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DOC #: _____
DATE FILED: March 29, 2010

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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NEW JERSEY CARPENTERS HEALTH FUND,

Plaintiff,

- against -

DLJ MORTGAGE CAPITAL, INC., et al.,

Defendants.
-----X

08 Civ. 5653 (PAC)

ORDER

This proposed class action arises out of the subprime mortgage meltdown. On January 1, 2008, the Court appointed New Jersey Carpenters Health Fund as Lead Plaintiff (“Plaintiff”). Plaintiff seeks damages on its own behalf and on behalf of all others similarly situated for alleged violations of Sections 11, 12 and 15 of the Securities Act of 1933 (the “Securities Act”), 15 U.S.C. §§ 77k, o, 771(a)(2). Plaintiff alleges that it participated in the private-placement purchase of \$2.39 billion of mortgage-backed securities, issued in the form of pass-through certificates (the “Certificates”) by Issuing Trusts (the “Issuing Trusts”). The Certificates were collateralized by the cash-flow of principal and interest payments from 20,694 residential home equity mortgages. The Certificates were issued in four separate offerings (HEMT 2006-5; HEMT 2006-4; HEMT 2006-6; and HEMT 2007-2, collectively, the “Offerings”) executed between August 28, 2006 and April 27, 2007 pursuant to a Registration Statement (the “Registration Statement”) and Prospectuses (the “Prospectuses,” and together with the Registration Statement, the “Offering Documents”) filed with the Securities and Exchange Commission (the “SEC”).

On June 24, 2009, the Defendants moved to dismiss the complaint under Fed. R. Civ. P. 12(b)(6).¹ The Court grants Defendants' motion to dismiss regarding Plaintiff's lack of standing as to: (i) claims arising from three Offerings in which Plaintiff did not participate, and (ii) claims arising from Section 12 of the Securities Act, with leave to replead. As to the Section 11 claims arising from all the alleged misrepresentations and omissions, the Court grants Defendants' motion in part and denies it in part.

Background²

In a mortgage securitization, mortgage loans are acquired, pooled together, and deposited into a specially-created common law trust. The trust in turn issues certificates to investors, who acquire the rights to the cash-flow generated from the underlying mortgage loans, typically the only assets of the trusts. The certificates evidence ownership interest in the trust.

Here, Credit Suisse acquired home equity mortgages by direct purchase from third-party subprime loan originators, principally New Century Mortgage Corporation ("New Century"), WMC Mortgage Corporation ("WMC"), and Accredited Home Lenders, Inc. ("AHL," and together with New Century and WMC, the "Originators"). CSM, in its capacity as depositor, acquired the loans from DLJMC and deposited them into the Issuing Trusts, where DLJMC securitized the cash-flows from the mortgage loans into the Certificates. CSS then underwrote the Certificates in the Offerings. Plaintiff alleges that DLJMC engaged and paid Moody's Investors Service, Inc. ("Moody's") and Standard and

¹ The Defendants include: DLJ Mortgage Capital, Inc. ("DLJMC") (the Sponsor and Seller for each of the Offerings); Credit Suisse Management, LLC ("CSM") (the Issuer of the Registration Statement and Depositor of the underlying collateral); Credit Suisse Securities (USA), LLC ("CSS") (the underwriter of the Offerings) (CSS together with DLJMC, CSM, and all their affiliates and subsidiaries, "Credit Suisse"); and individual signatories to the Registration Statement (collectively, the "Individual Defendants"): Andrew A. Kimura ("Kimura"); Thomas Zingalli ("Zingalli"); Jeffrey A. Altabef ("Altabef"); Michael A. Marriott ("Marriott"); and Evelyn Echevarria ("Echevarria"). The Section 11 claim names CSS, CSM, and the Individual Defendants; the Section 12 claim names CSS; and the Section 15 claim names CSS and the Individual Defendants.

² The facts in this section are drawn from the Complaint and assumed to be true for purposes of this motion.

Poor's ("S&P," and together with Moody's the "Rating Agencies") to ensure that the Certificates were assigned investment grade ratings and could thus be marketed to pension funds and insurance companies, which typically are unable to purchase securities below investment grade.

The Certificates were divided into a hierarchical structure of classes, known as tranches, reflecting different priorities of seniority, payment, exposure to risk and default, and interest payments. Plaintiff acquired \$16 million of the senior-most class of Certificates (HEMT 2006-5); Plaintiff did not acquire any Certificates in the other three Certificate classes (HEMT 2006-4; HEMT 2006-6; and HEMT 2007-2).

Plaintiff alleges that the value of its Certificates plummeted by 79% shortly after purchase. Marketed as investment grade securities, the Certificates were downgraded to speculative junk-bonds shortly after purchase. By the fourth month after each of the Offerings, borrower delinquency and default rates skyrocketed by over 5,000%; by the sixth month after each of the Offerings, borrower default and delinquencies increased from initial rates by over 8,000%. Plaintiff alleges that such a rapid and dramatic depreciation in value reflects the toxicity of the subprime residential mortgages collateralizing the Certificates even at the time of the Offerings.

Plaintiff alleges that the Offering Documents contain materially misleading statements and omissions relating principally to three general categories: (i) systematic disregard of loan-approval oversight and control mechanisms as represented in underwriting guidelines (the "Guidelines") by the Originators (including failure to conduct meaningful assessments of the borrower's creditworthiness and effective appraisals of the mortgaged property) that neither the Defendants nor the Rating Agencies detected because of wholly inadequate due diligence procedures (Compl. ¶¶ 106-13, 154-200); (ii) the elaborate Credit Enhancement scheme represented in the Offering Documents (including subordination; excess spread; swap agreements; and limited bond insurance) was inadequate in light of

the (undisclosed) impaired quality of the underlying home equity collateral (Compl. ¶¶ 119-35); and (iii) artificially inflated investment ratings by the Rating Agencies, which operated under material and undisclosed conflicts-of-interest, employed outdated rating models, and engaged in rate-shopping practices (Compl. ¶¶ 119-35.).

Discussion

Defendant makes three principal arguments in support of its motion to dismiss: (i) Plaintiff lacks standing to assert claims with respect to the three Offerings in which it did not purchase securities and, with respect to the Section 12 claim, for failure to allege that plaintiff was a direct purchaser; (ii) Plaintiff fails to allege a legally cognizable injury; and (iii) Plaintiff fails to allege a viable Section 11 claim.³

Pleading Standards

Since Plaintiff's allegations and claims sound in strict liability, not fraud, the Complaint is subject to the standards of Fed. R. Civ. P. 8(a), not to the heightened pleading requirements of Fed. R. Civ. P. 9(b). Fed. R. Civ. P. 8(a) provides that a pleading must "contain a short and plain statement of the claim showing that the pleader is entitled to relief." On a motion to dismiss under Fed. R. Civ. P. 12(b)(6), the court "must accept as true all of the factual allegations contained in the complaint," and construe the complaint in the light most favorable to the plaintiff. Bell Atl. Corp. v. Twombly, 550 U.S. 544, 572 (2007); See Ashcroft v. Iqbal, 129 S.Ct. 1937, 1950 (2009) ("When there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief.").

Allegations that are no more than legal conclusions, however, are not assumed to be true. Twombly, 550 U.S. at 572. Dismissal of a complaint under Fed. R. Civ. P. 12(b)(6) is appropriate if the plaintiff has failed to offer factual allegations sufficient to render the asserted claim plausible on its

³ The Court has carefully considered Defendants' remaining arguments; they are meritless.

face. Iqbal, 129 S.Ct. at 1949. To state a facially plausible claim, a plaintiff must plead “factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” Id. “[T]he pleading standard Rule 8 announces does not require ‘detailed factual allegations,’ but it demands more than an unadorned, the-defendant-unlawfully-harmed-me accusation.” Id. “A pleading that offers ‘labels and conclusions’ or ‘a formulaic recitation of the elements of a cause of action will not do.’ Nor does a complaint suffice if it tenders ‘naked assertion[s]’ devoid of ‘further factual enhancement.’” Id. While legal conclusions can form the framework of a complaint, they must be supported by factual allegations. Id.

(i) Legal Standing

a. Standing to Sue as to Classes of Securities which Plaintiff did Purchase

Plaintiff purchased Certificates in only one of the four separate Offerings (HEMT 2006-5). Defendants move to dismiss for lack of standing Plaintiff’s claims with respect to the three Offerings in which Plaintiffs did not purchase Certificates (HEMT 2006-4, HEMT 2006-6, and HEMT 2007-2).

A plaintiff must have standing to maintain a lawsuit. The standing inquiry has three elements: a “plaintiff must allege [1] personal injury [2] fairly traceable to the defendant's allegedly unlawful conduct and [3] likely to be redressed by the requested relief.” Allen v. Wright, 468 U.S. 737, 751 (1984). In the class action context, a plaintiff who represents a class must allege a personal injury. Lewis v. Casey, 518 U.S. 343, 357 (1996). A lead plaintiff asserting Section 11 claims concerning mortgage-backed securities from an issuing trust lacks standing to sue on claims arising from trust offerings which he did not purchase. Courts should dismiss these claims even at the pre-class certification stage. Lehman Brothers Securities and ERISA Litigation, 2010 WL 545992, at *3 (S.D.N.Y. Feb. 17, 2010) (analogizing to In re Salomon Smith Barney Mutual Fund Fees Litigation, 441 F. Supp. 2d 579 (S.D.N.Y.2006) (pre-class-certification dismissal of securities claims for lack of

standing where claims arose from securities offerings in which named plaintiffs did not participate, where named plaintiffs owned shares in twenty of eighty-eight mutual funds)); see also Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp. et. al., 658 F. Supp. 2d 299, 302-03 (D. Mass. 2009) (pre-class-certification dismissal of securities claims for lack of standing where claims arose from securities offerings in which named plaintiffs did not participate where named plaintiffs owned shares in two of eight issuing trusts).

The Certificates in each of the four Offerings were based upon a distinct pool of mortgages, originated largely by different mortgage lenders, and governed by a different prospectus supplement with different underwriting requirements and disclosures. Plaintiff – the only named plaintiff – does not allege that it purchased any HEMT 2006-4, HEMT 2006-6, or HEMT 2007-2 Certificates.

In support of its argument for standing, Plaintiff cites Hevesi v. Citigroup Inc., 366 F.3d 70, 82 (2d Cir. 2004), for the proposition that a lead plaintiff does not need standing to sue on every available cause of action. In Hevesi, however, at least one named plaintiff (though not the lead plaintiff) had standing on each cause of action. Here, by contrast, no named plaintiff has standing to sue as to HEMT 2006-4, HEMT 2006-6, or HEMT 2007-2 Certificates.

Accordingly, Plaintiff lacks standing to bring claims arising from Offerings in which it did not participate. Further, the Court dismisses allegations relating to WMC and AHL because, unlike New Century, these companies did not originate any of the mortgage loans underlying HEMT 2006-5.

b. Section 12(a) Standing

Defendants argue that Plaintiff lacks standing to raise a Section 12 claim because it failed to allege that it purchased the Certificates directly from the Issuing Trust, a prerequisite under Section 12. See Gustafon v. Alloyd Co., Inc., 513 U.S. 561, 578 (1995) (limiting Section 12 liability to “public offerings”). The Complaint alleges only that Plaintiff purchased Certificates “pursuant and traceable

to” the Offering Documents. (Compl. ¶ 9.) This, however, is insufficient to assert standing for Section 12 claims. See Nomura, 658 F. Supp. 2d at 305 (“If plaintiffs did in fact purchase the Certificates directly from the defendants, they should have said so. An evasive circumlocution does not serve as a substitute.”). At oral argument, Plaintiff’s counsel represented that Plaintiff was a direct purchaser. Accordingly, leave will be granted to amend so that standing may be properly alleged.

(ii) Alleging a Cognizable Injury in the Mortgage-backed Securities Context

Plaintiff’s alleged injury is the loss of market value. Plaintiff points to the fact that the value of its Certificates plummeted by 79% since the Offering (Compl. ¶¶ 53-57). Plaintiff maintains that it may “recover such damages as shall represent the difference between the amount paid for the security... and... the value thereof as of the time such suit was brought.” 15 U.S.C. § 77l(e).

Defendants argue that pleading market value loss is insufficient in the context of a mortgage-backed securities claim. With corporate securities, investors in publicly-traded stocks and bonds hope for an appreciation in market value to profit upon resale. According to Defendants, investors in mortgage-backed securities, however, bargain only for the repayment of principal plus interest, from the cash flows generated by the underlying mortgage loans.

Since Plaintiff does not allege that it failed to receive any principal or interest payments due under its Certificates, Defendants argue that Plaintiff failed to allege a cognizable injury. The alleged injury – 79% diminution of market value – is said to be immaterial in the context of mortgage-backed securities Certificates. Plaintiff might suffer a loss from the impairment of cash flow, but loss of value is not a cognizable loss. This is too cramped a reading of damages.

Many fixed-income debt securities, such as corporate bonds do not trade on national exchanges and yet institutional investors routinely purchase corporate bonds hoping to realize a profit through resale. Plaintiff may have purchased the Certificates expecting to resell them, making market value the

critical valuation marker for Plaintiff. This is a securities claim, not a breach of contract case.

Mortgage-backed Certificates are a type of security, which is why, in fact, the SEC has adopted a regulatory scheme relating to pooled asset-backed securities: 17 C.F.R. § 229.1111. At this stage all that may be said is Plaintiff's market value allegations are sufficient. See In re Countrywide Financial Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1169-70 (C.D. Cal 2008).

Defendants rely principally on AIG Global Sec. Lending Corp. v. Banc of Am. Sec., LLC, 2009 WL 1360687, at *16 (S.D.N.Y. May 14, 2009). That case involved asset-backed securities. The Court held that "[T]he plaintiffs' loss was not a decrease in market price, but a decrease in the amount of money returned to them over the securitization." Id.

AIG Global is not on point. AIG Global does not hold that investors in mortgage-backed securities do not allege a cognizable injury when they allege a loss arising from a decrease in market value. Plaintiffs were investors in asset-backed securities, fixed-income instruments serviced by cash-flows from consumers making installment contract payments. They claimed, under Section 10 of the Securities Exchange Act of 1934, that the issuing trust had insufficient funds to repay them. Id., at *1. The AIG Global investors purchased securities with the expectation that they would receive an income stream for the life of the securitization and brought a cause of action when the issuing trust failed to contractually deliver. Id., at *16. In discussing the adequacy of plaintiffs' loss causation proof on a motion for a new trial under Fed. R. Civ. P. 59, the AIG Global Court noted that there is a legal presumption applicable in typical securities cases that shares are purchased for the purpose of investment and that their true value to the investor is the price at which they may later be sold. Id. The Court explained, however, that this presumption was inapplicable to the asset-backed securities at issue because the investors did not allege a loss from selling the securities at a reduced price. Id. Here, by

contrast, Plaintiff does allege a drop in market value – not a failure to realize cash-flow from payments on the underlying mortgage loans.

Accordingly, the Court denies Defendants’ motion to dismiss Plaintiff’s claim for failure to allege a cognizable loss.

(iii) The Viability of Plaintiff’s Section 11 Allegations

Plaintiff has alleged a viable Section 11 claim regarding the systematic disregard of the mortgage underwriting Guidelines, but not regarding the allegations concerning appraisals and appraisal practices, loan-to-value ratios, and ratings and rating methodology.

To state a claim under Section 11 of the Securities Act, a plaintiff must allege that (1) it purchased a registered security, (2) the defendant participated in the offering in a manner giving rise to liability under Section 11, and (3) the registration statement “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” See 15 U.S.C. § 77k(a). A claim under this section may be asserted against every person who signed the registration statement, the directors of the issuer and the underwriter of the securities. Id. Section 15 creates derivative liability for individuals or entities that “control[led] any person liable” under Section 11. See 15 U.S.C. § 77o.

Courts find a violation of Section 11 when “material facts have been omitted or presented in such a way as to obscure or distort their significance.” In re Flag Telecom Holdings, Ltd. Sec. Litig., 618 F. Supp. 2d 311, 320-21 (S.D.N.Y. May 1, 2009). “The test for determining whether the prospectus contained a material misstatement or omission is whether the defendants’ representations in the prospectus, taken together and in context, would have misled a reasonable investor.” Id.

Defendants argue that cautionary language and risk disclosures prominently featured in the Offering Documents is such that, taken as a whole, the Offering Documents disclose potential risks

associated with the mortgage-backed securities investment and thus the Offering Documents “bespeak caution.”

“Under the bespeaks caution doctrine, alleged misrepresentations in a stock offering are immaterial as a matter of law if it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same offering.” Rombach v. Chang, 355 F.3d 164, 173 (2d Cir. 2004). The bespeaks caution doctrine applies to forward-looking statements, not representations of present or historical fact. Id. Moreover, “[t]he cautionary words must be specific, prominent, and must directly address the risk that plaintiffs’ claim was not disclosed.” Flag Telecom, 618 F. Supp. 2d at 322. “If a party is aware of an actual danger or cause for concern, the party may not rely on a generic disclaimer in order to avoid liability.” Edison Fund v. Cogent Inv. Strategies Fund, Ltd., 551 F. Supp. 2d 210, 226 (S.D.N.Y. 2008).

Defendants argue that the disclosures absolve them of almost all responsibility. The cautionary language in the Offering Documents, however, cannot shield Defendants from liability here. The disclosures fail to make clear the magnitude of the risk. Taken as a whole, the Offering Documents lend the clear impression that controls and oversight mechanisms were in place and that, in fact, the mortgage Originators were evaluating the creditworthiness of borrowers and appraising the value of the subject properties. Investors reasonably assumed that in offering mortgage-backed securities, the Defendants conducted adequate due diligence to ensure the accuracy of their representations. The Complaint alleges systemic borrower defaults, complete lack of controls and oversight, and flagrant violations of the Guidelines. According to the Plaintiff, the mortgage Originators and Defendants acted with reckless abandon in their zeal to generate loan volume and profits. The cautionary language and risk disclosures in the Offering Documents do not convey the severity of the investment risk – a risk already present at the time of the Offering.

The allegations here are extreme, yet plausible in light of the rapid and precipitous decline in market value, concurrent with skyrocketing mortgage loan delinquency rates and plummeting credit ratings. The Complaint alleges that the Rating Agencies attributed their downgrades – from investment grade securities to junk bonds – to aggressive underwriting practices by the Originators (Compl. ¶¶ 58, 114-19.). The bespeaks caution cannot immunize Defendants from liability where the harm had already occurred. See In re Prudential Secs. Inc. P’ships Litig., 930 F. Supp. 68, 72 (S.D.N.Y. 1996) (“The doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.”).

Two recent decisions dealing with similar facts and similar allegations, Lehman Brothers and Tsereteli v. Residential Asset Securitization Trust 2006-A-8, 2010 WL 816623 (S.D.N.Y. March 11, 2010), are instructive. In these cases, Judge Kaplan denied in part a motion to dismiss claims under Sections 11, 12, and 15 of the Securities Act arising from the subprime mortgage meltdown. In Tsereteli, for example, Judge Kaplan held that disclosures in offering documents for mortgage-backed securities were insufficient to shield defendants from liability where, as here: (a) the offering documents represented that the mortgage loan originators followed guidelines and standards through a system of control and evaluative mechanisms; (b) the offering documents contained cautionary language regarding exceptions to the guidelines and risk of default relating to certain categories of loans; and (c) the plaintiffs alleged that the originators abandoned their guidelines wholesale. 2010 WL 816623, at *3; see also Lehman Brothers, 2010 WL 545992, at *5 (“The complaint, however, does not allege that the loan originators simply made loans pursuant to the disclosed exceptions. Rather it alleges that the originators systematically failed to follow the underwriting guidelines.”). The same logic and language is applicable here.

Not every allegation survives, however. While the allegations of mortgage originators, appraisals, credit enhancements, and ratings are related, they are factually varied and analytically distinct. As Judge Kaplan held in Tsereteli, subjective opinions – as opposed to statements of fact – are only actionable under the Securities Act if a complaint alleges that the speaker did not truly have the opinion at the time it was made public. 2010 WL 816623, at *4 (citing Shields v. Citytrust Bancorp., 25 F.3d 1124, 1131 (2d Cir. 1994)). Accordingly, Judge Kaplan held that allegations regarding: (a) appraisal practices, (b) loan-to-value ratios, and (c) ratings and rating methodology, are not actionable where plaintiffs failed to allege knowing falsity at the time of publication. Id., at *4-*6; see also Lehman Brothers, 2010 WL 545992, at *4-*6 (dismissing allegations relating to: rating agencies' conflicts of interest (publicly known for years and immaterial as a matter of law); the inadequacy of credit enhancements arising from outdated rating models (statements of opinion)).

As in Tsereteli, Plaintiff fails to allege that the Originators, the Rating Agencies, or the Defendants made knowingly false statements at the time they published their appraisals, loan-to-value ratios, and ratings.⁴ Consequently, the Court dismisses Plaintiff's allegations regarding the appraisals, credit enhancements, credit rating, rating agencies, and loan-to-value ratios. As Judge Kaplan found, these are statements of opinion, not facts. They are not actionable where, as here, the Complaint fails to allege that that the speaker did not truly believe the statements at the time it was made public. Consequently, the Court grants Defendants' motion to dismiss as to allegations relating to appraisals and appraisal practices, loan-to-value ratios, and ratings and rating methodology.

* * *

Accordingly, the Court GRANTS Defendants' motion to dismiss regarding Plaintiff's lack of standing as to: (i) all claims arising from the three Offerings (HEMT 2006-4; HEMT 2006-6; and HEMT 2007-2), none of which Plaintiff purchased, and (ii) claims arising from Section 12 of the

⁴ Plaintiff conceded as much when asked about this failure at oral argument on March 18, 2010 (Tr. at 23-24.).

Securities Act for failure to allege that it was a direct purchaser of HEMT 2006-5. Plaintiff has leave, however, to replead allegations regarding the Section 12 claims. The Court DENIES Defendants' motion to dismiss allegations relating to the systematic abandonment of the Guidelines. Finally, the Court GRANTS Defendants' motion to dismiss as to allegations relating to appraisals and appraisal practices, loan-to-value ratios, and ratings and rating methodology.

In sum, the following remains of Plaintiff's action: (i) claims under both Section 11 and Section 15 relating to the abandonment of the Guidelines regarding only HEMT 2006-5, and, subject to correcting the pleading deficiency regarding Section 12 standing, (ii) Section 12 claims relating to the abandonment of the Guidelines regarding only HEMT 2006-5.

The parties are directed to appear for a status conference on April 27, 2010, at 3:30 p.m. The Clerk of the Court is directed to close out the pending motion in this case (Dkt # 54).

Dated: New York, New York
March 29, 2010

SO ORDERED



PAUL A. CROTTY
United States District Judge