Class Action and Related Litigation Arising from the Subprime Crisis

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From 1994 to 2005, the percentage of mortgages in the United States that were subprime more than quadrupled. Many of those mortgages were packaged into mortgage-backed securities. By 2006, mortgage interest rates reached four-year highs while home values plummeted. As a result, approximately 80,000 of those mortgages fell into delinquency, and by mid-2007, dozens of lenders participating in the subprime mortgage business had gone out of business. The resulting subprime lending crisis set off a wave of class action litigation in 2007. Borrowers, investors, and other plaintiffs filed 278 civil lawsuits in federal courts relating to subprime lending in 2007, with 65 percent of those cases filed in the latter half of the year. Many types of cases have arisen out of the subprime lending crisis, including borrower class actions, shareholder class actions, ERISA class actions, and shareholder derivative suits. This article discusses examples of the various types of cases that have been filed.

Borrower Class Actions

In *Andrews v. Chevy Chase,*[1] a Wisconsin couple filed a class
action suit against Chevy Chase Bank, a mortgage lender, for violations of the Truth in Lending Act (TILA), 15 U.S.C. § 1601, and Regulation Z, 12 C.F.R. § 226.20. In 2004, the Andrews received an advertising mailer that offered “Cashflow 5-Year Fixed; Note Interest Rate; 1.95 percent.” Since the interest rate on their current mortgage was 5.75 percent, the Andrews signed with Chevy Chase, only to discover later that the loan actually allowed the interest rate to rise and that the advertised 1.95 percent rate lasted only one month. The rate quickly reached more than 8 percent.

In 2005, the Andrews filed their lawsuit in the Eastern District of Wisconsin, seeking rescission for each class member, as well as compensatory damages and injunctive and other relief. The Andrews defined the class as any person who entered into a mortgage with Chevy Chase since April 20, 2004, where the loan contained a monthly adjustable rate but the disclosure statement contained the word “fixed” or failed to fully disclose the principal, interest, and other charges.

In January 2007, the district court held that Chevy Chase violated TILA in several respects, and extended by three years the time that the aggrieved borrowers had to exercise their right of rescission under the act. Interestingly, on October 17, 2007, the Seventh Circuit apparently agreed in part with the district court’s substantive decision and held that the failure to specify a payment interval is a violation of TILA.[2]

On the issue of rescission for all class members, the district court in *Andrews* observed that, “[t]here is no reason why a plaintiff who alleges that a defendant has violated TILA and caused widespread injuries should not be able to bring a class action. Denial of class action status would reward defendants who may have committed wrongs and leave victims who may have been wronged uncompensated.”[3] Chevy Chase appealed the decision certifying the class, and pursuant to Rule 23(f), the district court stayed the proceedings pending appeal. Both the appeal and the lawsuit remain pending.

Shareholder Class Actions

As with the Merrill Lynch litigation, several lawsuits also have been filed against NovaStar Financial, Inc., a real estate investment trust (REIT) in the Western District of Missouri. One example is *Owens v. NovaStar Fin. Inc.,*[4] a securities fraud class action on behalf of all investors in securities of NovaStar between May 4, 2006, and February 20, 2007, alleging violations of the Securities and Exchange Act of 1934 § 10(b) and Rule 10b-5.

According to the complaint, NovaStar originates, invests in, and services residential nonconforming (subprime) loans. On February 20, 2007, the company announced that its underwriting guidelines for 2006 were “inappropriate” and that it had suffered the loss of more than $14 million for the fourth quarter 2006. The company further announced that it did not expect to make any REIT taxable income for the next four years, that it therefore would not pay dividends, and that it was evaluating whether it would retain REIT status. As a result, the stock dropped more than 30 percent.

The complaint estimated that there were hundreds, if not thousands, of class members owning the more than 24 million shares of stock. The plaintiff alleged that NovaStar reported falsely inflated financial results and misrepresented the quality of its mortgage loan portfolios, among other things. As a result, the plaintiff alleged that NovaStar’s securities traded at artificially inflated or distorted levels.[5] On July 9, 2007, the district court in *Owens* consolidated the case with seven other lawsuits pending against NovaStar and assigned lead plaintiffs and counsel. After

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the case was consolidated, an amended complaint was refiled on October 19, 2007, in *In re 2007 NovaStar Fin.*[6]

In an interesting twist, in a recent decision the district court dismissed the entire lawsuit. Applying the Private Securities Litigation Reform Act (PSLRA), the court determined that the complaint did not satisfy the act's pleading requirements. "Ultimately, Plaintiff fails to identify a single false entry in the Company's financial statements, nor does not he identify the 'truth' that should have been disclosed."[7] The court observed that the complaint "reads more like a cautionary tale from a treatise on business management than a charge of knowing misstatements and concealments. Plaintiff has not stated a claim because companies (and their management) are not expected to be clairvoyant, and bad decisions do not constitute securities fraud." In addition, the court held that the complaint did not present facts creating an inference of scienter, "and this failing constitutes an independent reason to dismiss the case."[8]

ERISA Class Actions

Traditional ERISA class actions, often referred to as "stock concentration" or ERISA "breach of fiduciary duty" cases, concern breaches of fiduciary duties under ERISA relating to 401(k) and Employee Stock Ownership Plan (ESOP) investments in employer stock. Beginning in the summer of 2007 and continuing to the present, traditional ERISA class action claims have been joined by a new subclass of actions relating to the subprime mortgage crisis and the fall of the subprime lending industry. These ERISA stock concentration class actions allege that investment of company stock in plan assets was imprudent based upon the company's involvement in the subprime industry. For these cases, key issues will include what the defendant companies and fiduciaries are alleged to have known or should have known about the risks associated with subprime lending and investing. Those being sued under this theory include subprime mortgage originators, investment banks, and building companies and title agencies. Some of these new cases are discussed below.

Cases Against Subprime Mortgage Originators

In *In re Fremont Gen. Corp. Litig.*,[9] a consolidated class action was filed against Fremont General Corporation on behalf of all participants and beneficiaries of the Fremont Investment Incentive 401(k) Plan and the Fremont ESOP Plan as of January 2005. Fremont was, according to the complaint, the third-largest subprime mortgage lender in the U.S., with about half of its business focused on the subprime mortgage sector. The complaint alleges that Fremont's risky subprime lending practices and poor underwriting standards caused the company to bear the risk of hundreds of millions of dollars in uncollectible loans. Fremont stock, which represented more than 50 percent of the 401(k) Plan's net assets, fell from approximately $25 per share in 2005 to its current trading level (as of June 11, 2008) of $0.07 per share. According to the complaint, investment of Plan assets in company stock was imprudent based on the company's serious mismanagement and improper business practices. A motion to dismiss filed by Fremont, raising issues of a demonstrable link between the alleged misconduct and the harm suffered to the Plan, as well as the duty to disclose nonpublic information regarding the company to Plan participants, was recently denied by the district court on May 29, 2008, allowing the plaintiffs to continue to pursue their claims against Fremont.

Other instances of cases against subprime mortgage originators include *Alvidres v. Countrywide Fin. Corp.*,[10] (on March 17 and 18, 2008, and April 9, 2008, the district court denied various defendants' motions to dismiss, and on April 16, 2008, it granted plaintiffs' motion for class certification) and *Cedarleaf v. Huntington Bancshares, Inc.*,[11] (in addition to claims relating the Huntington's lending practices, plaintiffs claim Huntington exposed them to additional risk by acquiring Sky Financial in 2007, giving Huntington an additional $1.5 billion of subprime exposure and not disclosing the full extent of risk from the acquisition).

Cases Against Investment Banks

Investment banks that invested in mortgage-backed securities have also been impacted by the subprime mortgage crisis as,
beginning in the fall of 2007, they were forced to make downward adjustments in the accounting values of their assets based in the subprime market. As shares of company stock have declined in value due to the subprime crisis, so has the value of their employees' 401(k) Plan assets. The federal courts (particularly in the Southern District of New York) have begun to see filings of ERISA class actions against investment banks based on their investments in the subprime markets.

In *In re Morgan Stanley ERISA Litig.*,[12] plaintiffs claim that Morgan Stanley (and other named defendants) breached their fiduciary duties when they did not take steps to protect investors when ownership of company stock was no longer prudent based on Morgan Stanley's investment in the subprime market, and by not disclosing the risks of investing in Morgan Stanley. Plaintiffs also claim Morgan Stanley directors and officers made reassuring statements in press releases and conference calls even though they anticipated the subprime investment fallout. Morgan Stanley stock, which represented more than 50 percent of the 401(k) Plan's net

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assets, fell from approximately $84 per share at the beginning of 2007 to its current trading level (as of June 11, 2008) of $37.13 per share.

Other instances of cases against investment banks include *Alexander v. Washington Mutual, Inc.*[13] (in which plaintiffs alleged that the directors failed to monitor the performance of co-fiduciaries and publicly made misleading statements to inflate the value of company stock while at the same time selling thousands of their own shares); and *Steven v. Citigroup, Inc.*[14] (in which plaintiffs alleged that Citigroup's conduct was improper, particularly its participation in investment vehicles that were off the balance sheet).

Cases Against Building Companies and Title Agencies

In *In re Beazer Homes USA, Inc. ERISA Litig*.[15], defendant Beazer began reporting record earnings resulting from its strong inventory of homes and expectations of competitive advantages over other building companies in late 2005. Plaintiffs claim Beazer and other defendants breached their fiduciary duties to 401(k) Plan participants of the company by overstating its inventory, engaging in improper subprime lending practices, hiding account irregularities, and downplaying bankruptcy rumors. According to the complaint, this conduct resulted in the significant decline in the price of company stock by 2007, and plaintiffs filed suit alleging Beazer failed to inform Plan participants of potential risks to their investments, which rendered company stock an imprudent choice for the Plan and caused the stock to be artificially inflated. On October 11, 2007, Beazer announced interim findings from an internal investigation and declared it would be necessary for the company to file restated financial statements for the past three years with the SEC. On May 12, 2008, Beazer refiled with the SEC, and on June 11, 2008, the parties entered into a consent order allowing plaintiffs until June 27, 2008, to file a consolidated complaint. Beazer is expected to file a motion to dismiss once the consolidated complaint is filed.

In *In re First Am. Corp. ERISA Litig*.,[16] plaintiffs allege that First American, the nation's largest title insurer, relied heavily on business generated by the subprime mortgage industry. In particular, plaintiffs allege that First American conspired with Washington Mutual to unlawfully inflate real estate appraisals, causing a boost in First American's stock price and profits. At the end of 2006, approximately 35 percent of First American's 401(k) Plan investments were in company stock. Plaintiffs allege that investment of those assets in company stock was imprudent because First American knew, or should have known, of the consequences to the company from its dealings in the failing subprime mortgage market and of the eventual decline of artificially inflated company stock. On May 5, 2008, First American filed a motion to dismiss for failure to state a claim and plaintiffs opposed on June 4, 2008. That motion remains pending.

At the present time, it is too early to know if this trend of subprime class action filings will continue. As the various federal district courts begin to rule on motions to dismiss and other dispositive motions, and as the jurisprudence for these types of claims develops, it will become clearer whether this type of litigation is a flash in the pan with little practical effect, or whether it will result in massive overhaul to corporate policies relating to subprime lending and investments.

Shareholder Derivative Lawsuits

In 2007 and 2008, several lawsuits related to the subprime mortgage crisis were filed against Merrill Lynch in the Southern District of New York, including shareholder derivative actions. For instance, in *Arthur v. O'Neal,*[17] the plaintiff filed a shareholder derivative action, claiming that Merrill Lynch had become one of the largest victims of the crisis, and placing the blame on its former CEO, Stanley O'Neal, as well as other officers and directors. The plaintiff claims that by 2007, Merrill Lynch became the world's leading underwriter of collateralized debt offerings (CDOs), which are essentially mutual funds that buy securities backed by things such as mortgages, auto loans, and corporate bonds. About 40 percent of CDO collateral is residential mortgage-backed securities, secured by risky subprime mortgages.

According to the complaint, O'Neal committed several breaches of his fiduciary duties in his pursuit of CDOs and was ultimately responsible for the company's massive downturn in 2007, causing stocks to fall by $3.80, or 5.7 percent. The plaintiff also claims that the other officers and directors "turned a blind eye" to O'Neal's breaches while some intentionally caused Merrill Lynch to issue financial statements that concealed the dangers of the CDOs. On October 24, 2007, O'Neal announced that Merrill Lynch would write-down more than $8 billion in the value of its CDOs and other investments, and would suffer a $2.2 billion loss in the third quarter of the fiscal year 2007—which, according to the complaint, is the largest quarterly loss in the 93-year history of the company.

In support of the derivative nature of the lawsuit, the plaintiff claims that making a demand to the board of directors would be futile, as they are named defendants. The complaint raises four claims: (1) breach of the fiduciary du-

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ties of care, loyalty, and good faith; (2) corporate waste; (3) abuse of control; and (4) gross mismanagement. The plaintiff seeks, on behalf of Merrill Lynch as the nominal Defendant, damages of $8 billion as well as an order directing the company to take all necessary actions to reform and/or improve corporate governance.

In March 2008, the district court observed that there are 19 lawsuits pending before it against Merrill Lynch: five putative securities class actions, three shareholder derivative actions (including *Arthur*), and 11 ERISA actions. After a hearing, the court consolidated the cases and appointed lead counsel in each of the three categories. In compliance with that order, an amended complaint was filed in the consolidated cases. That lawsuit is still pending.

Conclusion

The subprime mortgage crisis does not appear to be slowing. The number and types of subprime-related class actions and lawsuits are likely to increase as the crisis unfolds. As many of these lawsuits are still in their infancy with no real standard having been set, courts will be on their own to determine a multitude of procedural issues, such as class certification, motions to dismiss, and consolidation in this subprime context, as well as issues arising under the various substantive laws discussed in this article. Time will ultimately tell whether this litigation will produce any meaningful precedent.

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1. Andrews v. Chevy Chase, 240 F.R.D. 612 (E.D. Wis. 2007).
2. Hamm v. Ameriquest Mortgage Co., No. 05-3984 (7th Cir. Oct. 17, 2007).
3. *Andrews*, 240 F.R.D. at 621; *see also In re* Ameriquest Mortgage Co., No. 05-CV-7097 (N.D. Ill. 2007) (“While we recognize that actual rescission is a personal remedy, we find nothing in TILA precluding declaratory relief authorizing class members to individually request rescission where they are legally entitled to do so.”); *but see* McKenna v. First Horizon Home Loan Corp., 474 F.3d 418 (1st Cir. 2007) (holding that an action for class-wide declaratory relief stating a right to rescission is not permissible under TILA).
4. Owens v. NovaStar Fin. Inc., No. 07-cv-0166 (W.D. Mo. Mar. 1, 2007).
5. *See also* Teamsters Local 282 Pension Trust Fund v. Moody’s Corp., No. 07-cv-8375 (S.D.N.Y. Sept. 26, 2007) (complaining of Moody’s investments in CDOs and invoking the fraud-on-the-market doctrine).
6. *In re* 2007 *NovaStar Fin., Inc.* Sec. Litig., No. 07-cv-0139 (W.D. Mo. Feb. 23, 2007).
7. *In re* 2007 *NovaStar Fin.*, No. 07-cv-0139, slip op. at 6 (W.D. Mo. June 4, 2008).
8. *Id*. at 7.
9. *In re* Fremont Gen. Corp. Litig., No. 07-cv-02693 (C.D. Cal. Consol. Compl. Oct. 25, 2007).
10. Alvidres v. Countrywide Fin. Corp., No. 07-cv-05810 (C.D. Cal. Sept. 6, 2007).
11. Cedarleaf v. Huntington Bancshares, Inc., No. 08-cv-0175 (S.D. Ohio Feb. 25, 2008).
12. *In re* Morgan Stanley ERISA Litig., No. 07-cv-11285 (S.D.N.Y. Dec. 14, 2007).
13. Alexander v. Washington Mutual, Inc., No. 07-cv-01906 (W.D. Wa. Nov. 19, 2007).
14. Steven v. Citigroup, Inc., No. 07-cv-11156 (S.D.N.Y. Dec. 11, 2007).
15. *In re* Beazer Homes USA, Inc. ERISA Litig., No. 07-cv-0952 (N.D. Ga. Apr. 30, 2007).
16. *In re* First Am. Corp. ERISA Litig., No. 07-cv-1357 (C.D. Cal. Nov. 16, 2007).
17. Arthur v. O’Neal, No. 07-cv-9696 (S.D.N.Y. Nov. 1, 2007).

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