizable injury insofar as it failed to allege any shortfall in the payment of cash flows to which it was entitled. Specifically, the defendants contended that the purported reduction in the "value" of the Certificates misconstrued the nature of MBS, because losses are suffered only when investors do not receive the cash-flow payments owed to them. The defendants further argued that the existence of a secondary market was irrelevant because the offering documents provided to NECA warned that it should not expect to be able to sell the Certificates.

Judge Cedarbaum denied the motion to dismiss the Section 12 and 15 claims from the bench, but reserved decision on the question of whether the Section 11 claim should be dismissed for failure to state a cognizable injury.[7] Section 11 permits claims by securities purchasers against issuers and underwriters where false or misleading information is included in a registration statement. Although Section 11 does not require a plaintiff to plead damages, the Court found that a plaintiff nevertheless "fails to state a claim if the allegations of the complaint do not support any conceivable statutory damages."[8]

In a decision issued on October 15, 2010, the Court held that NECA failed to state a claim for cognizable injury under Section 11, turning in large part on the fact that the Certificates were issued with an express warning that they might not be resalable. Judge Cedarbaum reasoned that NECA's knowledge that the Certificates might be illiquid meant that "it may not allege an injury based on the hypothetical price of the Certificates on a secondary market at the time of suit."[9] The Court also rejected NECA's claims regarding the increased risks it faced as a result of the declining value of the Certificates, noting that "Section 11 does not permit recovery for increased risk. Instead, to allege injury cognizable under Section 11, NECA must allege the actual failure to receive payments due under the Certificates."[10] Because NECA had not done so, Judge Cedarbaum dismissed the Section 11 claim.

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5 *Id.* at *3.

6 *Id.* at *4.

7 *Id.* at *1.

8 *Id.* at *2 (citation omitted).

9 *Id.* at *3.

10 *Id.* at *4.

Milbank's Articles and Practical Considerations

As noted above, the arguments made by the defendants and adopted by the Court in *NECA-IBEW* were first addressed in depth in an article published by Milbank in January 2009.[11] The *NECA-IBEW* decision appears to be the first reported case dismissing a '33 Act claim based on those arguments.

In these articles, Milbank explained that an MBS is a contractual interest in a share of the income stream from the mortgages collateralizing the security, and this contractual interest is fundamentally different from the interest an investor has in an equity security or even many corporate bonds. MBS are not traded on exchanges, and their inherent value is arguably not the price at which they can be sold, but rather the yield or income stream that they generate. For this reason, MBS offering documents generally limit an investor's bargained-for entitlement to anticipated principal and interest payments. If these amounts continue to be paid and there is no default, Milbank predicted that MBS purchasers would not be able to show losses cognizable under the securities laws merely because of an alleged change in the risks associated with the likelihood of continued future payments.

Judge Cedarbaum appears to have accepted these arguments, particularly in light of the caution in the offering documents in *NECA-IBEW* that investors should not expect to be able to sell the Certificates. Indeed, as pointed out in the Milbank articles, the "illiquidity disclosures" contained in almost all MBS offering documents may make it difficult for purchasers to credibly argue that they sustained losses based on a decline in the "market value" of a particular security. Because there can be no claimed expectation that MBS issued with such disclaimers could be sold on the open market or that such a market even exists, the "market value" of any particular MBS is seemingly irrelevant to whether a purchaser has suffered a cognizable loss under the securities laws.

Since Milbank's articles were published, defendants in several Section 11 and 12 cases, including *NECA-IBEW*, have aggressively argued that MBS purchasers who continue to be paid the full amount of principal and interest payments due to them have not suffered a legally cognizable injury.[12] Some such cases are still pending. It remains to be seen whether other courts will follow suit and dismiss Section 11 claims brought by MBS purchasers who continue to be paid in full, particularly in the face of clear disclaimers regarding "liquidity."[13] In any event, issuers or underwriters in '33 Act subprime cases and other cases relating to illiquid bonds with similar features and disclaimers should consider whether plaintiffs have received all the cash flows promised by the offering documents for a given security (*i.e.*, whether there have been any payment defaults for the securities at issue). If so, under the reasoning adopted in *NECA-IBEW*, such actions may be subject to dismissal notwithstanding any allegations regarding decreases in the "market value" of the securities.

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11 An updated version of the article was published in February 2010; *see supra* note 2.

12 *See, e.g., Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp. et al.*, No. 08-cv-10446 (D. Mass); *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc., et al.*, No. 08-cv-05653 (S.D.N.Y.); *Tsereteli and Vaszurele Ltd. v. Residential Asset Securitization Trust 2006-A8 et al.*, No. 08-cv-10637 (S.D.N.Y).

13 One court faced with facts similar to NECA-IBEW declined to dismiss Section 11 claims where plaintiffs "may have purchased the Certificates expecting to sell them." *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc, et al.*, No. 08-cv-05653, 2010 WL 1473299 at * 5 (S.D.N.Y. March 29, 2010). There, the Court rejected the defendants' argument that cognizable losses could only be proven by an MBS purchaser based on a impairment of cash flow, and found plaintiffs' allegations of a deterioration of the "market value" of their MBS holdings sufficient to state a securities fraud claim. *Id.* The Court, however, did not discuss whether the offering documents for the securities in that case disclaimed the existence of a secondary market, and, instead, presumed that the plaintiffs may have validly intended to turn a profit by reselling. In *NECA-IBEW*, Judge Cedarbaum distinguished the decision in *New Jersey Carpenters* on that basis.

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