KIRKLAND ALERT

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# Second Circuit Adopts Broad Class Standing Test and Concludes Out-of-Pocket Loss Not Required to Plead Section 11 Claim

On September 6, 2012, the U.S. Court of Appeals for the Second Circuit held that an investor that purchased mortgage-backed securities in two shelf registration statement offerings had standing to litigate securities fraud claims on behalf of investors that purchased different securities in other offerings pursuant to the same shelf registration statement, but only to the extent the mortgages backing all of the securities were originated by the same mortgage lenders.[1] The Second Circuit further held that in the context of illiquid securities, a plaintiff was not required to allege actual out-of-pocket losses, such as missed payments. Rather, allegations that ratings agencies had downgraded the securities, and that investors were exposed to a greater risk of future non-payment due to lenders' departures from mortgage underwriting standards, were sufficient to allege cognizable injury under Section 11 of the Securities Act of 1933. In doing so, the Second Circuit reinstated the putative class action as to seven of the 17 shelf offerings against Goldman Sachs.

## The Decision in *NECA-IBEW*

NECA-IBEW's claims under Sections 11, 12(a)(2) and 15 of the Securities Act were premised on allegations that the shelf registration statement contained false and misleading representations about loan originator underwriting standards, including how lenders assessed borrower's ability to repay, the absence of falsified loan documents, and the structure of real estate appraiser compensation. The complaint alleged that these statements were false due to widespread departures from underwriting standards in the residential mortgage industry, particularly by certain mortgage lenders, including National City, Countrywide, GreenPoint, Well Fargo, Suntrust and WaMu. The complaint did not allege that NECA-IBEW had experienced any out-of-pocket loss at the time the complaint was filed, such as a decline in the securities' market price. Instead, the complaint alleged that the securities were less valuable because they had been downgraded by credit rating agencies, and faced greater risk of nonpayment in the future because the mortgages backing the securities were more likely to go into default as the result of undisclosed departures from the lenders' underwriting standards.

NECA-IBEW filed suit purporting to represent a putative class of any investors that had purchased securities in any of the 17 securities offerings under the shelf registration statement, even though each offering was completed by a separate and unique supplemental prospectus, and each offering was divided into multiple tranches representing different payment priorities. The defendants moved to dismiss, arguing that NECA-IBEW could only purport to represent a class of investors that purchased the same exact securities in the same offerings as NECA-IBEW. Among other things, the defendants noted that the 17 individual shelf offerings were backed by mortgages originated by many different mortgage lenders, each of which had their own unique mortgage underwriting policies and practices. For example, mortgages originated by National City backed six of the seventeen offerings, and Countrywide originated mortgages backing five of the offerings. But NECA-IBEW's particular securities were only backed by mortgages originated by GreenPoint and Wells Fargo.

Judge Cederbaum of the Southern District of New York agreed with defendants and permitted NECA-IBEW only to bring suit on behalf of itself and other investors that purchased the same securities in the same two offerings and in the same tranches. The District Court also held that because NECA-IBEW had failed to allege that it had not received any scheduled payments under the securities, the complaint failed to allege cognizable injury under Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, and dismissed the case.

The Second Circuit reversed, relying heavily on the U.S. Supreme Court's decision in *Gratz v. Bollinger*,[2] which held that an individual who challenged the University of Michigan's practice of using race in transfer student

admissions also had standing to assert claims on behalf of applicants challenging the University's use of race in freshman class admissions. The Second Circuit expressly cited Gratz's rationale that "the same set of concerns is implicated by the University's use of race in evaluating all undergraduate admissions applications under the guidelines."

While acknowledging that "constitutional litigation seeking injunctive relief does not map all that neatly onto statutorily based securities litigation seeking monetary damages," the Second Circuit concluded that Bollinger adopted a "broad standard for class standing," whereby a plaintiff "has class standing if he plausibly alleges (1) that he personally has suffered some actual…injury as a result of putatively illegal conduct of the defendant, and (2) that such conduct implicates 'the same set of concerns' as the conduct alleged to have caused injury to other members of the putative class by the same defendants."[3]

Applying that standard, the Second Circuit concluded that NECA-IBEW had standing to assert claims on behalf itself and other investors that purchased securities backed by mortgages written by the same mortgage lenders, and not just on behalf of investors that purchased the same securities in the same two offerings as NECA-IBEW. The Second Circuit reasoned that the alleged misrepresentations about the specific lender underwriting guidelines formed the centerpiece of the plaintiff's claim, and raised a "sufficiently similar set of concerns" to justify class standing. The Second Circuit similarly rejected the defendants' argument that the plaintiff lacked class standing to represent investors in different tranches of the same securities offerings, because varying levels of payment priority did not raise a "fundamentally different set of concerns."

Finally, the Second Circuit concluded that even though the complaint had not alleged any missed payments under the instruments, it sufficiently alleged cognizable injury under Section 11 of the Securities Act. The Second Circuit found that the complaint's allegations that credit rating agencies downgraded the securities, and that investors were exposed to greater risk of non-payment of interest and principal due to lenders' alleged departures from underwriting standards, were sufficient to establish injury at the pleading stage. There was no requirement that a plaintiff actually allege the existence of a secondary trading market, or a decline in market price at the time of the filing of the complaint.

## The Consequences

In the Second Circuit, the mere fact that a plaintiff in a putative class action purchased securities under a shelf registration statement will not preclude that plaintiff from representing a class of investors that purchased securities in different tranches of that offering or in other offerings under the shelf. Instead, a factual analysis will be required to determine whether the various putative class claims raise a "sufficiently similar set of concerns".

NECA-IBEW affords broader class standing to plaintiffs in mortgage-backed securities and possibly other types of cases (the Second Circuit referred to other types of shelf offering disputes, including routine corporate bond issues), but the analysis will not end there. For example, the standing decision does not resolve whether class treatment under Rule 23 of the Federal Rules of Civil Procedure is appropriate. As the Second Circuit itself explained, "NECA's standing to assert claims on others' behalf is an inquiry separate from its ability to represent the interests of absent class members under Fed. R. Civ. P. 23(a),"[4] and that the District Court, "after reviewing all of the Rule 23 factors, retains broad discretion to make that determination."[5]

The Second Circuit's ruling that a plaintiff need not allege out-of-pocket loss to state a Section 11 claim under the Securities Act may make it easier for plaintiffs to bring suit with respect to illiquid securities where there is no readily-observable market price.

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1 *NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, No. 11-2762-cv, 2012 WL 3854431 (2d Cir. Sept. 6, 2012).

2 539 U.S. 244, 267 (2003).

3 2012 WL 3854431, at *12

4 *Id.* at *9 n.9.

5 *Id.* at *13 n.13.

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