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Underwriters, Residential Fail To Boot MBS Suit

By **Richard Vanderford**

Law360, New York (April 28, 2011) -- A New York federal judge on Thursday greenlighted part of a putative class action claiming that mortgage-backed securities sold by Residential Capital LLC and underwritten by Goldman Sachs Group Inc. contained lies in their offering statements.

The drop in the MBS' value when they went from investment-grade to junk status is a cognizable loss, and claims under Section 11 of the Securities Act of 1933 therefore can go forward, U.S. District Judge Harold Baer said.

"These allegations of injury are sufficient at the pleading stage," he said. Claims made about the quality the MBS under Sections 12(a)2 and 15, however, are not strong enough to go forward, he said.

The mixed ruling might not be all the investors hoped for, but it allows them to proceed with their claims against Residential, a major MBS issuer.

The plaintiffs, who have been joined by a group of intervenors, are institutional investors who in 2006 and 2007 bought MBS known collectively as RALI certificates.

The investors claim that the RALI certificates' seller, Residential Capital, and their underwriters, a group of big banks, are liable for disclosing weaknesses in the underlying loans.

In the lead-up to the financial crisis, Residential Capital had become one of the largest issuers of MBS in the world, and it used its heft to find rating agencies who would give its pools of often subprime mortgages better ratings, according to the plaintiffs.

The certificates all collapsed in value and received junk ratings when many of the underlying loans went into default or were foreclosed on, the plaintiffs say. They say the offering statements Residential Capital put out lied about how stringent the mortgage originators' lending guidelines were.

Judge Baer said their claims under Section 12 — which makes it illegal for sellers in a public offering to lie in offering statements — fail because the plaintiffs have not said whether they actually bought the RALI certificates in a public offering.

"It is true that intervenors allege the exact security purchased and the date of purchase," Judge Baer said. "However, the music stops there. Intervenors fail to adequately allege a direct purchase from a defendant."

Section 15 claims against the underwriter defendants — Goldman, Deutsche Bank Securities Inc., Citigroup Global Markets Inc. and UBS Securities LLC — also fail, Judge

Baer said. Section 15 makes "controlling persons" liable for misstatements that are illegal under Sections 11 and 12.

"The allegations that the RALI underwriter defendants exercised sufficient control are purely conclusory," Judge Baer said.

He said, though, ruled that a loss in MBS value is a cognizable loss under Section 11 and that the other claims are timely. He also rejected the defendants' attempts to argue that the investors knew about weaknesses in the securities.

The decision, though mixed, is a positive one for the investors behind the suit, said Steven Toll of Cohen Milstein Sellers & Toll PLLC, one of their attorneys.

"On balance, it's pretty good for us," he said.

An attorney for the defense did not immediately respond to a request for comment.

The plaintiffs received other good news today. Though Judge Baer denied their motion for class certification earlier, the Second Circuit has decided it will hear an interlocutory appeal of that decision, according to Toll.

The plaintiffs are represented by Cohen Milstein Sellers & Toll PLLC and Zwerling Schachter & Zwerling LLP.

The Residential Capital defendants are represented by Carpenter Lipps & Leland LLP. The underwriter defendants are represented by Fried Frank Harris Shriver & Jacobson LLP.

The case is New Jersey Carpenters Health Fund v. RALI Series 2006-QO1 Trust et al., case number 1:08-cv-08781, in the U.S. District Court for the Southern District of New York.

--Editing by Lisa Uhlman

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