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DERIVATIVES

Securitized Subprime Auto Loans – The Next Wave of Financial Litigation? Similarities to and Lessons From Residential Mortgage Backed Securities

BY CRAIG WEINER AND OFER REGER

In a persistently low-interest rate environment, investors have been scrambling for high-yield opportunities across a variety of asset classes. The last several years have seen an explosion in the issuance of high-yield debt (a/k/a ''junk bonds''), collateralized loan obligations (which pool lower-rated commercial loans and then slice them into tranches for sale to investors) and securities backed by consumer automobile loans.[1] Over the past two years, there has been widespread reporting in the media and cautionary messages from federal regulators regarding loosening underwriting standards in each of these markets, driven by investor demand and a so-called ''reach for yield.''[2] Securities backed by subprime auto loans in particular have garnered significant media coverage and governmental scrutiny. A number of news reports have cited trends in the subprime auto loan market similar to those which characterized, and helped fuel the issuance of, residential mortgage-backed securities (''RMBS'') prior to the financial crisis — such as questionable lending practices, falsified borrower information, market exuberance and loosening underwriting standards. This article explores some of these similarities and describes three recent de-

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[1] *See* Al Yoon and Katy Burne, *The Wall Street Journal*, ''Investors Clamor for Risky Debt Offerings,'' Apr. 2, 2014; Victoria McGrane and Gillian Tan, *The Wall Street Journal*, ''Lenders are Warned on Risk; Regulator Urges Caution by Banks About Looser Standards in Pursuit of Profits,'' June 25, 2014; Cyrus Sanati, *Fortune Magazine*, ''Janet Yellen reveals concerns for U.S. recovery'', May 8, 2014; Cyrus Sanati, *Fortune*, ''The rise of leveraged loans,'' Apr. 18, 2014; Sarah Husband, *Forbes*, ''Leveraged Loans: It's Official – CLO Issuance Hits All-Time High of $97.1B,'' Oct. 9, 2014. Issuance of high-yield debt and CLOs have slowed somewhat in 2015. *See* Joy Ferguson, *Forbes*, ''High Yield Bond Issuance Stalls in July As Market Eyed Commodities, Greece, China,'' Aug. 5, 2015; Tim Cross, *Forbes*, ''Leveraged Loan Issuance Surges to $19.1B, Thanks to Charter/TWC,'' July 24, 2015.

[2] *See* Victoria McGrane and Gillian Tan, *The Wall Street Journal*, ''Lenders are Warned on Risk; Regulator Urges Caution by Banks About Looser Standards in Pursuit of Profits,'' June 25, 2014; Jesse Hamilton, *Bloomberg News*, ''U.S. Banks Warned by OCC Against Return to Riskier Lending,'' June 25, 2014; Cyrus Sanati, *Fortune Magazine*, ''Janet Yellen reveals concerns for U.S. recovery'', May 8, 2014; Cyrus Sanati, *Fortune*, ''The rise of leveraged loans,'' Apr. 18, 2014.

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velopments in RMBS litigation which may impact future cases arising in the subprime auto loan context.

Subprime Auto Loan Securities – A Booming Market With Warning Signs

Issuances of securities backed by auto loans - many of them subprime - have increased dramatically in the last few years.[3] Total auto loan securitizations increased 150 percent from 2009 to a total of $17.6 billion in 2013.[4] Issuances of these securities continued to rise in 2014, with $20.2 billion sold in 2014, a 302 percent increase over 2010 (and 28 percent increase over 2013), according to Thomson Reuters IFR Markets.[5] Continuing this trend, a total of $16.8 billion of auto-loan-backed securities have sold through early August 2015.[6]

Like the mortgage-backed securities which caused such drastic losses only a few years ago (and exposed widespread fraud and sloppy paperwork on loans made to home buyers with poor credit), subprime auto loans are pooled and divided into tranches based on the risk and return of the underlying loans.[7] Many of the top tranches are given investment-grade ratings by ratings agencies, which enable major investors, like pension funds and insurance companies, to purchase the bonds.[8] As the increasing issuances suggest, there has been significant investor demand for these securities, which has bid up prices and thus lowered yields.[9]

For some time, analysts and credit rating agencies have been raising alarms about a bubble in the market and the potential fallout if borrowers fall behind on their payments.[10] In a series of articles in the *New York Times* beginning last summer and continuing through January of this year, the *Times* reported on fraudulent practices in the auto loan industry, highlighting cases of borrowers all across the country who were given loans based on false information, including overstated incomes and increased prices for the vehicles.[11] Last July, the *Times* cited a Standard & Poor's report which cautioned investors to expect ''higher losses,'' based on the longer repayment periods and higher auto loan balances characterizing recent auto loans (which underlie the bonds).[12] It was further reported that banks are writing off an average of $8,541 for each delinquent auto loan as entirely uncollectable, up about 15 percent from a year earlier.[13] In a September 2014 report, Standard & Poor's stated that subprime auto payments more than 60 days late had climbed to 3.6% in July 2014, up from 3% the year before.[14]

Nevertheless, the market for loans to borrowers with poor credit is booming. As several commentators have noted, some of the same dynamics that helped precipitate the 2008 mortgage crisis are playing out, albeit on a smaller scale, in the subprime auto loan market.[15] Of particular note is the fact that auto lenders collect less information from borrowers than home mortgage lenders.[16] This creates a market ripe both for fraud and also a sudden rise in delinquencies, as borrowers may find themselves unable to keep up with high monthly payments.[17] Most recently, analysts have blamed weaker performance in subprime auto securities on the increasing share of smaller, newer companies issuing bonds.[18]

Government Scrutiny

As with the recent boom in CLOs and high-yield debt, securities backed by subprime auto loans have also caught the attention of government regulators. In June of 2014, the Office of the Comptroller of the Currency released a report which warned banks about risky practices in indirect auto loans (among other things), citing loosening credit standards, longer terms, and rising average losses on defaulted loans.[19] In August 2014, it was reported that the Department of Justice had begun an investigation into underwriting criteria in the securi-

[3] *See* Carrick Mollenkamp, *Reuters*, ''Special Report: How the Fed fueled an explosion in subprime auto loans,'' Apr. 3, 2013; Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates,'' July 19, 2014; Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Focusing on G.M. Unit, U.S. Starts Civil Inquiry of Subprime Car Lending,'' Aug. 4, 2014.

[4] Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Focusing on G.M. Unit, U.S. Starts Civil Inquiry of Subprime Car Lending,'' Aug. 4, 2014.

[5] Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Investment Riches Built on Subprime Auto Loans to Poor,'' Jan. 26, 2015.

[6] Matt Scully, *Bloomberg Business*, ''Here's One Sign of Trouble in the Subprime Auto Lending Market,'' Aug. 11, 2015.

[7] Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates,'' July 19, 2014.

[8] *Id.*

[9] *See* Carrick Mollenkamp, *Reuters*, ''Special Report: How the Fed fueled an explosion in subprime auto loans,'' Apr. 3, 2013; Matt Scully, *Bloomberg Business*, ''Here's One Sign of Trouble in the Subprime Auto Lending Market,'' Aug. 11, 2015.

[10] Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Focusing on G.M. Unit, U.S. Starts Civil Inquiry of Subprime Car Lending,'' Aug. 4, 2014.

[11] Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates,'' July 19, 2014; Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''Loan Fraud Inquiry Said to Focus on Used-Car Dealers,'' Oct. 1, 2014.

[12] Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates,'' July 19, 2014.

[13] *Id.*

[14] Matt Robinson, Sarah Mulholland and Jody Shenn, *Bloomberg Businessweek*, ''Auto Loans: A Subprime Market Grows in the Shadows,'' Oct. 2, 2014.

[15] *See* Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates,'' July 19, 2014; Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Focusing on G.M. Unit, U.S. Starts Civil Inquiry of Subprime Car Lending,'' Aug. 4, 2014; Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''Loan Fraud Inquiry Said to Focus on Used-Car Dealers,'' October 1, 2014; Matt Robinson, Sarah Mulholland and Jody Shenn, *Bloomberg Businessweek*, ''Auto Loans: A Subprime Market Grows in the Shadows,'' Oct. 2, 2014.

[16] Matt Robinson, Sarah Mulholland and Jody Shenn, *Bloomberg Businessweek*, ''Auto Loans: A Subprime Market Grows in the Shadows,'' Oct. 2, 2014.

[17] *Id. See also* Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''Loan Fraud Inquiry Said to Focus on Used-Car Dealers,'' Oct. 1, 2014.

[18] Matt Scully, *Bloomberg Business*, ''Here's One Sign of Trouble in the Subprime Auto Lending Market,'' Aug. 11, 2015.

[19] Victoria McGrane and Gillian Tan, *The Wall Street Journal*, ''Lenders are Warned on Risk; Regulator Urges Caution by Banks About Looser Standards in Pursuit of Profits,'' June 25, 2014.

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tization of subprime auto loans.[20] In a subpoena to General Motors' finance subsidiary, the Justice Department requested information on underwriting criteria and on the way loans were represented to entities pooling them and assembling securities to be sold to investors.[21] The United States Attorney for the Southern District of New York was also reported to be investigating other companies, specifically looking into whether lenders fully disclosed to investors the credit-worthiness of borrowers whose loans made up the collateralized securities.[22] In October 2014, it was reported that federal and a number of state authorities were investigating used-car dealerships regarding their role in falsified borrowers' loan applications.[23] More recently, New York state authorities have been examining whether lenders, including large banks that purchase loans for eventual structuring into securities, are turning blind eyes to signs of fraud in the loan documents.[24]

Despite these well-publicized government investigations and probes, demand for auto loan-backed securities has remained brisk. It was widely reported last summer that Santander Consumer USA, the largest issuer of subprime auto loan securities, received a DOJ subpoena regarding its underwriting practices and contractual promises regarding loan quality.[25] Notwithstanding these reports, demand was so great for its subsequent sale of subprime auto loan bonds, that the size of its offering was increased from $1.1 to $1.3 billion when it sold the bonds on September 10, 2014.[26] As a former analyst with Moody's was quoted regarding the sale, ''The investors don't care. They're buying the rating. They're getting a higher yield and are happy with that.''[27]

Potential Claims and Lessons From RMBS Litigation

There is reason to believe that the dynamics at work in the market for securities backed by subprime auto loans create a fertile environment for risky underwriting practices, and as with RMBS issued in the late stages of bubble formation, potentially actionable misrepresentations in the offering documents of some of these securities. In the fallout of the subprime mortgage market, investors have pursued a number of successful claims against issuers, underwriters and ratings agencies regarding their roles in the sale of RMBS. Typically, federal claims have been brought under Sections 11, 12 and 15 of the Securities Act (1933)[28], and state law claims have been brought under Blue Sky laws and for breach of contract and warranty, negligent misrepresentation and fraud.

Of course, the specific causes of action have depended on the facts and type of entities involved in a suit. In the mortgage-backed-securities context, individual investors or classes of investors brought claims under state law and the Securities Act aimed at misrepresentations in offering documents and/or omissions regarding applicable underwriting standards and the quality of the underlying loans.[29] Investors also brought successful fraud-based claims (among others) against ratings agencies regarding their role in working with issuers to structure offerings, such that certain tranches would have investment-grade ratings.[30] Claims brought by monoline insurers have focused on misrepresentations in transactional documents relating to diligence that was provided by issuers and underwriters, commonly including claims that plaintiffs were fraudulently induced to issue policies.[31] Finally, trustees have brought suit based on representations and warranties in the pooling and servicing agreements regarding property values, loan-to-value ratios, borrower incomes and underwriting guidelines which were allegedly not followed.[32]

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[20] Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Focusing on G.M. Unit, U.S. Starts Civil Inquiry of Subprime Car Lending,'' Aug. 4, 2014.

[21] *Id.*

[22] *Id.*

[23] Jessica Silver-Greenberg and Michael Corkery, *The New York Times*, ''Loan Fraud Inquiry Said to Focus on Used-Car Dealers,'' Oct. 1, 2014.

[24] *Id. See also* Matt Scully, *Bloomberg Business*, ''Subprime Auto-Loan Bonds Skew Lender Incentives, Lawsky Says,'' Apr. 23, 2015 (describing New York Department of Financial Services investigation).

[25] *See*, *e.g.*, Sarah Mulholland, *Bloomberg Business*, ''Santander Consumer Gets U.S. Subpoena on Auto Loans,'' Aug. 8, 2014; Michael Corkery and Jessica Silver-Greenberg, *The New York Times Dealbook*, ''Santander Consumer Gets Subpoena in Subprime Car Loan Inquiry,'' Aug. 7, 2014. *See also* Ryan Tracy and Jeannette Neumann, *The Wall Street Journal*, ''Fed Takes Enforcement Action Against Santander's U.S. Unit,'' Sept. 18, 2014.

[26] Matt Robinson, Sarah Mulholland and Jody Shenn, *Bloomberg Businessweek*, ''Auto Loans: A Subprime Market Grows in the Shadows,'' Oct. 2, 2014.

[27] *Id*.

[28] The Second Circuit has summarized these three provisions of the Securities Act as follows:

> Section 11 imposes strict liability on issuers and signatories, and negligence liability on underwriters, ''[i]n case any part of the registration statement, when such part became effective, 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.'' 15 U.S.C. § 77k(a). A claim under § 11 belongs to ''any person acquiring such security.'' *Id.* Section 12(a)(2) imposes liability under similar circumstances against certain ''statutory sellers'' for misstatements or omissions in a prospectus. *See id.* § 77l(a)(2); *In re Morgan Stanley Info. Fund*, 592 F.3d at 359. And § 15 imposes liability on individuals or entities that ''control [ ] any person liable'' under § § 11 or 12. 15 U.S.C. § 77o.

NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co., 693 F.3d 145, 156 (2d Cir. 2012).

[29] *See* cases cited *infra* Notes 33, 34, 43, 62.

[30] *See*, *e.g.*, *Federal Home Loan Bank of Pittsburgh v. J.P. Morgan Secs. LLC*, No. GD09-016892, 2010 Pa. Dist. & Cnty. Dec. LEXIS 437, (Pa. Commw. Ct. Nov. 29, 2010). *See also King County v. IKB Deutsche Industriebank AG*, 863 F. Supp. 2d 288, 306 (S.D.N.Y. 2012) (upholding claims for negligent misrepresentation against ratings agencies under New York law); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155, 183 (S.D.N.Y. 2009) (upholding fraud claim under New York law against ratings agency alleged to have participated in the structuring of structured investment vehicles which included RMBS).

[31] *See*, *e.g.*, *CIFG Assurance of N. Am., Inc. v. Goldman, Sachs & Co.*, 106 A.D.3d 437 (N.Y. App. Div. 1st Dep't 2013); *Ambac Assurance Corp. v. EMC Mortgage LLC*, 39 Misc. 3d 1040(A), 975 N.Y.S.2d 364 (N.Y. Sup. Ct. 2013).

[32] *See*, *e.g.*, *Nomura Asset Acceptance Corp. Alternative Loan Trust v Nomura Credit & Capital, Inc.*, No. 653390/2012, 2014 N.Y. Misc. LEXIS 2905, 2014 NY Slip Op 31671(U) (N.Y.

Given the similar nature of the securitization process and reports of red flags in the underlying consumer loans, each of the aforementioned types of suits may also arise in the subprime auto loan securities context. Obviously the specifics of any case will depend on the particular facts, the specific roles of the parties and the language of applicable documents, but the issues raised by recent media stories – including falsified borrower applications, increasing average losses per default (analogous to overstated property values in homes), and the relatively smaller amount of information collected from auto loan applicants – do indeed seem to raise very similar issues to the residential mortgage loan context.

Key Issues from RMBS Litigation:

Standing and Class Certification

As with any other type of case, in RMBS litigation, standing is a threshold constitutional requirement that required a plaintiff to allege an injury traceable to the conduct of defendants. In the securities class action context, courts in many of the early RMBS cases held that named plaintiffs had no standing to sue on behalf of investors who purchased different offerings under the same (or similar) shelf registration statement(s).[33] However, in a 2012 decision, *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.* (''*NECA-IBEW*''), the Second Circuit held that the plaintiff pension fund had standing to sue on behalf of other investors who purchased certificates in different trusts issued under the same shelf registration statement but separate prospectus supplements, so long as the originators of the loans underlying the certificates were the same.[34]

For purposes of a putative class action, the *NECA-IBEW* court held that ''a plaintiff has class standing if he plausibly alleges (1) that he personally has suffered some actual injury as a result of the 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.''[35] The court noted that, ''in the context of claims alleging injury based on misrepresentations, the misconduct alleged will almost always be the same: the making of a false or misleading statement. Whether that conduct implicates the same set of concerns for distinct sets of plaintiffs, however, will depend on the nature and content of the specific misrepresentation alleged.''[36]

Because the complaint in *NECA-IBEW* focused on misrepresentations regarding whether underwriting guidelines had been followed by originators of the loans backing the various certificates, the Second Circuit held that the plaintiff there could represent other investors who had purchased certificates backed by loans from the same originators as those described in the complaint. The court also held that plaintiff had standing to represent investors who had purchased different tranches of the same offering, holding that the varying levels of payment priority and subordination of the different tranches did not raise a ''fundamentally different set of concerns.''[37]

The *NECA-IBEW* court noted the somewhat inconsistent treatment of the related issues of class standing and class certification in recent Supreme Court precedent, but held that the issue before it was one of class standing, not class certification. The court was careful to note that just because Plaintiff had class standing to represent other investors as described, the district court could still determine under a separate Rule 23 class certification analysis whether the putative class could be certified.[38] In a more recent decision, the Second Circuit reiterated that *NECA-IBEW*'s two-part test (quoted above) ''derives from constitutional standing principles,'' and is thus ''distinct from the criteria that govern whether a named plaintiff is an adequate class representative under Rule 23(a).''[39]

In subsequent cases, the Second Circuit reaffirmed its basic holding in *NECA-IBEW* and district courts in the Second Circuit and beyond have followed the ruling.[40] However, several courts outside the Second Circuit have disagreed with *NECA-IBEW* and declined to

Sup. Ct. June 26, 2014); *ACE Sec. Corp. v. DB Structured Products, Inc.*, No. 40 Misc.3d 562, 965 N.Y.S.2d 844 (N.Y. Sup. Ct. May 13, 2013) (reversed on statute of limitations grounds).

[33] *See, e.g., Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 770 (1st Cir. 2011); *Wachovia Equity Sec. Litig. v. Wachovia Corp.*, 753 F. Supp. 2d 326, 370 (S.D.N.Y. 2011); *Employees' Ret. Sys. v. J.P. Morgan Chase & Co.*, 804 F. Supp. 2d 141, 150 (S.D.N.Y. 2011) (stating that ''courts have almost unanimously found that claims under Section 11 or Section 12 require plaintiffs to have purchased in each of the challenged offerings'' and listing previous cases). *See also Me. State Ret. Sys. v. Countrywide Fin. Corp.*, 722 F. Supp. 2d 1157, 1163 (C.D. Cal. 2010); *In re Lehman Bros. Sec. & ERISA Litig.*, 684 F. Supp. 2d 485, 491 (S.D.N.Y. 2010); *but see In re CitiGroup Inc. Bond Litig.*, 723 F. Supp. 2d 568, 584-85 (S.D.N.Y. 2010) (''[W]here a plaintiff alleges untrue statements in the shelf registration statement or the documents incorporated therein — as opposed to an alleged untrue statement in a supplemental prospectus unique to a specific offering — then that plaintiff has standing to raise claims on behalf of all purchasers from the shelf.'').

[34] *NECA-IBEW*, 693 F.3d 145, 162-65 (2d Cir. 2012).

[35] *Id.* at 162 (internal citations and quotations omitted).

[36] *Id.*

[37] *Id.* at 164 (citation omitted).

[38] *Id.*

[39] *Ret. Bd. of the Policemen's Annuity & Benefit Fund of Chi. v. Bank of N.Y. Mellon*, 775 F.3d 154, 161 (2d. Cir. 2014).

[40] *See N.J. Carpenters Health Fund v. Royal Bank of Scotland Group, PLC*, 709 F.3d 109, 128 (2d. Cir. 2013); *N.J. Carpenters Health Fund v. DLJ Mortg. Capital, Inc.*, No. 08-civ-5653, 2014 U.S. Dist. LEXIS 35326, at *33 (S.D.N.Y. Mar. 17, 2014); *In re Harbinger Capital Partners Funds Investor Litig.*, No. 12 Civ. 1244, 2013 U.S. Dist. LEXIS 142268, at *22 (S.D.N.Y. Sept. 30, 2013); *In re Indymac Mortgage-Backed Secs. Litig.*, No. 09 Civ. 4583, 2013 U.S. Dist. LEXIS 103576, at *10-11 (S.D.N.Y. July 23, 2013). *See also Plumbers & Pipefitters Nat'l Pension Fund v. Burns*, 967 F. Supp. 2d 1143, 1164 (N.D. Ohio 2013) (applying *NECA-IBEW* holding to a 10(b)(5) claim); *NCUA Bd. v. Bear, Stearns & Co.*, No. 12-2781, 2013 U.S. Dist. LEXIS 125238, at *26 (D. Kan. Sept. 3, 2013) (applying *NECA-IBEW* to hold that plaintiff had standing and could assert *American Pipe* tolling for Securities Act claim); *cf Gabriele v. ConAgra Foods, Inc.*, No. 5:14-cv-05183, 2015 U.S. Dist. LEXIS 82585, *23 (W.D. Ark. June 25, 2015) (citing *NECA-IBEW* in consumer products class action and holding that plaintiff had standing, but deferring question of plaintiff's ability to represent class members who purchased products plaintiff had not purchased to class-certification-stage of proceedings).

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follow its reasoning.[41] These courts have held that a Plaintiff who has not purchased a specific security from a specific offering (and/or a specific tranche) cannot have constitutional standing to represent investors of such other offerings because Plaintiff has not suffered injury with respect to those other offerings. In many district court cases, the discussion of standing (or more accurately, class standing) and class certification has continued to be somewhat confused.[42] As discussed below, the intersection of this class standing/certification issue with the applicable statute of limitations can have important implications for unnamed putative class members when a case is dismissed at the class certification stage.

It is important to note that subsequent case law in the Second Circuit has arguably limited the applicability of the *NECA-IBEW* decision to claims brought under the Securities Act. Late last year, the Second Circuit held that plaintiffs alleging state law breach-of-duty claims against an RMBS trustee lacked standing to assert claims against the trustee related to trusts in which the plaintiffs did not invest. *Ret. Bd. of the Policemen's Annuity & Benefit Fund of Chi. v. Bank of N.Y. Mellon*, 775 F.3d 154, 159 (2d Cir. 2014) (*BNYM*). Plaintiff in *BNYM* brought state law claims on behalf of a purported class (including claims for breach of contract, breach of the covenant of good faith and fair dealing and breach of fiduciary duty), in addition to a claim under the Trust Indenture Act, arguing that the trustee (BNYM) failed to perform various duties in its relationship with the originator (Countrywide) for 530 different trusts.[43] Specifically, plaintiff alleged that the trustee ''violated its duties when it failed to notify certificate holders of Countrywide's breaches of the governing agreements, failed to force Countrywide to repurchase defaulted mortgage loans, and failed to ensure that the mortgage loans held by the trusts were correctly documented.''[44] The *BNYM* court held that these claims required ''loan-by-loan and trust-by-trust proof,'' because whether Countrywide breached its obligations under the governing agreements (thus triggering BNYM's duty to act) required examining Countrywide's conduct with respect to each trust, and whether a repurchase obligation was triggered required an examination of which specific loans, in which trusts, were in breach of the misrepresentations and warranties.[45] By contrast, the court stated that the alleged violations of the Securities Act in *NECA-IBEW*, ''inhered in making the same misstatements across multiple offerings.''[46] Ultimately, the court held that plaintiffs' claims did not implicate the ''same set of concerns'' as those of absent class members who purchased certificates in different trusts.[47]

For purposes of potential future actions regarding subprime auto securities, the ability of a named plaintiff in a putative class action to represent absent class members who purchased different offerings under the same shelf registration statement will depend somewhat on the court in which the action is brought. But, at least in the Second Circuit, a court is likely to allow an investor broad class standing (and certification of a class) for alleged violations of the Securities Act in appropriate circumstances.[48]

Statutes of Limitation/Statute of Repose

In simplest terms, the statute of limitations for violations of Sections 11, 12 and 15 of the Securities Act (set forth in Section 13) is one year from either (a) the sale of a security, (b) the discovery of an untrue statement or omission, or (c) the time such discovery should have been made by the exercise of reasonable diligence.[49] However, the Securities Act also contains a second limitations period, a so-called ''statute of repose,'' which states that ''in no event shall any such action be brought to enforce a liability more than three years after the

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[41] *See FDIC v. Banc of Am. Secs. LLC (In re Countrywide Fin. Corp. Mortgage-Backed Secs. Litig.)*, 934 F. Supp. 2d 1219, 1229-1230 (C.D. Cal. 2013) (stating that ''[t]he Court again rejects the reasoning of the Second Circuit's recent decision on class standing,'' and that the decision is ''inconsistent with'' Supreme Court and Ninth Circuit precedent). The Central District of California Court further stated that the *NECA-IBEW* ''decision is inconsistent with the prior rulings of every federal court to consider similar questions in the RMBS context, including the First Circuit Court of Appeal and numerous district courts, both in and outside the Second Circuit. Those courts extend standing only to the offerings or tranches purchased by the named plaintiff.'' *Id.* at 1229 (citing cases decided before *NECA-IBEW*). *See also Beaver County Employees. Ret. Fund v. Tile Shop Holdings, Inc.*, Civ. No. 14-786, 2015 U.S. Dist. LEXIS 26227, at *45 (D. Minn. Mar. 4, 2015) (declining to follow *NECA-IBEW*'s reasoning); *In re Zynga Inc. Secs. Litig.*, No. C 12-04007, 2014 U.S. Dist. LEXIS 24673, at *11 (N.D. Cal. Feb. 25, 2014); *Am. Int'l Group, Inc. v. Bank of Am. Corp. (In re Countrywide Fin. Corp. Mortgage-Backed Secs. Litig.)*, 943 F. Supp. 2d 1035, 1061 (C.D. Cal. 2013).

[42] *Compare Plumbers & Pipefitters Nat'l Pension Fund v. Burns*, 967 F. Supp. 2d 1143, 1164 (N.D. Ohio 2013) (stating in the context of a Rule 23 ruling that plaintiffs had ''class standing'' to assert bondholders' claims for the same reasons that typicality requirement was satisfied); *and In re Frito-Lay N. Am., Inc.*, No. 12-MD-2413, 2013 U.S. Dist. LEXIS 123824, at *40 (E.D.N.Y. Aug. 29, 2013) (stating that *NECA-IBEW* instructs that once a plaintiff satisfies Article III standing inquiry, his ability to represent putative class members who purchased other products plaintiff himself has not purchased is a question for a class certification motion); *with Gabriele v. ConAgra Foods, Inc.*, No. 5:14-cv-05183, 2015 U.S. Dist. LEXIS 82585, *23 (W.D. Ark. June 25, 2015) (stating that because plaintiff had satisfied the standing inquiry, his ability to represent putative class members who purchased different products was reserved for the class certification stage of the proceedings); *and Senne v. Kan. City Royals Baseball Corp.*, No. 14-cv-00608, 2015 U.S. Dist. LEXIS 91147, at *96 (N.D. Cal. July 13, 2015) (noting, in addition to ''tension in Supreme Court authority – and a split of authority among lower courts – as to when the Article III standing inquiry ends and the Rule 23 inquiry begins,'' that ''Courts in this District are split on the question of whether the standing inquiry can be deferred until after class certification'').

[43] *Ret. Bd. of the Policemen's Annuity & Benefit Fund of Chi. v. Bank of N.Y. Mellon*, 775 F.3d 154, 162 (2d Cir. 2014).

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.* at 163.

[48] While a Plaintiff seeking class certification must affirmatively demonstrate that the Rule 23 requirements are satisfied (e.g., numerosity, commonality, typicality, adequate representation), ''[a]s several courts have observed, however, suits alleging violations of Sections 11, 12(a)(2), and 15 of the Securities Act [of 1933] are 'especially amenable' to class action certification and resolution.'' *N.J. Carpenters Health Fund v. DLJ Mortgage Capital, Inc.*, No. 08-civ-5653, 2014 U.S. Dist. LEXIS 35326, at *10-12 (S.D.N.Y. Mar. 17, 2014) (quoting *In re IndyMac Mortgage-Backed Sec. Litig.*, 286 F.R.D. 226, 232 & n.40 (S.D.N.Y. 2012)).

[49] 15 U.S.C. § 77m.

[underlying] security was bona fide offered to the public, or . . . . more than three years after [its] sale.''[50]

The law is unsettled regarding the correct standard for determining when this limitations period begins to run, but under either possible standard (the ''inquiry notice'' or the ''discovery'' rule), the focus is on whether a reasonable investor should have investigated claims or discovered facts constituting the alleged violation.[51]

The timeliness issue that has come up most often in RMBS class actions has involved the tolling rules applicable to Securities Act claims. Many potential investor plaintiffs waited to file lawsuits, or to intervene in existing class action suits, in order to see how the existing class actions would develop. Some of these investors, relying on traditional tolling principles, sought to intervene in actions after courts entered decisions limiting the scope of putative classes (or denying claims or class certification altogether). A key question in the class action context has been whether and to what extent the statute of limitations for Securities Act claims is tolled by the pendency of a given class action.

Under what is known as *American Pipe* tolling, the commencement of a class action suit generally tolls the running of the statute of limitations for all purported members of a class who make timely motions to intervene after a suit is found inappropriate for class action status.[52] There has been some disagreement among the federal courts, however, regarding whether this *American Pipe* tolling may apply to Securities Act claims because the Supreme Court held in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (''*Lampf*'') that Section 13's three-year limitation is a ''period of repose inconsistent with tolling.''[53] In 2013, the Second Circuit in *Police & Fire Ret. Sys. of the City of Detroit v. Indymac MBS, Inc.* (''*Indymac*'') held that *American Pipe*'s tolling rule does not apply to Section 13's statute of repose, and denied certain putative class members' right to intervene in a class action where the proposed intervenors' claims had previously been dismissed for lack of standing and the three-year period of repose had run.[54] Courts outside the Second Circuit are not necessarily in agreement with this analysis, and some – including the Tenth Circuit – have held that *American Pipe* tolling does apply to Securities Act claims.[55]

The trial court in *Indymac* had previously upheld the named plaintiff's claim, but dismissed other claims for lack of standing (in 2010, prior to the Second Circuit's decision in *NECA-IBEW*),[56] including claims that the Second Circuit later determined could not rely on *American Pipe* tolling (in the Second Circuit's *Indymac* decision).[57] However, even after the decision in *Indymac*, courts both within the Second Circuit and beyond are divided about whether *American Pipe* tolling applies when a court determines that the named class representative lacked standing to bring any claims at the outset of a suit (and on which a different party later wants to sue).[58] One Southern District of New York court has stated that the Second Circuit in *Indymac* did not decide whether *American Pipe* tolling may apply to the ''*statute of limitations* such as the one in Section 11 where the initial plaintiff lacked standing''; rather, *Indymac* held that ''*American Pipe* tolling does not apply to Section 13's *statute of repose* under any circumstances.''[59]

The various different scenarios presented by these cases raise complex issues about the tolling principles applicable to class actions generally and the different statutes of limitation for Securities Act claims in particular.[60] The timeliness issues are further complicated by the fact that class standing and class certification issues have become subtly intertwined in recent RMBS jurisprudence. One District Court in California has cautioned that the policy implications of the Second Circuit's *NECA-IBEW* decision are ''worrisome'' because, if an investor has class standing to represent purchasers of offerings which plaintiff itself did not purchase, ''[i]t would enable plaintiff to expand a small securities purchase into an enormous and unwieldy class action that under *American Pipe*, would toll the statute of limitations as to all securities with any common mortgage

[50] *Police & Fire Ret. Sys. v. Indymac MBS, Inc.*, 721 F.3d 95, 106-107 (2d Cir. 2013) (quoting 15 U.S.C. § 77m).

[51] *See Fort Worth Employees' Ret. Fund v. J.P. Morgan Chase & Co.*, 301 F.R.D. 116, 133 (S.D.N.Y. 2014) (describing inquiry notice and discovery rule and collecting cases). Under the ''inquiry notice'' rule, some courts have held that the one-year period begins to run when public information, sometimes referred to as ''storm warnings,'' would lead a reasonable investor to investigate claims. *Id.* (citations omitted). In order to put a party on inquiry notice, such warnings must ''relate directly to the misrepresentations and omissions plaintiff later alleges in its action against the defendants.'' *Id.* (internal citations and quotation omitted). Alternatively, under the ''discovery rule'' (which the Supreme Court has held applicable to Section 10(b) of the Securities Exchange Act of 1934), the limitations period '' 'begins to run once the plaintiff did discover or a reasonably diligent plaintiff would have discovered the facts constituting the violation – whichever comes first.' '' *Id.* (quoting *Merck & Co. v. Reynolds*, 559 U.S. 633, 652-53 (2010)).

[52] *American Pipe Construction Co. v. Utah*, 414 U.S. 538, 553 (1974).

[53] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 363 (1991).

[54] *Indymac*, 721 F.3d 95, 102 (2d Cir. 2013).

[55] *See, e.g.*, *Prudential Ins. Co. of Am. v. Bank of Am.*, 14 F. Supp. 3d 591, 618 (D.N.J. 2014) (citing *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. Colo. 2000)). Some courts even within the Second Circuit have stated that *Indymac* only decided that *American Pipe* tolling cannot apply to Section 13's statute of repose, and implied that *American Pipe* tolling may still apply to the Section 13's (one-year) statue of limitations. *See Monroe County Employees' Ret. Sys. v. YPF Sociedad Anonima*, 980 F. Supp. 2d 487, 488-89 (S.D.N.Y. 2013), *infra* Note 58.

[56] *See In re IndyMac Mortgage-Backed Sec. Litig.*, 718 F. Supp. 2d 495, 501 (S.D.N.Y. 2010).

[57] *Indymac*, 721 F.3d at 103.

[58] *See Monroe County Employees' Ret. Sys. v. YPF Sociedad Anonima*, 980 F. Supp. 2d 487, 488-89 (S.D.N.Y. 2013) (Scheindlin, J.) (stating that authority among the district courts is split regarding whether *American Pipe* tolling applies where the initial plaintiff lacked standing and listing cases on both sides of the divide). *See also Police & Fire Ret. Sys. v. Goldman, Sachs & Co.*, No. 10 Civ. 4429, 2014 U.S. Dist. LEXIS 42452, at *20-*21 (S.D.N.Y. Mar. 27, 2014) (stating that it ''remains an open question in this circuit whether *American Pipe* applies when the class representative lacked standing to bring the claims on which another party now wants to sue'' and citing cases).

[59] *Monroe County Employees' Ret. Sys.*, 980 F. Supp. 2d at 489 (S.D.N.Y. 2013) (emphasis in original).

[60] Indeed, both the district courts cited in footnote 58 have held that *American Pipe* tolling may still apply to the one-year statute of limitations in Section 13 of the Securities Act, but not the three-year statute of repose (per *Indymac*). *Supra* notes 55, 58.

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originator, even if the originator created only a small portion of the loans at issue.''[61] It would seem that the Second Circuit's subsequent decision in *Indymac* (holding that *American Pipe* tolling does not apply to the Securities Act three-year statute of repose) should alleviate some of the concerns raised by the Central District of California, but it remains to be seen to what extent the *Indymac* decision will be followed when an absent class member has not had the benefit of an adjudication regarding its standing to sue.

These issues will almost certainly arise again if subprime auto securities generate any significant amount of litigation, and potential plaintiffs will have to carefully analyze pending cases to determine if it makes sense to intervene in existing cases, or file separate actions. Undoubtedly though, potential plaintiffs should be aware that the statutes of limitation for Securities Act claims are relatively short, and tolling principles that would otherwise be available to later-filing plaintiffs will not necessarily apply, particularly to Securities Act claims. Several courts have also strictly construed statutes of limitations for state law claims and dismissed RMBS cases as untimely.[62]

Causation

While a plaintiff must plead and ultimately prove that it suffered a cognizable injury for claims under Sections 11, 12 and 15 of the Securities Act, the standards for pleading damages and causation are not particularly demanding. As the *NECA-IBEW* court noted, ''[n]either scienter, reliance, nor loss causation is an element of § 11 or § 12(a)(2) claims.''[63] For a Section 11 claim, a successful plaintiff may recover ''the difference between the amount paid for a security'' and either the price at which the security is sold before or after suit, or the ''value'' of the security at the time suit was brought.[64]

The decreased value need not have fully materialized for the suing investor. In *NECA-IBEW* the defendants argued that plaintiff suffered no loss because the complaint did not allege any missed payment from the Trusts and plaintiff had admitted that no periodic payment had been missed.[65] Nevertheless, the court held that plaintiff had pleaded a cognizable injury by alleging a decline in the value of the certificates. In particular, allegations regarding negative watch labels assigned to the certificates by ratings agencies and downgrades of previously assigned ratings, as well as ''less-certain future cash flows'' were held to be sufficient pleadings of loss.[66] As the court stated, ''[w]e further hold that plaintiff need not plead an out-of-pocket loss in order to allege a cognizable diminution in the value of an illiquid security under § 11.''[67]

Subsequent decisions have reiterated that a plaintiff may have an actionable claim for a decline in value even if investors continue to receive scheduled distribution payments. In *Berger v. Apple REIT Ten, Inc.*, 563 Fed. Appx. 81 (2d Cir. 2014), the Second Circuit affirmed the dismissal of a complaint alleging violations of Sections 11, 12 and 15 of the Securities Act because it found that the allegedly misleading statements were not actionable misstatements or omissions. However, the court vacated and reversed the holding of the district court on loss causation, which found that plaintiffs had suffered no losses because ''investors had received monthly distribution payments and had never received less than $11 per share in the Apple REIT's redemption program.''[68] The Second Circuit reiterated its holding in *NECA-IBEW* that plaintiffs ''need not plead an out-of-pocket loss in order to allege a cognizable diminution in the value,'' and found that ''recent statements by an independent market participant indicating a market value of Apple REIT shares less than $11 . . . plausibly suggest a decline in the true value of [the] shares.''[69] District courts in RMBS class actions have also reiterated that ''a ratings downgrade is a cognizable injury'' for purposes of pleading a Securities Act violation.[70]

Once a plaintiff has properly plead a Section 11 violation, the burden rests on defendants to *disprove* loss causation – in other words, a properly plead Section 11 violation presumes that any diminution in value is attributable to the alleged misrepresentations and defendants have the burden to prove that the decrease in value resulted from external factors, such as market conditions.[71] Defendants in RMBS cases have routinely argued, often with the help of expert reports and testimony, that losses suffered by investors were caused (in whole or in part) by macroeconomic conditions rather

[61] *FDIC v. Bank of Am. Secs. LLC (In re Countrywide Fin. Corp. Mortgage-Backed Secs. Litig.)*, 934 F. Supp. 2d 1219, 1230 (C.D. Cal. 2013).

[62] *See., e.g., ACE Sec. Corp. v DB Structured Prods., Inc.*, No. 85, 2015 N.Y. LEXIS 1395, at *20 (N.Y. June 11, 2015) (in suit against sponsor for failure to repurchase loans that did not conform to sponsor's representations and warranties, holding that New York's six-year statute of limitations for breach-of-contract action accrued when Mortgage Loan Purchase Agreement was initially executed, transferring pool of loans to depositor; failure to cure was not a substantive condition precedent that deferred accrual of claim; claim dismissed as untimely); *Varga v McGraw Hill Fin. Inc.*, No. 652410/2013, 2015 N.Y. Misc. LEXIS 2848, *35 (N.Y. Sup. Ct. July 31, 2015) (dismissing plaintiffs' claims for fraud under New York's six-year statute of limitations because plaintiffs commenced action on July 9, 2013 and purchased the last of the securities at issue on May 29, 2007); *First Nat'l Bank & Trust Co. v. McGraw-Hill Cos.*, No. 13-C-5693, 2015 U.S. Dist. LEXIS 39080, at *22 (N.D. Ill. Mar. 27, 2015) (dismissing claims as untimely under Illinois Securities Law five-year statute of limitations); *CMFG Life Ins. Co. v. Banc of Am. Sec. LLC*, No. 13-cv-579, 2014 U.S. Dist. LEXIS 89993, at *7-*9 (W.D. Wis. July 2, 2014) (dismissing claims as untimely under Wisconsin law statute of limitations).

[63] *NECA-IBEW*, 693 F.3d at 156-57 (noting that these provisions, unless premised on allegations of fraud, ''place a relatively minimal burden on a plaintiff.'') (internal citation omitted).

[64] *Id.* at 165.

[65] *Id.* at 166.

[66] *Id.*

[67] *Id.* at 149.

[68] *Berger v. Apple REIT Ten, Inc.*, 563 Fed. Appx. 81, 84 (2d Cir. 2014).

[69] *Id.*

[70] *Police & Fire Ret. Sys. v. Goldman, Sachs & Co.*, No. 10-Civ.-4429, 2014 U.S. Dist. LEXIS 42452, at *9 (S.D.N.Y. Mar. 27, 2014); *see also Plumbers' & Pipefitters' Local #562 Supplemental Plan & Trust v. J.P. Morgan Acceptance Corp.*, No. 08-cv-1713, 2012 U.S. Dist. LEXIS 24106, at *29-30 (E.D.N.Y. Feb. 23 2012) (finding pleading of loss sufficient based on drastic ratings downgrade and explanation that value of certificates depended on underlying mortgages and assigned credit ratings).

[71] *NECA-IBEW*, 693 F.3d at 167.

than misstatements or omissions in offering documents.[72]

Lessons for Potential Subprime Auto Actions

As these recent decisions make clear, the pleading of loss causation, at least for a Securities Act claim, is not a particularly difficult obstacle. Investors holding bonds backed by subprime auto loans may have actionable claims even if scheduled payments continue but the bonds are downgraded by a ratings agency. Of course, losses will still have to be shown to recover damages, but in this respect, subprime auto investors may fare slightly better than previous RMBS investors. Defendants in RMBS cases argued that the effects of significant nationwide changes in the real estate market (including unprecedented declines in housing prices), the financial capital market (a severe drying up of liquidity) and the job market (surging unemployment rates) all had significant effects on the performance of the underlying mortgage loans, and hence the value of the securities.[73] Of course, a serious economic downturn may also trigger losses in subprime auto loan securities, but some of these factors would seem to apply to a lesser degree in the context of auto loans.[74] For instance, while there have been some reports of over-valued collateral in subprime auto loans, there is unlikely to be as sharp a decline in the market value of both new and used cars (both of which serve as collateral for subprime loans) as there was in housing prices several years ago. Furthermore, trends in car prices are likely to be less strongly correlated with trends in the broader economy than are trends in home prices.[75] And, as several commentators have noted, subprime auto loans are viewed by some investors as less risky because troubled borrowers often need vehicles to get to work, and will prioritize car payments over even mortgage payments.[76]

In any event, if recent media stories and governmental scrutiny are reliable indications, the characteristics of the subprime auto loan market currently resemble the mortgage market prior to the Great Recession. Investors in subprime auto securities should be aware that they may have actionable claims prior to the realization of out-of-pocket losses and class actions may be brought on behalf of large classes, which may alter the risk calculus of litigation, due to the potential for substantial recoveries. But recent RMBS cases instruct that statutes of limitations and repose may be strictly enforced, and not subject to traditional tolling principles, so it might not pay to sit on the sidelines as many RMBS investors over the past seven years have done.

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[72] *See*, *e.g.*, *Federal Housing Finance Agency v. Nomura Holding Am. Inc.*, No. 11cv6201, 2015 U.S. Dist. LEXIS 61516, at *240-*242, *373-*396 (S.D.N.Y. May 11, 2015) (discussing defendants arguments regarding macroeconomic factors causing losses in Section 12 case); *In re Washington Mutual Mortgage Backed Securities Litigation*, No. C09-37 MJP, 2012 U.S. Dist. LEXIS 102064 (W.D. Wash. July 23, 2012). *See also Federal Housing Finance Agency v. JPMorgan Chase & Co.*, 902 F. Supp. 2d 476, 489 (2012) (discussing causation arguments with respect to common law fraud claims); *Abu Dhabi Com. Bank v. Morgan Stanley & Co.*, 888 F. Supp. 2d 431, 472 (S.D.N.Y. 2012) (rejecting defendant's argument on summary judgment on common law fraud claims ''that plaintiff's losses were caused by the unprecedented and marketwide liquidity crisis that began in 2007'' because ''[s]ummary judgment is inappropriate so long as plaintiffs provide evidence 'that would allow a factfinder to ascribe some rough proportion of the whole loss to the defendant's alleged misstatements' '') .

[73] *See*, *e.g.*, cases cited *supra* Note 72.

[74] *See* Ben Geier, *Fortune*, ''Can Subprime Auto Loans Crash the Financial System?'' Jan. 13, 2015 (stating that ''[e]conomists generally agree that the housing market and the auto market are different enough that a repeat of 2008 caused by auto loans is unlikely''). ''The big difference is this – the amount of money we're talking about is significantly smaller than what created the home loan crisis and cars, in the end, are easier to repossess.'' *Id.*

[75] *See* Brad Tuttle, *Time*, ''Used Cars Are Going to Keep Getting Cheaper and Cheaper,'' Apr. 21, 2014 (noting that used car prices soared in recent years because fewer new cars were sold during the Great Recession). While used car prices were widely predicted to plummet in recent years, and did indeed drop somewhat (*see* John D. Stoll, *Wall Street Journal*, ''Used Vehicle Prices Fell For a Fourth Straight Month,'' Sept. 8, 2014), that trend may have come to an end. According to the Used Car Market Quarterly Report issued by Edmunds.com in August 2015, the average used vehicle transaction price hit a record high of $18,800 in the second quarter of 2015. *See* Q2 2015 Used Car Market Quarterly Report, available at http://www.edmunds.com/industry-center/data/used-car-market-quarterly-report.html.

[76] Michael Corkery and Jessica Silver-Greenberg, *The New York Times*, ''Investment Riches Built on Subprime Auto Loans to Poor,'' Jan. 26, 2015. As one Santander Consumer investor quoted in this article stated, ''You can sleep in your car, but you can't drive your house to work.'' *Id.*

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