

Securitization Litigation & The Debt Crisis: What's on the Horizon?

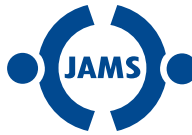


Moderator

HON. GLEN M. ASHWORTH (RET.)

Mediator/Arbitrator, JAMS (Dallas)

www.jamsadr.com



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Participants

- **Talcott (Tal) J. Franklin, Esq.** Partner, Patton Boggs, LLP
- **Terrell (Terry) Oxford, Esq.** Partner, Susman Godfrey, LLP
- **Gerard (Gerry) G. Pecht, Esq.** Partner, Fulbright & Jaworski, LLP
- **George Wailand, Esq.** Partner, Cahill Gordon & Reindel, LLP

ASHWORTH: The subject of our conversation today is the impact of the current debt crisis on mortgage and asset backed securities litigation. Debt securitization has certainly been the most significant financing vehicle since the 1980s, but we are currently working in an environment of heightened risk. We know that approximately 70% of subprime loans have been securitized, but there are also massive pools of commercial and consumer debt, including auto loans, student loans and credit card debt. A news day doesn't pass without some new reference to the U.S. mortgage crisis, the credit meltdown, the recent rescue and acquisition of Bear Stearns by JPMorgan Chase & Co., the Fannie Mae/Freddie Mac rescue, Congressional investigation and government intervention. The potential losses in the U.S. mortgage crisis alone are estimated at up to \$1 trillion dollars.

"We know that securitization litigation has the capability to require a huge time outlay by the lawyers, a significant cost to clients, and take up a sizeable amount of the court's time."

—Glen Ashworth

As the use of securitization has expanded in the markets, each unique underlying asset group which is transformed into a new, more liquid investment vehicle also offers equally unique investor rights and responsibilities. I know each of you have committed a substantial amount of your practices to these securitization issues and I'd like to talk about your views regarding where we are today and what's on the legal horizon.

Generally speaking, the trial of a securitization case represents a substantial undertaking of time and resources. Procedurally unwieldy, it is most certainly document intensive, often with hundreds of thousands of instruments supporting and assigning the underlying debt. So as a starting point, let's begin with a discussion of standing. Who owns the right to sue has always been a difficult threshold question in these cases.

Tal, you have tried as well as written on this issue. What is the status now?

FRANKLIN: Standing in these cases has caused great difficulty. In a recent ruling, a bankruptcy court sanctioned a securitization's servicer, its counsel, and the trustee a combined \$650,000 for what I believe was a result of counsel's failure to understand the securitization structure with respect to standing. Judges are also dismissing cases for failure to demonstrate loan ownership in bringing the suit. In other instances, judges are questioning the veracity of affidavits demonstrating loan ownership by the securitization trusts. Regardless of whether these rulings signify a trend or a departure in the law of standing, they point out the need for additional pre-suit diligence by attorneys litigating in this area. If you are litigating some aspect of the credit crisis and don't understand securitization, you are courting disaster.

PECHT: In the bankruptcy case Tal mentions, the court sanctioned both the loan originator and the trustee of the subprime mortgage pool for repeatedly

misrepresenting who actually owned the creditor's rights. The court commented that "[t]he link between lender and borrower in the current residential mortgage industry is a multilayered, tightly—if not hopelessly—entangled 'assembly line,' the purpose of which seems to be the avoidance of responsibility." The courts have been alerted to this complication, and are being vigilant in ensuring that the correct entities are asserting creditors' rights. In that environment, lawyers and their clients must pay attention to the details of the transactions, no matter how complicated.

OXFORD: I would say that any servicer should certainly try to make sure, when negotiating the deal on the front end, that the operative documents give it the right to sue. Leaving a lawsuit in the

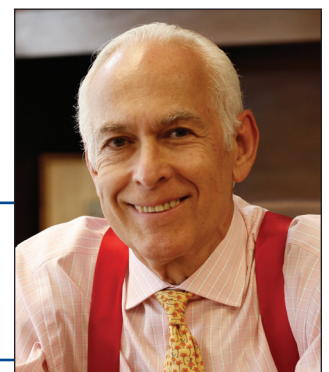
"The success of any claims against rating agencies would depend on whether there is real evidence of intentional wrongdoing, given their First Amendment protections."

—George Wailand

hands of the investors constitutes a recipe for disaster – lack of willingness to sue, coordination of suits, all kinds of problems.

ASHWORTH: I recently mediated a case like that – where loan ownership was not clearly demonstrable and affected the servicer's right to sue. The issue created a huge problem regarding proof and was one of the main reasons the parties chose early mediation.

Okay, now let's turn to claims. Has the current expansion of debt securitization affected a potential plaintiff's causes of actions, not just the breach claims, but



GEORGE WAILAND, ESQ.

Partner, Cahill Gordon & Reindel, LLP (New York)

www.cahill.com

CAHILL GORDON & REINDEL LLP


TALCOTT (TAL) J. FRANKLIN , ESQ.

Partner, Patton Boggs, LLP
(Dallas)
www.pattonboggs.com

PATTON BOGGS LLP
ATTORNEYS AT LAW

also the tort claims?

FRANKLIN: A securitization has an enormous number of participants, each of whom is a potential plaintiff: the borrowers whose loans are securitized, the lenders, depositors, and other parties who participate in establishing the trust or its collateral, the servicers and trustees who administer the trust, and the certificate holders who invest in the trust. If you chart out the parties and start drawing lines between them signifying who can sue who, it looks like a bowl of spaghetti.

While the claims themselves appear relatively conventional – breach of contract and warranty, negligent misrepresentation, fraud – placing these in a securitization context puts them in uncharted territory. For example, you have a series of voluminous and complex documents that establish the securitization trust, subject to lending, securities, and tax law. Further, many of the rulings that exist appear contradictory, particularly with respect to the tort claims. So you have a transaction generally worth over \$1 billion that involves hundreds of parties and is governed by voluminous regulations, complex documents, and inconsistent precedent. Not surprisingly, it will take a long time to sort this out.

WAILAND: The '33 and '34 Act claims by investors against issuers and underwriters may be difficult to defend if the level of diligence had deteriorated to the extent described by the media and pundits. Other areas likely to be pursued are the sufficiency of the disclosure about the creditworthiness of the borrowers, the quality of the appraisals, the assumptions used in defining the level of risk investors were undertaking, the possible impairment in the value of the mortgages and the risk disclosure itself. The success of any claims against rating agencies would depend upon whether there is real evidence of intentional wrongdoing, given their First Amendment protections.

We are likely to see numerous put-back claims to originators, loan sellers and depositors. To the extent that originators may have encouraged or been

complicit in borrower fraud, those claims will be difficult claims to defend. Municipalities are also getting into the act by trying to protect their large swaths of neighborhoods from being overrun by foreclosures. There are, of course, the securities and derivative claims by investors in the financial institutions that have taken billions of dollars in write-downs and have taken off-book items onto their balance sheets. On a related note, valuation of MBS securities has proven to be difficult in this area and is likely to generate customer litigation. How financial institutions chose assets to put into SIVs and potential differences in how institutions valued their own portfolio versus the valuation given to comparable assets placed in SIVs may present some interesting disputes.

Finally, some of the funds investing in real estate on a leveraged basis were

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marketed as safe, cash-equivalent type investments generating higher returns. The liquidity crisis wiped out massive amounts of value in these funds as they were forced to sell their leveraged positions into highly illiquid markets at huge losses to meet lenders' calls to pay down the loans or post additional collateral. The result was that investors who understood they were putting their money into conservative investment vehicles that were purchasing AAA-rated mortgage and other debt securities lost most or all of their investments. That too should be a fertile ground for litigation.

PECHT: Securitization suits come in many flavors with many potential participants. Some suits involve the parties to the securitization transactions themselves, some suits involve the mortgagees such as the bankruptcy case mentioned above, and many others involve shareholders in the investment banks and investors in subprime securities. Investment banks in particular face litigation on a number of fronts. The banks have been sued by their own shareholders alleging failure to disclose

exposure to subprime assets, by investors in securitized pools of subprime mortgages alleged failure to disclose risk in the prospectuses, by investors alleging that the banks aided fraud committed by hedge funds, and by trustees of now defunct loan originators alleging that the banks aided the misconduct of the management of the bankrupt originator.

The subprime collapse also created a ripple effect, embroiling entities of all sorts in litigation tangentially related to the subprime market. For example, the effect of the collapse on the monoline insurers caused a liquidity crisis for holders of auction-rate securities, and a spate of litigation has bloomed in that market as well, affecting issuers, investment banks, brokers, insurers, and investors. The sheer variety of issues and potential claims means that lawyers must have a good grasp of both the economic and legal issues surrounding the subprime market. We at Fulbright & Jaworski have formed a Subprime Practice Group to deal with these issues, pulling talent from across practice areas to ensure we have the needed expertise. We have also formed an Auction-Rate Securities Taskforce to deal specifically with litigation spawned from that situation.

OXFORD: The good news about the claims is that the contracts typically contain strong representations and warranties – at least, strong enough to support the claims. The plaintiff should be entitled to rely on these representations as a matter of law, without having to prove materiality or actual reliance. Moreover, representations and warranties serve the purpose of relieving the purchaser of due diligence on those matters. Any subsequent lawsuit should therefore avoid going off on a tangent of whether the purchaser was or was not careful enough in examining the loans in the trust.

The bad news is that the law of most states greatly reduces the ability to bring tort claims in contract cases – I might add – particularly in cases so heavily layered and papered over. Several panelists have noted the complexity of these securitization transactions. I hope the plaintiff's lawyers can find in their cases what we found in one of ours – a document prepared by the defendant that simply explains the entire process. I don't think anyone can get as lucky as we did, because the defendant's drawing turned on analogizing the entire securitization process to "making sausages."

This drawing, by the way, finds a close parallel in what I have heard several Wall Street analysts say: if you put garbage in, how can you expect any result other than "garbage out." Implicit in what

I am saying is that it is the job of the plaintiff's counsel to make the process – and the case, for that matter – as simple and understandable as possible.

ASHWORTH: George, having had the privilege of being the special master in a case in which you were defense counsel, what new defenses have developed and how have they morphed to respond to these claims?

WAILAND: Pleading hurdles erected by recent Supreme Court case law will make stating a securities claim tougher, but these matters are so well publicized, particularly in the subprime area, that the burdens are certainly not insurmountable. Moreover, with the various SEC, federal grand jury and AG investigations, hot documents are likely to turn up sooner rather than later. I anticipate that causation will be an important defense on both the liability and the damage sides. We have had an unprecedented meltdown in the housing market and a lesser disruption in other real estate and debt markets. The attribution of losses caused by these market declines to fraud will be problematic and enormous amounts of resources will be spent on economists to show that damages claimed were not proximately caused by any alleged fraud, but rather by general declines in real estate values. A related causation issue arises from the facts that MBS investors knew they were purchasing illiquid securities and that the illiquidity of the securities was a significant factor contributing to the loss. The sophistication of investors in securitization vehicles, their access to information regarding the specific investment and their knowledge of the market conditions and underwriting practices that created some of the problems in the sub-prime market will provide some interesting arguments for defendants.

ASHWORTH: Gerry, I know you follow the cases closely, what are your thoughts about this?

PECHT: The Supreme Court and other federal courts have become increasingly hostile to plaintiffs' claims under the securities laws. The Supreme Court's decisions in *Tellabs Inc. v. Makor Issuers & Rights Ltd.* and in *Dura Pharmaceuticals, Inc. v. Broud* require that a plaintiff plead facts raising a strong inference of scienter and demonstrate loss causation. In the Fifth Circuit, plaintiffs must now demonstrate loss causation to even certify a class under the securities laws. Most recently, the Supreme Court strictly limited the ability of plaintiffs to make claims against secondary actors under the "scheme liability" theory in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* Given the web

TERRELL (TERRY) OXFORD, ESQ.

Partner, Susman Godfrey, LLP (Dallas)
www.susmangodfrey.com

SUSMAN GODFREY L.L.P.



of transactions involved in these securities suits, plaintiffs may have difficulty asserting claims against a bank when the alleged primary actor is, for example, a hedge fund or loan originator, and when the precise cause of the subprime losses is hard to pinpoint.

ASHWORTH: Terry, any response from the Plaintiff's perspective?

OXFORD: Plaintiff's counsel can much more easily build a case around a few hot documents and good examples than try to examine every loan that went into the package. Best leave it to the defendants to bore the jury with the details of each loan and why the defendants – in spite of the particular mess they created and the awful stink arising out of the industry in general – really did right by the investors. George and Gerry both note the hostility of the Supreme Court to plaintiffs' securities claims, but – hey! – why should those claims be any different? Our Supreme Court as currently constituted exhibits a hostility to ALL plaintiffs' claims, no? For this reason, however, I like the lawsuits in which the trustee or servicer brings contract claims

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– Terry Oxford

based on the reps and warranties. That kind of lawsuit presents the best chance to avoid mischief by an active Court.

ASHWORTH: One of the trends I'm noticing in my ADR practice is that the financial pain in this credit meltdown is bringing more and different parties into the litigation process. In your opinion, which parties within the "securitization structure" have emerged with the most interesting claims and defenses?

FRANKLIN: People seem fascinated by a defense anticipated from the rating agencies. The rating agencies each received a "nationally recognized statistical rating organizations" designation from the SEC to perform their work, so they had few competitors. The issuer would pay the rating agency to rate the transaction, which the rating agencies maintain constitutes an opinion as to the default risk of the underlying assets. According to one estimate, due

to the initial ratings combined with the re-securitization of various securitized interests, 82 cents out of every subprime dollar ultimately commanded an "AAA" rating. With the benefit of hindsight, the rating agencies have downgraded a number of subprime transactions. Downgrades in other contexts have historically led to litigation over the ratings. In those cases, the rating agencies have asserted that the rating merely constituted the agency's opinion, which is speech protected by the First Amendment to the United States Constitution. In a notable case involving Enron, this defense proved successful. Whether the rating agencies can similarly succeed in this context will be interesting to follow.

ASHWORTH: It appears obvious that the depth and breadth of this credit crisis will not avoid the scrutiny of regulators and Congress. What is the one proposal each of you have seen so far that will have the greatest impact on securitization financing going forward, and what would be its legal implication?

WAILAND: The proposals that I have found the most troubling involve the imposition of a long-term moratorium on foreclosure and freezes on adjustable interest rates that are temporally unrelated to the perceived crisis and, thus, constitutionally dubious and proposals that require lenders to accept a reduced principal value commensurate with the decline in the value of the secured real estate. To the extent that there exists the potential for once again having a vibrant non-GSE MBS market in the future, such proposals would kill it.

FRANKLIN: The main danger of many proposals being considered to deal with the wave of foreclosures is that they do not take into account the unique aspects of the securitization structure. For example, a servicer may not have an option whether or not to adjust an adjustable rate mortgage. But even if the servicer has an option under its contract, the possibility of certificate holder suits still exists. For example, a certificate holder who was entitled to receive interest but not principal might object if a servicer chose not to adjust the adjustable


GERARD (GERRY) G. PECHT, ESQ.

Partner, Fulbright &
Jaworski, LLP (Houston)
www.fulbright.com

FULBRIGHT
& Jaworski L.L.P.
Attorneys at Law

rate mortgages in a pool, because the certificate holder made the investment anticipating the interest rate adjustments. So proposals that do not account for the securitization structure can cause more problems than they solve.

PECHT: The sheer variety of proposals floated in an attempt to deal with the subprime crisis will probably make it hard for any single proposal to be adopted. Given the variety of participants in the subprime market, including banks, credit rating agencies, loan originators, trustees, and investors, it would also be difficult for any single proposal to address the issues related to the subprime market in any sort of comprehensive way. Because of the network of transactions and participants in the subprime market, regulation in this area is far more likely to have severe unintended consequences than to ultimately be successful.

ASHWORTH: We know that securitization litigation has the capability to require a huge time outlay by the lawyers, a significant cost to clients, and take up a sizeable amount of the court's time. What aspects of ADR do you believe are helpful to make the process more efficient? Are there any innovative uses which you have found effective?

WAILAND: Securitization cases, particularly those involving an entire pool or a large part of one, have the capacity to clog the court system. Each property has its own issues so you are dealing with tens or even hundreds of smaller cases bundled up into a bigger case. In my experience, the level of judicial intervention required in such cases exceeds the time most judges are able or willing to commit. For all of the issues that can arise to be addressed in a meaningful way, a special master who has the time, skill and judicial background is really a necessity.

Another frightening thought is explaining the financial concepts involved in securitization to even a sophisticated jury (and one that no doubt is angry about the required time commitment) and hoping that they can absorb the numerous different factual scenarios that

are likely to be involved in a securitization case and place them into the context of a series of complex governing contracts. In my experience with selecting jurors in this area, one side consistently sought to seat the most highly educated jurors and the other side was looking for exactly the opposite, suggesting that the parties' jury research yielded strikingly similar results.

To me, these cases cry out for ADR. Not only do I believe that the parties owe it to themselves and the judicial system to find the best mediators, but these cases are strong candidates for post-dispute arbitration agreements so that the issues can be quickly and efficiently decided by a panel that has the background and temperament to comprehend the issues involved and make dispassionate decisions based on the evidence and agreements and free of preconceived notions about participants in the financial markets.

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PECHT: Meaningful ADR is critical to manage the risk of high-stakes litigation in this area. Securities class actions often allege potential damages in the hundreds of millions of dollars, while working with an experienced mediator can mitigate the risk of a large jury verdict. Particularly in an area like subprime, with so many complicated relationships and transactions and so much press likely to influence potential jurors, an experienced mediator with securities litigation experience can be invaluable in resolving a case in which a jury verdict is wildly unpredictable.

FRANKLIN: Jurors who get impaneled on these cases often cry. The jurors will be sacrificing career opportunities, family time, and much more to decide the parties' dispute. The litigants owe it to those people to engage in good faith settlement discussions. Good faith negotiations overseen by a mediator like you with experience in securitization cases

are more likely to result in resolution or, at a minimum, a clean conscience in asking the jury to hear the dispute. In addition, it is often important to realize in litigating a securitization case that, while there may be a dispute about some portion of the loan pool, the parties still need to work together with respect to the other loans in the pool.

Consequently, lawyers must zealously represent clients while remaining courteous and professional, treating all witnesses with respect, and disagreeing without being disagreeable. ADR can help with this. For example, a court, in reference to the cases you, George, Terry, and I worked on, called them "scorched earth" litigation, but there was never any animus with respect to counsel. That's a tribute to the professionalism of the lawyers involved, but also to the fact that you as a special master had the luxury of gaining a deep understanding of the very complex facts and making quick and detailed rulings.

ASHWORTH: Thanks for that, Tal, but I still remember how uncomfortable we all felt looking at the jury panel and appreciating that their service had the potential to last many weeks.

OXFORD: We did have one juror break down in tears when selected for our jury. Perhaps she felt at that point she could make use of her acting background, but certainly the other jurors selected did not feel a whole lot different. I think the Judge and plaintiff's counsel can do much to give the jury panel a feeling of some pride and patriotism in helping resolve a serious dispute stemming out of a nationwide crisis. Beyond that, of course, alternative dispute resolution can provide a welcome solution.

In the case Tal, George, and I litigated, the parties worked out a special master arrangement that kept the vast dispute out of the court house and greatly reduced expenses. Nevertheless, I often marveled at how difficult Texas law made it to create that kind of arrangement. For example, we had to make careful provision for appeal of certain rulings. I therefore think the Legislature could help us out quite a bit by making it easier for the parties to finance litigation parallel to the usual court system, thereby sparing the public judicial system the burdens of a large case, while permitting the parties to craft a system more suited to their own needs.

ASHWORTH: Gentlemen, thank you for your thoughts and expertise on this very difficult topic. By all accounts, we still have not seen the light at the end of the credit crisis tunnel. It should present a challenging time for all of us involved in these securitization issues. ■