

Deterrence and Fairness: Why the Current Financial Crisis Demands a Product-Oriented Relaxation of the PSLRA

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I. INTRODUCTION

*"I figured if I didn't understand it, and I had access to a couple hundred Ph.D.s, how the rest of the world is going to understand it sort of bewilders me."*¹

Since 2006, plaintiffs have initiated more than eight hundred subprime-related lawsuits.² As of December 30, 2008, plaintiff-investors filed two hundred and ten federal securities class actions alleging over \$856 billion in losses.³ The Second Circuit outpaced all other circuits with 92 filings, followed by the Ninth and Eleventh Circuits, with 28 and 17 respectively.⁴ The wave of securities litigation flows from the over-issuance of subprime mortgage loans, the subsequent bundling of those high-risk loans, and large-scale Wall Street investment in mortgage-backed securities.⁵ The dramatic decline in home values led to a surge in homeowner mortgage default, revealing the true risks embedded in mortgage-backed securities.⁶ Some economists find fault only in the inevitability of a recession, where other prominent scholars simply view

¹ *House of Cards* (CNBC television broadcast Mar. 29, 2009) (Allen Greenspan, Chairman of the Federal Reserve from 1987 until 2006, admitting his trouble understanding some of the complexities associated with the structured financial products at the heart of the financial crisis) (transcript available at http://vooogle.mreplay.com/transcript/House_of_Cards/58/CNBC/Sunday_March_1_2009/03_01_09/0/).

² Monica Pinciak-Madden & Katya Jestin, *Subprime Crisis: The Unraveling Promises to Increase the Number of Civil Suits and Criminal Investigations*, N. Y. L. J., January 5, 2009, at 1, available at <http://jenner.com/people/bio.asp?id=989> (scroll down to "available publications"; then follow "please click here to review article" hyperlink).

³ See *Securities Class Action Filings, 2008: A Year in Review*, Stanford Law School Securities Class Action Clearing House & Cornerstone Research, (Jan. 6, 2009), available at <http://securities.stanford.edu> (follow "full report" hyperlink under "Clearinghouse Research").

⁴ *Id.* at 3.

⁵ See Sally Pittman, *ARMS, but no Legs to Stand On: "Subprime" Solutions Plague the Subprime Mortgage Crisis*, 40 TEX. TECH L. REV. 1089 (2008) for an analysis of the leading factors contributing to the subprime mortgage crisis.; see also Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571, 590-91 (2008) ("Specifically, rising defaults in the subprime mortgage market caused world capital markets to seize up and the largest financial institutions in the world to suffer impaired liquidity and decreased capital.").

⁶ See Simkins, *supra* note 5, at 590 ("The uncertainty of the magnitude of subprime losses and the lack of transparency regarding which firms held the risk evolved to foment a full-fledged credit crunch and liquidity crisis in the financial sector.").

the crisis as the result of corporate greed and lax regulatory standards.⁷ Wall Street rooted its risk exposure in the global financial markets and now investors and the public alike must ask whether it could have been prevented.⁸ Suspecting that corporate executives concealed or understated the quality and risk associated with the mortgages backing these securities, investors have filed claims seeking relief under U.S. securities laws.⁹

Although private securities class actions provide for investor scrutiny and serve as an important deterrent to fraudulent activity,¹⁰ securities class actions receive less than favorable treatment in the federal courts pursuant to the Private Securities Litigation Reform Act of 1995 (“PSLRA”).¹¹ Specifically, the PSLRA mandates a stay of all discovery pending a motion to dismiss, which consequentially limits a plaintiff’s ability to sufficiently demonstrate fraudulent intent at the pleading stage.¹² The costs and complexities of securities litigation undoubtedly burden defendant corporations; however, the PSLRA places

⁷ *Id.* at 591 (citing Secretary Paulson’s warning of market “stress and volatility in early 2008” and suggesting that the “structured investment vehicles” holding credit risk in subprime mortgages were not disclosed on company balance sheets).

⁸ The FDIC closed 42 U.S. banks since March 7, 2008. FDIC.gov, Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Mar. 19, 2008); see also Aaron Unterman, *Innovative Destruction - Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 56 (2009) (“As of August 2008, over \$500-billion in losses have been reported, primarily by major international banks.”); see also Randall Dodd & Paul Mills, *Outbreak: US Subprime Contagion*, International Monetary Fund - Finance & Development, Vol. 45, Sec. 2 (June 2008), available at <http://www.imf.org/external/pubs/ft/fandd/2008/06/dodd.htm> (“Like an epidemic . . . the financial crisis spread when losses to intermediaries in one nontransparent market raised concerns about liquidity and solvency elsewhere.”).

⁹ The Securities Exchange of 1934, specifically the anti-fraud provisions located in section 10(b) and the regulations thereunder, provides for a private cause of action for securities fraud and insider trading. Securities Exchange Act of 1934, 15 U.S.C.S § 78j(b) (2009) (This section proscribes the “use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations.”).

¹⁰ See Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ‘33 and ‘34 Act Claims*, 76 WASH. U. L. Q. 537, 592–93 (1998) (arguing that Congress intended the Securities Act of ‘33 to “act as the incentive for a company to adhere to its disclosure obligations” and “subject public offerings, and thereby the companies, officers, and directors making them, to investor scrutiny.”).

¹¹ Patrick Hall, *The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit’s Interpretation of Materiality in Employer-Teamster v. America West*, 2004 B.Y.U.L. REV. 863, 873 (2004) (“With the stated purpose of deterring frivolous securities fraud claims, the PSLRA heightens the pleading requirements for private litigants by requiring that a complaint plead with particularity both falsity and scienter.”).

¹² *Id.*

an equally insurmountable burden on plaintiffs to prove securities fraud in its entirety at the pleading stage.¹³ The extraordinarily complex nature of mortgage-backed securities, coupled with the PSLRA discovery stay, often leaves plaintiffs with insufficient pre-filing hard evidence to satisfy a heightened pleading standard.¹⁴

As the new wave of subprime-related litigation takes aim at financial institutions,¹⁵ this comment seeks to address the inequity of the federal courts' application of the PSLRA's heightened pleading standard in the context of exotic, mortgage-backed securities. As a proposed solution, plaintiffs should be required to plead particularly those facts available to them prior to discovery that evince fraudulent intent on the part of the defendants. To prevail on a motion to dismiss, the defendant corporations should then bear the burden of rebutting qualified allegations of fraudulent intent or suffer the pangs of discovery. This comment argues that in the context of mortgage-backed securities, the PSLRA policy of deterring frivolous claims must give way to the overarching goals of securities regulation.

Part II of this Comment will address the background of U.S. securities laws and the specific PSLRA pleading requirements. Part III will address the circuit courts' interpretation of the PSLRA and the Supreme Court's recent interpretation of the 'scienter' requirement. Part IV argues that in the unique context of mortgage-backed securities, the current financial crisis calls for the relaxation of the PSLRA pleading requirements.

II. BACKGROUND

A. U.S. Securities Laws: Policy & History

The stock market crash of 1929 and the Great Depression that followed prompted Congress to pass regulatory legislation to provide for government oversight in the market of securities transactions.¹⁶ Prior to

¹³ See Sale, *supra* note 10, at 564 (arguing that the PSLRA is over-inclusive in eliminating securities class actions because "the Reform Act is likely to allow only the more flagrant and obvious cases of securities fraud to proceed past a motion to dismiss.").

¹⁴ See Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes For Discovery in Federal Securities Fraud Actions*, 77 B.U.L. REV. 69, 71 (1997) ("[O]nly in the unusual circumstances where the defendants have disclosed facts in their own federal securities filings . . . would information sufficient to satisfy the pleading standard become publicly available.").

¹⁵ See *Securities Class Action Filings*, *supra* note 3, at 2 (stating that almost half of all filings in 2008 involved the financial services sector).

¹⁶ See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION* 5 (5th ed. 2006).

the crash, many investors borrowed money to purchase over-valued, highly speculative securities.¹⁷ When stock prices dropped, panic ensued and massive margin calls triggered a market-wide sell-off of securities and a nationwide “run on the bank.”¹⁸ This “speculative driven stock market boom of the 1920s” stemmed primarily from the lack of regulatory presence, low transaction costs for market participation, and low interest rates.¹⁹ In 1934, there existed a public consensus that the crash was caused by excessive market speculation and Congress responded by enacting securities regulations as an effort to thwart another financial meltdown.²⁰

Congress enacted the Securities Act of 1933 to regulate public stock offerings and mandate specific disclosures prior to an initial public offering.²¹ Congress enacted the Securities Act with the fundamental purpose of replacing the *caveat emptor* approach to securities purchases with one of full disclosure.²² Complimentary to the Securities Act, Congress enacted the Securities and Exchange Act of 1934 to regulate the secondary market of securities transactions and created the Securities and Exchange Commission as the agency responsible for enforcement.²³ The Exchange Act seeks to promote the overall integrity of the U.S. capital markets by providing anti-fraud provisions and implementing regulatory controls over brokers and dealers in the secondary markets.²⁴

¹⁷ *Id.*

¹⁸ *Id.* The term, “run on the bank,” signifies a large-scale withdraw of bank deposits at the same time, forcing the bank into a severe and often fatal liquidity crisis. Mark E. Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation*, 41 B.C. L. REV. 195 (2000). For a detailed discussion of the bank panics of the Great Depression, see ELMUS WICKER, *THE BANKING PANICS OF THE GREAT DEPRESSION I* (2000) (stating that the 9,096 banks closed between 1930 and 1933).

¹⁹ Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 517 (2003) (The boom of the 1920s was driven by “an efficient environment including low transaction costs and the ability to negotiate for information” and thereafter “the market devolved into a speculative bubble.”).

²⁰ Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 409 (1990).

²¹ Cox, *supra* note 16, at 3; see also *The Law That Governs the Security Industry – Securities Act of 1933*, U.S. Securities and Exchange Commission, available at <http://www.sec.gov/about/laws.shtml> (often referred to as the “truth in securities” law).

²² See Cox, *supra* note 16, at 3 (summarizing that the prevailing view was that “Congress intended the Exchange Act to fill that role” and the Act’s fundamental purpose was “to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.”).

²³ *Id.* at 7; see also *The Law That Governs the Security Industry*, *supra* note 21 (The Act created and empowered the Securities and Exchange commission with the “power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation’s securities self regulatory organizations.”).

²⁴ See Cox, *supra* note 16, at 9.

Government enforcement of the mandatory disclosure and antifraud provisions of U.S. securities laws serves to prevent the systemic risks that cause financial markets to collapse.²⁵ The current financial crisis best exemplifies the far-reaching externalities of systemic or institutional-wide financial risk.²⁶ The principle justification for regulating this risk is market efficiency, wherein market failures can be corrected and crippling externalities can be prevented.²⁷

The Securities Act and the Exchange Act provide plaintiffs with numerous express and implied causes of action;²⁸ however, the Exchange Act's general fraud liability provision of Rule 10b-5 stands alone as the most prominent.²⁹ The basic elements of this private right of action include: (1) a material misrepresentation or omission made by the defendant; (2) such misstatements or omissions were made with scienter; (3) in connection with a purchase or sale of security; (4) reliance on the material misstatement or omission; (5) economic loss; and (6) a causal connection between the misstatement or omission and the economic loss.³⁰ Further, Federal Civil Rule of Procedure 9 mandates that claims of fraud be pleaded with particularity, but that intent "may be averred

²⁵ See Securities and Exchange Act of 1934, Rule 10b-5, 17 CFR 240.10b-5 (2009) (it is unlawful "to make an untrue statement of material fact or to omit to state a material fact necessary . . . in light of the circumstances under which they were made, not misleading . . ."); see also Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008) (defining systemic risk as "risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.").

²⁶ See Schwarcz, *supra* note 25, at 199 (noting that financial institutions and banks are important sources of capital and "their failure, especially in large numbers, can deprive society of capital and increase its cost.").

²⁷ *Id.* at 206 (stating that "[f]ailures of the financial system can generate social costs in the form of widespread poverty and unemployment, which in turn can destroy lives and foster crime.").

²⁸ See *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 (2005); see also Sale, *supra* note 10, at n.7, for a summary of the eight express and four implied causes of action under the Exchange Act of 1934 and the Securities Act of 1933.

²⁹ *Id.* at n.12. Section 10(b) of the Securities Exchange Act prohibits the "use or employ[ment] . . . of any . . . deceptive device . . . in connection with the purchase or sale of any security" and "in contravention of" Securities and Exchange Commission "rules and regulations." 15 U.S.C.S. § 78j(b). Thereunder, the SEC enacted Rule 10b-5 which prohibits issuers from making "untrue statement of a material fact" or an omission of a material fact "necessary in order to make the statements made . . . not misleading." 17 CFR § 240.10b-5 (2004).

³⁰ *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). Scienter is defined as a defendant's "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

generally.”³¹ Prior to the PSLRA, the federal courts imposed varying standards of the particularity required when alleging securities fraud and in an effort to both heighten and unify the gate-keeping role of the pleading stage, Congress enacted the PSLRA.³²

B. The Enactment of the Private Securities Litigation Reform Act

Congress enacted the Private Securities Litigation Reform Act (“PSLRA”) to amend the Securities Act of 1933 and the Securities and Exchange Act of 1934.³³ Among the many changes,³⁴ the PSLRA most notably created an unprecedented pleading standard in securities fraud class actions under section 10(b)-5 of the Exchange Act.³⁵ Securities class action plaintiffs alleging securities fraud must specifically identify each of the defendant’s statements alleged to be misleading or false and explain in what way those statements were misleading or false.³⁶ The PSLRA “scienter” provision further requires plaintiffs to plead specific and particularized facts that give rise to a *strong inference* that the

³¹ FED. R. CIV. P. 9(b). This pleading standard enhances the traditional notice pleading required by Federal Rule of Civil Procedure 8 that requires plaintiffs plead only “a short and plain statement of the claim showing that [they are] entitled to relief.” FED. R. CIV. P. 8.

³² See Sale, *supra* note 10, at 544.

³³ See generally Andre Douglas Pond Cummings, “*Ain’t No Glory in Pain*”: How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets 83 NEB. L. REV. 979, 1007 (2005) (stating that the express purpose of Securities Act of ‘33 and the Securities Exchange Act of ‘34 was to “strike a delicate balance between investor protection and enhancement of capital formation by U.S. corporations.”).

³⁴ James, D. Cox, Randall S. Thomas, & Lynn Bai, *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 2 VAND. L. REV. 355 (2008) (The PSLRA introduced (1) “a heightened pleading requirement”; (2) “procedures by which the court chooses a lead plaintiff for the class . . . the petitioner with the largest financial loss suffered”; (3) “a bar to the plaintiff from obtaining any discovery prior to . . . disposing of the defendants’ motions to dismiss”; (4) “joint and several liability was replaced with proportionate liability”; and (5) “contribution rights among co-violators are also based on the proportionate fault of each defendant.”).

³⁵ The general consensus among commentators is that the PSLRA represented a paradigm shift with respect to the burden of proof in securities litigation. See, e.g., Cox *supra* note 34, at 357 (noting that “the PSLRA cast aside—albeit only for securities actions—the less demanding notice pleading requirement that has been a fixture of U.S. civil procedure for decades.”).

³⁶ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 2504 (2007) (hereinafter cited to the Supreme Court Reporter, 127 S. Ct. 2499) (stating that the PSLRA “requires plaintiffs to state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant’s intention ‘to deceive, manipulate, or defraud.’”).

defendant acted with intent to defraud.³⁷ Additionally, upon a defendant's motion to dismiss, the PSLRA mandates a stay of discovery until the court rules on the pending motion.³⁸ In short, the PSLRA requires plaintiffs to plead facts establishing a strong inference that the defendants acted with intent to defraud without the benefit of ordinary discovery practices.³⁹ In most cases, plaintiffs are limited to the defendants' public disclosures in federal securities filings or available revelations in ongoing federal investigations.⁴⁰

Congress enacted the PSLRA in an effort to deter abusive private securities litigation by weeding out meritless claims prior to the initiation of expensive and time consuming discovery.⁴¹ Proponents of the PSLRA asserted that the burdensome and expensive discovery associated with securities class actions served to extort settlements from corporate defendants.⁴² Thus, the heightened pleading standard forces plaintiffs to prove the merits of their securities fraud claim prior to the defendants incurring substantial discovery expenses.⁴³ In short, Congress heightened the pleading standard in securities fraud class actions with the assumption that abusive discovery practices, pursuant to frivolous claims, unfairly extorted settlements from corporate defendants.⁴⁴

³⁷ *Id.* (holding that "plaintiffs must 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'"); *see id.* at 2509 ("The 'strong inference' standard 'unequivocally raise[d] the bar for pleading scienter.'").

³⁸ *See* Joel Seligman, *The Seventeenth Annual Corporate Law Symposium: Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 117 (2004) (explaining the PSLRA mandatory stay of discovery requires "all discovery and other proceedings shall be stayed during the pendency of a motion to dismiss" and that "[t]here have been relatively few exceptions to the stay provision.").

³⁹ *See generally* Cummings, *supra* note 33 (arguing that the PSLRA automatic stay of discovery provision acts to hamper victims of alleged securities fraud).

⁴⁰ Thomas, *supra* note 14, at 71.

⁴¹ Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives For Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U.L. REV. 91, 92 (2007) ("Congress recognized that something was broken in the private securities litigation arena."); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) ("As a check against abusive litigation in private securities fraud actions, the Private Securities Litigation Reform Act of 1995 (PSLRA) includes exacting pleading requirements.").

⁴² *See* Christine Hurt, *The Undercivilization of Corporate Law*, 33 IOWA J. CORP. L. 361, 385-87 (2008) (stating the enactment of the PSLRA primarily stemmed from a desire to end "strike suits" or abusive litigation).

⁴³ John M. Wunderlich, *Tellabs v. Makor Issues & Rights, Ltd.: The Weighing Game*, 39 LOY. U. CHI. L. J. 613, 654-55 (2008) (noting that Congress passed the PSLRA to prevent strike suits where high litigation and discovery costs forced parties into settling claim).

⁴⁴ *Id.*

The PSLRA's heightened pleading requirements and policy goals immediately faced criticism.⁴⁵ In fact, the House and the Senate overrode President Clinton's veto of the PSLRA in 1995.⁴⁶ President Clinton found that the heightened "state of mind" provision "impose[d] an unacceptable procedural hurdle to meritorious claims."⁴⁷ Also, many argued that the PSLRA enabled the dismissal of meritorious investor complaints against corporations that contributed to the Enron-era scandals of the early 21st century.⁴⁸ Congress enacted the PSLRA to address a narrow class of unmeritorious securities claims; however, this "kitchen sink" amendment creates a barrier, which in some circumstances, results in the dismissal of both meritorious and unmeritorious claims.⁴⁹ Congress enacted the PSLRA to deter frivolous claims, but limited all injured plaintiffs, in every context, to the same blanket discovery stay. Consequently, the discovery stay prevents plaintiffs from gaining access to the strong evidence necessary to survive a motion to dismiss.⁵⁰

III. APPLICATION OF THE PSLRA – PROVING SCIENTER AT THE PLEADING STAGE

A. *The Circuit Split and Tellabs*

After the enactment of the PSLRA, the circuit courts struggled to define the requisite level of intent necessary to plead a "strong inference" of scienter and three divergent approaches emerged.⁵¹ The Second

⁴⁵ See Cummings, *supra* note 33, at 1007 (2005) ("Congress passed the PSLRA in 1995 amid much dissension, spectacle, explicit warning, and ceremony and over a Presidential Veto."); Cf. Seligman, *supra* note 38, at 96 (discussing the four primary arguments for the enactment of the PSLRA).

⁴⁶ See Seligman, *supra* note 38, at 105 (stating the PSLRA represents the first time a veto by President Clinton had been overridden).

⁴⁷ *Presidential Veto Message on the Private Securities Litigation Reform Act*, 141 CONG. REC. S. 19034 (Dec. 21, 1995).

⁴⁸ Enron created hybrid of subsidiary corporations, partnerships, and energy based derivatives enabling it to deceive investors and employees, "to the tune of billions of dollars of nonexistent value." Cummings, *supra* note 33, at 1045; see also Seligman, *supra* note 38, at 113 ("[T]he diminution in the effectiveness of private federal securities litigation was one of several factors that contributed to a reduction in fraud deterrence.").

⁴⁹ See Seligman, *supra* note 38, at 117 ("The 1995 Act is a type of 'kitchen sink' legislation consisting of idea after idea piled upon one another to address an apparent problem with a disproportionate response.").

⁵⁰ Robert S. Greenberger, *Questioning the Books: Panel, in Enron's Wake, to Review Lawsuit Curbs*, WALL ST. J., Feb. 6, 2002, at A8 (quoting Columbia University law professor, Jack Coffee) ("You can't get discovery unless you have strong evidence of fraud, and you can't get strong evidence of fraud without discovery.").

⁵¹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509 (2007) (stating that "[w]ith no clear guide from Congress . . . Courts of Appeals have diverged again, this

Circuit adopted the most liberal standard, requiring plaintiffs to plead sufficient circumstantial evidence of recklessness or conscious behavior that would give rise to a strong inference of scienter.⁵² The Ninth Circuit adopted the most restrictive standard, wherein plaintiffs needed to specifically identify fraudulent statements, the speaker of those statements, and explain why those statements were misleading or false.⁵³ Finally, the circuits adopting an intermediary position utilized a “totality of the pleadings” approach, holding that allegations of motive and opportunity or recklessness could create a strong inference of scienter.⁵⁴ Those courts adopted a case-by-case, fact sensitive approach to the evaluation scienter.⁵⁵

In 2007, the Supreme Court sought to clarify the scienter issue in *Tellabs v. Makor Issues & Rights*.⁵⁶ The Court interpreted the “strong inference” requirement of the PSLRA such that the strength of the inference must be a powerful or compelling one or “strong in light of other explanations.”⁵⁷ The Court interpreted a “strong” inference as one that is “at least as compelling as any opposing inference of nonfraudulent intent.”⁵⁸ As such, the federal courts must engage in a comparative inquiry to determine whether plaintiffs have met their burden.⁵⁹

time in construing the term ‘strong inference.’”); see generally Daniela Nanau, *Analyzing Post-Market Boom Jurisprudence in the Second and Ninth Circuits: Has the Pendulum Really Swung Too Far In Favor of Plaintiffs?*, 3 CARDOZO PUB. L. POL’Y & ETHICS J. 943, 966 (2006).

⁵² See Nanau, *supra* note 51, at 967–68.

⁵³ *Id.* at 968; see *In re Silicon Graphics, Inc., Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (The Ninth Circuit expressly rejected the Second Circuit’s “motive and opportunity” standard and instituted the requirement that plaintiffs “plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.”).

⁵⁴ See Nanau, *supra* note 51, at 968 (finding that the First, Sixth, and Eleventh Circuit adopted some version of the “totality of the pleadings” approach).

⁵⁵ *Id.* at 969 (“These circuit courts reason that while the Reform Act heightened the pleading standard of scienter, it did not redefine scienter to exclude recklessness and limit liability to misrepresentations made with intent.”).

⁵⁶ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

⁵⁷ *Id.* at 2511 (“In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?”).

⁵⁸ *Id.* at 2510 (holding that “a court must consider plausible, nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.”).

⁵⁹ See *The Supreme Court, 2006 Term: Leading Case: Federal Statutes and Regulations—Private Securities Litigation Reform Act—“Strong Inference” Pleading Standard*, 121 HARV. L. REV. 385, 387–88 (2007) for a discussion of whether the Supreme Court meant “collective comparison” of inferences or “individual comparison.”

Putting aside the Seventh Amendment implications of permitting judges to make factual determinations at the pleading stage,⁶⁰ the requirement to plead fraudulent intent “with particularity” reflects the crux of the inequity of the PSLRA as applied to mortgage-backed securities.⁶¹ The PSLRA unfairly raises the plaintiff’s burden to prove fraudulent intent when certain facts are only within the purview of the defendants.⁶² Plaintiffs seeking relief for fraudulent or inadequate disclosure in the context of mortgage-backed securities require a reasonable degree of discovery in order to meet the PSLRA’s burden of particularity.⁶³

The high stakes of the current financial crisis illustrate the need for corporate defendants to share the burden of proof with investor-plaintiffs at the pleading stage. Recall that the Supreme Court requires a comparative inquiry of both fraudulent and nonfraudulent inferences derived from the pleadings.⁶⁴ In the arena of mortgage-backed securities, the sudden demise of the housing market presents a formidable competing inference for plaintiffs to overcome.⁶⁵ The current financial context and the complexities of the subprime mortgage market provide corporate defendants with a competing inference that requires little substantiation.

B. The Post-PSLRA Stock Market Collapse of 2002

The current financial crisis ominously mirrors the market crash of 2002, in which large-scale corporate deception flattened U.S. stocks and investor confidence.⁶⁶ Prior to the 2002 market crash, federal courts dismissed investors’ claims alleging securities fraud against entities such

⁶⁰ See Suja A. Thomas, *The PSLRA’S Seventh Amendment Problem* (Univ. of Cincinnati College of Law, Pub. Law & Legal Theory Research Paper Series, Paper No. 07-03), available at <http://ssrn.com/abstract=968893>, at 6 (stating that the enactment of the PSLRA impinges on the right to a jury trial because it sought “to fashion a remedy that focuses on the cause of action, not class actions . . .”).

⁶¹ See Seligman, *supra* note 38, at 119 (“The bar has been raised unequivocally with the actual knowledge standard.”).

⁶² *K-Tel Int’l Sec. Litig. v. K-Tel Int’l*, 300 F.3d 881, 900 (8th Cir. 2002) (Murphy, dissenting) (“Many relevant facts in securities cases may not be discoverable at the pleading stage because they are known only by key insiders.”).

⁶³ See Seligman, *supra* note 38, at 119 (“[T]he plaintiff should be given, in appropriate circumstances, the right to develop a case through discovery.”); see also *infra* Part IV.

⁶⁴ *Tellabs*, 127 S. Ct. at 2505.

⁶⁵ See, e.g., *Tripp v. IndyMac Bancorp, Inc.*, 2007 U.S. Dist. LEXIS 95445 (C.D. Cal. Nov. 29, 2007) (dismissing plaintiff’s claim, finding the likelihood that the defendants simply did not shield themselves from the drastic change in the housing market to be the strongest inference).

⁶⁶ See Cummings, *supra* note 33, at 1033.

as WorldCom, Tyco, Arthur Anderson and Deloitte & Touche.⁶⁷ This historical precedent raises the question of whether the practical effects of the PSRLA actually benefit investors in the long run.⁶⁸ Having uniformly heightened the pleading standard, no matter the context, the PSLRA serves, not to deter malfeasance, but instead, promotes the creation of complicated, structured finance in which fraudulent practices cannot be fettered out before discovery.⁶⁹ When securities class actions become less of a force, fraud deterrence deteriorates and injured investors are left at the mercy of the unpredictable and often under-funded enforcement powers of the SEC.⁷⁰ Effective SEC deterrence, however, cannot be relied upon as the only mechanism of enforcement.⁷¹

The intense wake of the current financial crisis must serve as a reminder of the enormous dependence this country has on the integrity of Wall Street.⁷² No other time in American history reflects the “inextricable tie” between the financial security of millions of Americans and the U.S. capital markets.⁷³ The recent corporate “bailout”⁷⁴ further

⁶⁷ WorldCom misstated over \$ 3.8 billion of expenses, claiming large profit margins when the company was in reality, hemorrhaging money. *Id.* at 1031 (“[T]he deceit by WorldCom, Tyco, and Arthur Andersen was alleged far earlier than the eventual collapse date of each, under the heightened pleading standards of the PSLRA.”).

⁶⁸ *Id.* at 1037 (arguing that PSLRA acts to “save consumers nothing, protect white-collar criminals and add to the burden of the victims of fraud.”).

⁶⁹ “Impact of Private Securities Litigation,” *Hot Securities Litigation Issues in a Down Economy* (MCLE, Inc.) (2002) p. 185 (presented November 7, 2002) (arguing the overall ineffectiveness of the PSLRA in deterring fraud).

⁷⁰ The SEC also lacks the human capital necessary to recognize complex and innovative fraudulent schemes. *See, e.g.*, Arthur Levitt, *How the SEC Can Prevent More Madoffs*, WALL ST. J., Jan. 5, 2009, available at <http://online.wsj.com/article/SB123111989471152931.html> (stating that “[o]ver the past few years, the SEC has not kept pace with inflation or innovation.”); *see also Restoring America’s Trust in America’s Business*, Sloan Project on Bus. Institutions at the Georgetown Univ. L. Center (November 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=784526 (conference proceedings for Panel 5) (noting the inadequacies of SEC enforcement and the costly and burdensome nature of strengthening the SEC).

⁷¹ *See Restoring American’s Trust*, *supra* note 70, at 88 (Mr. Wallison) (“My complaint is that we have criminal and civil laws that deal with these kinds of breakdowns that have occurred here.”).

⁷² Steven L. Schwarcz, *Markets, Systemic Risk, and the Subprime Mortgage Crisis*, 61 SMU L. REV. 209, 210 (2008) (“[T]he subprime mortgage crisis - can trigger a chain of market and/or financial institution failures, resulting in increases in the cost of capital or decreases in its availability.”).

⁷³ Nanau, *supra* note 51, at 975 (emphasizing the importance of acute enforcement of securities laws given the profile of today’s stockholders).

⁷⁴ On February 17, 2009, President Barack Obama signed into law a \$787 billion economic stimulus package with the stated purpose of “[m]aking supplemental appropriations for job preservation and creation, infrastructure investment, energy efficiency and science, assistance to the unemployed, and State and local fiscal stabilization, for the fiscal year ending September 30, 2009, and for other purposes.”

reduces any corporate incentive to provide investors with adequate and ongoing disclosure in the context of new and complex financial instruments.⁷⁵ The federal courts should implement the proposed pleading standard to strike a balance between protecting innocent market participants and deterring fraud in this innovative financial arena.⁷⁶

The PSLRA embodies important policy goals, and rather than suggest its repeal, courts should exercise flexibility in determining the sufficiency of a pleading. In light of the current financial crisis, the PSLRA must not function solely to reduce the sheer number of securities claims, but must be implemented in a manner that preserves meritorious actions.⁷⁷ Since the enactment of the PSLRA, the Supreme Court has refined the metes and bounds of its pleading requirements, but has not foreclosed the federal courts from broadening the scope of their pleading analyses.⁷⁸ Although the *Tellabs* ruling sought to clarify the requisite

American Recovery and Reinvestment Act of 2009, H.R. 1, 111th Cong. (2009). The bill is highly contentious because although it seeks to stimulate the economy, the package arguably provides financial support to the same corporations that are responsible for the crisis. See, e.g., David Brooks, *Money For Idiots*, N.Y. TIMES, Feb. 20, 2009, at A31 (“The Bush and Obama administrations have compensated foolishness and irresponsibility. The financial bailouts reward bankers who took insane risks. The auto bailouts subsidize companies and unions that made self-indulgent decisions a few decades ago that drove their industry into the ground.”).

⁷⁵ See Aaron Unterman, *Innovative Destruction - Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 81 (2009) (stating that “[g]overnment bailouts stand in stark opposition to the ideals of the market system” and by “[a]llowing major institutions to profit from irresponsible financial dealings and then intervening when they get in over their heads makes it too easy for these firms to avoid the consequences of their actions.”).

⁷⁶ *Id.* at 75 (urging courts to strike a balance ensuring “that the worst investor abuses come to light.”).

⁷⁷ Wunderlich, *supra* note 43, at 651 (“One of the primary problems with the *Tellabs* decision is its preoccupation with frivolous strike suits and excessive discovery costs . . . [the] PSLRA was enacted to stem frivolous strike suits as well as preserve meritorious claims.”).

⁷⁸ See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (rejecting aiding and abetting claims in private litigation); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (setting forth a standard for properly pleading loss causation); *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007) (requiring claims of fraud to be pled with more specificity than required by Rule 8 of the FRCP); *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007) (holding that plaintiffs must plead scienter particularly and those facts must give rise to a powerful or compelling inference of fraudulent intent); *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.* 128 S. Ct. 761 (2008) (rejecting plaintiff’s claim of scheme liability absent proof of actual reliance on the representations of indirect parties). The PSLRA actually provides for particularized discovery in certain circumstances, thus the proposed pleading standard does not disturb the discretion already provided to the courts by Congress. 15 USCS § 78u-4(b)(3)(B). (“[A]ll discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the

showing of scienter necessary to survive a motion to dismiss, the implementation of *Tellabs* in subprime-related litigation reveals distinguishable disparities in its application.⁷⁹

IV. MORTGAGE-BACKED SECURITIES – PASSING THE RISK, KEEPING THE BUCK

A. Mortgage-Backed Securities

Mortgage-backed securities are debt obligations that derive their cash flows from pools of mortgages.⁸⁰ The securities represent claims to the collective principal and interest payments made by the borrowers into the mortgage pool.⁸¹ The repackaging of mortgages into securities is also known as asset securitization or structured finance.⁸² These securities are customarily defined as mortgage-backed securities, but often mortgages make up many of the other asset-backed security classifications.⁸³ Investors in mortgage-backed securities evaluate risk primarily based on whether the issuer is private or government-backed, the quality of the underlying mortgage loans, and the credit enhancement or credit ratings afforded to the securities.⁸⁴

motion of any party that particularized discovery is necessary to preserve evidence *or to prevent undue prejudice to that party.*”) (emphasis added).

⁷⁹ See, e.g., *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) (*Tellabs II*) (holding that it was “possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud.”); cf. *Tripp, et al. v. Indymac Financial Inc. et al.*, 2007 U.S. Dist. LEXIS 95445 at *8–9 (C.D.C.A. 2007) (stating that the plaintiff confidential witnesses proffered no evidence indicating the individual defendants actual knowledge of the undisclosed financial risks).

⁸⁰ *Mortgage-Backed Securities*, U.S. Securities and Exchange Commission (last modified Jun. 25, 2007), <http://www.sec.gov/answers/mortgagesecurities.htm>.

⁸¹ *Id.*

⁸² *Id.*

⁸³ The entities issuing mortgage-backed securities or other asset-backed securities are referred to as Special Purpose Vehicles (“SVPs”). Generally, these securities fall into three categories: (1) MBS (mortgage-backed securities); (2) ABS (asset-backed securities); or CDO (collateralized debt obligation). CDO payments are backed by mixed pools of mortgage loans and other types of receivables that the SVP owns. ABS CDOs represent an even more complex financial instrument, deriving payments from “a mixed pool of ABS and/or MBS securities.” Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 376–79 (2008) (“CDO securities are backed by - and thus their payment derives principally or entirely from - a mixed pool of mortgage loans and/or other receivables . . .”).

⁸⁴ SEC Staff Report of the Task Force on Mortgage-Backed Securities Disclosure, *Enhancing Disclosure in the Mortgage-Backed Securities Markets*, at Part II.A (Jan. 2003), available at <http://www.sec.gov/news/studies/mortgagebacked.htm>.

The majority of mortgage-backed securities are issued or guaranteed by two government-sponsored enterprises (“GSEs”), Fannie Mae and Freddie Mac, and one government-owned entity, Ginnie Mae.⁸⁵ The government intervened in the secondary market of mortgage financing to facilitate broader lending practices by providing increased liquidity to mortgage lenders.⁸⁶ Congress statutorily created Fannie Mae, Freddie Mac, and Ginnie Mae to enable mortgage lenders and originators to sell their mortgage loans, thus providing lenders with the increased capital necessary to finance more lending.⁸⁷ The GSEs then pooled the purchased home mortgages and issued securities backed by the loan repayments, allowing the capital markets to invest in and promote home ownership at a low cost.⁸⁸ Seeking to capitalize on the potential benefits of pooling home mortgages, private financial institutions also began to develop innovative mortgage-based investment vehicles.⁸⁹

Mortgage-backed securities issued by government agencies receive a “full faith and credit” backing from the U.S. government.⁹⁰ Private financial institutions, however, also securitize and issue what are known as “private label” mortgage securities and must provide investors with their own guarantees.⁹¹ Initially, privately sponsored mortgage-backed securities presented great uncertainty and could not compete with the assurances provided by government-backed securities.⁹² Wall Street reacted by investing millions of dollars in the development of effective pricing models to estimate the value of their mortgage pools.⁹³ Ultimately, research analysts successfully developed models that provided investors with confidence.⁹⁴

The first generation of mortgage-backed securities simply facilitated a “pass through” of the borrowers’ repayments directly to the pool’s investors, offering each investor only partial ownership in the income streams.⁹⁵ Investment bankers then began to divide different income streams from the same pool of securities according to the risk

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ Christopher L. Peterson, *Predatory Structured Finance*, 28 *CARDOZO L. REV.* 2185, 2199 (2007).

⁸⁹ *Id.* at 2199–200.

⁹⁰ See *Mortgage-Backed Securities*, *supra* note 80.

⁹¹ *Id.*

⁹² See Peterson, *supra* note 88, at 2201–02.

⁹³ *Id.* at 2201.

⁹⁴ *Id.*

⁹⁵ *Id.* at 2202.

preferences of the investors, setting the stage for increased innovation and complexity in the market of mortgage-back securities.⁹⁶

B. The Infusion of Innovation and Subprime Mortgages

Modern mortgage-related financial structures present inherent mathematical and financial complexities.⁹⁷ Their complexities are propounded by the different credit ratings attributable to divided classes of mortgage-backed securities, known as “tranches.”⁹⁸ Each tranche receives a grade, from “senior,” which is least likely to be impacted by default, to “mezzanine,” or “junior,” with the most junior tranche representing the highest degree of risk.⁹⁹ As reflected by the current financial crisis, these different tranches did not earn a rating purely on the risk or value of the underlying asset, but often based on the degree of “protection” purchased by the seller.¹⁰⁰ In other words, any quality of receivable could be made into a Triple-A, gold star rating, with the right credit enhancements.¹⁰¹ Although insured tranches would often earn Triple-A ratings, many of the insurers turned out to have very little capital in the event of a default.¹⁰²

The ambiguity of the investment risk and the likely conflicts of interest between the credit rating agencies¹⁰³ and the financial institutions

⁹⁶ *Id.* at 2203 (“[O]ne security might entitle an investor to receive all the interest income - an ‘interest-only’ tranche’ . . . while another security might entitle investors to receive all payment toward loan principle - a ‘principle only tranche.’”).

⁹⁷ Rep. Henry A. Waxman, Chairman of the Committee of Oversight and Government Reform, stated that collateralized debt obligations represented “new financial inventions [that] were so complex that virtually no one really understood them.” *Committee Holds Hearing on the Credit Rating Agencies and the Financial Crisis* (Oct. 22, 2008) available at <http://oversight.house.gov/story.asp?ID=2255>.

⁹⁸ See Peterson, *supra* note 88, at 2203.

⁹⁹ Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 8 (2009).

¹⁰⁰ Private-label investors sought additional assurances that the investment would pay out. Rating agencies provided this extra assurance, by researching the risk of the investments and issuing a credit rating pursuant to that diligence. In order to earn an “investment grade” rating, credit rating agencies often require “credit enhancements.” *Id.*

¹⁰¹ Subordination and collateralization are the most common means pooled receivable earn Triple-A ratings. Subordination refers to an investor agreement to purchase different degrees of risk exposure, commensurate with return, by investing in various tranches. Over-collateralization is when the pool is owed more money than it needs to pay it. See generally Unterman, *supra* note 75, at 61–64.

¹⁰² *Id.* (arguing that credit enhancements often came in the form of bond insurance and, unlike traditional insurance carriers, are not required by law to keep capital reserves).

¹⁰³ See generally Emily Donahue, *SEC Report and Recent Class Action Spell Trouble for Rating Agencies*, 27-8 ABIJ 12 (October 2008) (analyzing the SEC report on the credit rating agencies “following a dramatic increase in delinquency rates for subprime mortgages that raised doubts about the accuracy of ratings issued for subprime residential

seeking to sell or resell these mortgage-backed securities caused many sophisticated investors to make poor investment decisions.¹⁰⁴ Financial institutions marketed mortgage-backed securities as “stable instruments insulated from the risks of a housing downturn . . . fooling investors to believe that bad loans could be transformed through the sophistication of the investment industry.”¹⁰⁵ However, these “bad” or subprime loans revealed themselves as anything but safe.¹⁰⁶

Many issuers of mortgage-backed securities likely made meticulous disclosures of the investment risk, adequately disclosed the characteristics of the pool of underlying mortgages, and provided investors with an accurate depiction of the underwriting standards. Plaintiff investors, however, may assert that the issuer materially omitted trends in the deteriorating quality of the loans or claim that the issuer made inadequate disclosures of the consequences of a decline in the housing market.¹⁰⁷ The complexity of the financial products does not automatically translate into inadequate disclosure or fraud, but plaintiffs in securities fraud class actions should get a presumption of inadequacy at the pleading stage in light of the financial instruments at issue.¹⁰⁸

mortgage-backed securities (RMBS) and the integrity of the ratings process in general”); *see also*, Steven Schwarcz, *Protecting Financial Markets: Lesson from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 401 (2008) (stating that “[r]ating agencies are customarily paid by the issuer of securities, but investors rely *heavily* on their ratings.”) (emphasis added).

¹⁰⁴ *See* Schwarcz, *supra* note 103, at 401 (stating that “the conflict would have been more material than normal because ratings were given to numerable issuances of CDO and ABS CDO securities, with each issuance and rating earning a separate fee”); *see also id.* at 385 (“[S]ophisticated investors and qualified institutional buyers (QIBs) are the very investors who lost the most money in the subprime financial crisis.”).

¹⁰⁵ *See* Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 87 (2008).

¹⁰⁶ Mortgage-pools increasingly became dominated by subprime mortgages. Subprime lending had originally provided borrower’s with low credit the opportunity to buy a home provided they posted additional collateral and paid a higher interest rate. More recently, as the demand for mortgage products grew, the underwriting standards of subprime mortgages deteriorated, with originators issuing mortgages with little substantiation of the borrower’s ability to repay. *See* Stuart R. Berkowitz, *The Subprime Mortgage Mess - A Primer to Assist Investors*, 64 J. MO. B. 122, 123 (2008).

¹⁰⁷ For example, many issuers disclosed the fact that they reserved the right to allow for exceptions to underwriting criteria, yet never indicated the increasing rate of such exceptions. *See* Mark Adelson & David Jacob, *ABS/MBS Litigation Outlook*, ASSET SECURITIZATION REPORT (November 19, 2007), *available at* http://www.adelsonandjacob.com/pubs/Litigation_Outlook.pdf (citing empirical evidence that cumulative default rates of securitized loans gradually increased over time).

¹⁰⁸ *See infra* Part IV.C.

C. Why These Plaintiffs are Different

Disclosure represents the bedrock principle of United States securities laws.¹⁰⁹ The adequacy of disclosure should not turn on the volume of information provided by an issuer or the number of times an investor reads a prospectus, but rather on whether investors can make meaningful investment decisions based on such disclosures.¹¹⁰ Billions of dollars are spent every year on corporate compliance with mandatory financial disclosures, but if these disclosures cannot adequately convey investment risks to market participants, the stock prices cannot accurately reflect the value of the investment.¹¹¹ The premise that mandatory disclosures act to “disinfect” or prevent fraudulent securities practices has not stood the test of time; disclosure is simply not translating into efficient or prudent securities transactions.¹¹² If securities regulation and securities issuers failed investors in the context of mortgage-backed securities, the very same securities laws providing private rights of action should not unreasonably restrict investors’ relief.¹¹³

An increasing number of securities lawsuits filed by mortgage-backed securities investors take aim at financial institutions.¹¹⁴ The non-exhaustive list of issuers named as defendants include Credit Suisse, HSBC, Lehman Brothers, Merrill Lynch, Citigroup, Washington Mutual,

¹⁰⁹ See Jonathan R. Macey, *Hodge O’Neal Corporate and Securities Law Symposium: After the Sarbanes-Oxley Act: The Future Disclosure System: A Pox On Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory versus Enabling Rules*, 81 WASH. U. L. Q. 329, 330 (2003).

¹¹⁰ *Id.* (“The Enron collapse demonstrates . . . that disclosure . . . is useful only if market mechanisms are in place that are capable of observing and interpreting the information . . .”). An example of such ineffectual disclosure can be found amidst the Enron scandal which represented fraud masked by the complexities of innovative financial structuring. See Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 21, 2001 (quoting Congressman John Dingell) (“What we’re looking at here is an example of superbly complex financial reports. They didn’t have to lie. All they had to do was to obfuscate it with sheer complexity . . .”), available at http://faculty.msb.edu/homak/homahelpsite/webhelp/Enron_Why_It_Went_Bust_Fortune_12-24-01.htm.

¹¹¹ See Macey, *supra* note 109, at 334.

¹¹² *Id.* at 349 (stating that it is an improper assumption “that sophisticated traders can decode opaque, complicated, or obscure financial reporting” and “[t]his, in turn, creates a significant hole in the theory of market efficiency.”).

¹¹³ *Id.* at 349–50. (Allowing issuer defendants to introduced inadequate disclosures into the marketplace and imposing the PSLRA pleading standard on investors does not “promote true objectivity among outside monitors and towards generating better and more accurate information for internal monitors.”).

¹¹⁴ Faten Sabry, Anmol Sinha & Sungi Lee, *The Snowball Effect, A Brief Review of Subprime Securities Litigation* (May 2008), available at http://www.mmc.com/knowledgecenter/viewpoint/A_Brief_Review_of_Subprime_Securities_Litigation.pdf.

Bear Stearns, UBS, Morgan Stanley, and Bank of America.¹¹⁵ Investor-plaintiffs bringing securities fraud class actions against financial institutions should be entitled to a relaxed pleading standard under the PSLRA because of the very nature of mortgage-backed securities. Disclosures made by issuers were inherently inadequate such that even the most sophisticated investors were unaware of the risky mortgages and the often undercapitalized insurance that supported the high grades of the investments.¹¹⁶ Further, many of the subprime mortgage originators were not affiliated with any bank and therefore were outside the scope of federal regulation.¹¹⁷ Thereafter, investment banks created these complex debt obligations and sold them to the investing public as safe investments.

Arguably, not every prospectus can adequately portray the true risks of an investment, but this is not the only trouble with mortgage-backed securities.¹¹⁸ In traditional securities transactions, it is assumed that the issuing company's interests are aligned with that of its shareholders; if the company grows and succeeds, executives, employees and shareholders all stand to benefit. Mortgage originators, however, are often uninterested in the quality of their borrowers and more concerned with the commission paid on the loan.¹¹⁹ The originators have the luxury of passing the risk of loss on a mortgage by selling the right to repayment to the entities that pool mortgages and issue mortgage-backed securities.¹²⁰ Additionally, the investment bankers responsible for the creation of the complex financial products only stood to gain on the performance of the fund, while their employers bore the risk of loss.¹²¹

¹¹⁵ See *id.* at 105.

¹¹⁶ See *Exporting Risk*, *supra* note 105, at 82 (arguing that “[t]he complexity of CDOs mask and misrepresent risk transfers through an opaque grading system which combines investment pools with different risk exposures” and “[t]he complexity and lack of transparency of securitized assets has allowed investor ignorance to be manipulated for profit and this will likely be reflected in widespread securities litigation.”).

¹¹⁷ Alan S. Blinder, *Six Fingers of Blame in the Mortgage Mess*, N.Y. TIMES, Sept. 30, 2007, § 3 (Business), available at <http://www.nytimes.com> (search “six fingers of blame”; then follow the “Six Fingers of Blame in the Mortgage Mess” hyperlink).

¹¹⁸ The prospectus in a typical offering of securities can be hundreds of pages long. See Schwarcz, *supra* note 103, at 383.

¹¹⁹ Cathy Lesser Mansfield, *The Usury Law Debate: The Road to Subprime “HEL” Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 552 (2000) (“[L]oans may even be issued to borrowers who have no ability to pay based on loan applications falsified by mortgage brokers or lender employees eager for high commissions.”).

¹²⁰ See Schwarcz, *supra* note 103, at 384.

¹²¹ See Unterman, *Exporting Risk*, *supra* note 105, at 83–84. (“The fee structure associated with securitization allowed for investment bankers and credit rating agencies to convert the likelihood of future income from an investment into an immediate fee, thus they took on little risk of a failed investment.”).

The complexities of the financial products, insufficient disclosures, and the limited information available regarding the mortgage pools' underlying assets creates an insurmountable hurdle for plaintiffs under a strict implementation of the PSLRA pleading standard.

D. "Collective Scierter" and "Core Product" Approach to Pleading

The proposed pleading standard invokes recent circuit court methodology in which the courts analyzed the pleadings with the factual circumstances or context of the securities purchases in mind. In *Tellabs*, the Supreme Court mandated the federal courts to consider the totality of the pleadings when comparing inferences of scienter and this holistic approach may seem favorable to plaintiff-investors.¹²² However, as discussed earlier, the context of the housing meltdown presents a difficult background against which to assess the defendants' conduct.¹²³

Circuit courts have, in certain circumstances, eliminated or modified the specificity necessary for plaintiffs to establish scienter under the PSLRA.¹²⁴ The Ninth Circuit recently held that "[v]ague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter."¹²⁵ In *South Ferry v. Killinger*, the United States Court of Appeals for the Ninth Circuit held that if, because of the nature of the information, it would be "absurd" to suggest management's ignorance, such general assertions may give rise to a strong inference of scienter.¹²⁶ The court additionally held that general or vague allegations of scienter, supported by particularized allegations of defendants' access to factual information within the company, may support a strong inference of scienter.¹²⁷

The Seventh Circuit recently held that allegations of an undisclosed problem with a "core" product can bolster a strong inference of

¹²² *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007) (holding that the allegations must be considered collectively).

¹²³ *Tripp v. IndyMac Bancorp, Inc.*, 2007 U.S. Dist. LEXIS 95445 at *10 (C.D. Cal. Nov. 29, 2007) ("However, an even stronger inference is that Defendants were simply unable to shield themselves . . . from the drastic change in the housing and mortgage markets.").

¹²⁴ *See, e.g., South Ferry LP v. Killinger*, 542 F.3d 776 (9th Cir. 2008).

¹²⁵ *Id.* at 784.

¹²⁶ *Id.* at 786.

¹²⁷ *Id.* at 785 (citing *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1231 (9th Cir. 2004)) ("[T]he plaintiffs had pleaded facts showing a strong inference of scienter because, among other things, the CEO of the defendant company was quoted as saying: 'All of our information is on one database. We know exactly how much we have sold in the last hour around the world.'").

scienter.¹²⁸ In *Makor Issues & Rights v. Tellabs* (“*Tellabs II*”),¹²⁹ the court aptly describes the competing inferences standard of the PSLRA scienter requirement, explaining that defendants generally seek to infer “that although the statements were false and material, their falsity was the result of innocent, or at worst careless, mistakes at the executive level . . . rather than an intent to deceive or a reckless indifference to whether the statements were misleading.”¹³⁰ Although the plaintiffs could not specifically name those defendants that perpetrated the alleged fraud, the court found it difficult to believe that no senior executives had knowledge of the falsity of the statement made about core company products.¹³¹ The court found the depth and diversity of twenty-six confidential witnesses persuasive enough to permit drawing inferences from such testimonies.¹³² The defendants countered the allegations of motive and opportunity by arguing they did not profit from deceiving investors about product demand, but the court found that this argument confused expected results with realized ones.¹³³

Provided a plaintiff pleads with particularity inadequate, fraudulent, or misleading statements of investment risk and supports those allegations with all facts available to them prior to discovery, the defendants should be required to rebut those specific allegations. Defendants’ inability to effectively rebut allegations of misrepresentation, proper due diligence, or intent, should impute the alleged falsity and knowledge on the defendant at the pleading stage. For example, in *South Ferry*, the defendants could not rebut the presumption that information about the demand for a core product would be known by key executives, thus the court imputed the requisite knowledge.¹³⁴ The proposed standard aligns with this presumption such that a defendant’s *unsupported* inference can never defeat a *strong* inference of scienter.¹³⁵

¹²⁸ *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702 (7th Cir. 2008) (“*Tellabs II*”).

¹²⁹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) (holding that the case be remanded to determine whether the plaintiffs established a strong inference of scienter).

¹³⁰ *Id.* at 709.

¹³¹ *Id.* at 709–11 (“The plausibility of an explanation depends on the plausibility of the alternative explanations.”).

¹³² *Id.* at 712 (“[C]onfidential sources listed in the complaint in this case, in contrast, are numerous and consist of persons who from the description of their jobs were in a position to know at first hand the facts to which they are prepared to testify.”).

¹³³ *Id.* at 710 (holding that “the benefits of concealment might exceed the costs” when executives withhold bad news with the hopes of future good news).

¹³⁴ *South Ferry LP v. Killinger*, 542 F.3d 776 (9th Cir. 2008).

¹³⁵ *Tellabs II*, 513 F.3d at 710 (describing a scenario where the court could not ignore the theory of corporate scienter stating “[s]uppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero” and holding that a

Compare a recent Second Circuit holding in *Teamsters Local 445 Freight Division v. Dynex Capital*,¹³⁶ where the court reversed the district court holding and found that the plaintiffs failed to adequately plead scienter.¹³⁷ The court mandated a dismissal of the securities fraud claim because the plaintiffs failed to prove a “strong inference that *someone* whose intent could be imputed to the corporation acted with the requisite scienter.”¹³⁸ The court found the overall weakness in the market, rather than fraudulent activity, provided the strongest inference to be drawn from the poor performance of certain mortgage-backed securities.¹³⁹

In *Dynex*, the plaintiffs alleged that the corporate defendants misrepresented the quality of loans and the true value of the collateral underlying certain Dynex bonds.¹⁴⁰ The proposed pleading standard would require the defendants to counter such allegations with proof of due diligence and appropriate disclosures concerning the very complex and very risky underwriting standards backing their mortgage-based securities. The Second Circuit’s interpretation of the PSLRA’s scienter requirement insulates and even provides corporate executives with a roadmap of conduct that will keep them out of court. The recent approaches of the Seventh and Ninth Circuits, although not fully embracing a product-oriented analysis, rationalize the necessity to relax the strict pleading requirements of the PSLRA when the context of the fraud so requires. In the context of the current financial crisis, the toxicity of the packaged subprime loans, the undisclosed associated risks of default, and the exorbitant fees earned by the originators and investment bankers provides such a context.

plaintiff may raise a strong inference of “corporate scienter without being able to name the individuals who concocted and disseminated the fraud.”)

¹³⁶ *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190 (2d Cir. 2008).

¹³⁷ *Id.* The *Dynex* case presents a circumstance where the court is asked to impute “corporate scienter” because the plaintiffs cannot specifically correlate the alleged misstatements made on behalf of the corporation with an individual defendant. Several circuits, including the Ninth, have been unwilling to impute such scienter on the corporate entity without specific proof of knowledge of the fraud on the part of individual corporate actors. See *South Ferry LP v. Killinger*, 542 F.3d 776 (9th Cir. 2008). However, many of those circuits have budged when the circumstantial evidence is such that the information must have been known to the corporate executives, and in the context of mortgage-backed securities, lax underwriting standards and the deteriorating value of the underlying collateral of a security, if sufficiently alleged, should provide such a circumstance. See generally Patricia S. Abril & Ann Morales Olazabal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81 (2006).

¹³⁸ *Id.* at 197 (emphasis added).

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 193 (“Teamsters alleges, the defendants ‘misrepresented the cause of the bond collateral’s poor performance; misrepresented the reasons for restating its loan loss reserves; and concealed the loans’ faulty underwriting.’”).

E. Solution - Product-Oriented Relaxation of the PSLRA

The countless layers of transactions, coupled with the inherently complex nature of mortgage-backed securities calls for flexibility in evaluating pleadings in securities class actions. After defendant corporations freely structure destructive financial instruments, exercise zero due diligence concerning the value of the assets backing the securities, and purchase whatever credit ratings they desire, we cannot allow them to hide behind the PSLRA. Plaintiffs' *access* to trial should not turn on the lack of direct evidence of intent, but rather on the strength of the circumstantial evidence evincing such intent.

A starting point in the court's analysis should be the context of the purchase of the mortgage-backed securities at issue.¹⁴¹ The most substantial risk involved with the purchase of mortgage-backed securities is the risk that the borrowers of the underlying loans will not provide timely repayments.¹⁴² Losses associated with the current financial crisis fall predominately on institutional investors, arguably the most sophisticated investors in the world.¹⁴³ If institutional investors failed to interpret the risk properly, and institutional investors are the dominate class of investors in mortgage-backed securities, it can be inferred that those savvy investors were uninformed.¹⁴⁴ Although inadequate disclosure is not the only inference to be drawn from such a context, it presents a "strong" enough inference to place financial institutions and investor-plaintiffs on the same footing at the pleading stage.¹⁴⁵

¹⁴¹ The "context" will undoubtedly change as federal regulators and the public take aim at mortgage-backed securities. The "context" before the court will evolve as implementation of heightened disclosures are mandated in the arena of mortgage-backed securities or alternatively, the court likely would find that the risks associated with contemporaneous purchases of mortgage-backed securities are now well publicized. For examples of possible reforms in the disclosure of mortgage-backed securities, see *Policy Statement on Financial Market Developments: The President's Working Group on Financial Markets*, 14 *LAW & BUS. REV. AM.* 447, 450-51 (2008) (suggesting mandating oversight of institutional investors, disclosure of rating agency processes and practices, and reforming the mortgage origination process).

¹⁴² SEC Staff Report of the Task Force on Mortgage-Backed Securities Disclosure, *Enhancing Disclosure in the Mortgage-Backed Securities Markets*, Part II.C.5.b. (Jan. 2003), <http://www.sec.gov/news/studies/mortgagebacked.htm>.

¹⁴³ *Id.* at Part II.B.

¹⁴⁴ Former SEC Chairman, Arthur Levitt, once explained "[i]nformed investors, armed with accurate information, ensure market prices represent fair value." Unterman, *Innovative Destruction*, *supra* note 8, at 86.

¹⁴⁵ Recall that the Supreme Court held in *Tellabs* that the strong inference required to plead scienter need only be "strong in light of other explanations." See *supra* note 57. Regardless of the circuits' stance on the *level* of intent necessary to satisfy the scienter element (motive and opportunity, recklessness, or deliberate recklessness), a rebuttable presumption of intent provides plaintiffs and the courts with the opportunity to evaluate the merits of the plaintiffs' allegations through the lenses of the defendants' rebuttal. See

The product-oriented approach to the PSLRA pleading requirements also provides investors and the public with an avenue of meaningful deterrence. The PSLRA serves as a check to deter frivolous litigation, maintaining the overarching goal of limiting the high costs of discovery and settlements on defendant-corporations.¹⁴⁶ Although these costs may be high, the benefit of investor initiated class actions serves as a mechanism for the deterrence of corporate fraud, and this deterrent alleviates the need for burdensome and costly regulations.¹⁴⁷

V. CONCLUSION

The current financial crisis stems from misaligned incentives, innovative and complex financial products, and greed. The heightened pleading standard of the PSLRA cannot create an atmosphere of immunity for corporate actors in light of the far-reaching externalities presented by the current crisis.¹⁴⁸ Although the SEC represents one of the principal mechanisms of fraud deterrence in the financial markets, it cannot adequately provide the security necessary to restore and maintain investor protection.¹⁴⁹ The high expectations placed on Wall Street executives often foster illegal conduct or fraud, yet the PSLRA limits investors' remedies to those instances when fraudulent activity is obvious and public.¹⁵⁰ When the courts interpret the PSLRA pleading

Michael R. Dube, *Motive and Opportunity Test Survives Congressional Death Knell in Private Securities Litigation Reform Act*, 42 B.C. L. REV. 619 (2001), for an extensive analysis of the circuit split regarding the requisite level of intent necessary to establish a strong inference of scienter.

¹⁴⁶ See discussion *supra* Part II.B.

¹⁴⁷ Regulation often follows in the wake of a financial crisis. In response to the Enron, Tyco, and WorldCom scandals, Congress passed the Sarbanes-Oxley Act. For a discussion of the adverse impacts of Sarbanes-Oxley, see J. Brent Wilkins, *The Sarbanes-Oxley Act of 2002: The Ripple Effect of Restoring Shareholder Confidence*, 29 S. ILL. U. L. J. 339, 341 (2005) (stating that as a result of the Sabanes-Oxley Act "mid-cap companies found that the cost of being public has almost doubled, from \$ 1.3 million to almost \$ 2.5 million.").

¹⁴⁸ Kevin S. Shmelzer, *The Door Slammed Shut Needs to be Reopened: Examining the Pleading Requirements Under the Private Securities Litigation Reform Act*, 78 TEMP. L. REV. 405, 425 (2005) ("[T]he PSLRA may have given too much comfort to corporate executives to the detriment of individual investors.").

¹⁴⁹ See, e.g., James D. Cox & Randall S. Thomas, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 898 (2004) (summarizing the results of an empirical study finding that "SEC actions result in lower average (median) settlements, are brought against on average (but not median) smaller market capitalization companies, have shorter average (median) class periods, and take longer on average (median) to reach settlement.").

¹⁵⁰ See Shmelzer, *supra* note 147, at 415 (finding a "dichotomy in the pleading standards" when the plaintiff proves motive and opportunity of executive's personal gain, but no "specific instances of deliberate recklessness.").

standard too stringently, it furthers only one policy goal of the PSLRA: preventing the initiation of securities litigation.¹⁵¹ A pleading standard, seeking to deter frivolous lawsuits, should not turn on procedures or particularities. The fact that the mere absence of direct proof of specific incidences of fraud mandates a dismissal of securities class actions sends a message to corporate executives that they may externalize any and all risk associated with risky investments, so long as they do so quietly. The proposed standard prevents the dismissal of a meritorious claim merely because publicly disclosed evidence of fraud is hidden beneath layers of transactions and complex mathematical equations.¹⁵²

A product-oriented carve-out in the context of mortgage-backed securities embraces the policy goals of the PSLRA and requires defendants in class action lawsuits to rebut targeted allegations of fraud upon a motion to dismiss; avoiding the burdens and costs associated with blanket discovery requests. Clarity in pleading standards carries special importance when plaintiffs are made up of municipalities, local and state governments, unions, and retirees, all seeking the recovery of billions of dollars.¹⁵³ Studies reveal that the strength and effectiveness of investor remedies correlates with stronger stock markets.¹⁵⁴ The strength of investor rights is “a key element of sound corporate governance” and “necessary components of an investor protection regime.”¹⁵⁵ Because investor confidence drives the financial marketplace, the costs of litigation cannot outweigh the benefits to the public.¹⁵⁶ The proposed standard, complemented by the PSLRA provisions directly addressing discovery concerns,¹⁵⁷ provides for an even-handed approach to

¹⁵¹ *Id.* at 426 (concluding that Congress swung the pendulum too far in protecting defendants).

¹⁵² See Thomas, *supra* note 14, at 80 (“Investors need a mechanism to investigate potential securities fraud complaint where there is some evidence fraud has occurred.”).

¹⁵³ See Cummings, *supra* note 33, at 1039 (finding that a variety of organizations and politicians warned that the PSLRA would deny local governments and municipalities recovery).

¹⁵⁴ Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law*, 32 DEL. J. CORP. L. 345, 366 (2007) (citing a study of 49 nations comparing financial development with strong investor remedies that found a low burden of proof deters self-dealing and promote financial markets).

¹⁵⁵ *Id.* (“Investor protection is essential to securing the appropriate economic and financial operation of the public corporation.”).

¹⁵⁶ See generally Wunderlich, *supra* note 43, at 669 (“[T]he risk posed by a standard resulting in the dismissal of meritorious suits is likewise paramount.”).

¹⁵⁷ *Id.* at 666 (discussing that the PSLRA mandates Rule 11 sanction for the filing of baseless claims, in addition to the mandatory discovery stay provision).

evaluating the merits of a mortgage-backed securities claim, while still preserving the goals of private securities litigation.¹⁵⁸

¹⁵⁸ Keith Johnson, *Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors*, 60 LAW & CONTEMP. PROB. 155, 155 (1997) (“The first is the goal of obtaining compensation for wronged investors who have suffered losses at the hands of corporate wrongdoers. The second is filling the role of private attorneys general to sanction violators and deter future misconduct.”).