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Outcome Uncertain for Defendants After Round One in Subprime RMBS Investor Litigation

On April 22, 2008 Judge Elizabeth Kovachevich of the U.S. District Court for the Middle District of Florida rendered one of the first decisions in subprime backed securities litigation brought against an issuer, trustee and credit enhancement provider. Shortly thereafter, Judge Theresa L. Springmann of the U.S. District Court for the Northern District of Indiana followed with an opinion in a case brought against the same defendants arising out of the same securitization by a different investor. These two early decisions are a mixed result for mortgage industry defendants, leaving the outcome of other cases uncertain.

Over the past two years, subprime mortgage related litigation has swept the United States. The bulk of this litigation has been filed by borrowers, and has focused on alleged violations of the Truth in Lending Act, state consumer fraud statutes, and other consumer protection statutes such as the Real Estate Settlement Procedures Act, the Equal Credit Opportunities Act, and others. As the effects of the flattening or decline in home values combined with rising interest rates on adjustable rate mortgages causes foreclosures to spike, investors in residential mortgage backed securities have now begun to feel the effects. Naturally, litigation has resulted.

Investor-driven litigation is typically different from borrower-driven litigation. Investors' claims are based upon securities law for the most part, and generally allege fraud or other deception in the marketing of RMBS securities.

One of the earliest sets of cases involving allegations by investors that they were duped into investing in subprime mortgage backed securities was filed against Credit Suisse First Boston (as issuer), Bank of New York (as Trustee for the RMBS trust) and Triad Guaranty Insurance Corporation (as the mortgage insurer for the RMBS trust). In *Bankers Life Insurance Co. v. Credit Suisse First Boston Corp., et al.*, the plaintiff, Bankers Life Insurance Co., purchased mortgage-backed pass-through

certificates on the secondary market. The certificates represented ownership of a trust that owned a pool of subprime residential mortgages on properties located in several states. CSFB sold the certificates on the open market based on information set forth in a prospectus.

Shortly after the *Bankers Life* case was filed, other investors in the same securities filed identical cases in federal courts in Indiana (AmericanTrust Federal Savings Bank and First Bank of Richmond) and in Illinois (Sterling Federal Savings Bank).

Plaintiffs in these cases alleged that CSFB committed fraud, negligent misrepresentation and breached its fiduciary duty to investors by issuing a prospectus that misrepresented the condition of the subprime mortgages in the pool. Plaintiffs alleged that the defendants knew or should have known that the prospectus was materially misleading, and that certain warranties and representations in the related pooling and servicing agreement should have been either complied with or cured.

Not satisfied to sue those involved with the marketing of the securities themselves, the plaintiffs in these cases expanded their allegations to include a third-party, Triad Guaranty Insurance Corporation. Triad had supplied a "credit enhancement" for the trust in the form of mortgage insurance. Plaintiffs alleged that they had relied upon this credit enhancement in choosing to invest, but that the insurance Triad supplied was illusory. Plaintiffs alleged that Triad improperly denied numerous claims filed by the Trust on the basis that the loans in question had been tainted by fraud.

In the first decision on a motion to dismiss in this series of cases, the Middle District of Florida delivered a mixed result. Significantly, the court dismissed all claims asserting that any of the defendants committed fraud on investors. Claims against CSFB and related defendants based on common law fraud and breach of contract were dismissed, as well as a

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breach of contract claim against BONY. The claim against Triad was dismissed for lack of standing given that the Plaintiff was not a party to the insurance contract. A civil conspiracy claim against the CSFB defendants and BONY was also dismissed.

However, Bankers Life was given leave to file an amended complaint. In addition, the court found that the complaint asserted plausible claims for negligent misrepresentation, breach of fiduciary duty, and breach of contract against the CSFB defendants and BONY. The court determined that Bankers Life asserted sufficient allegations to establish that it reasonably relied on representations in a prospectus issued more than two years before Bankers Life purchased the certificates, that CSFB may have had a duty to update the prospectus, and that statements in the prospectus may have created a fiduciary relationship between CSFB and certificate holders. The court also found that certain contract terms intended to limit the defendants' exposure and liability did not apply given the plaintiff's allegations of bad faith conduct, among other reasons. CSFB and BONY have asked the court to reconsider its decision. In the meantime, Bankers Life has already filed an amended complaint against all of the defendants.

Three weeks later the court in the *AmericanTrust* case rendered a decision granting Triad's motion to dismiss. The court found that AmericanTrust lacked standing to assert claims under the policy of insurance because it was neither a party to the insurance contract or a direct beneficiary. The court went even further, finding that even if AmericanTrust had standing, the complaint failed to allege any facts beyond a purely speculative level to establish that Triad breached any of its contractual obligations. The court has not yet addressed any of the other defendants' motions to dismiss. In addition, motions to dismiss are currently pending in the *First Bank of Richmond* and *Sterling* cases.

The results with regard to CSFB and BONY are thus mixed. For Triad, the result

seems more clear. Investors in RMBS transactions are not likely to be successful in holding third-party credit enhancement providers such as Triad liable for allegedly failing to provide the enhancement the investors thought they would receive. This result is further development of a theme recently advanced by the U.S. Supreme Court in *Stoneridge Investment Partners v. Scientific-Atlanta Inc.*, which dismissed Section 10(b) claims against third-party vendors alleged to have participated in some scheme to defraud on the basis that the plaintiffs could not allege that they relied upon any direct statement from the third-parties. *Stoneridge*, and cases such as the recent decisions in *Bankers Life* and *AmericanTrust*, demonstrate an emerging judicial trend against extending liability to third-party participants in securities transactions.

These cases are important to participants in the mortgage backed securities industry because they are setting the tone for the volume of cases likely to follow. How issues are resolved in this first round of cases will shape how claims are framed in later cases. For Triad and other mortgage insurers, early wins in cases such as *Bankers Life* and *AmericanTrust* are important in limiting potential future exposure.

ABOUT THE AUTHORS

Thomas J. Cunningham is the leader of Locke Lord Bissell & Liddell LLP's Class Actions Practice Group. Mr. Cunningham focuses his practice in the representation of financial institutions and mortgage industry participants in class action and complex litigation. Simon A. Fleischmann is an attorney in the Class Actions Practice Group at Locke Lord Bissell & Liddell where he also represents the firm's financial institution clients in class and complex litigation. Mr. Cunningham and Mr. Fleischmann represent Triad Guaranty Insurance Corporation in the *Bankers Life*, *AmericanTrust*, *First Bank of Richmond* and *Sterling* cases.