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Standing in Mortgage-Backed Securities Class Action Litigation

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Over the past several years, courts have been inundated with securities class actions concerning complex financial products known as "mortgage-backed securities" (MBS). In these cases, courts have been called upon to apply these uniquely structured securities principles that were developed in litigation involving far less complicated fixed income and equity products. The complex nature of MBS has thus given rise to significant challenges for litigants and novel questions for the courts.

This article discusses the current state of the law concerning standing in MBS class action litigation. As discussed below, this issue in particular has required courts to engage in careful analyses of the intricate architecture of these instruments to resolve motions directed at the standing of a party to serve as the named plaintiff in an MBS class action.

Mortgage-Backed Securities

MBS are created in the first instance when a financial institution purchases a large group of mortgage loans from banks or other lenders, or "originators," that originally provided the loans. The loans are then securitized by being deposited into a trust and grouped together into several different collections, or pools. *See, e.g.*, *N.J. Carpenters Health Fund v. DLJ Mortg. Capital, Inc.*, No. 08 Civ. 5653 (PAC), 2010 WL 1473288, at *1 (S.D.N.Y. Mar. 29, 2010). These pools are then further divided into tranches, with different investment characteristics and a different risk profile for each tranche. *See, e.g.*, *In re Wells Fargo Mortg.-Backed Certificates Litig.*, 712 F. Supp. 2d 958, 961 (N.D. Cal. 2010). Subsequently, the financial institutions sell interests in the trust tranches in the form of MBS in an offering with documentation that identifies the underlying loans. *See, e.g., In re IndyMac Mortg.-Backed Secs. Litig.*, 718 F. Supp. 2d 495, 499 (S.D.N.Y. 2010). The holders of the MBS are entitled to a portion of the revenue stream generated by the principal and interest payments on the underlying mortgage loans. Each tranche constitutes a separate security, with a separate Committee on Uniform Security Identification Procedures (CUSIP) identifier.

It is common for several MBS offerings to be made under a single shelf registration statement and base prospectus filed with the Securities and Exchange Commission (SEC). The single registration statement and base prospectus contain general statements and disclosures; additional, specific details are contained in the supplemental prospectus for each offering. Each individual MBS offering is accompanied by a distinct prospectus supplement with details regarding the specific loans underlying that offering. *See, e.g., In re Lehman Bros. Secs. & ERISA Litig.*, 684 F. Supp. 2d 485, 488 (S.D.N.Y. 2010).

Each MBS offering is made by a specific trust and is based on the specific set of loans held by that trust. *See, e.g., N.J. Carpenters Health Fund v. Novastar Mortg., Inc.*, No. 08 Civ. 5310 (DAB), 2011 WL 1338195, at *1 (S.D.N.Y. Mar. 31, 2011). A security certificate in one MBS offering is typically backed by a completely different set of loans than a security certificate in another MBS offering. Similarly, each tranche is based on a specific loan pool, and two tranches of a single offering may be backed by completely different loans in two different loan pools. Loan pools may differ in a number of respects, including the origination channels for the underlying mortgage loans and the types of underlying mortgage loans (e.g., prime jumbo versus sub-prime, residential versus commercial, fixed rate versus adjustable rate versus hybrid adjustable rate versus negative amortization, conforming balance versus nonconforming balance). And a single pool of loans may comprise a mix of loan types and origination channels that is not seen in any other pool.

As a result of these structural differences among tranches, each tranche is distinguished by different investment characteristics and a different risk profile based on, for example, its original principal balance, interest rate, payment right and priority, and credit enhancement rights. *See, e.g., N.J. Carpenters Vacation Fund v. Royal Bank of Scotland Grp., PLC*, 720 F. Supp. 2d 254, 258 (S.D.N.Y. 2010) (noting that MBS "are often divided into groups ('tranches') based on the relative riskiness of the underlying loans, the order in which the Certificates are paid out, and their corresponding interest rates"). Each MBS tranche also has a separate credit rating.

MBS Class Action Litigation

Allegations in MBS class actions typically are brought under sections 11 and 12(a)(2) of the Securities Act of 1933. 15 U.S.C. §§ 77k, 77*l*(a)(2). In general, plaintiffs asserting claims under these provisions have alleged that the MBS offering documents contained untrue statements and material omissions. Because several MBS offerings are made under a single shelf registration statement, class actions often include claims based on every offering covered by a common registration statement, notwithstanding that the named plaintiff purchased MBS only in a subset of those offerings. These claims, however, typically do not allege that the untrue statements and material omissions are in the common shelf registration statement; rather, they allege that the misstatements and omissions are in the individual prospectus supplements accompanying each offering. *See, e.g., In re Morgan Stanley Mortg. Pass-Through Certificates Litig.*, 2010 WL 3239430, at *5 (S.D.N.Y. Aug. 17, 2010); *Pub. Employees' Ret. Sys. of Miss. v. Goldman Sachs Grp., Inc.*, 2011 WL 135821, at *7 (S.D.N.Y. Jan. 12, 2011).

Constitutional Standing

To establish constitutional standing under Article III, a plaintiff must demonstrate that it has personally suffered an injury in fact that is fairly traceable to a defendant's alleged misconduct and is likely to be redressed by a decision in the plaintiff's favor. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560–61 (1992). "That the suit may be a class

action . . . adds nothing to the question of standing, for even named plaintiffs who represent a class must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class to which they belong and which they purport to represent." *Lewis v. Casey*, 518 U.S. 343, 357 (1996) (internal quotation omitted).

Although the Supreme Court has held that, in certain limited circumstances, a determination on standing can be postponed until after class certification has been decided (e.g., *Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999); *Amchem Prods. v. Windsor*, 521 U.S. 591 (1997)), the majority of courts in the MBS context have held that standing is a threshold question, antecedent to class certification. *See, e.g., Pub. Employees' Ret. Sys. of Miss. v. Merrill Lynch & Co., Inc.*, 714 F. Supp. 2d 475, 480–81 (S.D.N.Y. 2010).

It is firmly established that a plaintiff cannot satisfy the injury-in-fact requirement with respect to MBS that it did not purchase. Every court to address standing in the context of multiple MBS offerings has held that plaintiffs lack standing to challenge MBS offerings in which they themselves did not purchase securities. *See Me. State Ret. Sys. v. Countrywide Fin. Corp.*, 722 F. Supp. 2d 1157, 1163–64, n.6 (C.D. Cal. Nov. 4, 2010) (collecting cases). This is because, "[a]s part of their case, Plaintiffs would have to show that the practices of which they complain occurred with respect to the mortgages in which they invested, and thereby caused injury." *City of Ann Arbor Employees' Ret. Sys. v. Citigroup Mortg. Loan Trust Inc.*, 703 F. Supp. 2d 253, 260 (E.D.N.Y. 2010). But if plaintiffs "did not invest in any such pool of mortgages, they can make no such showing." *Id.*

As courts have explained, "the harm Plaintiffs may have suffered based on misstatements in the Offering Documents for the Certificates they purchased has no bearing on any harm suffered by other investors based on alleged misstatements in other offering documents with details about other offerings that Plaintiffs did not purchase." *Royal Bank of Scotland*, 720 F. Supp. 2d at 265. If the plaintiffs did not purchase securities in a given offering, they have not suffered any injury stemming from that offering and thus have no standing with respect to securities issued in that offering.

Indeed, most of the factual allegations in MBS class actions "are unique to each of the offerings: the downgrade in credit ratings, the particular guidelines used by the mortgage originator for that pool of loans, and the default and delinquency rates all differ based on the particular offering." *Pub. Employees' Ret. Sys. of Miss.*, 2011 WL 135821, at *7. As a district court in the Eastern District of New York explained:

Ultimately, Plaintiffs must be able to prove falsity with respect to statements, or omissions regarding the mortgages in which they purchased interests. Those statements will inevitably require reference to particular pools of mortgages contained in particular securities. If Plaintiffs did not purchase those securities, they lack standing to make any

claim of injury flowing from false statements referring to lending practices of particular institutions. In sum, Plaintiffs lack Constitutional standing, because they cannot trace their injuries to Defendants' conduct.

City of Ann Arbor, 703 F. Supp. 2d at 260.

Defendants in MBS cases have argued that just as a plaintiff's allegations are unique to each MBS offering because each offering comprises a separate, distinct group of mortgage loans, the same allegations are also unique to each MBS tranche. Each tranche, the argument goes, can be backed by a separate, distinct pool of loans, with different principal amounts, interest rates, credit ratings, credit risk attributes, types of loan products, monthly payment rights, and credit enhancement rights. Consequently, any alleged misrepresentation regarding the loan pool underlying one tranche could not injure (and would be wholly irrelevant to) an investor who purchased only a tranche backed by a different pool of loans. Thus, defendants argue, without such injury, there can be no constitutional standing under Article III.

The two courts that have directly addressed this issue so far have reasoned that the same principles underlying the denial of standing across offerings also apply to tranche standing: "[Y]ou can only represent the class of persons or entities that purchased . . . the certificate from the particular tranche from the particular trust that you purchased." *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, No. 08 Civ. 10783 (MGC), at 8 (S.D.N.Y. Sept. 22, 2010) (oral argument on motion to dismiss the third amended complaint) (stating that "it must be the same tranche as yours" and noting that "the effects are very different in different tranches"). A court in the Central District of California likewise held that "Plaintiffs must establish that they have tranche-based standing as to the securities involved here." *Me. State*, No. 10 Civ. 302 (MRP) (MAN), at 4 (C.D. Cal. May 5, 2011); *see also Mass. Bricklayers & Masons Fund v. Deutsche Alt-A Secs.*, 2010 WL 1370962, at *1 (E.D.N.Y. Apr. 6, 2010) ("The amended pleading . . . shall plead only those causes of action with respect to securities actually purchased by Plaintiffs. With respect to those Trusts, Plaintiffs shall specify in the pleading the tranches in which they invested.").

Under these courts' analysis, the differences in loan pools collateralizing the different tranches of an offering demonstrate that a plaintiff who has not purchased in a given tranche has not suffered any cognizable injury with respect to that tranche; the alleged injury suffered by a purchaser of one tranche associated with one loan pool is fundamentally different from an alleged injury suffered by a purchaser of another tranche associated with a different loan pool. *See Me. State*, No. 10 Civ. 302, at *13 (C.D. Cal. May 5, 2011) ("The key to the standing issue is the significant differences between the underlying pools of mortgages."). Accordingly, there can be no constitutional standing as to tranches in which a plaintiff has not made a purchase. *See NECA-IBEW*, No. 08 Civ. 10783 (MGC), at 8; *Me. State*, No. 10 Civ. 302, at 13–15 (C.D. Cal. May 5, 2011).

Statutory Standing

To bring a claim under section 11 or 12(a)(2) of the 1933 act, a plaintiff must satisfy the separate standing requirements prescribed by that statute. A section 11 claim may be asserted only by "any person acquiring such security." 15 U.S.C. § 77k(a). Similarly, a section 12(a)(2) claim may be asserted only by "the person purchasing such security." *Id.* § 77*l*(a). In the context of MBS class action litigation, "[f]ederal courts have consistently dismissed '33 Act claims related to offerings in which the plaintiffs did not actually make the purchase at issue for lack of statutory standing." *Me. State*, 722 F. Supp. 2d at 1163, n.7 (citing cases).

Given that courts have consistently held that each MBS offering under consideration should be deemed a separate security, defendants have argued that the standing requirements under the 1933 act likewise apply to all tranches within an MBS offering. Thus, defendants have further argued that plaintiffs must establish that they actually purchased in each MBS tranche at issue to establish standing under the 1933 act. In its recent decision on this issue, the *Maine State* court confirmed this reasoning, stating, "the plain text of the Securities Act dictates that Plaintiffs must have acquired or purchased the security on which they sue[,] and] [i]t is undisputed that each [tranche] is a separate security."

Conclusion

The unique structure of MBS has been the principal rationale for courts' decisions on the issue of standing in MBS cases. As the financial services industry continues to create new and highly complex products through financial engineering, the courts will continue to be called upon to apply well-established principles to novel factual contexts in securities class action cases.

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