

# FINANCIAL LITIGATION

## INSIGHTS

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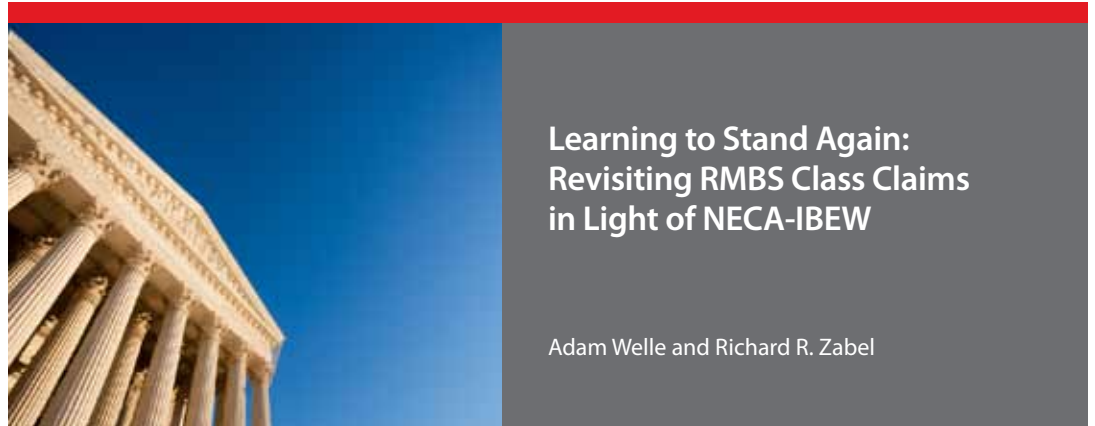
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### **Learning to Stand Again: Revisiting RMBS Class Claims in Light of NECA-IBEW**

Adam Welle and Richard R. Zabel

The Fall 2010 issue of *Financial Litigation Insights* addressed a trend by federal courts in limiting investors from representing others in cases for fraud in the residential mortgage backed securities (RMBS) market. Specifically, certain courts precluded class plaintiffs from suing for those who purchased securities derived from the same shelf statement but who did not purchase the same security. Other courts limited classes to investors in the same trust (regardless of tranche level). But those limitations, at least for some, were lifted by the Second Circuit in *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*,<sup>1</sup> so it may be time to rethink class membership.

#### **RMBS Class Actions**

After investors incurred huge losses and learned of misrepresentations for RMBS purchased from 2005 to 2008, some plaintiffs brought class actions under the Securities Act. Class plaintiffs often sought recompense for all that purchased securities derived from the given shelf statement. That document and its supplements attested to loan quality and compliance with underwriting standards—representations alleged false. The class-action mechanism ostensibly allowed investors that did not litigate themselves to have a chance at a remedy.

But several rulings in 2010, discussed in the Fall 2010 issue, excluded investors from classes if they did not purchase the exact security as named representatives. These rulings were based on the “class standing” doctrine, which holds that a plaintiff may not represent a class if he or she has not been injured by the same conduct as other class members. According to these rulings, class standing failed because named plaintiffs did not allege injury from the same securities. As this newsletter pointed out, those rulings shut the door to relief for many investors.

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### NECA-IBEW

The Second Circuit may have opened the door back up when it reversed one of those decisions in *NECA-IBEW*. In that case Goldman Sachs made representations in a shelf statement about underlying loans from several originators, and created 17 tranches with different risk levels and securities available for purchase. The plaintiff pension fund based its claims on misstatements in the shelf statement, but Goldman argued that the claims should be limited to those who purchased certificates in the tranches from which the pension fund made purchases.

The Second Circuit rejected Goldman's argument, holding the class proper because (1) the pension fund suffered actual injury as a result of the alleged illegal conduct and (2) that conduct implicated the same set of concerns as that which harmed other class members. The concerns were that origination practices for the loans were falsely stated. This meant that the pension fund had standing to assert claims for other investors who received the same shelf statement, so long as the originators for those loans were the same.

The Second Circuit reaffirmed *NECA-IBEW* on March 1, 2013 when it reversed another dismissal of class claims on standing doctrine. In *New Jersey Carpenters Health Fund v. Royal Bank of Scotland Group PLC*, the court relied on the law of *NECA-IBEW*: "[W]here an issuer had issued multiple securities under the same shelf registration statement, a plaintiff who had invested in at least some of those securities could, as the representative of a putative class, bring claims based on securities in which it had not invested so long as all of the relevant claims implicated 'the same set of concerns.'"<sup>2</sup>

And on March 18, 2013, the Supreme Court denied certiorari review for *NECA-IBEW*.

### RMBS Class Rulings Revisited

So what are the ramifications for investors previously kicked out of classes? The answer may depend on several factors:

First is settlement. For many cases where the class was before restricted, the parties may have settled before *NECA-IBEW*. Previously excluded investors probably would not have been covered by those settlements, and thus would have to bring their own claims (if they're still valid).

A second issue is the jurisdiction of potential class claims. For investors with claims relating to shelf statements asserted by Second Circuit plaintiffs, those claims may now be valid or subject to reinstatement, if the case is ongoing. Some New York federal judges have gone back on their old holdings excluding non-certificate holding class members.<sup>3</sup> But for cases outside the Second Circuit, the question is more difficult. The First Circuit, for example, said in 2011 that an RMBS class can only be made up of the same certificate holders.<sup>4</sup> District courts in other areas of the country have taken that view, and a California federal court affirmed its disagreement with *NECA-IBEW* in 2012.<sup>5</sup>

One other difficulty is the condition that underlying loans be originated by the same entities. According to the ruling, only representations regarding the same originator underwriting practices invokes the "same set of concerns" and thus justify class standing. Some New York federal courts have been careful of this distinction.<sup>6</sup>

As of right now, below are the statuses of some RMBS class litigation addressed in the Fall 2010 article<sup>7</sup> that had previously excluded as class plaintiffs those who did not hold the plaintiff's specific certificates:

Case	Post-NECA-IBEW action?
<i>N.J. Carpenters Health Fund v. RALI Series 2006-QQ1 Trust</i> , No. 08-cv-08781 (S.D.N.Y.)	April 30, 2013 Order for reconsideration granted and certain class claims revived
<i>N.J. Carpenters' Vacation Fund v. The Royal Bank of Scotland Group</i> , No. 08-cv-05093	April 30, 2013 Order for reconsideration granted and certain class claims revived
<i>City of Ann Arbor Employees Retirement v. Citigroup Mortg. Loan Trust</i> , No. 08-cv-01418 (E.D.N.Y.)	Claims settled before chance for reconsideration
<i>NECA-IBEW Health &amp; Welfare Fund v. Goldman Sachs &amp; Co.</i> , No. 08-cv-10783	Reversed and Remanded by Second Circuit, some class claims reinstated
<i>In re Wells Fargo Mortg. Backed Certificates Litig.</i> , 09-cv-01376 (N.D. Cal.)	Claims settled before chance for reconsideration
<i>Pub. Employees' Retirement System of Miss. v. Merrill Lynch &amp; Co.</i> , No. 08-cv-10841 (S.D.N.Y.)	Claims settled before chance for reconsideration
<i>In re Indy-Mac Mortgage Backed Sec. Litig.</i> , 09-cv-04583 (E.D.N.Y.)	Nov. 16, 2012 Order for reconsideration denied pending Supreme Court action
<i>In re Morgan Stanley Mortg. Pass-Through Certificates Litig.</i> , 09-Civ-02137 (S.D.N.Y.)	Jan. 11, 2013 order reversed prior holding and will allow plaintiff to assert claims for 14 offerings

## Implications

The bottom line is that investors that relied on potential class membership and who felt thwarted by prior rulings should reassess their options in light of the Second Circuit's rulings. Those investors may have renewed claims as class members, and would thus need to decide whether they should opt out and bring their own suit or can rely on class membership.

What is also uncertain is how these issues translate into the validity of remaining claims, specifically the statute of limitations. Sometimes a class action covering a claim will toll the limitations period for an overlapping individual claim, often at least until that class claim is dismissed or the class is redefined to exclude the individual claim. Since the statute of limitations under the Securities Act (for sections 11, 12, and 15) is one year from discovery or three years from either the security's offering or sales date, tolling may be essential for any new claim based on conduct from 2005 through 2008.

The Second Circuit's ruling has opened up potential claims for many investors, but the ruling's requirements for shared loan originators and jurisdictional limitations require prompt and diligent consideration of any chances for recovery.

- 693 F.3d 145 (2d Cir. 2012).
- \_\_\_ F.3d \_\_\_, No. 12-1707-cv (2d Cir. March 1, 2013).
- In re Lehman Bros. Secs. & ERISA Litig.*, 09 MD 2017, 2013 U.S. Dist. LEXIS 13999, \*20 n.3 (S.D.N.Y. Jan. 23, 2013); *N.J. Carpenters Health Fund v. RALI Series 2006-QQ1 Trust*, No. 2:08-cv-08781 (S.D.N.Y. May 1, 2013).
- Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 770 (1st Cir. 2011).
- FDIC v. Countrywide Financial Corp.*, No. 2:12-CV-4354, 2012 U.S. Dist. LEXIS 167696 (C.D. Cal. Nov. 21, 2012).
- See N.J. Carpenters Health Fund v. DLJ Mortg. Capital*, No. 08 Civ. 5653, 2013 U.S. Dist. LEXIS 12630, \*22 (S.D.N.Y. Jan. 23, 2013); *Plumbers' & Pipefitters Local # 562 Supp. Plan & Trust v. J.P. Morgan Acceptance Corp. I ("Local 562")*, No. 08 Civ. 1713 (ERK), 2012 U.S. Dist. LEXIS 132057 (E.D.N.Y. Sept. 14, 2012).
- This table addresses those cases noted in the Fall 2010 article. Many other cases have certainly been affected by the NECA-IBEW ruling.



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## Structural Complexity as a Cover for Fraud? Analyzing Losses from Exotic Structured Investment Products

Thomas B. Hatch and Katherine S. Barrett Wiik

Investors in the twenty-first century face more options than ever before. Traditional vehicles like stocks, bonds, annuities, options, futures, and asset-backed securities have been joined by a broadening array of esoteric and novel structured investment products. It is now possible to earn a degree in “Financial Engineering,” a multi-disciplinary field that merges mathematics, statistics, economic theory, and computer modeling and applies it to the world of structured finance. Financial engineers conceptualize novel investment products, which are then

underwritten by major Wall Street banks, rated by rating agencies, and brought to the market.

A number of exotic structured investment products have led to investors experiencing significant losses during the recent financial crisis. Such structured investment vehicles have included constant proportion debt obligations (CPDOs), return optimization securities, yield magnet notes, reverse exchangeable securities, and principal-protected notes.<sup>1</sup>

Structured Investment Product	Description
<b>Constant Proportion Debt Obligations (CPDOs)</b>	A CPDO “is a fully-funded structured credit product.” <sup>2</sup> It consists of a special purpose vehicle that issues floating rate notes, which are purchased at par by investors. The proceeds received from investors are held in a cash account, as collateral for a long position in a portfolio of credit default swaps. A CPDO is leveraged, because “the notional size of the long position is a multiple of the size of the cash account.” <sup>3</sup> Typically, a CPDO has a ten-year maturity.
<b>Return Optimization Securities (ROSs)</b>	These structured notes “were supposed to perform like a basket of securities or an index such as the S&P 500. Unlike a stock index or currency basket, however, which could be subject to volatility and big swings, the returns on these investments would be capped, and in exchange for the cap, the investor was supposed to get built-in downside protection.” <sup>4</sup>
<b>Principal-Protected Notes (PPNs)</b>	A structured note with principal protection “refers to any structured product that combines a bond with a derivative component—and that offers a full or partial return of principal at maturity... Structured notes with principal protection typically reflect the combination of a zero-coupon bond, which pays no interest until the bond matures, with an option or other derivative product whose payoff is linked to an underlying asset, index or benchmark. The underlying asset, index or benchmark can vary widely from commonly cited market benchmarks to foreign equity indices, currencies, commodities, spreads between interest rates or “hybrid” baskets of various asset types... These products are designed to return some or all principal at a set maturity date—typically ranging up to 10 years from issuance. The investor also is entitled to participate in a return that is linked to a specified change in the value of the underlying asset.” <sup>5</sup>

<b>Reverse Exchangeable Securities</b>	Reverse exchange securities, also called reverse exchangeable notes, are short-term notes that are linked to an underlying stock, index such as an equity index, or a basket of indices. Reverse exchangeable notes are bonds that “pay a fixed interest rate and guarantee to return the investor’s initial investment after a specified period, unless the linked stock falls below a certain threshold. If that happens, the notes often pay back just a fraction of the original investment.” <sup>6</sup>
<b>Yield Magnet Notes</b>	Yield magnet notes are an equity-linked investment, with notes generally tied to a basket of specific stocks, which provide for the return of principal at maturity of the note. The variable coupon payments are determined based on the price performance of a portfolio of underlying stocks. <sup>7</sup> The notes provide for a combination of fixed coupon payments and variable coupon payments during the term of the notes. ‘Magnet’ features of the notes function to ‘lock in’ the price appreciation of the underlying stocks when certain performance criteria are met.

An analysis of these complex structured products has led one scholar to opine “that these products were designed so as to place buyers at a disadvantage to the investment banks that originated the products and the broker-deals that sold them.”<sup>8</sup> Australian Judge Jayne Jagot, who has handled a large case recently regarding claims against rating agencies related to constant proportion debt obligations, described those CPDOs as “grotesquely complicated.”<sup>9</sup>

Disputes stemming from losses from exotic structured investment products are making their way through the courts and before arbitrators. Despite their reassuring name suggesting preservation of principal, many investors have experienced substantial losses from principal-protected notes issued by entities such as Lehman Brothers.<sup>10</sup> FINRA has fined UBS Financial Services, Inc. \$2.5 million and required it to pay \$8.25 million in restitution for omissions and statements made that misled investors about principal-protected notes.<sup>11</sup>

In November 2012, Judge Jagot issued judgment against rating agency S&P, finding they were liable for the “AAA” ratings they assigned to constant proportion debt obligations arranged by ABN Amro Bank N.V. In that case, *Bathurst Regional Council v. Local Government Financial Services & Ors (No. 5)*, the Court concluded that S&P failed to develop its own model to rate these structured

products and instead simply adopted its client’s model without bothering to verify its underlying assumptions.<sup>12</sup>

The more complicated financial products become, the more important it is for investors to understand and assess risks before making investment decisions. At the same time, no matter how complicated the instrument, underwriters, sellers, and raters of structured investment vehicles may be held accountable for their representations and omissions. An instrument’s complexity is not an excuse for lack of transparency, for failing to fully disclose characteristics of the investments, for knowingly or recklessly using an untested ratings model, or for being reckless about a structured product’s risks.

Investors in the twenty-first century face more options than ever before. Traditional vehicles like stocks, bonds, annuities, options, futures, and asset-backed securities have been joined by a broadening array of esoteric and novel structured investment products.

In the unfortunate event that an investor experiences a significant loss from a structured investment product, it is essential that she have the expertise (or counsel and advisors with the expertise) to critically assess the circumstances of the underlying investment and loss. What representations were made by the underwriter and any rating entities about the investment vehicles and credit or liquidity risk? Were those representations accurate and complete? What assumptions were made by those bringing the structured products to market and rating the instruments, and were those assumptions made transparent to investors? What duties, if any,

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were owed by the sellers of the investment products and were those duties met?

While the financial meltdown may temporarily increase skepticism about structured investment products, it is likely that complex structured investment products will remain part of the financial market for the foreseeable future. Financial engineers are around to stay. At all stages of the investment process, investors should increase their financial literacy with structured investment products. If they face losses from complex structured products, counsel familiar with structured finance products can help them separate genuine structural complexities from potential fraud.

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2. Michael B. Gordy and Sren Willemann, *Constant Proportion Debt Obligations: A Post-Mortem Analysis of Rating Models*, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2010-05, at 2, available at <http://www.federalreserve.gov/pubs/feds/2010/201005/201005pap.pdf>.
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5. Securities and Exchange Commission, *Structured Notes with Principal Protection: Note the Terms of Your Investment*, June 2, 2011, available at <http://www.sec.gov/investor/alerts/structurednotes.htm>.
6. Jean Eaglesham, *Complex Bond Faces Regulators' Scrutiny: 'Reverse Convertible Notes' Can Tumble Along With Stock*, Wall Street Journal, March 31, 2011.
7. Richards, *Return Optimization Securities and Other Remarkable Structured Investment Products*, at 6-7.
8. Richards, *Return Optimization Securities and Other Remarkable Structured Investment Products*, at 2.
9. Floyd Norris, *A Casino Strategy, Rated AAA*, NY Times, Nov. 8, 2012.
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12. Norris, *A Casino Strategy, Rated AAA*, NY Times, Nov. 8, 2012. A summary of Judge Jagot's lengthy opinion in the *Bathurst Regional Council* case can be found at <http://s2.webtemplate.com.au/bridgehead/PiperAlderman/media/files/9595.pdf>.



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Tom Hatch leads the firm's Financial Litigation Group. He represents clients in various types of financial litigation with an emphasis on representing institutional investors. He graduated *magna cum laude* from William Mitchell College of Law.



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Katherine represents institutional investors in financial litigation involving misrepresentation claims against underwriters and rating agencies regarding residential mortgage-backed securities (RMBS). She has also represented institutional plaintiffs seeking to recover losses from a major bank's securities lending program. Katherine is a graduate of Harvard Law School and a former law clerk for the U.S. Court of Appeals for the Sixth Circuit.

## Meet Our In-House Economic Consultants



### ***Fabricio Nunez, Ph.D. Economist***

Fabricio is a Senior Legal Consultant in the Minneapolis office. He was born in Ecuador; he attended college in Chile and obtained his MPP and Ph.D. in Applied Economics from the University of Minnesota. When he isn't partaking in complex quantitative analysis at work, he is teaching economics courses at Augsburg College and Minneapolis Community and Technical College. He loves to spend quality time with his daughters and watch as many movies as possible, ranging from summer blockbusters to indie productions.



### ***Guo Chen, M.S.***

Guo is a Legal Economic Analyst also based in Minneapolis. Originally from China, he obtained his B.A. in Economics from Renmin University in Beijing. He is currently completing his thesis to get his Masters in Economics from the University of Minnesota. In between number crunching, you can find him traveling, hiking, or reading.

Fabricio and Guo are members of the 15-person Financial & Economic Consultants Group at Robins, Kaplan, Miller & Ciresi L.L.P., an in-house group comprised of C.P.A.s, M.B.A.s, Ph.D. economists, and other analysts who assist the legal teams in addressing a myriad of financial, accounting and economic issues that arise in complex litigation. Our firm offers the value and advantages of these in-house professionals to more effectively and efficiently serve its clients.

***Fabricio and Guo recently sat down and discussed their work for our legal teams and how that work benefits firm clients. Here's what they had to say:***

### **How would you describe the work you do on a daily basis?**

**Fabricio:** Our team works closely with attorneys on a range of financial litigation and antitrust cases. We provide in-depth economic analyses, helping to disentangle complex econometric and statistical models. This helps attorneys develop stronger legal theories and support those theories with specific data, which positively affects case preparation and client representation.

**Guo:** We manipulate complex financials, analyze economic data, and explain complex economic concepts to attorneys to help them fortify their own knowledge and bolster their cases. We keep direct lines of communication open between all team members to enable the quick transfer of information, which cuts down on confusion, extra legwork, and billable hours.

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### What do you see as your team's greatest accomplishments?

**Fabricio:** We are constantly thanked for our insights on financial matters. This really shines through on the questions we answer on a daily basis. By speaking to us, the attorneys are able to clearly articulate complex financial issues to their clients in a meaningful and understandable way.

**Guo:** I think it comes down to our willingness to help and spend time educating the attorneys on important issues that affect their work. Our experience and perspectives gives attorneys the information they need to fully craft their arguments and best represent their clients.

### What do you like most about working at the firm?

**Fabricio:** I think the best thing is that each day I encounter intellectually challenging questions that require resolution. As attorneys rely on me to give them the information they need to advocate for and counsel their clients, I find there's a constant need to be very logical and methodological about the way I analyze each problem and report results.

**Guo:** For me, it's the people. The attorneys are easy to work with and a collaborative environment is emphasized. We all listen to each other and learn from one another. This collaboration lends itself well to the holistic way we approach our work and how we interact with our clients.

### Just for fun, can you name one fact about yourself that most people don't know?

**Fabricio:** I'm obsessed with the color of my lawn. I spend a lot of time in my yard, pruning, gardening, mowing, and weeding. I blame my father — he was the same way.

**Guo:** When I was a teenager, I won a national Chinese calligraphy contest. To this day, I dedicate time to my calligraphy.

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