Securities Class Actions Against Financial Institutions

Law360, New York (October 15, 2008) -- As the devastation wrought by the ever-widening subprime and financial markets maelstrom has spread throughout the world, the outlook for United States financial institutions continues to progress from bad to worse.

In a three-month span, nine American banks -- including the nation’s former largest savings and loan, Washington Mutual -- have been closed by regulators.[1]

In the year, the Federal Deposit Insurance Corporation (FDIC) has shut down thirteen banks, and the agency recently invoked its authority to force a sale of financial services giant Wachovia Corporation.

With second quarter 2008 bank profits down 87 percent from the same quarter last year and 117 more banks and thrifts on the FDIC’s “Problem List” of at-risk institutions, many more bank failures are likely to follow.[2]

Blue-chip Wall Street investment banks are disappearing at an astonishing pace as well. On Sep. 15, 158-year-old Lehman Brothers, crushed under $613 billion in debt, filed for bankruptcy.

The day prior, Merrill Lynch announced that it would be taken over by Bank of America. Both Lehman and Merrill outlasted Bear Stearns, whose stock had traded at $172/share in January 2007 (and at $93/share in February 2008) before the troubled banking house was snapped up by JPMorgan Chase at the fire sale price of $10/share.[3]

Those financial institutions fortunate enough to survive the carnage have seen their market capitalizations pummeled. As of the Oct. 13, 2008 close, the NYSE Financial Sector Index had tumbled 40 percent year-to-date.

Shares of troubled insurance titan American International Group, Inc. (“AIG”), the recent recipient of over $100 billion in federal government aid, had fallen from a 52-week high of almost $70 to close at $2.57. In September, the Federal Reserve announced that
Morgan Stanley (down 81 percent on the year as of Oct. 13, 2008) and Goldman Sachs (down 57 percent over the same period), the last two remaining pure Wall Street investment banks, would become bank holding companies in order to gain access to the Fed’s emergency lending facilities.[4]

Morgan Stanley is hopeful that a recent $9 billion preferred stock investment by Mitsubishi UFJ Financial will inoculate it from the plague.[5]

Even before the breathtaking market collapse in October, the credit crisis had already spawned a torrent of shareholder litigation. Over half of the 110 securities class action lawsuits filed during the first six months of 2008 involved allegations relating to the subprime fallout and ensuing credit crunch.[6]

As the market pain continues and the government bailout ramps up, securities class action litigation against finance sector companies and their directors and officers is likely to increase exponentially. This article provides an overview of subprime-related securities claims under the federal securities laws that have been asserted to date and key legal defenses against such claims.

Financial Crisis Securities Class Action Claims

Given the role that widespread relaxation of mortgage lending standards played in fueling the current crisis, claims alleging misrepresentations and omissions regarding lending practices are driving much of the recent spate of securities litigation against financial institutions.

In Lipetz v. Wachovia Corp., for example, shareholder plaintiffs accused the troubled bank of representing that it had selective underwriting and loan origination practices while concealing that it was (a) issuing ever increasing quantities of risky “Pick-A-Payment” loans that allowed borrowers to choose how much to pay each month and roll any interest shortfall into the outstanding balance, and (b) cutting back on diligence to verify that loan applicants’ incomes and assets were commensurate with the loans the borrowers sought.[7]

According to the complaint, Wachovia and two of its top executives knew that the increasing numbers of optional payment loans issued to borrowers whose ability to pay had not been sufficiently vetted “would become toxic” for Wachovia, but concealed this information from investors and instead touted the bank’s conservative underwriting standards.

In another noteworthy case, former Washington Mutual (“WaMu”) executives are defending allegations that the defunct savings and loan pressured real estate appraisers to inflate appraisals of home values obtained in connection with loan applications in order to make loans originated by WaMu appear less risky than they in fact were.[8]
The plaintiffs allege that the overstated appraisals created a false appearance that WaMu’s loan underwriting standards were stringent and that its portfolio of loans were in effect guaranteed against borrower default by the values of the underlying properties.

Underwriting decisions by entities in the business of insuring loans pooled and securitized for resale to secondary market investors helped spread the reach of the subprime crisis, and many third-party guarantors have also become targets of shareholder litigation.

Ambac Financial Group Inc. has been sued by investors claiming that the company clandestinely lowered underwriting standards in order to boost earnings on insurance contracts guaranteeing bundles of mortgage-backed securities and so-called “credit default swaps,” insurance-like agreements guaranteeing other classes of asset-backed securities.[9]

According to the complaint, Ambac characterized its underwriting standards as “strict” and its exposure to credit losses as “small” even as the company was allegedly guaranteeing increasing volumes of riskier financial instruments.

Claims alleging fraudulent accounting of various stripes have also been prevalent. A number of financial institutions whose assets -- from loans held for investment or sale, to derivative financial instruments like mortgage-backed securities and collateralized debt obligations -- have fallen precipitously in value in the wake of rising loan defaults, have been accused of deliberately overstating asset values in previously published financial reports.

Shareholders have sued Texas-based Franklin Bank Corp., alleging that the bank failed to charge off “uncollectible” loans and record appropriate write-downs on foreclosed real estate the bank owned and loans it held for investment.[10]

Financial giant Citigroup, Inc. has also been beset by shareholder complaints claiming that the company overstated the carrying values of mortgage and other debt securities in which it was heavily invested, despite alleged knowledge that the assets had become impaired.[11]

Allegations of understated loan loss reserves and inadequate internal controls over financial accounting are included in many of the recently filed shareholder suits.[12]

The numerous recent equity offerings through which many troubled financial institutions have sought to raise capital have been another fertile source of claims. Purchasers of the newly-minted securities have sued alleging misstatements or omissions of critical information in connection with such offerings.

Not only the stock issuers, but also offering underwriters -- typically a handful of top Wall Street banks -- have been targeted in these offering-related claims. Merrill Lynch,
JPMorgan, Goldman Sachs, and many others are presently defending investor claims arising from their roles as underwriters in recent equity offerings.[13]

A frequent claim in offering-related cases is that the offeror’s management misled investors into believing that the offering proceeds would satisfy the company’s capital needs, when in fact the company's financial position was far more tenuous.[14]

Heads of institutions that tried and failed to raise capital through back channels rather than public offerings are likely to face similar claims that they misled the market with rosy statements about the companies’ financial health even as the companies verged on collapse.

Lehman Brothers CEO Richard S. Fuld, Jr. was recently grilled by a Congressional panel comprised of members of the House Committee on Oversight and Government Reform on precisely that topic.[15]

*How Much Traction Will Financial Crisis Securities Claims Gain?*

What degree of success plaintiffs will enjoy in the many subprime-related securities fraud class action lawsuits filed during the last two years remains in question. To date, only a few opinions have been issued evaluating the legal sufficiency of complaints alleging subprime-related claims. Both defendants and plaintiffs have scored some early victories, although on the whole, defendants appear to be having the better of the fight thus far.

In In re Novastar Fin. Inc. Sec. Litig., No. 07-0139-cv-W-ODS, 2008 WL 2354367 (W.D. Mo. June 4, 2008), a Missouri district court dismissed claims that the now bankrupt mortgage lender defrauded investors by concealing alleged defects in internal controls and diminished loan underwriting standards and failing to properly account for expected loan losses.

The court concluded that plaintiffs failed to allege false statements or omissions with the particularity required by the Private Securities Litigation Reform Act of 1995 (the “Reform Act”) and failed to raise a strong inference of defendants’ scienter.

Significantly, the court concluded that allegations that the company’s loan loss reserves ultimately proved inadequate, at most, might state a claim for managerial incompetence, but failed to state a claim of securities fraud.

The court also found that allegations that the company “may have changed or even weakened its internal controls or underwriting standards ... did not mean that those controls or standards were not ‘strong’ or ‘effective’ as described in the Company’s public statements.” Plaintiffs were denied an opportunity to amend their complaint and have appealed the dismissal.
A California district court issued another noteworthy dismissal of claims against a defunct mortgage banker in Tripp v. IndyMac Financial, Inc., No. CV07-1635-GW(VBKx) 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007). Plaintiffs in that case claimed that defendants falsely portrayed IndyMac’s internal controls as strong and deceived investors into believing that the company would remain financially stable despite allegedly slack loan underwriting guidelines that exposed the company to massive losses.

Although the complaint discussed the alleged “beliefs and opinions of certain confidential witnesses with respect to the allegedly problematic areas of IndyMac’s operations,” the court found that plaintiffs “failed to allege that the individual Defendants shared these beliefs and opinions or even that they were aware of them and found them to be reliable and justified.” Accordingly, the court concluded that plaintiffs had not adequately alleged the element of scienter.

The court noted further that the fact that many of the defendants had retained sizeable holdings of IndyMac stock was a factor tending to undermine any inference of their scienter.

As courts address the legal sufficiency of the recent barrage of subprime-related securities fraud complaints, the devil will always be in the details. Earlier this year in Atlas v. Accredited Home Lenders Holding Co., 556 F. Supp. 2d 1142, 1156 (S.D. Cal. 2008), another California district court denied a motion to dismiss claims accusing executives of deceiving investors by directing employees to disregard the company’s stated lending policies and manipulating loan loss reserves to present a misleading appearance of the company’s profitability.

The court held that the complaint’s allegations regarding certain defendants’ direct participation in encouraging deviations from lending guidelines and review of specific documents and other internal sources of information that contradicted challenged representations about the company’s lending practices, sufficed to raise the required strong inference of scienter.

Plaintiffs will also take some measure of comfort in the recent decision denying defendants’ motion to dismiss in In re Countrywide Fin. Corp. Deriv. Litig., 554 F. Supp. 2d 1044 (C.D. Cal. 2008). Although Countrywide is a shareholder derivative action, the complaint includes claims under the federal securities laws.

The court concluded that specific factual allegations of defendant involvement in promoting widespread deviation from underwriting policies, together with $850 million in insider stock sales, including many trades that the court found suspicious in timing and amount, raised a strong inference of scienter.

Because courts are just beginning to grapple with the first wave of subprime-related securities fraud claims, it is too early to gauge the overall impact the litigation will have.
Several factors, however, suggest that financial institutions and their directors and officers will be well-positioned to defend these lawsuits.

By and large, the last widespread crisis affecting financial institutions -- the rash of savings and loan failures during the late 1980s and early 1990s -- did not yield a windfall for private securities class action plaintiffs.[16]

Since then, of course, Congress has enacted the Reform Act, imposing heightened pleading standards for securities fraud claims, including requirements that plaintiffs must allege particular facts explaining how specific challenged statements misrepresented or omitted material facts required to be disclosed and raising a strong inference that defendants acted with scienter.

And recently, the United States Supreme Court has issued a series of opinions construing the Reform Act's pleading requirements that have further increased the difficulty of stating a securities fraud claim. In Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005), the Court confirmed that plaintiffs must plead a causal connection between the alleged fraud and their claimed losses. In Bell Atlantic Corp. v. Twombly, 127 S. Ct. 1955, 1965 (2007), the Court that held that even Rule 8 notice pleading requires plaintiffs to allege more than a “conceivable” basis for their claims; they must plead facts "enough to raise a right to relief above the speculative level."

A few months later, in Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2504 (2007), the Court clarified that the Reform Act requires plaintiffs to allege facts raising an inference of scienter that is “cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”

Finally, in Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 128 S. Ct. 761 (2008), the Court articulated limits on the extent to which the conduct of third-party actors accused of participating in or facilitating allegedly misleading statements can be successfully challenged under the securities laws.

Many of the current subprime-related securities fraud claims filed to date appear to fall short of the Reform Act’s particularity requirements. Merely alleging that financial institutions made what in hindsight have been revealed as unsuccessful or even misguided decisions regarding to whom to extend credit or in which classes of asset-backed securities to invest or insure does not state a claim of securities fraud.

It is well settled that the federal securities laws were not enacted to police alleged corporate mismanagement. Thus, complaints that rail against “risky” underwriting decisions without pleading particular facts explaining how specific material information regarding such decisions was misrepresented or concealed should be dismissed.[17]

In addition, plaintiffs claiming fraudulent understatement of loan loss reserves will need to allege more than simply that stated reserves proved insufficient in hindsight. The
setting of loan loss reserves is a matter of business judgment, and the securities laws do not require that such judgments ultimately prove correct.

Furthermore, reserves inherently involve future-looking projections that can only be validated well after they are made, and therefore enjoy statutory protections that, in most cases, make it difficult if not impossible for a plaintiff to state a claim for securities fraud based on merely on allegedly "faulty" or "inadequate" reserves.[18]

The scienter hurdle may also prove particularly problematic for plaintiffs in subprime-related lawsuits. To begin with, the scope and severity of the subprime fallout tend to undercut any inference of fraudulent motive. Was every institution that has suffered losses stemming from the legions of bad loans that have paralyzed financial markets run by fraudsters?

And if institutions’ subprime loans, investments in securities backed by such loans, and/or commitments to guarantee such securities were so clearly doomed to fail as plaintiffs contend, why did so many institutions embrace each with such enthusiasm?

In addition, many executives who are now defending claims that they defrauded investors about their companies’ subprime-related activities have themselves incurred heavy losses in their own holdings of company stock as share prices have plummeted, negating scienter.

To survive dismissal, securities fraud plaintiffs will have to plead detailed factual allegations supporting inferences of deliberate or severely reckless conduct that are at least as compelling as the non-fraudulent inferences arising from the above factors and other case-specific circumstances.

The recent In re American Express Co. Sec. Litig., 02 Civ. 5533(WHP), 2008 WL 4501928 (S.D.N.Y. Sept. 26, 2008) decision may be a harbinger of the difficulties plaintiffs will face in successfully pleading subprime-related securities fraud claims against financial institutions.

Although the events underlying the American Express case predated the present subprime crisis, the case involved allegations that are closely parallel to many that have been advanced in the recent subprime-related actions.

The plaintiffs claimed that defendants concealed risks associated with the company’s investment in high-yield debt securities, including below-investment grade bonds and CDOs, failed to timely and accurately account for losses on those investments, and failed to disclose inadequacies in the company’s risk management controls.

The court dismissed the complaint, finding that plaintiffs had not adequately alleged scienter.
Significantly, the court rejected plaintiff’s contention that they had adequately alleged that defendants were at least “reckless” in failing to disclose risks associated with the company’s high-yield debt portfolio and to correct public statements by the company that plaintiffs claimed misrepresented the risks.

According to the court, plaintiff’s allegations did “no more than state in conclusory fashion what Defendants should have known.” Such allegations, the court concluded, “are not entitled to any weight.”

The court also held that plaintiff’s confidential witness allegations failed to specifically tie any of the individual defendants to knowledge of inaccurate accounting or inadequacies in the company’s risk control policies: “None of the confidential sources specifically states that any Individual Defendants had information or access to information indicating that Amex was not properly valuing the High Yield Debt, that is risk control policies were inadequate, that Amex was violating GAAP, or that contradicted the Company’s statements.”

American Express is potentially significant not just because of the close factual parallels between the allegations at issue in that case and those that have been leveled against so many financial institutions in the recent onslaught of subprime-related claims, but also because the decision was issued by the Southern District of New York, where a large percentage of the recently-filed subprime cases are also pending.

Together with the Novastar and IndyMac decisions, American Express suggests that plaintiffs may struggle to plead actionable securities fraud claims based on subprime-related losses.

**Conclusion**

Notwithstanding the myriad challenges that shareholder plaintiffs will face in seeking to maintain subprime-related securities class actions against financial institutions and their directors and officers, the severity of the present economic chaos virtually assures that there will be no shortage of fodder for such litigation.

Related derivative litigation, ERISA class action lawsuits, and actions by other parties, including government agencies like the FDIC, bankruptcy trustees and uninsured depositors will likely be prevalent as well. The coming years should prove formative ones for each type of litigation.

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[16] DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990) (affirming dismissal of securities fraud claims arising out of financially distressed bank); Adams v. Resolution Trust Corp., 927 F.2d 348 (8th Cir. 1991) (affirming dismissal of securities and common law fraud claims arising out of savings and loan failure); Resolution Trust Corp. v. Latham & Watkins, 909 F. Supp. 923 (S.D.N.Y. 1995) (affirming dismissal of securities fraud claims arising out of savings and loan failure). But see Cenwick Fund v. Castle, No. 90 Civ. 5608, 1993 WL 88243 (denying plaintiff’s motion for summary judgment, but allowing securities fraud claims to proceed to trial); In re American Continental Corp./Lincoln Savings And Loan Sec. Litig., 794 F. Supp. 1424 (D. Ariz. 1992) (denying motion to dismiss securities fraud claims arising out of Lincoln Savings and Loan failure).

[17] In re Novastar Fin., Inc. Sec. Litig., No. 07-0139-CV-W-ODS, 2008 WL 2354367, at *3 (W.D. Mo. June 4, 2008) (dismissing securities fraud claims that, among other things, challenged disclosures regarding underwriting guidelines); In re Impac Mortgage Holdings, Inc. Sec. Litig., 554 F. Supp. 2d 1083, 1095 (dismissing securities fraud claims that, among other things, challenged disclosures regarding “internal controls and operations”); see also Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (allegations of arguable mismanagement do not state claim under federal securities laws).