New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 253—NO. 18

WEDNESDAY, JANUARY 28, 2015

SECOND CIRCUIT REVIEW

Expert Analysis

Limiting Scope of 'Class Standing' Doctrine in RMBS Cases

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This month, we discuss *Retirement Board v. The Bank of New York Mellon*,[1] in which the U.S. Court of Appeals for the Second Circuit resolved two matters relating to residential mortgage backed securities (RMBS) on which district courts have been divided. In a decision written by Judge Debra A. Livingston and joined by Judge Dennis Jacobs and Judge José A. Cabranes, the court held that a named plaintiff in a putative class action does not have standing to assert breach-of-duty claims against an RMBS trustee on behalf of absent class members who had invested in trusts other than those in which the named plaintiff had invested.

The court also addressed the scope of the Trust Indenture Act of 1939 (TIA). Where applicable, the TIA obligates a trustee to disclose information relating to the securities underlying the trust, among other things. As a matter of first impression, the court held that the TIA does not apply to RMBS trusts governed by pooling and servicing agreements (PSAs). Accordingly, the court affirmed in part and reversed in part the district court order, remanding the case for further proceedings consistent with its opinion.

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Background

Retirement Board concerned 530 RMBS trusts created between 2004 and 2008. Most of the trusts were governed by PSAs and organized under New York law. In general, RMBS trusts are organized to receive the stream of payments generated by mortgage loans and to redistribute the revenue to investors or "certificateholders." Mortgage lenders sell pools of mortgages into the trust, and investors then purchase certificates representing the right to a share of the revenue. These certificates are often divided into different classes or tranches. The trustee typically hires a mortgage servicer to oversee and administer the mortgages.

The Bank of New York Mellon (BNYM) acts as trustee for all 530 RMBS trusts at issue in this case. Countrywide Home Loans and its affiliates (collectively, "Countrywide") originated all of the underlying mortgage loans, sold those loans to the trusts, and acted as the mortgage servicer for the trust. In the process, Countrywide made a number of representations and warranties about the loans' characteristics, credit quality, and underwriting. The PSAs required BNYM both to ensure that the loans were properly documented and to provide notice to Countrywide if it became aware of a material breach. Upon notice, Countrywide was obligated either to cure the defect or to repurchase the defective loan.

Plaintiffs—who invested in some, but not all, of the trusts—asserted claims on behalf of a putative class of investors who purchased certificates from any of the 530 trusts. Plaintiffs alleged (1) that Countrywide's failure to adhere to prudent underwriting standards resulted in many loans being in breach and, therefore, defaulting at a higher rate than expected; (2) that BNYM knew about defects among the underlying loans and had a duty to enforce Countrywide's repurchase obligations; (3) that BNYM failed to ensure that the loans were properly documented, which allegedly made it more difficult to foreclose the loans; and (4) that the TIA obligated BNYM to inform certificateholders of Countrywide's breaches.

Prior Proceedings

Plaintiffs filed an initial complaint on Aug. 5, 2011, and filed a verified class action and derivative complaint (the "amended complaint") on Aug. 31, 2011. BNYM moved to dismiss the amended complaint on Dec. 16, 2011, arguing that plaintiffs lacked standing to assert claims on behalf of investors in trusts in which plaintiffs had not invested. BNYM also argued that the PSA-governed trusts were exempt from the TIA. On April 3, 2012, Southern District Judge William H. Pauley III granted defendant's motion for lack of standing, but denied the motion with respect to the applicability of the TIA.

On April 17, 2012, BNYM filed a motion for reconsideration of the district court's TIA holding or, alternatively, to certify the issue for interlocutory appeal. The court certified the issue, and BNYM petitioned the Second Circuit for leave to appeal. Plaintiffs filed a separate petition seeking review of the district court's standing decision, and the Second Circuit granted both petitions on May 7, 2013.

The Second Circuit's Decision

The Second Circuit reviewed the TIA decision de novo under Federal Rule of Civil Procedure 12(b)(6), accepting the complaint's factual allegations as true and drawing all reasonable inferences in plaintiffs' favor. The court reviewed the standing decision under the same standard pursuant to Rule 12(b)(1), since the district court's decision was based entirely on allegations included in the complaint. The court affirmed the standing decision, but reversed the TIA decision.

Plaintiffs Lacked Class Standing. The court began by noting that the doctrine of standing arises from the constitutional limitation of federal court jurisdiction to "cases" or "controversies."[2] In determining whether plaintiffs had standing to pursue claims on behalf of investors in other trusts, the court turned to its recent decision in *NECA v. Goldman Sachs* for guidance.[3] Issued after the district court order in this case, *NECA* involved a putative class action alleging misrepresentations under the Securities Act of 1933. *NECA* developed a two-part test for "class standing:"

> [I]n a putative class action, 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.[4]

NECA concerned a number of RMBS trusts that had very similar offering documents, but contained loans originated by different entities. The court found that plaintiff had class standing to assert misrepresentation claims with respect to certificates corresponding to loans from the same originator as the certificates in which plaintiff had invested, but not with respect to certificates corresponding to loans from other originators.

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The distinction stemmed from the NECA court's reasoning that a determination whether an originator followed the applicable underwriting guidelines implicated the "same set of concerns" with respect to other loans from that same originator, but not with respect to loans from another originator.

The Second Circuit had not yet applied the NECA test to breach-of-duty claims, and district courts have divided on the issue. The court found there to be no dispute that plaintiffs in *Retirement Board* had satisfied the first prong of the NECA test. However, the court found that plaintiffs failed to satisfy the second prong, holding that, in contrast to *NECA*—which focused on statements in offering documents that were nearly identical for all trusts—BNYM's alleged misconduct "must be proved loan-by-loan and trust-by-trust."[5] That is, to determine whether BNYM had a duty to act, the court must first determine whether individual loans were in breach, and the fact that loans in one trust were in breach has no bearing on the status of loans in another trust.

Plaintiffs proposed to demonstrate that all trusts contained loans in breach, but the court found that this proposal "fundamentally misses the point of the class standing inquiry," since the "fact that it would be possible for a plaintiff to litigate a given claim plainly does not imply that she should be the one to litigate it."[6]

Implications. The court's ruling that plaintiffs' breach-of-duty claims do not raise the "same set of concerns" as claims arising out of trusts in which plaintiffs did not invest clarifies the scope of the class standing doctrine articulated in *NECA* and resolves a division among the district courts.

PSA-Governed Trusts Are Exempt from the TIA. The court next addressed the TIA decision and concluded that certificates issued by the PSA-governed trusts (the New York certificates) were exempt from the TIA, another issue that has divided district courts. The TIA's coverage is defined by §§304(a)(1)-(10) of the act. These sections enumerate securities to which the TIA does not apply; any instrument not exempted from coverage is subject to the TIA. The TIA lays out a number of requirements, but the relevant requirement for the New York certificates—had they not been exempt—would have been an obligation for BNYM to notify investors of Countrywide's alleged breaches with respect to the underlying loans.

BNYM argued that the New York certificates were exempt either under §304(a)(1) or under §304(a)(2) of the TIA.[7] The court declined to rule on the §304(a)(1) argument but found that the New York certificates qualified for exemption under §304(a)(2). Therefore, the court reversed the district court's contrary holding.

Decision Not to Rule on §304(a)(1). The court found it unnecessary to rule on BNYM's argument that the New York certificates are exempt under §304(a)(1). That section exempts "any security other than (A) a note, bond, debenture, or evidence of indebtedness, whether or not secured, or (B) a certificate of interest or participation in any such note, bond, debenture, or evidence of indebtedness, or (C) a temporary certificate for, or guarantee of, any such note, bond, debenture, evidence of indebtedness, or certificate."[8]

Both parties, as well as the district court, had focused on whether the certificates were considered debt or equity under the assumption that equity securities (but not debt securities) are exempt under §304(a)(1). However, the court disagreed with this assumption and found that a security's status as debt or equity would not be dispositive. Given the certificates' exemption under §304(a)(2), the court declined to decide whether the New York certificates are debt or equity.

Exemption Under §304(a)(2). The court found that the New York certificates were exempt under §304(a)(2), which is consistent with the Securities and Exchange Commission's position.[9] Section 304(a)(2) exempts "any certificate of interest or participation in two or more securities having substantially different rights and privileges."[10] The application of §304(a)(2) to PSA-governed trusts is an issue of first impression in the Second Circuit. The court broke §304(a)(2) into three factors and addressed those factors in turn.

'Certificate of Interest or Participation.' The court first concluded that the New York certificates are "certificates of interest or participation" under the meaning of §304(a)(2). The court recognized that there was little case law fleshing out a definition of this phrase, but looked to the Supreme Court's decision in *Tcherepnin v. Knight* for guidance.[11] Ultimately, the court determined that the salient characteristic of a certificate of interest or participation is that payments to certificateholders are contingent on the cash flow generated by the instruments underlying the certificate.

The district court had reasoned that, since the mortgage servicer had the ability to retain certain payments from the underlying loans, payments to certificateholders were not contingent on the cash flow generated by those loans. The court disagreed, holding that it was not the case that investors "must literally receive all of the cash flows generated by the underlying instruments in order for their investment to qualify as a certificate of interest or participation."[12]

The court also rejected plaintiffs' argument that payments were not contingent on loan performance because the cash flow from the mortgages is first re-directed to the various classes of certificates. The court recognized that many certificates will require rules for parceling out revenue and reasoned that a holding that predicated the application of the TIA on a case-by-case analysis of those rules would inject an unacceptable level of uncertainty into RMBS issuances. Further, the court noted that plaintiffs proposed no standard pursuant to which courts might conduct such an analysis.

> The court's ruling that plaintiffs' breach-of-duty claims do not raise the "same set of concerns" as claims arising out of trusts in which plaintiffs did not invest clarifies the scope of the class standing doctrine articulated in 'NECA' and resolves a division among the district courts.

'Two or More Securities.' The court next concluded that the New York certificates were certificates of interest or participation in "two or more securities" under the meaning of §304(a)(2). In so finding, the court rejected plaintiffs' argument that each certificate corresponded only to its tranche rather than to the underlying loans. The court noted, among other things, that tranches are merely groupings of certificates that do not generate any payments separate from those generated by the underlying loans. "[I]t is therefore impossible," the court concluded, "for the certificates at issue to be certificates of interest or participation in their corresponding tranches."[13]

The court also rejected plaintiffs' alternative argument—raised in a footnote—that mortgage loans are not securities at all, noting that it had "no difficulty concluding that the mortgage loans held by the trusts do qualify as securities."[14]

'Substantially Different Rights and Privileges.' Finally, the court concluded that the underlying loans have "substantially different rights and privileges" as required by §304(a)(2), noting that, "[a]mong other things, the loans have different obligors, payment terms, maturity dates, interest rates, and collateral."[15]

Implications. The court's ruling that the TIA does not apply to PSA-governed trusts brings the Second Circuit's jurisprudence back in line with the SEC's interpretation. In so ruling, the court has resolved a division of the district courts and clarified the obligations—and potential liabilities—of RMBS trustees.

The combination of this ruling with the clarification of the scope of the class standing doctrine in the breach-of-duty context marks *Retirement Board* as a case that will have a significant impact on future RMBS litigation.

1. *Ret. Bd. of the Policemen's Annuity & Ben. Fund of the City of Chicago v. Bank of New York Mellon*, No. 13-1776-CV, 2014 WL 7272269 (2d Cir. Dec. 23, 2014).
2. U.S. Const. Art. III, §2.
3. *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012).
4. Id. at 162 (alterations, internal quotation marks, and citations omitted).
5. *Ret. Bd.,* 2014 WL 7272269, at *7.
6. Id.
7. 15 U.S.C. §77ddd(a)(1); (a)(2). BNYM first argued for exemption under 15 U.S.C. §77ddd(a)(2) in its motion for reconsideration, but plaintiffs never argued for waiver and so the court considered the argument. See *Ret. Bd.*, 2014 WL 7272269, at n.3.
8. 15 U.S.C. §77ddd(a)(1).
9. See U.S. Securities and Exchange Commission, Trust Indenture Act of 1939, Interpretive Responses Regarding Particular Situations §202.01, available at http://www.sec.gov/divisions/corpfin/guidance/tiainterp.htm (last accessed Jan. 14, 2015).
10. 15 U.S.C. §77ddd(a)(2).
11. *Ret. Bd.*, 2014 WL 7272269, at *10 (citing *Tcherepnin v. Knight,* 389 US 332 (1967)).
12. Id. at 11.
13. Id. at 12.
14. Id. at 13.
15. Id.