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Lessons Learned: 10 Years of Financial Services Litigation Since the Financial Crisis

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The financial crisis and the Great Recession began a little more than 10 years ago, on September 15, 2008, when Lehman Brothers filed for bankruptcy. The next day, September 16, the Federal Reserve implemented a rescue of AIG, and the day after that the markets were in a state of free fall. On September 18, the government announced a further rescue proposal, and, on September 19, the Treasury Department guaranteed U.S. money market funds, an unprecedented move. The ensuing crisis led to manifold legislative, regulatory, and political reactions in the United States and abroad. The business and legal landscapes for financial institutions were, and remain, significantly altered. For financial institutions, the crisis also produced years of litigation in the United States spanning a broad range of claims.

Ten years out from the beginning of the Great Recession, it is worth reflecting on the course of that litigation, which appears to be finally reaching the beginning of the end. Perhaps the largest category of such litigation related to the growth of the mortgage market that marked the decade before the financial crisis and the expansion of both the government-sponsored and private securitisation markets, in particular for residential mortgage-backed securities ("RMBS") that emerged to finance that growth. The downturn in the U.S. housing market, the resulting impact on mortgage performance, and the ensuing domino effect on institutions and investors arguably were among the most significant causes of the financial crisis.

The extent and depth of the financial crisis took the financial institutions that had participated in the mortgage market by surprise. One thing is clear: the legal infrastructure that supported the mortgage underwriting and securitisation markets was not created with such a crisis in mind. The securitisation contracts upon which billions of dollars in liability ultimately turned were often hastily put together, and few, if any, parties to the contracts had reflected on what would happen if a substantial percentage of the securitised mortgages failed to perform (as opposed to the low default rates typical in the boom years). As might be expected, the ensuing waves of litigation took some time to emerge, were sometimes dominated by the "bad facts" of the crisis, inspired legal creativity and ingenuity, and required the courts to craft new applications of traditional legal principles. Ultimately, well-established legal rules generally prevailed and financial institutions and other market participants developed an understanding of how better to address potential legal risks going forward.

The Course of Financial Crisis Era Litigation

Litigation stemming from the financial crisis emerged in waves as different aspects of the mortgage-related markets came into focus. In reviewing the course of this litigation, it is worth keeping in mind the many different types of financial institutions connected to the mortgage underwriting and securitisation markets; none were left untouched by financial crisis-related litigation. These businesses reflected the gamut of financial institutions: mortgage brokers and mortgage companies that specialised in making subprime mortgages; retail banks that increased their mortgage and other home lending activities; commercial and investment banks that specialised in RMBS and/or commercial mortgage securitisations ("CMBS") and in even more complicated financial instruments, such as collateralised debt obligations ("CDOs"); the bond rating agencies that deemed such securities to be investment quality; the insurance companies that issued protection for some securitisations; the hedge funds and bank trading operations that invested in such securities; the trustee companies responsible for administering the trusts issuing such securities; and mortgage-servicing businesses, often operated by banks, that were responsible for servicing such mortgages once underwritten. Government or quasi-government institutions were also heavily involved in the mortgage markets, in particular the Federal Housing Authority ("FHA"), which guarantees smaller and more standard mortgages in an effort to make home ownership more accessible, and Government-Sponsored Enterprises ("GSEs"), such as Fannie Mae and Freddie Mac, that guarantee mortgages as part of their huge mortgage securitisation activities and even purchased enormous amounts of the RMBS issued during the pre-crisis years, which, in turn, fuelled the growth and expansion of that market.

The financial-crisis litigation emerged in waves. While it is beyond the scope of this chapter to discuss in detail each type or subset of financial-crisis litigation, in hindsight it generally can be categorised into three main waves. The initial wave focused on the institutions most immediately and visibly affected by the crisis. Thus, corporate and securities litigation against firms that suffered significant losses as a result of their mortgage exposure or even went out of business represented the first wave. Government-led investigations and civil actions dominated the next wave as public attention focused on the effect the crisis was having on ordinary people subjected to foreclosure. Finally, private civil litigation expanded as various investors in mortgage-related products realised the extent of their losses (or seized the opportunity to buy bonds at distressed prices as a litigation investment) and began to press litigation against the various parties involved in making and securitising mortgages – or at least those parties who by then still remained in business.

First Wave: Corporate and Securities Litigation

The first wave of litigation was marked by corporate and securities cases involving the firms that suffered the greatest initial losses on the financial markets. Thus, as some of the largest financial institutions experienced significant and highly publicised losses as a result of their exposure to the mortgage markets, the companies and their directors faced shareholder corporate and securities litigation. These litigations did not break particular new ground, although they were the initial battleground over the extent to which financial institutions and their officers and directors should be viewed as having legal responsibility for losses related to the financial crisis.

Generally, the financial institutions and their officers and directors did well in these cases. The legal theories pursued in these cases required showing intentional or reckless misconduct or bad faith, a high standard. For example, in 2009, in an early victory for a financial institution, Citigroup obtained dismissal of all but one claim in a shareholder derivative action that sought recovery for Citigroup's losses in the subprime lending market. The plaintiffs, shareholders of Citigroup, claimed that the defendants, directors and former directors of Citigroup, breached their fiduciary duty by allegedly not properly monitoring and evaluating the risks Citigroup faced in its exposure to subprime loans. The Delaware Court of Chancery held that plaintiffs' allegations did not establish the bad faith required for liability for a director's oversight lapses.[1] This early victory for a financial institution board likely prevented what would have been a host of similar claims.

Second Wave: Government-Led Investigations and Civil Litigation

The second wave of litigation was instigated by the government, which eventually directed significant resources to enforcement related to perceived lapses in mortgage origination, servicing, and securitisation. This effort was driven both by political imperatives and a real need for government intervention to assist those hit hardest by the financial crisis. The Obama Administration established the RMBS Working Group, which brought together federal and state agencies to investigate the securitisation market, while the Financial Fraud Enforcement Task Force focused on issues of fraud more broadly. Notably, the government relied more on civil tools than criminal ones. This generated public criticism from those who felt individual bankers responsible for the crisis should serve jail time, even as one of the earliest criminal cases brought in the wake of the financial crisis against two Bear Stearns hedge fund managers resulted in outright acquittals of all charges. The government's focus on civil tools nonetheless proved to be a smart strategy as its civil remedies were more flexible and subject to lower burdens of proof, thereby allowing the government to make its cases more easily.

The first significant government intervention began as a result of a practice that came to be known as "robo-signing". This term referred to the alleged practice by mortgage-servicing companies, which were responsible for handling mortgage foreclosures, of having individuals sign foreclosure documents under oath without a proper basis for doing so. While in most cases, although not all, the foreclosures were nonetheless legitimate, the scandal captured attention as it put a spotlight on the public's concern that financial institutions were not doing enough to help struggling homeowners avoid foreclosure. In February 2012, the Department of Justice ("DOJ") and the Department of Housing and Urban Development, along with the attorneys general of 49 states, reached a $25 billion agreement – the "national mortgage settlement" – with the five largest servicers of mortgage loans, Bank of America, J.P. Morgan, Wells Fargo, Citigroup, and Ally Financial, as settlement for alleged abuses in the banks' handling of their mortgage loan servicing and foreclosure businesses. The agreement required the mortgage servicers to commit more than $20 billion toward financial relief for consumers. It also created new standards intended to prevent future foreclosure inadequacies and abuses, such as stricter oversight of the foreclosure process, with compliance to be conducted under the oversight of an independent monitor.

The DOJ also obtained significant settlements through its use of a statute that had been mostly forgotten until the financial crisis. Passed in the aftermath of a prior banking crisis – the savings and loan crisis of the 1980s – the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") allows the government to seek civil monetary penalties based on violation of certain criminal statutes that relate to financial institutions. But, most importantly, it provides the government with tools to undertake pre-litigation civil investigations. The DOJ, with state attorneys general and other regulators often running parallel inquiries, used FIRREA to undertake investigations that resulted in additional significant settlements out of court to resolve RMBS claims. While the government had a great deal of leverage in these negotiations, financial institution lawyers were able to negotiate broad releases and innovative settlement components that gave the banks settlement credit for consumer relief activities. Although the settlement totals were large, the breadth of the releases across multiple federal and state agencies allowed affected institutions to make the case to the markets that the financial crisis was "behind them". These settlements included, both in cash and other consideration such as consumer relief: $16.65 billion from Bank of America; $13 billion from J.P. Morgan; $7.2 billion from Deutsche Bank; $7 billion from Citigroup; $5.28 billion from Credit Suisse; $5.06 billion from Goldman Sachs; $4.9 billion from RBS; $2.6 billion from Morgan Stanley; $2.09 billion from Wells Fargo; $2 billion from Barclays; and $1.375 billion from Standard & Poor's.

Another, even older, legal tool put to use was the *qui tam* action, in which a private plaintiff brings a lawsuit under the False Claims Act claiming the government was defrauded. If successful, the private plaintiff gets a portion of the recovery. Often these actions are initially filed under seal, enabling the government to investigate the private plaintiff's claims and determine whether to intervene. Such cases, common in other industries, were previously not typically used in the financial arena, but, in light of the various ways the government subsidised the mortgage markets, these cases provided a fruitful avenue for plaintiff firms and the government. One notable example of such a case was brought against Countrywide Home Loans, a leading originator of subprime mortgage loans, by a former executive. The government later intervened and significantly broadened the scope of the case, adding several additional defendants and claims under FIRREA for civil penalties for certain alleged violations of federal mail and wire fraud laws. This would later prove to be a grave overreach. The government prevailed at trial, with the jury rendering a general verdict in favour of the government. The district court then entered a $1.27 billion judgment against Countrywide.

But, in a rare victory for a financial institution, that verdict and the $1.27 billion judgment were reversed on appeal. The Second Circuit concluded that instead of proving mail or wire fraud sufficient for FIRREA liability, the government had merely proved intentional breach of contract.[2] The case was a significant setback for the government, which had sought to broaden the parameters of federal mail and wire fraud beyond the traditional requirements of common law fraud. It is also a clear example of the courts' consistent application of traditional common law contract and tort requirements to financial crisis and recession era cases.

Third Wave: Private Civil Litigation

The final wave of litigation, which gained momentum in 2011 and 2012 and continues even today, involved private civil litigation related to the securitisation markets. These cases even pitted financial institution against financial institution, as they were often brought by investors in mortgage-backed securities or other financial institutions that touched an aspect of the mortgage markets.

Many of these cases rested on contractual claims that required no finding of fault – just the willingness of courts to enforce the plain language of securitisation and other agreements underlying the mortgage securitisation markets. On the other hand, the courts' adherence to traditional contract principles meant that plaintiffs had to prove contractual breaches, and generalised pleading of widespread wrongdoing did not suffice. While not a comprehensive review of all such cases, the civil litigation that financial institutions faced can be sorted into several categories, including securities and fraud claims related to the purchase of RMBS, repurchase claims for defaulted mortgages, claims against servicers, and claims against trustees. Other areas of litigation not covered here included claims by monoline insurers who guaranteed many RMBS deals, claims by investors in complex instruments such as CDOs, and claims against the bond rating agencies.

Securities Claims

Many of the first cases filed by RMBS investors were claims under the securities laws, alleging that the prospectus supplements that accompanied the sale of each securitisation contained misstatements about the quality of the loans underlying the securitisations. Critically, these claims do not require evidence of scienter by the seller or reliance upon the false statement by the buyer. The Federal Housing Finance Agency ("FHFA"), an independent agency created by Congress to act as the conservator of Fannie Mae and Freddie Mac, instituted litigation in 2011 against 18 financial institution defendants, alleging violations of the federal securities laws in the sale of mortgage-backed securities to Freddie Mac and Fannie Mae. Because of the near strict liability nature of Securities Act claims, FHFA was able to secure more than $20 billion in settlements from bank defendants. The one bank that went to trial against FHFA – Nomura – lost.[3] As the *Nomura* court framed it, at the centre of these highly complex cases was merely the simple question of whether, under the Securities Act, defendants' securities offering documents accurately described the home mortgages underlying the securities. That court found the magnitude of the falsity to be "enormous". Private litigants also pursued such claims, often as class actions.

However, because Securities Act claims based on misstatements in a securities prospectus have a very strict three-year statute of limitations, this wave of RMBS litigation was the first to be resolved, and very little of it remains outstanding.

Loan Repurchase Claims

Loan repurchase claims constituted a large category of litigation against financial institutions. A loan repurchase claim, sometimes referred to as a "putback claim", flows from an alleged breach on the part of a defendant RMBS sponsor, originator, or other contractually responsible party of representations and warranties about the nature of the underwriting of the loans and of the diligence conducted on the overall quality of the loans. The claims are therefore generally for breach of contract – of the representations and warranties – and made by a trustee on behalf of a securitisation trust. As such, repurchase claims must be brought by parties to the contract, and investors must act through the trustee to press such claims. RMBS contracts, typically known as pooling and servicing agreements, generally provided for three equitable remedies in the event of a breach: cure the breach; repurchase the breaching loan; or provide a substitute compliant loan.

Courts typically applied traditional common law legal principles to loan repurchase claims. This resulted in some early decisions that significantly helped to cabin litigation and ultimately limit financial institutions' exposure. As noted, most securitisation agreements provide for a trustee to act on behalf of the certificate-holders, who are the trustee's beneficiaries, and these agreements contain provisions, called "no-action clauses", that restrict the certificate-holders' ability to act directly instead of through the trustee on their behalf. Courts have strictly interpreted these provisions, significantly restricting the proliferation of litigation. In an early case, *Walnut Place*, the Appellate Division of the New York Supreme Court, First Department, interpreting a no-action clause, held that a certificate-holder could only sue on behalf of the trustee if it met the strict requirements of the no-action clause. In that case, as in most RMBS contracts, the no-action clause required the certificate-holder to notify the trustee of an "Event of Default" before it could bring its own suit and contained other restrictions.[4] This strict enforcement of no-action clauses foreclosed direct contract actions by investors and required them to work through trustees, who typically required evidence of substantial ownership and an indemnity from investors before bringing suit on their behalf. Although the volume of representation and warranties litigation was large, *Walnut Place* and subsequent similar decisions meant that there was far less of it than if every individual investor – including opportunistic investors who bought distressed RMBS securities long after the financial crisis – could have sued in their own names.

Another important New York case, *Ace*, concerned the strict application of the six-year statute of limitations for repurchase claims, resulting in another application of traditional contract law that helped limit the sprawl of post-crisis litigation. Applying traditional principles of state contract law, the New York Court of Appeals held that breaches of representations and warranties about loan quality occur, and thus claims for breach accrue, on the date the representations are made (usually the date the securitisation closes), and not when the representations and warranties are discovered to be false or (as some plaintiffs argued) when an RMBS sponsor refuses to repurchase a loan. The Court of Appeals noted the general principle that statutes of limitation, in serving the public policy goal of repose, generally apply regardless of potential harshness, and that New York law repeatedly disfavours cause of action accrual dates that cannot be ascertained with certainty in contrast to bright line rules.[5] Because New York law limits tolling for contract claims to six years beyond the six-year statute of limitations, for a total of 12 years after issuance, and because the very last pre-crisis RMBS trusts closed in late 2007, the timeline for bringing claims – at least under New York law – is just about running out.

The New York courts have also cabined liability through strict application of the "sole remedy" clause in RMBS contracts, which requires trustees to prove their claims through the "loan-by-loan" repurchase protocol rather than through generalised allegations of wrongdoing.[6] For example, in one recent case, *Ambac*, the Court of Appeals reiterated the "well settled" principle of contract law that contract terms providing for sole remedies are strictly enforced, as they represent the parties' agreement on the allocation of risk of economic loss. Although there has been some divergence in the courts about the admissibility of statistical sampling to prove repurchase claims, the court in the one repurchase case to have gone to trial prohibited statistical sampling and ultimately forced the trustee to prove breach on a loan-by-loan basis for thousands of loans, a process that was very expensive and time-consuming.[7]

These proof requirements, and the doubts around the validity of statistical sampling, may have contributed to a trend of pre-trial settlements.

Faced with proliferating claims, and wanting to demonstrate to shareholders, regulators and others that the legacy of the financial crisis was manageable, some of the largest American banks, first Bank of America, then J.P. Morgan, Citigroup, and others, negotiated bulk settlements with groups of investors and RMBS trustees to obtain broad releases for origination and servicing claims across hundreds of trusts. These settlements made use of New York's Article 77 procedure, which allows a trustee to seek approval of a decision made with respect to a trust (here, the decision to settle all potential claims), binding all investors who have received notice and an opportunity to be heard. While the headline numbers on these bulk settlements were large, the preemptive settlements effectively cut off the threat of mushrooming litigation, the settlement rates as a percentage of losses ended up being very favourable compared to cases that did go to litigation, and shareholders and other constituencies were reassured that the banks had a plan for containing legacy liabilities.

Claims Against Servicers

In contrast to repurchase claims, private claims against servicers have been both less successful and, correspondingly, less common. This is because it is difficult to prove a breach of the servicing standards in the securitisation agreements, which are often phrased generally, such as imposing the obligation to service loans "prudently" or in accord with "industry custom and practice". Servicers could defend claims by arguing that their servicing of the loans was within their business judgment or consistent with (arguably previously low) industry standards. Further, securitisation agreements often contained exculpatory provisions that restricted servicers' liability only to instances of willful misconduct or gross negligence.

As such, servicer claims (outside of the government enforcement context discussed above) had little success. Indeed, one trial court, though permitting the claim to survive summary judgment, noted that it was doubtful an expert's opinion that a servicer's conduct deviated from contractual servicing standards could amount to "gross negligence, malfeasance, or bad faith", as the securitisation agreement required.[8] And, in that case, the plaintiff then abandoned its pursuit of that claim at trial.

Some investors, such as those who pursued the bulk settlement strategy discussed above, rather than pursuing litigation chose to negotiate with servicers for improved servicing practices as part of a global resolution of claims.

Claims Against Trustees

Perhaps the final wave of RMBS litigation has involved claims by securitisation investors against trustees in which the investors claimed that the trustees improperly administered the trusts. The allegations in these cases often highlighted trustees' failures to bring repurchase claims within the strict statute of limitations discussed above.

Investors asserted both contract and negligence claims against trustees, as well as statutory claims under the federal Trust Indenture Act. Because the trustee's duties are set out by the relevant contract, negligence claims were often dismissed in light of the familiar rule that a breach of contract is not a tort unless a duty independent of the contract was breached. Under New York law, an indenture trustee's duties are strictly defined and limited to the terms of the indenture. As such, contract claims brought against trustees flow from the provisions of an indenture or a pooling and servicing agreement for particular lapses, such as the failure to notify investors of breaches, the failure to take proper steps if there is an event of default, or the failure to maintain collateral files. Many of these cases turned on whether an event of default occurred, as such an event often triggers additional duties for the trustee. Courts often permitted these claims to proceed to discovery when the allegations were based on public information about alleged breaches while cautioning that such public information would alone not be sufficient evidence for liability, which often required proof of actual notice of a breach of the contract. As such, the trustee's notice or knowledge of an event of default as defined by the relevant contract is often a critical issue.

Even when they survive motions to dismiss, however, claims against trustees face significant barriers to establishing damages. In a seminal case, a federal appellate court noted that a trustee's misconduct must be shown "loan-by-loan and trust-by-trust".[9] In the wake of that decision, numerous courts held that statistical sampling cannot be used to prove claims against trustees. For example, a recent decision in the Southern District of New York held that "[l]oan-by-loan proof is required to establish the Trustee's liability to the Certificate-holders because, under . . . [the pooling and servicing agreements], the Trustee has neither the obligation nor the ability to demand cure, substitution, or repurchase of a nonconforming loan unless – among other things – it can identify a [representation and warranties] breach . . . that 'materially and adversely' affects the value of that particular loan".[10]

And, also recently, the courts have declined to certify classes of investors in trustee litigations, noting that difference in timing and structure of investors' investments make class litigation infeasible.[11] The trend has been to deny class certification because of the myriad individualised determinations that would be necessary to determine standing, statutes of limitations, and damages. Such limitations on class actions also applied in securities actions brought by RMBS investors.

Lessons Learned

The financial crisis that began in the fall of 2008 led to a cascade of litigation against financial institutions. The course of that litigation is a case study in how major litigation can wind its way through the legal system. But it also provides valuable lessons for financial institutions going forward when facing such an onslaught of litigation. Financial institutions would do well to remember these lessons:

Traditional legal principles should win out, but may take time. The litigation unleashed by the financial crisis emerged in waves. At times, the "bad facts" of the crisis overwhelmed the ability of financial institutions to fight back. But, ultimately, traditional common law legal principles generally prevailed. Financial institutions paid a significant cost for their financial-crisis litigation exposure, but ultimately were able to cabin it and move forward.

Legal innovation and creativity will emerge. The legal system set up for the mortgage industry was not built in anticipation of the mass defaults and related claims that resulted from the financial crisis. Lawyers on both sides of the "*v.*" were able to develop innovative ways to resolve these cases and judges were open to adopting them as long as they did not stray too far from legal principles. Many of those innovations will be part of the litigation arsenal going forward.

Financial institutions need to think carefully through the legal structures that they build for new products and services and the long-term risk of going into new business areas. The regulatory environments faced by financial institutions in the mortgage-related product area changed forever as a result of the financial crisis. But

the financial industry is constantly changing and a product that looks safe in good times may pose unexpected legal risk when times turn bad. The mortgage legal structure was not built for the mass litigation that resulted from the financial crisis. Well-run financial institutions now spend more time thinking through the risks posed by new products and expansion, and more frequently involve counsel and risk personnel in the decision-making process.

We can all hope that no similar financial crisis will soon emerge. If one does, the 10-year course of financial crisis-related litigation fortunately teaches that the legal system should have the tools and flexibility to address the resulting legal fallout.

Endnotes

1. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).
2. *See United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650 (2d Cir. 2016).
3. *See Fed. Hous. Fin. Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441 (S.D.N.Y. 2015).
4. *Walnut Place LLC v. Countrywide Home Loans, Inc.*, 96 A.D.3d 684 (N.Y. App. Div. 1st Dept. 2012).
5. *See ACE Sec. Corp. v. DB Structured Prods., Inc.*, 36 N.E.3d 623 (N.Y. 2015).
6. *See*, *e.g.*, *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 106 N.E.3d 1176 (N.Y. 2018).
7. *U.S. Bank, Nat'l Ass'n v. UBS Real Estate Sec. Inc.*, 205 F. Supp. 3d 386 (S.D.N.Y. 2016).
8. *Assured Guar. Mun. Corp. v. Flagstar Bank, FSB*, 892 F. Supp. 2d 596, 607 (S.D.N.Y. 2012).
9. *See Ret. Bd. of the Policemen's Annuity and Benefit Fund of the City of Chicago v. Bank of New York Mellon*, 775 F.3d 154 (2d Cir. 2014).
10. *See*, *e.g.*, *Royal Park Inv. SA/NV v. Deutsche Bank Nat'l Trust Co.*, No. 14 Civ. 4394 (AJN) (BCM), 2018 WL 4682220, at *5 (S.D.N.Y. Sept. 28, 2018).
11. *See*, *e.g.*, *Royal Park Inv. SA/NV v. Deutsche Bank Nat'l Trust Co.*, No. 14 Civ. 4394 (AJN), 2018 WL 1750595 (S.D.N.Y. Apr. 11, 2018).

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