

The Specialist

Marc Gross and Joshua Silverman subprime class actions

Funds turn to US courts to recover subprime losses

In the wake of the global credit crisis, a growing number of European pension funds are bringing class actions to US courts in an attempt to recover losses

Pension funds around the globe have lost hundreds of billions of dollars in the recent mortgage and credit market meltdown. Increasingly, they are turning to US courts to seek recovery of these losses. Most claims are brought as class actions. In recent years, European funds have begun to play a more prominent role in these cases. The UK's National Association of Pension Funds estimates that 23 per cent of British funds have now actively participated in a securities class action.

With the economic crisis emanating from a downfall in housing prices, it is no surprise that many lawsuits target firms connected in some way to subprime lending. According to The D&O Diary, a weblog that tracks these lawsuits, 126 subprime-related securities fraud class actions have already been filed in US courts.

Of these, 21 relate to illiquid auction rate securities (ARS) falsely marketed as cash equivalents. Most banks have settled ARS claims under pressure from US regulators. However, some of these settlements leave institutions with the largest losses out in the cold. Credit Suisse, for example, only agreed to redeem ARS positions of \$10m (£7.72m) or less.

Targets in the remaining suits run the gamut from banks to real estate investment trusts to homebuilders. European funds will be particularly impacted by three categories of these suits.

First, no industry has destroyed more investor wealth over the past year than the US financial service industry. Shareholders in storied institutions like Bear Stearns and Lehman Brothers lost virtually all of their investments,

despite assurances from management that capital was sufficient. AIG had to sell over 80 per cent of itself to the federal government after misvalued credit default swaps swallowed the firm's operating capital.

Class actions are pending against all of these firms; as well as Citigroup, Wachovia, BankAtlantic, BankUnited, Fifth Third, National City, and others. Most suits allege that the banks were heavily exposed to risky subprime and Alt-A loans but did not fully disclose this risk to shareholders, or misvalued credit instruments in their financial statements.

Many banks were also large issuers of common stock, preferred stock and trust preferreds, or TruPS (junior subordinated debt issued indirectly through a special-purpose trust). Investors that bought positions in (or traceable to) these offerings may have a leg up under US securities laws. The Securities Act 1933, which is limited to securities offerings, is an investor-friendly statute that allows recovery without proof of fraudulent intent.

A major factor in suits against banks is whether any defendant has sufficient funds to satisfy a judgment or enter into a reasonable settlement. Many culpable banks have already gone under or are hanging on by the thinnest of margins.

Second, are structured financial instruments. To rid their balance sheets of toxic loans, US banks and mortgage originators packaged them into mortgage-backed securities (MBS), some of which were further repackaged into collateralised debt obligations (CDOs).

The banks heavily marketed both MBS and CDO securities to European and Asian institutional investors. Many MBS and virtually all CDO prices plummeted as the market learned that the underlying loans were low quality.

Investors in some MBS securities are fighting back. For example, purchasers of Countrywide MBS securities have filed both class action and individual claims alleging that the registration statements and prospectuses falsely described a stringent origination process that was supposed to ensure that the collateral consisted of viable loans.

Investigations into Countrywide by several state attorney-generals and the FBI suggest that these assurances were false. Instead, it appears that a large portion of the loans were actually the result of mortgage fraud. Former



Illustration by discoduroi

Countrywide brokers and appraisers now admit that they were encouraged to falsify paperwork or bypass guidelines to get unqualified loans funded.

Government officials are also investigating similar accusations of origination fraud by IndyMac, Washington Mutual, and Wachovia. To date, those banks have not been named as defendants in suits by MBS investors.

CDO claims are substantially more difficult in US courts because CDOs are not registered under the securities act. Therefore, CDO investors do not enjoy protections under that statute and are generally forced to proceed under difficult state law theories.

Third, are agency obligations and preferreds. European investors were large holders of agency debt and preferred shares issued by Fannie Mae and Freddie Mac. In early September, after accounting and operational deficiencies eroded their respective capital bases, the US Treasury Department placed them in conservatorship. Common shares lost most of their value and preferred shares declined as much as 90 per cent.

While the government's rescue plan protected senior debt and securitised offerings, it provided no support to common or preferred shareholders.

A number of institutions that purchased various series of Fannie Mae and Freddie Mac preferred stock in late 2007 and 2008 offerings have brought claims against the issuers and underwriters. Reports by the Office of Federal Housing Enterprise Oversight, a regulatory body, and congressional investigators may bolster investors' claims that the companies concealed capital deficiencies by inflating the value of mortgage and tax assets.

In US courts, each side generally pays its own legal fees, regardless of who wins. For this reason, securities fraud actions in the US pose less risk to plaintiffs than in countries with a 'loser pays' scheme. Plaintiffs can also control their own out-of-pocket costs by negotiating a contingent fee or hybrid fee arrangement.

European funds that purchased on US exchanges have the same access to US courts and an equal right to be appointed lead plaintiff as US investors. They may also have a right to pursue claims in American courts for securities purchased elsewhere if the issuer is a US entity or, in certain situations, if the misconduct occurred principally in the US.

There are three ways that European funds can participate in US securities fraud cases. First, within 60 days after a class action is filed, a fund with large losses can seek to be appointed lead plaintiff. Second, funds can monitor existing class actions and file claim forms once a settlement is reached or a judgment is obtained. Finally, funds can opt out of the class action and file an individual claim.

KEY FACTS

- Some 126 subprime-related securities fraud class actions have already been filed in US courts
- US courts make each side pay their own legal fees, regardless of who wins

Opt-out claims are beginning to play a larger role, and for good reason. In recent cases, both US and European institutions have secured substantially greater recoveries by pursuing their own opt-out claims. For example, in a lawsuit involving AOL/Time Warner securities, German, Dutch and UK funds pursued opt-out claims, as did several US pension funds. Although many of the settlements remain confidential, some claimants disclosed that they achieved settlements several times higher than they would have received as a member of the class action.

Whether through class actions or opt-out claims, European funds are certain to remain a fixture in US securities litigation in the years to come. ■

Marc Gross is a partner and Joshua Silverman is office counsel at Pomerantz Haudek Block Grossman & Gross