FEDERAL SECURITIES FILINGS INCREASE IN 2007 DUE TO SUBPRIME DEBACLE

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The good news: the overall filing of federal litigations in 2007 was drastically reduced from the prior year. The bad news: federal securities litigations increased for the first time in three years. The reason: turmoil in the capital markets resulting primarily from the subprime credit crisis.[1]

Many predict that 2007 marks the crest of an impending wave of subprime-related litigation, and there are strong indications that they may be right. In evaluating the question, it is helpful to understand the number of cases that have been filed, the nature of the cases, who has been targeted in the litigation, and whether the ongoing issues on Wall Street suggest a continuing trend.

INCREASE IN 2007 FILINGS DUE TO SUBPRIME LITIGATION

Whereas the number of overall federal litigations filed in 2007 fell drastically from the prior year (less than 250,000 cases in 2007 compared to 280,000 cases in 2006), there was a 3% *increase* in the amount of federal securities litigations filed in 2007 (approximately 1590 cases in 2007, compared to approximately 1540 in 2006). Interestingly, and perhaps tellingly, this appears to be the only area of litigation where there was an increase, including in the following areas: competition, employment, intellectual property and product liability.[2]

This slight uptick appears to be due to the filing of subprime-related litigations. And, of course, these numbers do not include arbitration proceedings filed by private investors, potential litigations that are resolved pre-litigation, or state court filings which, if counted, would likely significantly increase the number of subprime related disputes. One well-known plaintiffs' attorney who filed a subprime NASD arbitration proceeding on behalf of an individual investor, claims that he has been contacted by numerous investors and "expect[s] to file [similar] claims in excess of $100 million in losses." [3]

AN ANALYSIS OF THE SUBPRIME SHAREHOLDER CLAIMS BEING FILED

According to a recent study published by NERA Economic Consulting, as of December 15, 2007, there were 38 subprime shareholder class actions, the majority

1 Source: Federal Court Dockets, Law 360.
2 *See* fn 1.
3 Reuters, *Bear Stearns Sued Over Hedge Fund Losses*, August 1, 2007.

of which were concentrated in the Second and Ninth Circuits, with the greatest number being filed in the United States District Court for the Southern District of New York. The NERA study also indicated that while the first subprime litigation was filed early in 2007, the rate of the filings accelerated towards the end of the year so that the filings made in the second half of the year were four times greater than the amount filed in the first half.[4]

Most commonly, the claims are brought by shareholders claiming that public companies made false and misleading public statements that materially exaggerated performance and understated potential risk, or materially misrepresented the companies' financial statements by: (i) understating their allowance for loan losses, (ii) overstating the value of their investments that were backed by subprime assets, or (iii) overstating the value of their residual interests in securitizations by failing to timely write down impaired assets. Other investor lawsuits claim that prospectuses were materially misstated due to a failure to fully and fairly set forth the potential for loss resulting from investments in subprime assets.

Such lawsuits, many of which were filed in late 2007 by Bill Lerach's old firm, Coughlin Stoia Geller Rudman & Robbins LLP, target a number of different participants in the ABS industry, including banking and mortgage lenders, residential home builders, REITs, bond insurers and credit rating agencies. The big question, of course, is whether the majority of the filings is behind us or yet to come.

PREDICTING THE FUTURE

Although it is always impossible to perfectly predict what tomorrow holds, every indication is that subprime litigation is still only ramping up. Much of the shareholder litigation stems from newly disclosed losses and, given the number of write-downs and losses in the last quarter of 2007, subprime litigation shows no signs of slowing down in 2008. As noted in the conclusion of the NERA study, "As the [subprime] crises in the credit markets continues to deepen and the market for subprime mortgages continues to suffer accordingly, more litigation is likely to follow." [5]

As we discuss in our next edition, however, all hope is not lost. Strong defenses exist for targets of these litigations, including, among other things, the significant difficulties inherent in valuing subprime collateral, the lack of foreseeability of impending losses, recent market conditions that have resulted in the losses, and the failure of plaintiffs to properly plead scienter under the recent United States Supreme Court Tellabs decision.

If you have any questions about the issues raised in this article or would like more information, please contact your Arnold & Porter attorney or:

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4 Stephanie Plancich, Brian Saxton and Svetlana Starykh, NERA Economic Consulting, *2007 Year End Update, Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High* (December 2007).

5 *See* fn 4.