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SECURITIES LITIGATION

Subprime-Related Securities Litigation: Where Do We Go from Here?

The current turbulent market conditions have exposed companies involved in subprime-related businesses to federal and state regulatory probes and civil litigation and this is only the beginning. The theories of liability range from false financial statements to misleading and omitted disclosures to breach of directors' duty of oversights. What are some of the key defenses available and where do we go from here?

by Jonathan C. Dickey, Marshall King, and Katherine Shih

In the last six months, numerous originators, syndicators, insurers, and rating agencies involved in the purchase and sale of subprime mortgage-backed securities, collateralized mortgage obligations (CMOs), and collateralized debt obligations (CDOs) have announced significant write-downs or other adverse financial impacts stemming from the ever-widening "credit crunch." One published report states that as of early January 2008, over a hundred companies had announced write-downs totaling more than $150 billion, and it eventually could approach $300 billion.[1] These adverse developments have been followed swiftly, and predictably, by a wave of private securities litigation, as well as regulatory inquiries from federal and state authorities. The financial crisis has spread to the worldwide financial markets as well, as US policymakers explore potential market place solutions that will help avoid more drastic consequences for the world economy.

In March 2008, the federal government stepped in to provide financial assistance to the US capital markets, in light of the financial distress being experienced by several prominent Wall Street firms. Congress also is now considering various legislative reforms, including more stringent regulatory oversight not only of subprime mortgage originators, but other market participants as well. On March 31, 2008, Treasury Secretary Paulson announced the Treasury Department's proposals for regulatory reforms, including both short-term and long-term recommendations for new federal oversight functions, and the creation of new federal agencies to carry out these functions. While these proposals are intended to address certain of the perceived problems with the current regulatory scheme, the Paulson proposals are likely to generate significant debate in Congress and elsewhere in the coming months, as some policymakers contend that the Paulson proposals do not go far enough, and others contend that the proposals go too far.[2]

In the meantime, activist shareholders are on the warpath, seeking to force companies to make more robust disclosure of operational details and to have greater transparency on subprime (and other)

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mortgage related activities.[3] The corporate governance challenges for the companies being targeted by these activist shareholders (including Lehman, Washington Mutual, Bear Stearns and Wachovia) no doubt will be intense in the coming months. At least one pension fund, the Laborers' International Union of North America, plans to submit shareholder proposals to 28 companies in 2008.[4]

Current Civil and Regulatory Proceedings

Federal Regulatory Probes

The Enforcement Division of the Securities and Exchange Commission (SEC or Commission) recently disclosed that it has three dozen active investigations into possible misconduct in the subprime industry. The Commission has formed a "Subprime Task Force" to focus on these investigations, which cover the entire "foodchain" of the subprime marketplace, from originations to securitization. The Task Force includes all divisions of the SEC, including the Enforcement Division and the Division of Trading and Markets, and will investigate possible fraud and breaches of fiduciary duty. A principal focus of the SEC's investigations is, of course, the valuation practices of major Wall Street firms with regard to their holdings of CMOs and CDOs. As the SEC colorfully has put it, the Staff is looking at "who knew what when and what did they disclose to the marketplace along the way."[5]

The Department of Justice also has become active in investigating potential criminal aspects of the subprime meltdown. In late January 2008, the Federal Bureau of Investigation (FBI) said that it has opened criminal inquiries on at least 14 companies, led by the FBI's economic crimes unit in Washington, DC. The FBI is working with the SEC Enforcement Division as well. According to a published report, in February 2008, the US Attorney's office in the Southern District of New York asked the SEC for information specifically relating to the SEC's investigation of one major Wall Street firm, and the US Attorney for Eastern District of New York is investigating two other Wall Street firms.[6]

Besides the SEC and DOJ, FINRA also has announced that its enforcement unit is engaging in a market "sweep" of more than a dozen firms involved in the marketing and sale of CMOs. The inquiry focuses on three types of products: (1) principal only, (2) interest only, and (3) "inverse floater" CMOs.

State Regulatory Probes

Regulatory inquiries are not confined to the federal agencies. Various state attorneys general now are pursing article investigations into possible violations of state laws, including the attorneys general in New York, Connecticut, and Massachusetts.

The New York Attorney General, Andrew Cuomo, has issued subpoenas to a wide variety of market participants, with a focus in part on whether loans purchased and sold by Washington Mutual, a federally regulated bank, were over-valued through the use of fraudulent appraisals. In connection with that probe, Cuomo has created tensions with at least one federal agency, OHFEO, which has jurisdiction over one of the companies that purchased some of the challenged subprime loans. Recently, a leading company that performed "due diligence" for a number of firms involved in the purchase and securitization of subprime loans, Clayton Holdings, struck an immunity deal with the NY Attorney General, and agreed to cooperate with the AG in its ongoing investigation.

In Massachusetts, the Securities Division of the Secretary of the Commonwealth has brought suit against a major Wall Street firm in one instance of alleged improper conduct in connection with the sale of CDOs to the City of Springfield, MA, which the State contends were not suitable for investment by Springfield. Officials in the State of Maine also are said to be investigating the same Wall Street firm.[7] State regulators are looking closely at a wide variety of market participants, and the investigations are expected to involve a wider array of conduct as they proceed.

Private Civil Litigation

By the end of 2007, hundreds of federal civil suits had been filed against various market participants in the subprime arena, with a majority of the class action cases having been filed in courts within

the Second Circuit.[8] Over a hundred companies have been sued, and new filings continued in the early months of 2008, and are "rising fast."[9] Representative of the "piling on" aspect of these suits, Merrill Lynch alone has been sued in at least four class actions, seven derivative suits, and 10 ERISA class actions.

Civil suits relating to the subprime lending industry are not all new, of course. Some of the earlier suits include cases against New Century (first filed in February 2007), and a class suit against Bear Stearns and others (filed in April 2007). One of the earliest suits against investment banks relating to subprime securitizations was filed in September 2006 against five investment banks, arising out of the collapse of American Business Financial Services, a subprime originator.

No one expects the level of new case filings to diminish soon. As former SEC Commissioner and Stanford Law Professor Joseph Grundfest has remarked, "it will be a multi-ring circus."[10] Besides an onslaught of class action litigation, one of the prominent plaintiffs' firms, Coughlin Stoia (the firm formerly run by Bill Lerach), has warned that many institutional investors and pension funds, including foreign funds, are likely to bring "opt out" cases of their own.[11]

In the civil cases filed to date, plaintiffs' counsel have typically employed several different theories of liability. Although these theories will be hotly contested by defendants in these cases, they are representative of the sweeping nature of the civil litigation claims being advanced.

False financial statements. In most of the cases filed to date, in one form or another, plaintiffs' counsel challenge the integrity of the issuer's financial statements. At its core, the accounting issue is whether the issuer used appropriate methodologies to establish the "fair value" of the securities or instruments under the relevant provisions of GAAP, and whether it failed to take impairment charges or other write-downs on a timely basis.

Misleading disclosures regarding loan practices. Besides false financial statements, some of the suits filed against originators allege that they failed to disclose that actual underwriting practices were different from what those companies had publicly disclosed. In the Countrywide litigation, for example, plaintiffs allege that "Countrywide's actual lending practices differed materially from the description of those practices in the Company's SEC filings, press releases and conference calls."

Undisclosed risk of subprime market collapse. In some of the cases involving subprime originators, plaintiffs allege that the issuer failed to warn investors of an impending subprime collapse. In the Countrywide litigation, for example, plaintiffs allege that Countrywide "knew that the economy could not possibly support the historically high real estate prices," and should have taken steps to "protect itself should the real estate market collapse, even though there was sufficient commentary in the media about the [housing] bubble." According to this theory of fraud, the originators, but no one else, knew that the bottom was about to fall out of the housing market.

Undisclosed exposure to subprime risks. Some of the cases recently filed allege that the issuer failed to disclose the nature and extent of its involvement in subprime-related business activities. For example, in the securities class action suit filed against Citigroup in November 2007, plaintiffs allege that Citigroup failed to disclose the extent to which its CDO portfolio "contained billions of dollars worth of impaired and risky securities, many of which were backed by subprime mortgage loans," and that Citigroup "failed to properly account for highly leveraged loans such as mortgage securities."[12]

Undisclosed sell-off of subprime securities. In some of the cases, plaintiffs allege that the companies made material misrepresentations and omissions by failing to disclose that at the same time that they were engaged in securitization activities, those companies were selling off their own inventories of subprime securities.

Breach of directors' duty of oversight. In some of the derivative suits filed to date, directors have been sued not for their direct complicity in improper conduct relating to subprime loans, but for breaching their alleged "duty of oversight" under state law.

Adverse effects of subprime lending on municipalities. In a more novel vein, a few cities have brought suits against subprime defendants alleging that their practices have targeted minorities and other classes of people, and that those classes have been harmed disproportionately. For example, in January 2008 the City of Cleveland sued a long list of banks and mortgage companies, alleging they engaged in a "public nuisance" by causing massive numbers of city residents, including low-income and disadvantaged citizens living in an impoverished "rust belt" community, to take out subprime loans they could not afford. Likewise, the Mayor and City Council of Baltimore recently sued Wells Fargo for damages caused by large levels of subprime foreclosures in that city, particularly foreclosures involving African-American borrowers.

The "Global" Fact Story

The "global" fact story underlying all of the recently-filed securities suits cannot be ignored, and would appear to undermine the arguments advanced by plaintiffs' lawyers in many of the pending civil cases that the market was unaware of the risks associated with subprime lending in general, or the adverse impacts that the downturn in the housing market might have on subprime lenders and syndicators.

At the end of 2006, several major companies involved in the origination of subprime loans began to experience adversity in a fairly public way: Ownit shut down operations in December 2006; ReMae filed for bankruptcy in February 2007; and New Century went bankrupt in April 2007.[13] What was fueling these bankruptcies and other adverse trends? This question likely is to be the subject of vast "Monday morning quarterbacking," but many commentators argue that a major contributor was the downturn in the US housing market, which had otherwise been on a tear for most of the last 20 years.[14] According to these commentators, as housing prices rose, the appetite for subprime loans increased, and consumers remained confident that they would have an exit strategy from subprime loans featuring "teaser" rates for adjustable rate loans. Again according to these commentators, consumers assumed that with a rising market, they could always refinance, and the reset features on such loans would never be triggered. Instead, the theory goes, as housing prices began declining, consumers became locked into loans they could not afford or refinance, and proceeded to default in record numbers.

How did underwriting practices contribute to this? The answer is fact specific to each originator, in part. But the overall complexion of certain of these underwriting practices was not unknown—"no documentation" or "low documentation" loans, and other features of subprime lending practices were widely reported. Perhaps in recognition of those prevailing practices, in February 2007, Freddie Mac publicly announced that it was revising its own underwriting criteria for the purchase of subprime loans, and would require that originators must qualify a borrower not on the ability to pay the "teaser" rate, but also on any reset rates.[15] Clearly, this disclosure also reflected the fact that the market for subprime loans was tightening.

Notwithstanding these changing conditions in the housing market, the market for mortgage-backed securities remained relatively stable through at least the first half of 2007. As a result, defendants will argue that there were still reasonable bases for the fair value accounting for various classes of mortgage-backed securities.

By June 2007, the ABX index that tracks trading prices for BBB-rated subprime mortgage backed securities had dropped to roughly 50 percent of its value at the beginning of the year. Also in June, Bear Stearns announced flat profits, in part due to adverse conditions in the mortgage market; and it committed over $3 billion to support two Bear Stearns-sponsored hedge funds. By July, Standard & Poors and Moody's were beginning to downgrade bonds backed by subprime mortgages. These and other facts have caused plaintiffs' lawyers to contend that by mid-2007, the market "knew" that subprime issues would impact mortgage-backed securities. In a complaint recently filed against UBS, for example, Coughlin Stoia, one of the leading plaintiffs' firms, alleges: "In mid-July [2007], it became apparent to the market that banks . . . would be adversely affected by the mortgage meltdown."[16]

The biggest write-downs of subprime mortgage backed securities came in the second half of 2007. Why not sooner? The answer may depend in part on the practices of individual firms to review their valuation models, and adjust them to reflect current market conditions. Of course, the answer also depends in part on how each firm (perhaps in conjunction with its outside auditors) evaluated and applied the accounting literature for fair value accounting.

Key Defenses

Falsity. A central question in many of the cases may be whether the company's valuation models were reasonably sound, and whether the key assumptions used in the models were valid, and not undermined by material adverse information known to management. In this regard, how the SEC evaluates the valuation questions may be critical to the outcomes of some of these cases. If the SEC, for example, were to concur that XYZ Company's valuation methodology was not reckless, then it will be difficult for private plaintiffs to prove otherwise. Similarly, if the valuation models were sound, then XYZ's public disclosures, including risk factor disclosure, will be highly defensible.

Scienter. As suggested above, the "global" fact story is, in essence, a story of a relatively swift deterioration in the market for mortgage-backed securities. Most companies defending these cases will point to the fact that if they were reckless in not anticipating this market collapse, then so were government regulators, politicians, and the Chairman of the Federal Reserve Bank, who gave encouraging public remarks about the state of the subprime market in March 2007. Just recently, Fed Vice-Chairman Donald Kohn said that the Federal Reserve itself had failed to fully appreciate the risks that financial institutions were taking, and that "I'm not sure anybody did, to be perfectly honest."[17]

Similarly, if senior management and the Board can point to objectively sound internal controls and valuation models, then the case for *scienter* will be a challenging one for plaintiffs' counsel. Moreover, the fact that some of the major Wall Street firms held billions of dollars of CDOs and other mortgage-backed securities on their own books directly controverts any plausible inference of *scienter*; if senior management was aware of an impending disaster, it defies logic, or human behavior, to think that they would continue to hold massive amounts of mortgage-backed securities in a market that was about to collapse.

All of these arguments will be aided by the Supreme Court's recent decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[18] In *Tellabs,* the Court held that trial courts must consider all competing inferences that might bear on *scienter*, and may only allow a case to proceed if plaintiffs present a "cogent and compelling" case of *scienter*. In the subprime cases, defendants clearly will be able to point to a wide variety of facts and circumstances that give rise to plausible competing inferences and that will defeat *scienter*. Indeed, at least one recent decision in a mortgage lending related securities class action granted defendants' motions to dismiss on *scienter* grounds, citing *Tellabs* with approval.[19]

Reliancel "truth on the market." Based on the global fact story that is emerging, it would seem that defendants in some of the cases will have powerful defenses to reliance based on the publicly-disclosed facts concerning the downturn in the subprime market, and the copious risk factor disclosure that companies were publishing, and Wall Street analysts were writing about, during the time period of late 2006 through the summer of 2007. These defendants can credibly argue that many of the adverse facts on which investors' claims are based were known and knowable, and therefore the claims are subject to a "truth on the market" defense. Indeed, as noted in a recent paper by several university professors, "with respect to macroeconomic issues, such as the current or future state of the economy, interest rates or the national housing market, it is quite implausible to believe that the SPVs or the investment banks sponsoring or underwriting the MBS or sponsoring the CDOs had any special knowledge concerning these matters that was not already known by the market."[20]

Loss causation defenses. Many corporate sellers and holders of mortgage-backed securities who have been sued had seen their share prices fall steadily since at least July 2007,[21] when the market began to

react significantly to subprime concerns.[22] This fact alone may pose a daunting challenge to the plaintiffs' bar in pleading and proving loss causation under the Private Securities Litigation Reform Act (PSLRA).

Indeed, in a recent decision from the Southern District of New York, the court held that the fact of a declining stock price prior to the issuance of "curative" information may be fatal to plaintiffs in these cases. In *60233 Trust v. Goldman, Sachs & Co.,*[23] Judge Griesa dismissed, on loss causation grounds, a suit by the shareholders of Exodus Corporation (Exodus) against Goldman Sachs and one of Goldman's analysts. Exodus' shares had traded at $24.75 at the beginning of the class period in January 2001, but had trended steadily downward after that. The class period ended six months later, in June 2001. During that week, Exodus' share price fell from $5.01 (pre-disclosure) to $1.59 (post).[24] Focusing on the movement of Exodus' share price during the class period, Judge Griesa concluded that the case should be dismissed on loss causation grounds:

> The loss in value of the stock occurred gradually over the course of the entire class period, and the stock had lost most of its value before the June 14–21 events. This gradual loss of value occurred during the time when the alleged false and misleading statements were being issued. The complaint does not even refer to the phenomenon of the gradual loss of the stock's value, much less attempt to explain it as related to loss causation.[25]

The court's ruling in *60233 Trust* holding could be applied effectively to a number of subprime cases. Take, for example, the case of E*Trade Financial Corp., which saw its share price hold steady in the $21–$24 range until the end of July 2007, after which its stock began a steady decline: from $20.46 on July 25, to $17.50 on August 1, and to $13.55 on August 16th. When E*Trade made its first alleged corrective disclosure (an announcement that it would exit the wholesale mortgage business and revisit its earnings guidance for 2007) on September 18, 2007, the market barely reacted, with share prices moving from $14.21 on September 17th, to $14.00 on September 18th, and to $14.51 on September 19th. Share prices leveled off for a time, then began decreasing steadily again in mid-October, dropping from $13.92 on October 10th to $8.59 on November 9th, the day before E*Trade's second alleged corrective disclosure. Upon the second corrective disclosure (an announcement of a subprime-related securities write-down) E*Trade's stock price fell significantly, to $3.55 on November 12th and to $5.00 on November 13th. This fact pattern is consistent with *60233 Trust,* and arguably should arrive at a similar result—dismissal of the case on loss causation grounds.

Foreign Issuers

Other jurisdictions, such as the United Kingdom, have yet fully to feel the impact of the subprime crisis in the United States, but that is not to say that they will not do so. For example, the Financial Services Authority (FSA), the United Kingdom's equivalent to the SEC, already has conducted a thematic review of certain sectors of the subprime market and has brought disciplinary proceedings against a small number of mortgage firms found to have mis-sold subprime mortgages. The FSA's interest in the mortgage market is continuing in 2008. It also is clear that a significant proportion of the US subprime debt and securities ended up within the English borders.

Further, foreign issuers already are being pulled into litigation in the United States. Among the foreign companies that have been sued already over their subprime activities are UBS, A.G., which after a subprime-related write-down became the subject of a putative securities class action, and Credit Suisse Group, which recently was sued by Bankers Life Insurance Company on the theory that it failed to disclose known risks associated with bonds backed by subprime mortgages and that it withheld the bonds' ratings.

A significant issue in the cases against foreign issuers will be whether and to what extent the courts will permit foreign investors to participate in a class action. Case law provides little certainty on the subject. Although, in the high-profile *Royal Dutch Shell* case in late 2007, the District of New Jersey dismissed outright the claims of a foreign investor who brought a putative class action against a foreign

issuer for shares purchased on a foreign exchange,[26] in January 2008, a court in the Southern District of New York permitted an action to go forward under similar circumstances, even appointing the foreign investor as lead plaintiff.[27] Other recent cases occupy a middle ground, looking at whether the shares at issue were purchased on a US or foreign exchange,[28] and whether the foreign purchaser's country of origin would recognize any US judgment reached,[29] in determining whether foreign investors may bring suit or serve as lead plaintiff in suits against foreign issuers.

D&O Insurance

One potential area of concern that has arisen is the question whether the exposures outlined above are going to be covered by insurance. According to one report published in the Fall of 2007, "forecasts concerning the impact of the subprime crisis on the D&O market at this early date are necessarily murky due to the complexity of the issues involved."[30] A few areas of potential "murkiness" are set forth below.

First, there is the basic pocket book issue of whether defense costs will be covered for certain aspects of the subprime-related legal proceedings. When an issuer is forced to commence an internal investigation, unconnected to pending litigation, and without any formal enforcement proceeding having been brought against the company, some D&O policies may prohibit reimbursement of defense costs for such purely investigative matters. These costs alone could be multi-million dollar sums.

Second, the extent to which fraudulent underwriting practices took place (*e.g.*, falsely inflated appraisals), and whether such conduct may fall within the so-called conduct exclusions in the relevant D&O policies, remains to be seen. Of course, it will be hotly contested whether members of senior management were aware of non-compliant underwriting practices.

Third, if any of the many pending derivative suits proceed past the pleading stage due to "demand futility," will the resolutions of those cases (whether by settlement or judgment) be covered by insurance? A company cannot indemnify directors or officers if there is an adjudication that they breached fiduciary duties to the company—but in theory the "Side A" coverage in the typical D&O policy should afford coverage, at least for settlements.

Fourth, issues may arise with regard to whether coverage for certain claims will be denied due to the alleged "improper personal benefit" received by individual defendants (*e.g.,* improper executive compensation or stock options granted based on the company achieving certain financial results that were inflated falsely by subprime related revenues). Many D&O policies contain such exclusions, although the exclusion often requires an actual adjudication before the exclusion can be successfully invoked.

These and other coverage issues may complicate the job of defense counsel in the defense and settlement of the cases being brought.

Where Do We Go from Here?

The turbulent market conditions likely are to continue throughout the rest of this year, and with that turbulence, many commentators expect that delinquency and default rates will continue to escalate. The values of securities linked to subprime mortgages may remain depressed, and further write-downs are expected.

The pending civil securities cases are likely to grind slowly through the court system. For example, although one major Wall Street firm and its directors recently were sued in a number of derivative cases, the federal court ordered that those suits stayed until mid-September at the earliest. It is doubtful, therefore, that any definitive court rulings will occur in these cases much before the end of 2008.

Readers will remember the crisis that emerged when Enron and Worldcom went bankrupt seemingly overnight, and how Congress swiftly reacted to the political firestorm by passing the Sarbanes-Oxley Act of 2002. In the ensuing years, many commentators have questioned whether the Sarbanes-Oxley Act imposed too much regulation, and perhaps over-reacted to the problems of a handful

of high-profile companies that collapsed. Some of the rhetoric today concerning the need for mortgage industry reforms is reminiscent of those politically charged debates from 2001 and 2002. However those debates are resolved, it is fair to assume that the mortgage industry will be overhauled, for better or for worse.

In the meantime, how should boards of directors react to the "credit crunch"? No set of best practices has yet to emerge, but some commentators have suggested that the lesson learned from the subprime "meltdown" is that boards need to re-assess their oversight roles and responsibilities, take more proactive steps to understand the nuances of the valuation practices of the companies on whose boards they serve, and understand the details of the complex financing and hedging strategies their companies are employing. But the sheer complexity of the "credit crunch" as currently understood underscores the daunting nature of such a task for the typical board member. "Best practice" nostrums are easy to formulate, but sometimes difficult to swallow. As has been true in past crises, corporate boards should strive to make informed business judgments based upon a careful deliberative process. How that result is achieved in individual corporations should not necessarily be pursuant to a formula prescribed by federal regulators or policy makers.

NOTES

1. "Subprime Related Writedowns," *Advisen* (Jan. 10, 2008); "End in Sight for Subprime-Related Writedowns," *Reuters* (Mar. 14, 2008) (*citing* Standard & Poors estimates).
2. "Paulson Plan Begins Battle Over How to Police Market," *Wall St. J.* (March 31, 2008).
3. "Shareholder Backlash Emerges on Subprime Mess," *Wall St. J.* (Feb. 11, 2008).
4. "How the Subprime Mess Hits Governance," *Compliance Week* (Dec. 11, 2007).
5. "SEC Pursuing Dozens of Investigations Regarding Subprime Mortgage Industry," *BNA Corp. Accountability* (Feb. 15, 2008).
6. "Prosecutors Widen Probe into Subprime," *Wall St. J.* (Feb. 8, 2008).
7. *Id.*
8. "Advisen Report Analyzes Impact of Subprime Meltdown on E&O and D&O Insurers," *Reuters* (Feb. 7, 2008); "Subprime Mortgage and Related Litigation 2007: Looking Back at What's Ahead," *Navigant Consulting* (Feb. 2008).
9. *Advisen Report, supra* n.8; "Subprime-Related Lawsuits Mount," *Reuters* (Feb. 14, 2008) (quoting one commentator speculating that the 2007 subprime-related lawsuits filed were "just the beginning"); "Subprime Related Lawsuits Spreading to New Industries," *Financial Week* (Mar. 7, 2008).
10. Vikas Bajaj, "If Everyone's Finger-Pointing, Who's to Blame?," *N.Y. Times* (Jan. 28, 2008).
11. "Individual Suits Likely Over Subprime Losses," *Advisen* (Nov. 26, 2007).
12. *Saltzman v. Citigroup Inc.,* 07 Civ. 9901 (S.D.N.Y. Nov. 8, 2007).
13. On March 26, 2008, the final report of the bankruptcy examiner in New Century's bankruptcy proceedings was publicly released. The report includes an overview of the subprime mortgage market and purports to set forth a detailed account of New Century's subprime lending practices and its related accounting and risk management policies and practices.
14. *See, e.g.,* R. Steinberg, "How Government Failed in the Subprime Mess," *Compliance Week* (Jan. 23, 2008).
15. *See, e.g.,* Freddie Mac 2006 Annual Report, at 69 ("We will only buy ARMs, and mortgage-backed securities backed by those loans, for which borrowers have been qualified at the fully-indexed and fully-amortizing rate in order to protect the borrowers from the payment shock that could occur when the interest rates on their ARMs increase").
16. *Wesner v. UBS AG,* 07 CV 11225 (S.D.N.Y. Dec. 13, 2007).
17. D. Paletta, "Fed Admits Missteps on Banks," *Wall St. J.* (Mar. 5, 2008).
18. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007).
19. *See* Tripp v. Indymac Financial Inc., *et al.,*2007 WL 4591930 (C.D. Cal. Nov. 29, 2007) (rejecting plaintiffs' arguments supporting a strong inference of *scienter*, and noting that "an even stronger inference is that Defendants were simply unable to shield themselves as effectively as they anticipated from the drastic change in the housing and mortgage markets").
20. J. Bethel, A. Ferrll, and G. Hu, "Legal and Economic Issues in Subprime Litigation," Discussion Paper, John M. Olin Center for Law, Economics and Business (Feb. 2008).
21. A sampling of subprime-related securities defendants who witnessed a steady downward share price trend beginning in mid-2007 includes ACA Capital Holdings, Citigroup, Countrywide Financial Corp., E*Trade Financial Corp., Huntington Bancshares, Inc., and Washington Mutual.
22. *See, e.g.,* "Shares Off as Some Profits Disappoint," *N.Y. Times*, July 21, 2007 (describing decline in stocks in reaction to "[j]itters over subprime lending"); Eric Dash, "Big Banks Offer Assurances to Calm Investors' Jitters," *N.Y. Times*, July 21, 2007 (describing persistent investor nervousness about subprime securities market, even in face of reassurances by large banks); Joshua Resner, "Stopping the Subprime Crisis," *N.Y. Times*, July 25, 2007 (describing downgrades by rating agencies in early July of even AAA rated securities; warning that many CDOs might still be overrated).
23. *60233 Trust v. Goldman, Sachs & Co.*, 2007 WL 4326730 (S.D.N.Y. Dec. 4, 2007).
24. *Id.* at *11.

25. *Id.* at *31.

26. In re Royal Dutch/Shell Transport Sec. Litig., 522 F. Supp. 2d 712, 724 (D.N.J. 2007).

27. *Corwin v. Seizinger,* 2008 WL 123846, at *4 (S.D.N.Y. Jan. 8, 2008). Judge Chin appointed the Luxembourg-based foreign investor as lead plaintiff over the protests of two other putative lead plaintiffs, one of which was United States-based investor. *Id.*

28. *See, e.g.,* In re Rhodia S.A. Sec. Litig., 2007 WL 2826651, at *12 (S.D.N.Y. Sept. 26, 2007).

29. *See*, *e.g*., In re Vivendi Universal, S.A. Sec. Litig., 242 F.R.D. 76, 109 (S.D.N.Y. 2007); Borochoff v. Glaxosmithkline PLC, 246 F.R.D. 201, 205 (S.D.N.Y. 2007).

30. The Subprime Meltdown and D&O Insurance, Advisen (Sept. 24, 2007).

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