

## COMMENTS

# Standing on Ceremony: Can Lead Plaintiffs Claim Injury from Securities That They Did Not Purchase?

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### INTRODUCTION

Between 2007 and 2008, the American economy experienced its worst contraction since the Great Depression.<sup>1</sup> News soon spread that a financial instrument called a “mortgage-backed security” was a prime cause of this disaster, compounding a host of extant problems in the housing market, including low interest rates, relaxed lending standards, and misplaced assumptions that prices would continue to rise indefinitely.<sup>2</sup> Yet the damage done by mortgage-backed securities spilled beyond housing—institutional investors<sup>3</sup> bet big on these products, only to realize too late that many of these securities were backed by loans issued haphazardly at best, fraudulently at worst. Shockwaves from the meltdown spread throughout not just the nation, but the global economy, casting corporate titans and individuals alike into ruin.<sup>4</sup> Six years later, the world is still struggling to shake off the fallout.<sup>5</sup>

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<sup>1</sup> See Bob Willis, *U.S. Recession Worst since Great Depression, Revised Data Show* (Bloomberg Aug 1, 2009), online at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNivTjr852TI> (visited Aug 12, 2014).

<sup>2</sup> See Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-technical Paper*, 8 *J Bus Inquiry* 120, 121–26 (2009) (noting that mortgage-backed securities were linked to all of the primary causes of the housing bubble and the resultant collapse of the housing market).

<sup>3</sup> Institutional investors are business entities that accumulate large sums of money for investment; they include pension funds, banks, insurance companies, mutual funds, and foundations. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 *Mich L Rev* 520, 595–604 (1990). Such organizations play an important role in financial markets. See id at 567–70.

<sup>4</sup> See Holt, 8 *J Bus Inquiry* at 126–28 (cited in note 2).

<sup>5</sup> See Organisation of Economic Co-operation and Development, *Society at a Glance 2014: OECD Social Indicators* \*17–35 (Mar 18, 2014), online at

In the wake of this crisis, class action litigation alleging securities fraud has become commonplace.<sup>6</sup> Investors in devalued financial products like mortgage-backed securities generally claim that they were misled by misstatements or omissions in offering documents, for which they have recourse under federal law. Because of the way that financial institutions promulgate these documents, one type of offering document—called a “shelf registration statement”—may be shared across many different securities offerings. These offerings also involve unique documents called “supplemental prospectuses,” which describe the characteristics particular to each security. Thus, while an allegedly misleading shelf registration statement lends itself to class action litigation regarding all offerings that it covers, supplemental prospectuses differentiate between those offerings, diminishing their apparent similarity and hence their susceptibility to class adjudication.

This tension has spawned uncertainty over class action standing, which essentially requires that the class representative, acting on behalf of the class members, demonstrate a personal stake in the outcome of the litigation.<sup>7</sup> Many courts have held that lead plaintiffs must have personally purchased from each securities offering that they seek to prove is fraudulent.<sup>8</sup> However, some courts have allowed named plaintiffs in such class actions to bring closely related claims without having purchased the same securities as other class members.<sup>9</sup> These conflicting decisions have given rise to the following question: Does a named plaintiff have standing to litigate claims concerning mortgage-backed securities that he or she did not actually purchase?

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<http://www.oecd.org/els/soc/OECD2014-SocietyAtAGlance2014.pdf> (visited Aug 12, 2014) (discussing the continuing impact of the 2008 recession on social indicators in several countries).

<sup>6</sup> See Christopher J. Miller, Note, “Don’t Blame Me, Blame the Financial Crisis”: A Survey of Dismissal Rulings in 10b-5 Suits for Subprime Securities Losses, 80 *Fordham L Rev* 273, 289–90 (2011) (reviewing thirty-four such cases).

<sup>7</sup> See Joseph McLaughlin, *McLaughlin on Class Actions* § 4:28 at 852 (West 10th ed 2013).

<sup>8</sup> See, for example, *Plumbers’ Union Local No. 12 Pension Fund v Nomura Asset Acceptance Corp*, 632 F3d 762, 771 (1st Cir 2011); *Maine State Retirement System v Countrywide Financial Corp*, 722 F Supp 2d 1157, 1164 (CD Cal 2010).

<sup>9</sup> See, for example, *NECA-IBEW Health & Welfare Fund v Goldman Sachs & Co*, 693 F3d 145, 164 (2d Cir 2012); *In re CitiGroup Inc Bond Litigation*, 723 F Supp 2d 568, 584 (SDNY 2010).

This Comment addresses that question,<sup>10</sup> which remains unresolved despite the billions of dollars at stake.<sup>11</sup> It proposes a two-step test for determining which claims, if any, a named plaintiff in a mortgage-backed securities class action has standing to press. Each step captures a discrete set of cases. First, drawing from common ground between the conflicting opinions of the First and Second Circuits, this test asks whether allegedly misleading language appears in the common shelf registration, the supplemental prospectuses, or both. Second, expanding on the Second Circuit's methodology, the proposed test asks whether any loan originators were common to both the named plaintiff's securities purchases and those of the entire class. Together, these steps screen for standing more comprehensively and incisively than either of the current approaches.

This Comment comprises three parts. Part I provides background on mortgage-backed securities, federal securities law, and standing doctrine. Part II presents the split that has developed in the circuit courts. After exploring the terrain between these apparently polarized opinions, Part III proposes a two-step test for class action standing.

#### I. BACKGROUND: MORTGAGE-BACKED SECURITIES, SECURITIES LAW, AND STANDING

This Part proceeds in three sections. The first examines mortgage-backed securities and their role in the financial crisis. The second discusses relevant securities law and the idiosyncra-

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<sup>10</sup> As discussed in this Comment, the question is limited to mortgage-backed and other asset-backed securities. Similar issues have also arisen in cases involving other types of securities. Compare *In re Salomon Smith Barney Mutual Fund Fees Litigation*, 441 F Supp 2d 579, 604–07 (SDNY 2006) (holding that lead plaintiffs have standing to represent purchasers only from mutual funds that they actually purchased), with *In re Franklin Mutual Funds Fee Litigation*, 388 F Supp 2d 451, 461–62 (D NJ 2005) (deciding that plaintiffs could bring claims against funds from which they had not purchased as long as the named plaintiffs “pleaded direct claims” against those defendants). However, because of the idiosyncratic way that mortgage-backed and other asset-backed securities are structured—which is integral to analyzing and solving the highlighted problem—this Comment necessarily narrows its scope to these products. See Part I.A.1. Also, for simplicity's sake, the various breeds of relevant asset-backed securities are referred to herein as “mortgage-backed securities.”

<sup>11</sup> See Petition for a Writ of Certiorari, *Goldman, Sachs & Co v NECA-IBEW Health & Welfare Fund*, No 12-528, \*3 (US filed Oct 26, 2012) (available on Westlaw at 2012 WL 5361534) (“Goldman Petition”) (claiming that “the [Second Circuit's] decision will effectively increase by tens of *billions* of dollars the potential liability that financial institutions face in this and similar class actions”).

sies of offering documents. The third describes the current state of standing doctrine.

#### A. Insecurity: Mortgage-Backed Securities and the Financial Meltdown

The following two sections provide an overview of mortgage-backed securities and their role in the financial crisis. Part I.A.1 describes the process of securitization, emphasizing how the structure of a mortgage-backed security allocates risk. Part I.A.2 outlines how these products catalyzed a global disaster and describes its consequences.

##### 1. Securitization.<sup>12</sup>

At the heart of a mortgage-backed security is simply a pool of mortgages—the familiar method by which most people pay for a home. Mortgages are grouped together and sold by financial institutions to raise capital,<sup>13</sup> create a market for investment,<sup>14</sup> and increase the amount of credit available to homebuyers.<sup>15</sup> The process begins with lenders, or “originators,” who offer mortgages to individual borrowers based on their perceived creditworthiness.<sup>16</sup> This process yields prime or subprime mortgages, with the latter carrying higher interest rates and going to those with relatively poor credit histories.<sup>17</sup> Thus, because of their greater risk of default, those potentially least able to bear the financial burden are saddled with the highest interest rates.<sup>18</sup> This leaves

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<sup>12</sup> Securitization, also known as structured finance, is “[the] process of converting relatively illiquid secured loans into freely tradable securities.” Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U Ill L Rev 1359, 1367.

<sup>13</sup> See Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 NC Bank Inst 5, 36–37 (2009).

<sup>14</sup> See Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 Hastings Bus L J 77, 92 (2008).

<sup>15</sup> See Moran, 13 NC Bank Inst at 37 (cited in note 13).

<sup>16</sup> See Jennifer E. Bethel, Allen Ferrell, and Gang Hu, *Legal and Economic Issues in Litigation Arising from the 2007–08 Credit Crisis*, in Yasuyuki Fuchita, Richard J. Herring, and Robert E. Litan, eds, *Prudent Lending Restored: Securitization after the Mortgage Meltdown* 163, 167 (Brookings 2009).

<sup>17</sup> See Financial Crisis Inquiry Commission, *Preliminary Staff Report: The Mortgage Crisis* \*5–6 (draft report, FCIC Apr 7, 2010), online at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/2010-0407-PSR\\_-\\_The\\_Mortgage\\_Crisis.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-PSR_-_The_Mortgage_Crisis.pdf) (visited Aug 12, 2014).

<sup>18</sup> See Alexander S. Bonander, Note, *Fannie Mae, Freddie Mac, and Due-Diligence Failures: Should Comparative Responsibility Be Imposed on a Government-Sponsored Entity's Claims Brought under Sections 11(a) and 12(a)(2) of the Securities Act of 1933?*, 98 Iowa L Rev 835, 840 (2013).

lenders and subprime borrowers with a slim margin for error in assessing what the homebuyer can afford: if either party overestimates, intentionally or unintentionally, the buyer may be stuck with a debt load that he or she is unable to service.

Traditionally, lenders handled the mortgages that they originated throughout the instrument's lifespan, bearing the full risk of default.<sup>19</sup> For the reasons mentioned above,<sup>20</sup> originators now typically sell their mortgages to financial institutions called arrangers, which are the next piece in the mortgage-backed security puzzle.<sup>21</sup> An arranger is typically an investment bank and is almost always a different entity than the originator.<sup>22</sup> Arrangers pool mortgages from various originators for two primary reasons: (1) to achieve a sufficiently large asset value to support a secondary market, thereby making the securitization process economically worthwhile; and (2) to reduce risk through diversification.<sup>23</sup> After aggregating a pool of mortgages, the arranger transfers it to a special-purpose entity, which is a trust or subsidiary corporation designed to securitize the myriad loans.<sup>24</sup> Special-purpose entities segregate the mortgages from the arranger's other assets for legal and tax purposes.<sup>25</sup> Finally, with the help of an underwriter,<sup>26</sup> a ratings agency,<sup>27</sup> and possibly a

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<sup>19</sup> See Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L Rev 2039, 2049 (2007).

<sup>20</sup> See text accompanying notes 13–15.

<sup>21</sup> See Richard M. Hynes, *Securitization, Agency Costs, and the Subprime Crisis*, 4 Va L & Bus Rev 231, 239 (2009).

<sup>22</sup> See Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 Utah L Rev 1109, 1111.

<sup>23</sup> See Joseph C. Shenker and Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 Tex L Rev 1369, 1377 n 29 (1991).

<sup>24</sup> Hynes, 4 Va L & Bus Rev at 239 (cited in note 21).

<sup>25</sup> See Shenker and Colletta, 69 Tex L Rev at 1377–78 (cited in note 23). One objective of special-purpose entities is to achieve bankruptcy remoteness. See *id.*

<sup>26</sup> A securities underwriter buys securities—here, from the special-purpose entity—and resells them to investors or otherwise facilitates distribution. See Joseph K. Leahy, *What Due Diligence Dilemma? Re-envisioning Underwriters' Continuous Due Diligence after WorldCom*, 30 Cardozo L Rev 2001, 2010 (2009), citing *In re WorldCom, Inc Securities Litigation*, 308 F Supp 2d 338, 343 (SDNY 2004).

<sup>27</sup> See Thomas Schopfloch, et al, *Subprime and Synthetic CDOs: Structure, Risk, and Valuation* \*5 (NERA Economic Consulting June 3, 2010), online at [http://www.nera.com/nera-files/PUB\\_CDOs\\_Structure\\_Risk\\_Valuation\\_0713.pdf](http://www.nera.com/nera-files/PUB_CDOs_Structure_Risk_Valuation_0713.pdf) (visited Aug 12, 2014). The credit ratings agency is supposed to grade securities according to their risk, though this process may have failed in the years leading up to the financial crisis. See Bonander, 98 Iowa L Rev at 841–42 (cited in note 18).

third-party servicing company,<sup>28</sup> the special-purpose entity issues bond certificates representing claims against the underlying assets—the pooled mortgages and the attendant payments of principal and interest by the homebuyers.<sup>29</sup> Arrangers, special-purpose entities, and underwriters are all securities issuers. Institutional and other investors then purchase the certificates, entitling these investors to payments passed through from the homebuyers. In simplified form,<sup>30</sup> the transaction forms a two-way street between homebuyers and institutional investors, with originators, arrangers, and special-purpose entities paving the way. Capital flows down the street from cash-rich institutional investors to homebuyers who need financing. Mortgage payments travel the opposite direction, passing through to investors and, if all goes well, generating a steady return on investment.

Within this transactional structure, originators, arrangers, and special-purpose entities essentially function as middlemen between large groups of unwitting homebuyers and end purchasers of mortgage-backed securities. Other than certain fees extracted along the way, everything a given homebuyer pays toward his or her mortgage passes through to the investor—as do the risks of default and interest rate fluctuation.<sup>31</sup>

Where the risk of default is situated matters, especially when the mortgages backing the security are subprime, because subprime mortgagors are more likely to default.<sup>32</sup> While originators, which are ideally situated to assess borrowers' creditworthiness,<sup>33</sup> are supposed to account for this enhanced risk, the pass-through nature of the transaction<sup>34</sup> changes their incentives.

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<sup>28</sup> See Hynes, 4 Va L & Bus Rev at 239 (cited in note 21). The servicer “collect[s] payments from the borrower, update[s] account information and pursue[s] delinquent debtors.” Id.

<sup>29</sup> See id.

<sup>30</sup> Securitization is complex, and a full discussion of it lies outside the scope of this Comment. For a thorough analysis of securitization, see generally Steven L. Schwarcz, *Securitization Post-Enron*, 25 *Cardozo L Rev* 1539 (2004). See also Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 *Stan J L Bus & Fin* 133, 135–44 (1994); Adam B. Ashcraft and Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* \*2–12 (Federal Reserve Bank of NY Staff Reports No 318 Mar 2008), online at [http://www.newyorkfed.org/research/staff\\_reports/sr318.pdf](http://www.newyorkfed.org/research/staff_reports/sr318.pdf) (visited Aug 12, 2014).

<sup>31</sup> See Moran, 13 *NC Bank Inst* at 36–37 (cited in note 13) (describing mortgage-backed securities as “pass-through” certificates).

<sup>32</sup> See text accompanying notes 16–18.

<sup>33</sup> As the only entity in the mortgage-backed security transaction that actually interfaces with and evaluates individual borrowers, originators should be screening out some potential homebuyers and sorting those who remain based on perceived creditworthiness.

<sup>34</sup> See text accompanying note 31.

Namely, by passing through the risk of default to the investor, originators obviate the need to be as careful and may even create a perverse incentive to make misrepresentations about a borrower's ability to repay, at worst.<sup>35</sup> In short, the originator gets paid regardless of whether the homebuyer ultimately defaults.<sup>36</sup> These structural problems are exacerbated when originators exploit their position vis-à-vis borrowers by engaging in predatory tactics,<sup>37</sup> such as offering low introductory teaser rates followed by potentially unaffordable variable rates.<sup>38</sup> This tactic was common prior to the financial crisis and relied on an economic environment conducive to refinancing.<sup>39</sup>

## 2. (In)securitization: the financial meltdown.

A perfect storm in the mortgage-backed securities market catalyzed the financial meltdown of 2007–08, spreading and amplifying losses associated with borrower default.<sup>40</sup> Exogenous events revealed—too late—flaws inherent in these securities. The end result was an estimated \$2.2 trillion in global banking losses.<sup>41</sup>

Mortgage-backed securities pass through risk to investors, potentially reducing originators' incentives to exercise caution in lending.<sup>42</sup> In the subprime-mortgage market, which grew explosively from 2001 to 2005,<sup>43</sup> this reduced caution posed a particular

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<sup>35</sup> See Ashcraft and Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* at \*5 (cited in note 30). Also, because of an information asymmetry between arrangers and third parties, the mortgage-backed securities market may suffer from an adverse selection problem: arrangers, which have more information about the quality of the mortgages, can pass the worst loans off to investors and keep the best ones. See id at \*6.

<sup>36</sup> Of course, the originator has countervailing reputational incentives, but those play out over a longer time horizon and at any rate proved insufficient to prevent the kind of advantage taking that fueled the financial crisis.

<sup>37</sup> See Ashcraft and Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* at \*5 (cited in note 30).

<sup>38</sup> See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 167–68 (cited in note 16).

<sup>39</sup> See id. Because the initially affordable interest rate would later reset—increasing monthly payments by 15 to 35 percent or more—many subprime borrowers absolutely needed the option to refinance at a lower rate. Schopflocher, et al, *Subprime and Synthetic CDOs* at \*11 (cited in note 27).

<sup>40</sup> See Federal Crisis Inquiry Commission, *Preliminary Staff Report* at \*19–20 (cited in note 17).

<sup>41</sup> See International Monetary Fund, *Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity* \*13 (Oct 2010), online at <http://www.imf.org/External/Pubs/FT/GFSR/2010/02/pdf/text.pdf> (visited Aug 12, 2014).

<sup>42</sup> See text accompanying notes 30–39.

<sup>43</sup> See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 167–68 (cited in note 16).

threat: the granting of loans that were extremely susceptible to housing price declines because they offered low teaser rates that later reset to a higher level.<sup>44</sup> One of the most risky and common subprime mortgages was an adjustable-rate loan dubbed the “2/28” because it gave the borrower a low, fixed teaser rate for two years, then reset to a much higher variable rate for the next twenty-eight.<sup>45</sup> Many subprime borrowers used products like this expecting their home to appreciate, which would then allow them to either refinance when their mortgage reset or resell (“flip”) their house for a profit.<sup>46</sup> What few of these borrowers contemplated, however, was that if housing prices fell, they would be unable to refinance or sell and possibly unable to make their mortgage payments.<sup>47</sup> Because many subprime borrowers financed nearly the entire value of their home, a price decline might even leave them “underwater”—owing more than the market value of their home.<sup>48</sup>

But in the midst of a housing bubble,<sup>49</sup> overly optimistic borrowers and lenders failed to adequately anticipate price declines. Instead, imbued with irrational exuberance, buyers with marginal incomes, limited net worth, and poor credit histories executed unaffordable mortgages, hoping to flip or refinance.<sup>50</sup> Inevitably, the bubble burst.<sup>51</sup> Housing prices peaked in early 2006, then began to decline;<sup>52</sup> concurrently, the background interest rate increased, exerting still more pressure on homeowners whose adjustable-rate mortgages had just reset.<sup>53</sup> Lacking the

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<sup>44</sup> See Schopflocher, et al, *Subprime and Synthetic CDOs* at \*4 (cited in note 27); Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 168 (cited in note 16). See also text accompanying notes 37–39.

<sup>45</sup> See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 168 (cited in note 16).

<sup>46</sup> See Schopflocher, et al, *Subprime and Synthetic CDOs* at \*11 (cited in note 27).

<sup>47</sup> See *id.*

<sup>48</sup> Miller, 80 *Fordham L Rev* at 276 (cited in note 6).

<sup>49</sup> See Financial Crisis Inquiry Commission, *Preliminary Staff Report* at \*13 (cited in note 17) (noting that the increase in real housing prices in the United States between 1998 and 2006 was substantially greater than in any earlier time period). A speculative bubble is a market condition in which the market price of an asset is artificially inflated from its intrinsic value due to the aggregated poor judgments of investors. See John Patrick Hunt, *Taking Bubbles Seriously in Contract Law*, 61 *Case W Res L Rev* 681, 689–90 (2011).

<sup>50</sup> See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 177 (cited in note 16).

<sup>51</sup> See Financial Crisis Inquiry Commission, *Preliminary Staff Report* at \*13–14 (cited in note 17).

<sup>52</sup> Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 180 (cited in note 16).

<sup>53</sup> *Id.*



option to refinance, many subprime borrowers found themselves underwater and facing impossibly high payments.<sup>54</sup>

Thus was the systemic risk<sup>55</sup> posed by mortgage-backed securities realized. Between 2006 and 2009, the national rates of mortgage-payment delinquencies and home foreclosures skyrocketed.<sup>56</sup> Fearful of losing income, investors in mortgage-backed securities sought to enforce repurchase agreements that required originators to buy back bad mortgages.<sup>57</sup> Overextended subprime originators lacked the capital to do so, and many were driven to bankruptcy,<sup>58</sup> right along with some prime originators.<sup>59</sup> In response, credit ratings agencies began downgrading mortgage-backed securities, triggering write-downs<sup>60</sup> at the trusts holding the impaired assets and requiring these trusts to raise capital to meet regulatory requirements.<sup>61</sup> To do so, they attempted to sell their mortgage-related assets, flooding the already-glutted market and driving down prices in a vicious cycle.<sup>62</sup> Ultimately, the entire financial services industry was reorganized, foreclosures spiked, and investors in mortgage-backed securities lost huge sums of money.<sup>63</sup>

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<sup>54</sup> See *id.* (noting that mortgage payments for many had risen by as much as 30 percent by February 2008).

<sup>55</sup> For a definition of systemic risk, see Steven L. Schwarcz, *Systemic Risk*, 97 *Georgetown L J* 193, 204 (2008):

[Systemic risk is] the 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.

<sup>56</sup> See Financial Crisis Inquiry Commission, *Preliminary Staff Report* at \*20 (cited in note 17).

<sup>57</sup> See Carrick Mollenkamp, James R. Hagerty, and Randall Smith, *Banks Go On Subprime Offensive: HSBC, Others, Try to Force Struggling Smaller Players to Buy Back Their Loans*, *Wall St J* A3 (Mar 13, 2007).

<sup>58</sup> See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 182 (cited in note 16).

<sup>59</sup> See Associated Press, *American Home Mortgage Seeks Chapter 11 Bankruptcy Protection*, *NY Times* C3 (Aug 7, 2007); Kemba J. Dunham, *Subprime Woes Slap Other Lenders: Share Prices Tumble for Mortgage REITs Regardless of Exposure*, *Wall St J* B7 (Mar 14, 2007).

<sup>60</sup> A “write-down” is a reduction in the book value of an asset to reflect market conditions. See John Clark, *International Dictionary of Insurance and Finance* 338 (Glenlake 1999). With mortgage-backed securities in a tailspin, large write-downs signaled firms’ financial distress and exacerbated the sell-off. See Miller, 80 *Fordham L Rev* at 278–79 (cited in note 6).

<sup>61</sup> See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 182–84 (cited in note 16).

<sup>62</sup> See *id.* at 183.

<sup>63</sup> See *id.* at 173. See also Moran, 13 *NC Bank Inst* at 84–85 (cited in note 13).

## B. When the Smoke Cleared: Suing to Recoup Losses

The following two sections provide a summary of relevant securities law and the issuing documents that it requires. Part I.B.1 covers the statutory regime usually invoked by plaintiffs in mortgage-backed securities class actions. Part I.B.2 describes the interaction of two types of documents mandated by that regime.

### 1. Governing securities law.

In the wake of the financial meltdown, securities-fraud class actions have proliferated, typically alleging that the offering documents contained misstatements or omissions.<sup>64</sup> Under §§ 11, 12, and 15 of the Securities Act of 1933<sup>65</sup> ('33 Act), a plaintiff has a cause of action for securities fraud if he or she: (1) purchased a security, (2) relied on a materially fraudulent statement, and (3) the security decreased in value.<sup>66</sup> Specifically, the '33 Act imposes liability for false or misleading statements contained in registration statements,<sup>67</sup> prospectuses,<sup>68</sup> or oral communications,<sup>69</sup> and extends liability to anyone who “controls any person [so] liable.”<sup>70</sup> This is a strict liability cause of action, hinging on the mere existence of a fraudulent statement in the offering documents, rather than the issuers’ intent at the time that they produced those documents.<sup>71</sup>

In the context of mortgage-backed securities class actions, plaintiffs usually allege that risks associated with the loan underwriting practices or the loans themselves—all pertaining to underlying conduct by originators—were not properly disclosed by the arrangers, trusts, and underwriters (collectively, the

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<sup>64</sup> See, for example, *Maine State Retirement System v Countrywide Financial Corp.*, 722 F Supp 2d 1157, 1161 (CD Cal 2010); *In re Wells Fargo Mortgage-Backed Certificates Litigation*, 712 F Supp 2d 958, 962 (ND Cal 2010); *In re IndyMac Mortgage-Backed Securities Litigation*, 718 F Supp 2d 495, 498 (SDNY 2010).

<sup>65</sup> Pub L No 73-22, 48 Stat 74, codified as amended at 15 USC § 77a et seq.

<sup>66</sup> '33 Act §§ 11, 12, 15, 48 Stat at 82–84, codified at 15 USC §§ 77k(a), 77l(a)(2), 77o.

<sup>67</sup> '33 Act § 11, 48 Stat at 82, codified at 15 USC § 77k(a).

<sup>68</sup> '33 Act § 12, 48 Stat at 84, codified at 15 USC § 77l(a)(2).

<sup>69</sup> '33 Act § 12, 48 Stat at 84, codified at 15 USC § 77l(a)(2).

<sup>70</sup> '33 Act § 15, 48 Stat at 84, codified at 15 USC § 77o.

<sup>71</sup> See *In re Lehman Brothers Securities and ERISA Litigation*, 684 F Supp 2d 485, 494 (SDNY 2010) (“[Defendants] are strictly liable for any misstatements in the Offering Documents that they signed unless they can establish the due diligence defense.”); *NECA-IBEW Health & Welfare Fund v Goldman Sachs & Co.*, 693 F3d 145, 148 (2d Cir 2012) (“[These sections] impose essentially strict liability for material misstatements contained in registered securities offerings.”).

issuers).<sup>72</sup> Although their actions form the basis for the allegations of fraud, originators *are not* liable under the aforementioned sections of the '33 Act. Rather, the '33 Act targets entities responsible for producing the misleading offering documents—arrangers, trusts, and underwriters.<sup>73</sup>

For instance, imagine that in 2006 a plaintiff bought a mortgage-backed security from a group of issuers. The issuers stated in the offering documents that “all originators determined that borrowers have a monthly income sufficient to meet their mortgage obligations.” After the financial crisis and a precipitate drop in the security’s value, it comes to light that the originators failed to verify many homebuyers’ incomes. This bad underlying conduct by the originators renders the statement in the offering documents—which the issuers drafted—false. Under the '33 Act, the plaintiff now has a cause of action against the *issuers*, but not the originators.<sup>74</sup> And because the claim is one of strict liability,<sup>75</sup> the plaintiff need not prove that the issuers acted with knowledge of the originators’ bad underlying conduct.

## 2. Offering documents: shelf registration statements and supplemental prospectuses.

Allegedly misleading statements usually occur in shelf registration statements and supplemental prospectuses.<sup>76</sup> A shelf registration statement is a statutory construct that facilitates the issuance of securities,<sup>77</sup> but it also creates a complication that lies at the core of this Comment. Governing multiple separate security issuances,

The shelf registration statement includes a “base” or “core” prospectus that typically contains general information, including the types of securities to be offered and a description of the risk factors of the offering. It will generally not include transaction-specific details—such as pricing information, or

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<sup>72</sup> See, for example, *NECA-IBEW*, 693 F3d at 151–54.

<sup>73</sup> '33 Act §§ 11, 12, 48 Stat at 82–83, codified at 15 USC §§ 77k(a), 77l(a)(2).

<sup>74</sup> Of course, the plaintiff still has to establish all three elements of the claim. See text accompanying note 66.

<sup>75</sup> See note 71.

<sup>76</sup> Oral misstatements are technically also covered but are rarely at issue in these cases. See 15 USC § 77l(a)(2).

<sup>77</sup> It does so by allowing issuers to create a boilerplate template for many different offerings. See *NECA-IBEW*, 693 F3d at 150. Supplemental prospectuses, on the other hand, must be made anew for each offering. See *id.* at 150–51.

information regarding the specific assets to be included in the vehicle from which the securities are issued.<sup>78</sup>

It enables qualified issuers to continually offer securities by writing and filing a shelf registration statement covering all offerings. Originators do not author a registration statement, although their underlying conduct bears on its content.

Issuers then supplement the shared registration statement with prospectuses unique to each offering.<sup>79</sup> Supplemental prospectuses *do* contain transaction-specific details and are narrowly tailored to each offering.<sup>80</sup> These supplements are deemed to create *new* registration statements particular to each offering, which are distinct from shelf registration statements.<sup>81</sup> This package—shelf registration statement plus supplemental prospectus—constitutes the offering documents for a given issuance and explains in detail the characteristics of the underlying assets.<sup>82</sup> Thus, while an identical shelf registration statement may subsume different offerings of mortgage-backed securities, the final “registration statement,” as contemplated by the statutory language,<sup>83</sup> integrates a unique prospectus that focuses in greater detail on the particular loans and their respective risks.<sup>84</sup> This critical distinction engenders the conflict this Comment covers.<sup>85</sup>

### C. Standing and Class Actions

Because class actions often result in settlement, threshold procedural questions carry special significance and may dramatically affect potential liability or even be dispositive of the litigation.<sup>86</sup> Class action standing doctrine can decide the crucial

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<sup>78</sup> *Id.* at 150 (citation omitted).

<sup>79</sup> See 17 CFR § 230.415(a)(6).

<sup>80</sup> See *NECA-IBEW*, 693 F3d at 150.

<sup>81</sup> See 17 CFR § 229.512(a)(1)–(2). See also *Finkel v Stratton Corp.*, 962 F2d 169, 174 (2d Cir 1992). Shelf registration statements—as opposed to just registration statements—are a presupplement document.

<sup>82</sup> See *Plumbers’ Union Local No. 12 Pension Fund v Nomura Asset Acceptance Corp.*, 632 F3d 762, 766 (1st Cir 2011).

<sup>83</sup> 15 USC § 77b(a)(8) (“The term ‘registration statement’ means the statement provided for in section 77f of this title, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference.”).

<sup>84</sup> See *NECA-IBEW*, 693 F3d at 158.

<sup>85</sup> For more on shelf registration statements, see *Finkel*, 962 F2d at 174.

<sup>86</sup> See FRCP 23(f), Advisory Committee Notes to the 1998 Amendments (suggesting that denial of certification effectively bars appellate review and ends the litigation, while

questions of whether and how a class ultimately proceeds. This Section will first discuss standing in general and then narrow in on class actions.

### 1. Standing generally.

Standing is a threshold question that determines a federal court's Article III power to adjudicate a given controversy.<sup>87</sup> In order to establish standing, a plaintiff must show that she has: (1) personally suffered an injury in fact, (2) that is fairly traceable to a defendant's alleged misconduct, and (3) that can be redressed by the court.<sup>88</sup> The first requirement, most relevant here, dictates that a plaintiff must have experienced "an invasion of a legally protected interest which is (a) concrete and particularized . . . and (b) actual or imminent."<sup>89</sup> By making this necessary showing, a plaintiff satisfies Article III's case or controversy requirement<sup>90</sup> and exhibits a personal stake in the outcome of the litigation.<sup>91</sup> This assures the court that the plaintiff is the proper party to present the claim "in an adversarial context and in a form historically viewed as capable of judicial resolution."<sup>92</sup>

Standing doctrine is thought to serve several purposes lumped under "the idea of separation of powers."<sup>93</sup> This "idea,

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its grant may force a defendant to settle rather than incurring the cost of defending and risking ruinous liability).

<sup>87</sup> *Warth v Seldin*, 422 US 490, 498 (1975). This doctrine, both as applied to class actions and generally, has been criticized by many commentators, who suggest that it be used sparingly for several reasons. First, it is inconsistently invoked. See, for example, Daniel D. DeVoglas, Note, *Without a Leg to Stand On? Class Representatives, Federal Courts, and Standing Desiderata*, 97 Cornell L Rev 627, 636 (2012); James Keenley, Comment, *How Many Injuries Does It Take? Article III Standing in the Class Action Context*, 95 Cal L Rev 849, 850 (2007). Second, judges may capitalize on this doctrinal uncertainty by using standing to dodge difficult questions. See Richard J. Pierce Jr., *Is Standing Law or Politics?*, 77 NC L Rev 1741, 1762 (1999). Standing doctrine has even been referred to as "a word game played by secret rules." *Flast v Cohen*, 392 US 83, 129 (1968) (Harlan dissenting).

<sup>88</sup> See *Lujan v Defenders of Wildlife*, 504 US 555, 560–61 (1992).

<sup>89</sup> *Id.* at 560 (quotation marks omitted).

<sup>90</sup> The case or controversy requirement refers to the constitutional grant of jurisdiction over all federal cases and controversies between certain enumerated parties. US Const Art III, § 2, cl 1.

<sup>91</sup> See *Baker v Carr*, 369 US 186, 204–08 (1962).

<sup>92</sup> *Flast*, 392 US at 101. In other words, the personal harm element "ensur[es] that litigants are truly adverse . . . ensuring that the people most directly concerned are able to litigate the questions at issue." William A. Fletcher, *The Structure of Standing*, 98 Yale L J 221, 222 (1988).

<sup>93</sup> *Allen v Wright*, 468 US 737, 752 (1984).

which is more than an intuition but less than a rigorous and explicit theory, [is] about the constitutional and prudential limits to the powers of an unelected, unrepresentative judiciary in our kind of government.”<sup>94</sup> Absent a standing screen, Supreme Court jurisprudence suggests three possible ways that courts might infringe on the powers of other branches or otherwise overstep their constitutional bounds: (1) by presiding over nonadversarial cases, which are outside Article III’s grant of authority; (2) by adjudicating controversies that are more properly decided elsewhere in the political system; and (3) by allowing Congress to conscript the judiciary in battles against the executive branch.<sup>95</sup>

Aside from these constitutional concerns, some commentators argue that standing doctrine also serves a number of practical functions. Some examples include: (1) reducing judicial costs by screening access,<sup>96</sup> (2) reducing private litigation expenses,<sup>97</sup> (3) ensuring vigorous advocacy,<sup>98</sup> and (4) avoiding collusive suits.<sup>99</sup> These practical functions of standing surface in the mortgage-backed securities class action context. For instance, the question addressed by this Comment directly bears on both the public and private costs of class action securities litigation. A strict class standing rule might prevent some plaintiffs from entering court at all, reducing public costs as well as defendants’ litigation expenses, whereas a more permissive rule would likely have the opposite effect. Likewise, if class standing ensures adequate representation long before certification, a stricter application of standing would have similar effects. That is, it would be like applying Federal Rule of Civil Procedure 23(a)(4)<sup>100</sup> earlier in the litigation—before the costly discovery and motions practice related to class certification.<sup>101</sup>

In sum, standing is meant to ensure that the plaintiff is the right person to air the grievance and will vigorously prosecute the case. In addition to constitutional standing doctrine, “the Supreme Court has also recognized ‘statutory standing’ and

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<sup>94</sup> *Vander Jagt v O’Neill*, 699 F2d 1166, 1179 (DC Cir 1983) (Bork concurring).

<sup>95</sup> See Heather Elliott, *The Functions of Standing*, 61 *Stan L Rev* 459, 468 (2008).

<sup>96</sup> See Kenneth E. Scott, *Standing in the Supreme Court—A Functional Analysis*, 86 *Harv L Rev* 645, 672–73 (1973).

<sup>97</sup> See *id.* at 673–74.

<sup>98</sup> See Karl S. Coplan, *Ideological Plaintiffs, Administrative Lawmaking, Standing, and the Petition Clause*, 61 *Me L Rev* 377, 424–25 (2009).

<sup>99</sup> See *id.* at 425.

<sup>100</sup> FRCP 23(a)(4) requires that class representatives “fairly and adequately protect the interests” of putative class members.

<sup>101</sup> See text accompanying notes 258–59.

‘prudential standing.’”<sup>102</sup> The former “refers to standing afforded to certain plaintiffs via legislative fiat.”<sup>103</sup> The latter denotes the “judicially self-imposed limits on the exercise of federal jurisdiction, such as the general prohibition on a litigant’s raising another person’s legal rights.”<sup>104</sup> Prudential standing has an uneasy relationship with the class action, which depends on a named plaintiff litigating on behalf of others. Although “formulated at a high level of generality,”<sup>105</sup> standing is an important preliminary jurisdictional hurdle that protects our government’s separation of powers, screens out potentially ineffective or collusive plaintiffs, and affects the public and private costs of litigation.

## 2. Class action standing.

By appointing one or more named plaintiffs to represent the interests of absent parties, class actions chafe against traditional notions of standing. This collision occurs along two general lines: multiple defendants<sup>106</sup> and multiple claims. The friction addressed in this Comment arises from a mixture of these two tensions.

A pair of broad approaches to class action standing emerges from the case law: the strict model and the permissive model. The strict model requires named plaintiffs to establish personal standing as to each claim asserted by the class. It defines the judicial power in terms of the particularized injuries before the court,<sup>107</sup> such that the elements of standing—*injury in fact*, *causation*, and *redressability*—constitute an “irreducible constitutional minimum.”<sup>108</sup> *Blum v Yaretsky*<sup>109</sup> exemplifies this interpretive viewpoint. The named plaintiffs, nursing home patients

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<sup>102</sup> DeVougas, Note, 97 Cornell L Rev at 634 (cited in note 87).

<sup>103</sup> Id.

<sup>104</sup> *Allen*, 468 US at 751. For further discussion of third-party standing, see Marc Rohr, *Fighting for the Rights of Others: The Troubled Law of Third-Party Standing and Mootness in the Federal Courts*, 35 U Miami L Rev 393, 396–441 (1981) (examining the development and status of third-party standing in the federal courts).

<sup>105</sup> Fletcher, 98 Yale L J at 223 (cited in note 92).

<sup>106</sup> For instance, distinct legal entities may engage in illegal practices that are guided by a single, uniform policy. *Payton v County of Kane*, 308 F3d 673 (7th Cir 2002), is illustrative. A class of former arrestees challenged nineteen counties’ practice of imposing a bail fee as a condition of release, but the named plaintiffs had individual claims against only two counties. Id at 675–77. The district court dismissed the suit for lack of standing. Id at 677. The Seventh Circuit reversed, assessing standing “with reference to the class as a whole.” Id at 680.

<sup>107</sup> See Matthew R. Ford, *Adequacy and the Public Rights Model of the Class Action after Gratz v. Bollinger*, 27 Yale L & Pol Rev 1, 8–9 (2008).

<sup>108</sup> *Lujan*, 504 US at 560.

<sup>109</sup> 457 US 991 (1982).

receiving Medicaid benefits, had been transferred to a lower level of care, allegedly without adequate notice or an administrative hearing.<sup>110</sup> However, they also sought to include in their class patients who had been transferred to a *higher* level of care.<sup>111</sup> With respect to this latter group, the Supreme Court determined that the representatives lacked standing, because “[none] of the individual respondents have been either transferred to more intensive care or threatened with such transfers.”<sup>112</sup> The Court stated, “a plaintiff who has been subject to injurious conduct of one kind [does not] possess by virtue of that injury the necessary stake in litigating conduct of another kind, although similar, to which he has not been subject.”<sup>113</sup>

Naturally, the permissive model takes a more expansive view of class action standing. In this paradigm, named plaintiffs need not allege a personal injury as to each claim asserted by the class. Rather, their claims can simply be similar to those of the class. An example can be found in *Gratz v Bollinger*.<sup>114</sup> The named plaintiffs, both white, were denied admission to the University of Michigan’s College of Literature, Science, and the Arts; had they been minorities, as defined by the school, their academic records would have qualified them for automatic admission under the school’s admissions guidelines.<sup>115</sup> On behalf of a class consisting both of those who had already been prejudiced by the admissions guidelines and those who prospectively might be, the plaintiffs alleged Title VI and Fourteenth Amendment violations.<sup>116</sup> In dissent, Justice John Paul Stevens argued that the named plaintiffs lacked standing because they were contesting the freshman admissions policy, yet they could only ever be subject to the transfer policy.<sup>117</sup> The majority disagreed, stating that “the University’s use of race in undergraduate transfer admissions does not implicate a significantly different set of concerns than

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<sup>110</sup> *Id.* at 995–96.

<sup>111</sup> *Id.* at 997.

<sup>112</sup> *Id.* at 1001.

<sup>113</sup> *Blum*, 457 US at 999. For another example of the strict model applied to a class action, see *Lewis v Casey*, 518 US 343, 358 (1996) (deciding that, rather than having the power to remedy all of the claimed inadequacies of legal assistance available in a prison, the Court could rule only on those related to the prison’s failure to accommodate illiterate inmates, like the class representative).

<sup>114</sup> 539 US 244 (2003).

<sup>115</sup> *Id.* at 251–54.

<sup>116</sup> *Id.* at 252–53.

<sup>117</sup> See *id.* at 284–87 (Stevens dissenting).



does its use of race in undergraduate freshman admissions.”<sup>118</sup> In essence, the Court found that the plaintiffs had standing because “*the same set of concerns* [was] implicated by the University’s use of race in evaluating all undergraduate admissions applications.”<sup>119</sup>

## II. STANDING APART: THE GREAT DIVIDE

As courts adjudicate claims arising from the financial meltdown, disagreement has grown over how to treat class action standing in the context of mortgage-backed securities fraud. It is undisputed that lead plaintiffs lack standing to raise claims *on their own behalf* regarding securities that they did not personally purchase.<sup>120</sup> Under a strict model, the story ends there—if a named plaintiff cannot establish personal standing as to each claim, then he or she lacks standing to pursue those claims for the class. However, if it is alleged that a shelf registration statement common to a batch of securities is fraudulent, thus implicating the same set of concerns across many securities offerings, the permissive model calls for expanding the conventional scope of standing. This Part, which discusses the circuit split between courts embracing these competing models, comprises three sections. The first discusses the First Circuit’s position, which confines class action standing to the particularized injuries suffered by the named plaintiff. The second considers the permissive approach taken by the Second Circuit. The last explores the practical significance of this distinction.

### A. The First Circuit’s Strict Model

Most courts to consider this issue have held that a named plaintiff lacks standing to represent the interests of investors in mortgage-backed securities that the named plaintiff did not personally purchase.<sup>121</sup> These courts reason that such plaintiffs have suffered no injury from securities that they did not purchase and therefore have no stake in the litigation of claims

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<sup>118</sup> *Gratz*, 539 US at 265.

<sup>119</sup> *Id.* at 267 (emphasis added). For another example of the permissive model, see *Flast*, 392 US at 105–06 (holding that taxpayers had standing to raise claims about allegedly unconstitutional governmental conduct despite a relatively negligible interest in the tax revenue supporting it).

<sup>120</sup> See *NECA-IBEW Health & Welfare Fund v Goldman Sachs & Co.*, 693 F3d 145, 158 (2d Cir 2012) (“[The plaintiff] clearly lacks standing to assert such claims on its behalf because it did not purchase those Certificates.”).

<sup>121</sup> See, for example, *Maine State Retirement System v Countrywide Financial Corp.*, 722 F Supp 2d 1157, 1163 n 6 (CD Cal 2010) (collecting cases).

related to those securities. However, the First Circuit is thus far the only federal court of appeals to adopt this position, and it did so somewhat reservedly.

That opinion was handed down in *Plumbers' Union Local No. 12 Pension Fund v Nomura Asset Acceptance Corp.*<sup>122</sup> The named plaintiffs bought mortgage-backed securities from two of the eight defendant trusts, all of which shared two shelf registration statements.<sup>123</sup> The trusts were organized by a single arranger—Nomura, the lead defendant—but were backed by loans from different mixes of originators and had different supplemental prospectuses.<sup>124</sup> During the financial crisis, the certificates issued by all eight trusts were downgraded and lost substantial value.<sup>125</sup> Representing a class of purchasers from all eight trusts, the plaintiffs sued on the theory that the registration statements contained false or misleading information about the mortgage-underwriting guidelines, property-appraisal practices, and investment ratings.<sup>126</sup>

The court began its analysis by acknowledging the uncertainty surrounding class action standing.<sup>127</sup> It stated that class representatives “regularly litigate not only their own claims but also claims of other class members based on transactions in which the named plaintiffs played no part.”<sup>128</sup> The First Circuit observed that the Supreme Court’s holdings on class action standing are inconsistent and that several circuits have departed from the strict posture, allowing classes to proceed when “the claims are essentially of the same character as the claim against a properly named defendant.”<sup>129</sup>

After wrestling with this ambiguity, the First Circuit made an important qualification, giving some ground to the permissive model:

The qualification, on which we reserve judgment, is one where the claims of the named plaintiffs necessarily give them—not just their lawyers—*essentially the same incentive to litigate the counterpart claims of the class members* because

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<sup>122</sup> 632 F3d 762 (1st Cir 2011).

<sup>123</sup> *Id.* at 766.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Nomura*, 632 F3d at 766–67, 772–76.

<sup>127</sup> See *id.* at 768 (“The issue looks straightforward and one would expect it to be well settled; neither assumption is entirely true.”).

<sup>128</sup> *Id.* at 769.

<sup>129</sup> *Id.* at 769–70.

the establishment of the named plaintiffs' claims necessarily establishes those of other class members. The matter is one of *identity of issues* not in the abstract but at a ground floor level. In such a case, . . . the substance of the Article III concern may vanish even if in form it might seem to persist.<sup>130</sup>

Despite this qualification, and despite the fact that “a handful of district court cases have allowed securities claims to proceed in situations that may fit the possible exception we have outlined above,” the First Circuit ultimately affirmed dismissal of the claims against the six trusts from which the named plaintiffs had not purchased.<sup>131</sup> It determined that the “identity of issues and alignment of incentives” required to trigger the potential exception were not present, because each trust was backed by loans from a different mix of originators.<sup>132</sup> The court required that securities purchased by class members be backed by a mix of originators *identical* to that in offerings purchased by the named plaintiffs.<sup>133</sup> This holding illustrates the strict model of standing: the court dismissed all claims related to trusts from which the named plaintiffs did not buy.<sup>134</sup> And since two separate offerings will rarely have an identical originator mix,<sup>135</sup> the First Circuit essentially limited class standing to the particularized injuries suffered by the lead plaintiffs—thereby enshrining the traditional, narrow notion of standing.

Various district courts have dismissed similar claims on the basis of the strict model, rejecting the position that a flaw in the common registration statement implicates the same fundamental issues for all purchasers.<sup>136</sup> Often citing each other, these opinions

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<sup>130</sup> *Nomura*, 632 F3d at 770 (emphasis added).

<sup>131</sup> *Id.* at 771.

<sup>132</sup> *Id.*

<sup>133</sup> See *id.* at 770–71.

<sup>134</sup> See *Nomura*, 632 F3d at 771.

<sup>135</sup> Arrangers aggregate a large portfolio of mortgages from different originators, then subdivide it into separate offerings and lots within those offerings. See Bethel, Ferrell, and Hu, *Legal and Economic Issues* at 170 (cited in note 16).

<sup>136</sup> For examples of cases holding that named plaintiffs have class standing only with respect to the securities that they personally purchased, see *In re IndyMac Mortgage-Backed Securities Litigation*, 718 F Supp 2d 495, 501 (SDNY 2010); *In re Lehman Brothers Securities and ERISA Litigation*, 684 F Supp 2d 485, 490–91 (SDNY 2010); *Massachusetts Bricklayers and Masons Funds and Pipefitters' Retirement Fund Local 598 v Deutsche Alt-A Securities*, 2010 WL 1370962, \*1 (EDNY); *City of Ann Arbor Employees' Retirement System v Citigroup Mortgage Loan Trust Inc.*, 703 F Supp 2d 253, 260–61 (EDNY 2010); *Public Employees' Retirement System of Mississippi v Merrill Lynch & Co.*, 714 F Supp 2d 475, 480–81 (SDNY 2010); *Maine State Retirement System*, 722 F Supp 2d

generally reason as follows: (1) in order to establish Article III standing, named plaintiffs must show personal injury per traditional standing analysis; (2) because each supplemental prospectus is deemed to create a new registration statement, the argument that all offerings share a common shelf registration fails; and (3) furthermore, the named plaintiffs lack statutory standing with respect to securities that they did not purchase because §§ 11 and 12 of the '33 Act grant a cause of action to only the person actually acquiring a particular security.<sup>137</sup> This reasoning turns on distinguishing a shelf registration statement, applicable to a batch of securities, from a final registration statement created by filing a supplemental prospectus.<sup>138</sup>

Courts justify this distinction on the basis of both the statutory language and the fact that the representations made in supplemental prospectuses are unique.<sup>139</sup> Two provisions of the '33 Act are commonly drawn on: the section treating supplemental prospectuses as creating new registration statements,<sup>140</sup> and the passage stating that “any person acquiring such security . . . may . . . sue.”<sup>141</sup> The former, it is argued, undermines the notion that a shelf registration is truly common to all offerings it covers, while the latter implies that a purchaser may sue regarding only securities that he or she acquired. As to the claim that supplemental prospectuses contain unique information, recall that they “focus[ ] on the specific loans underlying each offering and the specific underwriting standards and origination practices in effect at the time those specific loans were originated,”<sup>142</sup> while shelf registration statements are “general in content” and

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at 1163–64; *In re Wells Fargo Mortgage-Backed Certificates Litigation*, 712 F Supp 2d 958, 963–64 (ND Cal 2010).

<sup>137</sup> See, for example, *Wells Fargo Mortgage-Backed Certificates*, 712 F Supp 2d at 964–65; *Lehman Brothers Securities*, 684 F Supp 2d at 490–91; *Maine State Retirement System*, 722 F Supp 2d at 1164 (“For the reasons stated in [*Wells Fargo Mortgage-Backed Certificates*] and [*Lehman Brothers Securities*], Plaintiffs have standing only with respect to the [offerings] in which the named plaintiffs purchased.”).

<sup>138</sup> When an offering is made pursuant to a common registration statement with a supplemental prospectus, “each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein.” 17 CFR § 229.512(a)(2). In other words, the representations in the shelf registration statement are deemed to be repeated in the new registration statement, and mingle with those in the supplemental prospectus.

<sup>139</sup> See, for example, *Maine State Retirement System*, 722 F Supp 2d at 1164.

<sup>140</sup> See note 138.

<sup>141</sup> 15 USC § 77k(a).

<sup>142</sup> *Maine State Retirement System*, 722 F Supp 2d at 1164.

“point investors to specific details contained in the supplements.”<sup>143</sup>

#### B. The Second Circuit’s Permissive Model

The Second Circuit recently made an apparently momentous break from precedent,<sup>144</sup> transplanting the permissive model exemplified by *Gratz* into the realm of securities law. It developed a new method of determining when a lead plaintiff may bring claims regarding securities that he or she did not personally purchase. However, like the First Circuit in *Nomura*, the Second Circuit qualified its holding.

The facts of *NECA-IBEW Health & Welfare Fund v Goldman Sachs & Co*<sup>145</sup> read much like those in *Nomura*. The named plaintiff bought certificates from two of seventeen offerings made pursuant to the same shelf registration statement.<sup>146</sup> Each offering was issued by a separate trust, which were all arranged by Goldman Sachs,<sup>147</sup> and backed by loans from different mixes of originators.<sup>148</sup> Accordingly, the final offering documents included supplemental prospectuses unique to each security.<sup>149</sup> After the certificates’ ratings were downgraded in 2008, they lost much of their value.<sup>150</sup> Representing a class of purchasers from all seventeen trusts, the plaintiff sued on the theory that the offering documents—including the common shelf registration statement—contained false or misleading information about the mortgage-underwriting guidelines, property-appraisal standards, and securities’ ratings.<sup>151</sup>

The district court, explicitly following the First Circuit’s position in *Nomura*, dismissed the named plaintiff’s claims concerning the fifteen trusts from which it had not purchased securities; the judge rejected the argument that all buyers were subject to the same misrepresentations via a common shelf registration

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<sup>143</sup> *New Jersey Carpenters Vacation Fund v Royal Bank of Scotland Group, PLC*, 720 F Supp 2d 254, 265 (SDNY 2010).

<sup>144</sup> It is significant that this circuit—which contains New York City, the hub of American finance—chose to revamp standing analysis in mortgage-backed securities class actions, especially after so many contrary decisions from its district courts (see note 136).

<sup>145</sup> 693 F3d 145 (2d Cir 2012).

<sup>146</sup> *Id.* at 149.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 153.

<sup>149</sup> *NECA-IBEW*, 693 F3d at 153.

<sup>150</sup> *Id.* at 153–54.

<sup>151</sup> *Id.* at 151.

statement.<sup>152</sup> On review after appeal, the Second Circuit began its analysis by differentiating between ordinary standing and class standing.<sup>153</sup> Then it noted “tension” in Supreme Court precedent.<sup>154</sup> However, the Second Circuit did not stop there: it also thoroughly reviewed each of the seminal cases representing the strict and permissive models.<sup>155</sup> From these, particularly *Gratz*, it distilled a preliminary method for determining class action standing: inquiring whether defendants’ 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.<sup>156</sup>

Applying this formula, the Second Circuit rejected the idea that standing cannot exist under a common shelf registration statement merely because it has been supplemented by unique prospectuses.<sup>157</sup> After all, the court reasoned:

The fact that those representations appeared in separate Offering Documents . . . does not by itself raise “a number of fundamentally different concerns,” because the location of the representations has no effect on a given purchaser’s assertion that the representation was misleading . . . just as [in *Gratz*] the difference in the University of Michigan’s transfer and freshman admissions policies had no effect on the University’s assertion that diversity was a compelling state interest.<sup>158</sup>

Additionally, the misstatements in the supplemental prospectuses were “nearly identical.”<sup>159</sup> Reading this language alone, one would think that the court simply embraced the permissive model wholesale.

But, as in *Nomura*, the Second Circuit qualified its holding. Importantly, the court ultimately allowed the class to proceed against only seven of the seventeen trusts.<sup>160</sup> Recognizing the complexity of these transactions,<sup>161</sup> the court limited class standing

<sup>152</sup> See *id.* at 154.

<sup>153</sup> *NECA-IBEW*, 693 F3d at 158.

<sup>154</sup> *Id.* at 160.

<sup>155</sup> See *id.* at 160–62. These cases were discussed in Part I.C.2 and will be scrutinized further in Part III.A.

<sup>156</sup> *NECA-IBEW*, 693 F3d at 162.

<sup>157</sup> See *id.*

<sup>158</sup> *Id.* at 162–63 (citation omitted).

<sup>159</sup> *Id.* at 163.

<sup>160</sup> *NECA-IBEW*, 693 F3d at 164.

<sup>161</sup> See *id.* at 163 (“[Class members] bought Certificates issued through 17 separate Offerings, each backed by a distinct set of loans issued by a distinct set of originators.”).

to participants in offerings backed by loans from originators common to the two offerings from which the named plaintiff had purchased certificates.<sup>162</sup> Such a distinction was necessary, the court explained, because “differences in the identity of the originators backing the Certificates matters for the purposes of assessing whether those claims raise the same set of concerns.”<sup>163</sup> In short, claims against two or more offerings that lack *any* overlapping originators would draw on very different proof.<sup>164</sup>

To illustrate this approach, imagine two offerings, both covered by the same shelf registration statement: offering 1, with originators A and B; and offering 2, with originators C and D. If the named plaintiff has purchased only from offering 1, he or she must prove that originator A or B has engaged in underlying conduct, such as failing to verify borrower income,<sup>165</sup> that renders offering 1’s documents false or misleading. Showing bad underlying conduct on the part of C or D—which would matter to buyers from offering 2—will not avail the named plaintiff. Thus, it makes little sense to create a class of purchasers from offerings 1 *and* 2, even if those offerings’ shelf registration statements are otherwise identical.

At least four different courts have followed *NECA-IBEW*.<sup>166</sup> Interestingly, several district courts have gone even further,

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<sup>162</sup> See *id.* at 164. The Second Circuit’s approach will be referred to as the “common-originator test.”

<sup>163</sup> *Id.* at 163.

<sup>164</sup> See *NECA-IBEW*, 693 F3d at 163.

<sup>165</sup> See text accompanying notes 72–75.

<sup>166</sup> See *New Jersey Carpenters Health Fund v Royal Bank of Scotland Group, PLC*, 709 F3d 109, 128 (2d Cir 2013) (vacating dismissal of claims in a mortgage-backed securities class action and remanding the case for reconsideration under the *NECA-IBEW* standard); *New Jersey Carpenters Health Fund, New Jersey Carpenters Vacation Fund v Residential Capital, LLC*, 2013 WL 6669966, \*3 (SDNY) (rejecting an interpretation of *NECA-IBEW* that would require a common shelf registration to implicate the “same set of concerns”); *New Jersey Carpenters Health Fund v DLJ Mortgage Capital, Inc.*, 2013 WL 357615, \*1–9 (SDNY) (granting in part the plaintiff’s motion for reconsideration in light of *NECA-IBEW* and finding that the Second Circuit’s test expands the plaintiff’s class standing); *Plumbers’ & Pipefitters’ Local No. 562 Supplemental Plan & Trust v J.P. Morgan Acceptance Corp I*, 2012 WL 4053716, \*1 (EDNY) (applying the *NECA-IBEW* test in a mortgage-backed securities class action). See also *Gates v UnitedHealth Group Inc.*, 2014 WL 1316928, \*4 (2d Cir) (suggesting that a plaintiff might be able to bring “claims on behalf of the beneficiaries of other [health insurance] plans . . . in light of this Court’s decision in [*NECA-IBEW*]”); *Plumbers & Pipefitters National Pension Fund v Burns*, 967 F Supp 2d 1143, 1164 (ND Ohio 2013) (applying the *NECA-IBEW* test in a securities-fraud class action and concluding that it permits stockholders to assert claims on behalf of bondholders); *In re Frito-Lay North America, Inc All Natural Litigation*, 2013 WL 4647512, \*10–13 (EDNY) (applying *NECA-IBEW* in the context of a consumer-fraud class

allowing claims against *all* offerings made under an allegedly fraudulent shelf registration statement to proceed, regardless of originator mix. In *In re Countrywide Financial Corp Securities Litigation*,<sup>167</sup> the Central District of California parsed the language of § 11 of the '33 Act to distinguish between “registration statement” as used there and as used elsewhere, suggesting that the statute grants a named plaintiff standing to represent anyone who buys a security traceable to a common defective shelf registration statement.<sup>168</sup> In *In re CitiGroup Inc Bond Litigation*,<sup>169</sup> the Southern District of New York extended this position to a class action alleging that the shelf registration statement common to a batch of mortgage-backed collateralized debt obligations<sup>170</sup> (CDOs) was fraudulent.<sup>171</sup> In that case, after explicitly adopting the conclusion from *In re Countrywide*, the court held that “where the actionable part of the registration statement is alleged to be common to all purchasers from the same shelf, then a plaintiff has standing to represent them.”<sup>172</sup> And again, in *In re American International Group, Inc 2008 Securities Litigation*<sup>173</sup> (“AIG”), the same district court reached a similar result, this time distinguishing between alleged misstatements in supplemental prospectuses and in a common shelf registration statement.<sup>174</sup> Recently, this court went the furthest yet in *New Jersey Carpenters Health Fund, New Jersey Carpenters Vacation Fund v Residential Capital, LLC*,<sup>175</sup> liberally interpreting NECA-IBEW’s “same set of concerns” language to require only common originators, not necessarily even a shared shelf registration

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action). But see *Oklahoma Police Pension and Retirement System v U.S. Bank National Association*, 2013 WL 6508843, \*5 (SDNY) (declining to apply NECA-IBEW to sweep in entirely different species of claims that resulted in allegedly similar injury). For a lengthy criticism of NECA-IBEW from a court in another circuit, see *FDIC v Countrywide Financial Corp*, 2012 WL 5900973, \*9–12 (CD Cal).

<sup>167</sup> 588 F Supp 2d 1132 (CD Cal 2008).

<sup>168</sup> *Id.* at 1165.

<sup>169</sup> 723 F Supp 2d 568 (SDNY 2010).

<sup>170</sup> CDOs are a type of asset-backed security similar to mortgage-backed securities. CDOs are backed not just by mortgages, but also by other receivables owned by the special-purpose entity. See Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 Minn L Rev 373, 376 (2008). For purposes of this Comment, CDOs can be collapsed into the term “mortgage-backed securities.” See note 10.

<sup>171</sup> See *In re CitiGroup*, 723 F Supp 2d at 584–85.

<sup>172</sup> *Id.* at 584.

<sup>173</sup> 741 F Supp 2d 511 (SDNY 2010).

<sup>174</sup> See *id.* at 537–38.

<sup>175</sup> 2013 WL 6669966 (SDNY).



statement.<sup>176</sup> Noting that “there was no language [in *NECA-IBEW*] finding that a shared registration statement was an essential element of the ‘same set of concerns’ requirement,” Judge Harold Baer held that common originators plus substantial textual similarity in offering documents satisfies the class standing analysis.<sup>177</sup>

### C. Why Does It Matter?

A class action’s utility lies partly in organizing a large group of discrete claimants, solving collective action problems that they might otherwise face.<sup>178</sup> Yet mortgage-backed securities cases typically involve sophisticated plaintiffs with much at stake, who theoretically might be willing to sue in smaller classes or even singly, subject to the lead plaintiff appointment provisions of the Private Securities Litigation Reform Act of 1995.<sup>179</sup> In this environment, will claims reach court one way or the other, rendering this topic moot? Not necessarily. Aside from statutory guidelines for determining who is the “most adequate plaintiff,”<sup>180</sup> economic considerations limit the potential for circumventing this question.

First, even for large institutional investors, the potential increase in claim size yielded by a more inclusive class can be profound—in *NECA-IBEW*, for instance, granting standing to claims against just five additional offerings, out of a total of seventeen,<sup>181</sup> meant the difference between a possible recovery of less than \$500,000 and several billion dollars.<sup>182</sup> Had the First Circuit’s strict model controlled *NECA-IBEW* instead, the class would have been restricted to pursuing claims worth only \$500,000—likely not enough to justify litigation expenses.<sup>183</sup> Second, the identity of the lead plaintiff will greatly affect potential liability for similar reasons. It is extremely unlikely that any one investor,

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<sup>176</sup> See *id.* at \*3.

<sup>177</sup> *Id.*

<sup>178</sup> See Jonathan R. Macey and Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U Chi L Rev 1, 8–9 (1991).

<sup>179</sup> Pub L No 104-67, 109 Stat 737, codified in various sections of Title 15.

<sup>180</sup> 15 USC § 78u-4(a)(3)(B)(iii)(I).

<sup>181</sup> *NECA-IBEW*, 693 F3d at 149.

<sup>182</sup> See Goldman Petition at \*27 (cited in note 11).

<sup>183</sup> Mortgage-backed securities class actions tend to require extensive discovery. See, for example, *Maine State Retirement System v Countrywide Financial Corp.*, 2013 WL 6577020, \*15 (CD Cal) (involving six years of discovery and the production of nearly ten million pages of documents).

or even several, will have bought all the securities covered by a given shelf registration statement.<sup>184</sup> Again taking *NECA-IBEW* as an example, the lead plaintiff, presumably the class member with the largest financial stake in the relief sought,<sup>185</sup> had actually purchased from only two out of seventeen offerings.<sup>186</sup> Relaxing traditional standing requirements more than tripled the number of different offerings that the plaintiff could represent claims against.<sup>187</sup> In short, restructuring litigation, either through attempting to cherry-pick lead plaintiffs or split up the class, will not avoid the question under discussion.

### III. SCREENING FOR STANDING: A TWO-STEP TEST

This Part, which proposes a solution to the circuit split, includes two sections. The first suggests that *Nomura* and *NECA-IBEW* are each, perhaps unknowingly, anchored to a critical, unexplored middle ground that lies between the strict and permissive models that they exemplify. The second, drawing from this newly charted realm, articulates a test for class action standing in the mortgage-backed securities context.

#### A. Finding a Common Ground between the Split

At first blush, the strict and permissive models of class action standing employed in *Nomura* and *NECA-IBEW* seem diametrically opposed. Indeed, the courts reach opposite outcomes on nearly identical facts and cite different cases to get there. Yet both circuits clearly qualify their holdings, and these qualifications act like tethers that pull the decisions ineluctably back toward the middle ground. This Section elucidates that common ground.

##### 1. Paving the way: *Nomura's* "same incentive."<sup>188</sup>

In the end, the First Circuit embraced the strict model, requiring that the named plaintiffs possess personal claims against *each offering* for which they sought to represent purchasers.<sup>189</sup> But

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<sup>184</sup> Hundreds of different offerings may be implicated in these cases. See, for example, *Maine State Retirement System*, 722 F Supp 2d at 1161 (mentioning 427 separate offerings).

<sup>185</sup> See 15 USC § 78u-4(a)(3)(B)(iii)(I)(bb).

<sup>186</sup> *NECA-IBEW*, 693 F3d at 149.

<sup>187</sup> See *id.* at 164.

<sup>188</sup> See *Nomura*, 632 F3d at 770.

<sup>189</sup> See *id.* at 771.

the court also explicitly anticipated the possibility of a situation warranting relaxation of the strict model: namely, a case in which “the claims of the named plaintiffs necessarily give them . . . essentially *the same incentive to litigate the counterpart claims of the class members* because the establishment of the named plaintiffs’ claims *necessarily* establishes those of other class members.”<sup>190</sup> With the proper “identity of issues . . . the substance of the Article III concern may vanish even if in form it might seem to persist.”<sup>191</sup> And the court went further, giving examples of three cases that might fit this mold:<sup>192</sup> *Payton v County of Kane*,<sup>193</sup> *Fallick v Nationwide Mutual Insurance Co*,<sup>194</sup> and *AIG*.

In *Payton*, a class of former arrestees who were released on bail from Illinois jails in nineteen counties contested the imposition of a bail fee as a condition of release.<sup>195</sup> This practice, authorized by state statute, was common to all nineteen counties, but the amount of the fee varied.<sup>196</sup> Since the named plaintiffs had individual claims against only two of the nineteen counties, the district court dismissed the entire case for want of standing.<sup>197</sup> On appeal, the Seventh Circuit identified this as “a classical problem of standing,” because although all nineteen counties charged a bond fee, “a plaintiff must allege that a defendant—the very defendant sued—has somehow wronged her in a legally cognizable way.”<sup>198</sup> However, because “[t]he constitutionality of a bond fee (whether it is \$1 or \$45) should not differ from one county to the next, when such a fee is imposed pursuant to the same statute,” the court concluded that it was reasonable for the plaintiffs to bring suit against all the counties.<sup>199</sup> After all, there is “no reason to truncate potentially efficient uses of the class action . . . [which] may be superior to 19, or 102, different cases in each Illinois county.”<sup>200</sup> The key to this judgment was that all the counties were “following a common statute,” providing a “common

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<sup>190</sup> Id at 770 (emphasis added).

<sup>191</sup> Id.

<sup>192</sup> See *Nomura*, 632 F3d at 770–71.

<sup>193</sup> 308 F3d 673 (7th Cir 2002).

<sup>194</sup> 162 F3d 410 (6th Cir 1998).

<sup>195</sup> *Payton*, 308 F3d at 675.

<sup>196</sup> Id.

<sup>197</sup> Id at 675–76.

<sup>198</sup> Id at 678.

<sup>199</sup> *Payton*, 308 F3d at 680.

<sup>200</sup> Id at 681.

factor [that] assures that the representative has the same legal claim as the unnamed parties.”<sup>201</sup>

The *Fallick* court reasoned along similar lines. The plaintiff’s ERISA-governed health plan was one of many administered by Nationwide Mutual Insurance Company.<sup>202</sup> After being denied medical benefits, he challenged Nationwide’s “reasonable and customary” standard for assessing claims, which also applied to other plans; the proposed class included participants in such other plans.<sup>203</sup> The district court dismissed all claims regarding other plans for lack of standing.<sup>204</sup> On appeal, the Sixth Circuit held that, once the district court had determined that the named plaintiff had standing to press his claim, the standing inquiry was satisfied for all the plans.<sup>205</sup> In other words, “once an individual has alleged a distinct and palpable injury to himself he has standing to challenge a practice even if the injury is of a sort shared by a large class of possible litigants.”<sup>206</sup> As in *Payton*, because the practice applied universally, the named plaintiff could properly bring all the stated claims—including those dealing with plans in which he had not participated.

*AIG* is the most relevant of these three cases, for it presents facts similar to those in the cases at the core of this Comment. After the emergency bailout of AIG, the named plaintiffs brought a class action on behalf of other purchasers of securities issued by AIG, alleging that the defendants had materially misstated their exposure to the subprime-mortgage market.<sup>207</sup> The named plaintiffs argued that, because the alleged misstatements and omissions appeared in three common shelf registration statements, they had standing to assert claims against all 101 offerings made pursuant to those statements, even those in

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<sup>201</sup> *Id.*

<sup>202</sup> *Fallick*, 162 F3d at 411.

<sup>203</sup> *Id.* at 411–12.

<sup>204</sup> *Id.* at 412.

<sup>205</sup> *Id.* at 423.

<sup>206</sup> *Fallick*, 162 F3d at 432, quoting *Senter v General Motors Corp.*, 532 F2d 511, 517 (6th Cir 1976).

<sup>207</sup> *AIG*, 741 F Supp 2d at 517. Note that this is not a standard mortgage-backed securities case—the plaintiffs were purchasers of AIG stock shares and alleged that AIG misrepresented its exposure to mortgage-backed securities that it (not the plaintiffs) was dealing in. This posture effectively removes originators from the analysis, because the plaintiffs had not directly invested in any mortgage-backed securities. Instead, they sought to prove bad underlying conduct by AIG, such as failing to disclose the valuation and risk of its portfolio. See *id.* at 522. Thus, while raising some of the same issues, *AIG* is distinguishable.

which they did not participate.<sup>208</sup> The court agreed, finding that they had standing across the board:

[Because] Plaintiffs do not rely on the information furnished in the prospectus and pricing supplements unique to each of the 101 offerings but rather on the alleged material misstatements and omissions located in the common elements of the three different registration statements . . . Plaintiffs therefore can trace the injury of the purchasers in each of the 101 offerings to the *same underlying conduct* on the part of the defendants.<sup>209</sup>

This would not have been the case, however, had the plaintiffs relied on misstatements and omissions located only “in the prospectus supplements unique to each particular offering.”<sup>210</sup>

If these cases are read alongside *Nomura*, the outlines of the First Circuit’s qualification can be discerned: when different claims concern *common underlying conduct*—be it by different counties, through different health plans, or within different securities offerings—they pass muster in a class action standing analysis. This is because the legality of the conduct will not meaningfully differ from one claim to the next. In this context, as the First Circuit pointed out, the substance of traditional Article III standing analysis vanishes.<sup>211</sup>

In terms of real-world incentives, it is also more economical for both sides to apply their resources to a one-off battle, rather than litigate the same basic issue time and again, with potentially inconsistent and unpredictable results. While plaintiffs clearly would rather aggregate their resources and reduce litigation expenses by creating a larger class, it could be argued that defendants would prefer a piecemeal litigation approach, so as to avoid “bet the company” situations.<sup>212</sup> However, considering the greatly increased legal costs that would result from a multiplicity of cases, this strategy might well backfire. Even the cost of litigating numerous “victories” might conceivably add up to as much or more than the cost of a one-off loss. Allowing like claims to proceed also promotes judicial efficiency by avoiding redundant

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<sup>208</sup> Id at 537.

<sup>209</sup> Id at 538 (emphasis added).

<sup>210</sup> Id.

<sup>211</sup> See *Nomura*, 632 F3d at 770.

<sup>212</sup> Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 Colum L Rev 237, 292 n 138 (2009) (noting that companies sometimes prefer to settle legal disputes rather than “bet the company” in litigation).

review and promotes efficacy by concentrating the efforts of both sides on a single showdown. Finally, concerns about the adequacy of the named plaintiff's representation are quelled: given the "same incentive" to litigate the counterpart claims,<sup>213</sup> that plaintiff will not shortchange the claims of the rest of the class.

So why, after delineating this qualification, did the First Circuit find that *Nomura* fell outside of it? Notably, the court did *not* make this finding on the ground that supplemental prospectuses create new registration statements, destroying their erstwhile commonality.<sup>214</sup> Rather, the court based dismissal on a *perceived* lack of commonality in the underlying conduct, which resulted from different mixes of originators.<sup>215</sup> Recall that the conduct of originators—failing to verify a borrower's income, for example—potentially renders an issuer's statement misleading, and therefore subjects the issuer to liability under the '33 Act.<sup>216</sup> The First Circuit stated, "Each trust is backed by loans from a different mix of banks; no named plaintiff has a significant interest in establishing wrongdoing by the particular group of banks that financed a trust from which the named plaintiffs made no purchases."<sup>217</sup> In short, because each trust had *some* different originators, the court thought that the underlying conduct at issue could vary from one trust to the next. While this holding apparently tracks the court's qualification, at least insofar as it focuses on underlying conduct, it departs from the qualification in spirit—anything less than *complete* originator commonality deprives a claim of standing.

2. Following the yellow-brick road: *NECA-IBEW*'s "same set of concerns."<sup>218</sup>

Turning to the qualification in *NECA-IBEW*, it quickly becomes clear that these two cases stand in less tension than appears at first glance. Indeed, *Nomura*'s "same incentive" and

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<sup>213</sup> *Nomura*, 632 F3d at 770.

<sup>214</sup> This is the reasoning of many district courts that have adopted the strict model in mortgage-backed securities class actions. See, for example, *Maine State Retirement System v Countrywide Financial Corp.*, 722 F Supp 2d 1157, 1164 (CD Cal 2010); *In re Wells Fargo Mortgage-Backed Certificates Litigation*, 712 F Supp 2d 958, 964 (ND Cal 2010).

<sup>215</sup> See *Nomura*, 632 F3d at 771. Note that "different mixes" does not mean that no originators overlapped.

<sup>216</sup> See Part I.B.1.

<sup>217</sup> *Nomura*, 632 F3d at 771.

<sup>218</sup> *NECA-IBEW*, 693 F3d at 162.

“identity of issues” language<sup>219</sup> sounds much like *NECA-IBEW*’s “same set of concerns” language.<sup>220</sup> Does *NECA-IBEW*, then, simply fall neatly into the qualification spelled out by the First Circuit? Not exactly, for two reasons. First, while the named plaintiff in *NECA-IBEW* did allege that the common shelf registration statement contained misstatements and omissions,<sup>221</sup> it also alleged that the unique supplemental prospectuses were materially misleading.<sup>222</sup> Second, like in *Nomura*, “the originators of the loans backing each of the 17 Trusts . . . varied dramatically.”<sup>223</sup> Under the First Circuit’s approach, that fact alone would have stripped the lead plaintiff of standing to sue the trusts from which it did not buy.<sup>224</sup>

To address the first problem, the Second Circuit had to innovate. Here, the “same set of concerns” language did more than *Nomura*’s “same incentive.” Namely, it allowed the court to gloss over the distinction between a common shelf registration, which is incorporated into all the final securities offering documents, and the supplemental prospectuses, which contain information unique to each offering. Invoking the “same set of concerns” talisman from *Gratz*, the Second Circuit determined that the shelf registration–supplemental prospectus distinction “does not by itself raise ‘a number of fundamentally different concerns’ because the location of the representations has no effect on a given purchaser’s assertion that the representation was misleading (the source of the injury).”<sup>225</sup>

Although drawn from a very different legal context—constitutional litigation seeking injunctive relief—the analogy to *Gratz* is apt. Textual similarity between the documents governing the different claims was as important in *Gratz* as in *NECA-IBEW*. In *Gratz*, wherein the named plaintiffs, potential transfer applicants, sought to represent freshman applicants, the Court stressed: “The guidelines used to evaluate transfer applicants specifically cross-reference factors and qualifications considered in assessing freshman applicants. In fact, the criteria used to

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<sup>219</sup> *Nomura*, 632 F3d at 770.

<sup>220</sup> *NECA-IBEW*, 693 F3d at 162.

<sup>221</sup> *Id.* at 151.

<sup>222</sup> *Id.* The plaintiff argued that “the common [Shelf] Registration Statement provides the glue that binds together the absent Class Members’ purchases of Certificates, as well as the additionally misleading [Prospectus] Supplements.” *Id.* at 157.

<sup>223</sup> *Id.* at 153.

<sup>224</sup> See text accompanying notes 215–17.

<sup>225</sup> *NECA-IBEW*, 693 F3d at 162–63 (citation omitted), quoting *Gratz*, 539 US at 264.

determine whether a transfer applicant will contribute to the University's stated goal of diversity are *identical* to that used to evaluate freshman applicants."<sup>226</sup> Similarly, in *NECA-IBEW*, the Second Circuit relied on the fact that the defendants "inserted nearly identical misrepresentations into the Offering Documents associated with *all* of the Certificates, whose purchasers plaintiff seeks to represent."<sup>227</sup> Essentially, both courts reasoned as follows: if the allegedly violative language giving rise to two different claims is nearly identical, the same set of concerns is implicated. Thus, it makes no sense to artificially distinguish between textually similar categories of claims that revolve around the same fundamental dispute.

The Court in *Gratz* also eschewed the freshman/transfer distinction because of the practical similarity between the types of claims. Both freshman and transfer applicants contested the idea that an interest in diversity can justify the use of race in undergraduate admissions decisions, and that justification was "the sole rationale the University had provided for any of its race-based preferences in undergraduate admissions."<sup>228</sup> In other words, the claims were focused on the same underlying conduct. Indeed, the Court noted, "[T]he *only* difference between the University's use of race in considering freshman and transfer applicants is that all underrepresented minority freshman applicants receive 20 points and 'virtually' all who are minimally qualified are admitted, while 'generally' all minimally qualified transfer applicants are admitted outright."<sup>229</sup> In the mortgage-backed securities context, this kind of de minimis difference is analogous to the potentially irrelevant variations—minute details about individual offerings that likely have no bearing on the alleged fraud<sup>230</sup>—introduced by supplemental prospectuses.<sup>231</sup> Indeed, as a court interpreting *NECA-IBEW* recently suggested, a common shelf registration may not even be necessary when substantial

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<sup>226</sup> *Gratz*, 594 US at 265.

<sup>227</sup> *NECA-IBEW*, 693 F3d at 162. The court was referring to statements from the shared shelf registration statement that were repeated in each offering's final documents. *Id.* at 162–63.

<sup>228</sup> *Gratz*, 594 US at 267.

<sup>229</sup> *Id.* at 266.

<sup>230</sup> See Part I.B.2.

<sup>231</sup> Of course, the supplemental prospectuses are arguably irrelevant only when claims are predicated on alleged misstatements or omissions in the common shelf registration statement.



textual similarity and common originators exist in two separate offerings, though it is sufficient.<sup>232</sup>

To address the second concern—different originator mixes—the Second Circuit qualified its innovation, retreating toward the common ground between *NECA-IBEW* and *Nomura*. Acknowledging that “[t]he putative class members here did not all purchase debt backed by a single company through offering documents tainted by a single misstatement about that company,” the court reasoned that claims concerning *entirely different* mixes of originators “could turn on very different proof” about their underlying conduct, which is what actually renders an issuer’s statement misleading.<sup>233</sup> Thus, it concluded, “to the extent certain Offerings were backed by loans originated by originators common to [the offerings from which NECA bought], NECA’s claims raise a sufficiently similar set of concerns” to establish standing with respect to those other claims.<sup>234</sup> In short, named plaintiffs have standing to bring claims regarding securities that they did not purchase if those securities share similar misstatements and common originators with the securities that they did buy.

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Despite their facially conflicting holdings, *NECA-IBEW* and *Nomura* stand astride common ground. Each court at least imagines an expansion of the traditional scope of standing when the underlying conduct is essentially the same and the named plaintiff has the proper incentives to adequately represent the entire class. They similarly reject the formalistic distinction between a registration statement before and after supplementation with a prospectus. Where they diverge is in their treatment of originator mixes: the First Circuit would require an identical pool as between the offerings that the plaintiff and class members bought, while the Second Circuit requires only some commonality.<sup>235</sup>

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<sup>232</sup> See *New Jersey Carpenters Health Fund*, 2013 WL 6669966 at \*3. An example might be a situation in which an arranger has copied an alleged misstatement from the shelf registration statement of an otherwise unrelated offering.

<sup>233</sup> *NECA-IBEW*, 693 F3d at 163.

<sup>234</sup> *Id.* at 164.

<sup>235</sup> The Second Circuit looks for “at least some” originator commonality. *Id.* It does not assign a value to or expound on this standard. See note 273.

## B. Growing an Analytical Framework from Common Ground

Having identified the common ground between *NECA-IBEW* and *Nomura*, an analytical framework can begin to take root and perhaps grow into a better mode of assessing standing in mortgage-backed securities class actions. Synthesizing elements of these and other cases, this Section creates a two-step test for standing in this context: First, do the plaintiff's allegations concern misstatements or omissions in the common shelf registration statement, the supplemental prospectuses, or both? Second, were "at least some" originators common to both the allegedly fraudulent offering that the named plaintiff participated in and the offerings in which class members participated? Each part of the test examines a lead plaintiff's interest in different aspects of the claim—step one ensures that the plaintiff is targeting the same allegedly misleading statements, while step two verifies a shared interest in the originators' underlying conduct.

### 1. Step one: statement commonality.

The first part of this test asks exactly which of the offering documents are allegedly misleading, with three possible answers: (1) only the shelf registration statement common to all the securities offerings, (2) only the supplemental prospectuses unique to each offering, or (3) both.<sup>236</sup> This step screens out cases in which the named plaintiff does not have a personal stake in establishing that some *statements* relevant to other class members were misleading.

If only the common shelf registration statement is allegedly misleading,<sup>237</sup> the named plaintiff would have standing—contingent on the outcome of step two—to sue on behalf of all other purchasers of securities offered under it. This falls squarely within the qualification created by *Nomura's* "same incentive"

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<sup>236</sup> Of course, the final offering documents incorporate the shelf registration statement and the supplemental prospectuses. This test looks at the parts *ex ante* and would ignore any nonunique segments of the supplemental prospectuses. For instance, if a supplemental prospectus substantially repeats some allegedly misleading information already given in the shelf registration statement, the answer to this inquiry is not thereby changed to "both." The answer would be "both" if, on the other hand, the supplemental prospectus included substantially unique information that was also alleged to be misleading.

<sup>237</sup> At least one court has stated that even a common shelf registration might not be necessary. See *New Jersey Carpenters Health Fund*, 2013 WL 6669966 at \*3 (determining that substantial textual similarity in the supplemental prospectus of a security issued under a different shelf registration statement would also pass muster, provided that it had some common originators).

language;<sup>238</sup> that is, claims concerning identical flaws in different securities offerings are not meaningfully distinct. Like the former arrestees contesting a policy shared across many counties<sup>239</sup> or the health plan participant challenging a standard implemented in different plans,<sup>240</sup> plaintiffs arguing that a common shelf registration is misleading with respect to the security that they purchased have the exact same incentives for pressing their claim as they do for claims arising from any other security issued under that statement. Indeed, this is the result of *AIG*,<sup>241</sup> precisely because the plaintiffs alleged only that the common shelf registration statement was misleading.<sup>242</sup> And if this approach is consistent with the First Circuit's strict model, it is certainly acceptable under *NECA-IBEW*'s more permissive "same set of concerns" language. In that case, the Second Circuit allowed claims alleging that *both* the shelf registration statement *and* the supplemental prospectuses were misleading to proceed<sup>243</sup>—something that this test would not do.

If only the respective supplemental prospectuses are allegedly misleading, on the other hand, the plaintiff lacks standing to represent the claims of purchasers from other offerings. In this case, the test mandates that the class must be pared down to purchasers of the securities that the lead plaintiff bought. This follows because a supplemental prospectus pertains only to a given offering and contains "transaction-specific details—such as pricing information, or information regarding the specific assets to be included in the vehicle from which the securities are issued."<sup>244</sup> It is issued as part of the "offering documents" for one particular security.<sup>245</sup> In these circumstances, there would be no obvious glue to bind the claims of the named plaintiff and the class members that purchased other securities.

The more difficult case is one in which the plaintiff alleges that both the common shelf registration statement and the

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<sup>238</sup> Though the First Circuit delineated this qualification, it did not necessarily adhere to it. See Part III.A.1.

<sup>239</sup> See *Payton*, 308 F3d at 675.

<sup>240</sup> See *Fallick*, 162 F3d at 411–12.

<sup>241</sup> The First Circuit cited this case as an example of the qualification. See Part III.A.1.

<sup>242</sup> *AIG*, 741 F Supp 2d at 538. For more cases holding likewise, see *In re CitiGroup Inc Bond Litigation*, 723 F Supp 2d 568, 585 (SDNY 2010); *In re Countrywide*, 588 F Supp 2d at 1166.

<sup>243</sup> See *NECA-IBEW*, 693 F3d at 153, 164.

<sup>244</sup> *Id* at 150.

<sup>245</sup> *Nomura*, 632 F3d at 766.

supplemental prospectuses are misleading in unique ways.<sup>246</sup> The Second Circuit faced this locational distinction in *NECA-IBEW*<sup>247</sup> because the alleged misstatements occurred in both the common shelf registration statement and the supplemental prospectuses.<sup>248</sup> The plaintiff claimed that the problematic information from the shelf registration statement was “essentially repeated” in the supplemental prospectuses.<sup>249</sup> Unfortunately, the court did not meaningfully analyze the veracity of that claim, which is dubious.<sup>250</sup> For instance, although the court described the supplemental prospectuses as containing “similar, generic misrepresentations,” it also noted that “only the Prospectus Supplements . . . set forth [the originators’] respective lending guidelines—the descriptions of which, plaintiff alleges, were [ ] misleading.”<sup>251</sup> Indeed, the plaintiff even described the supplemental prospectuses as “additionally misleading.”<sup>252</sup> Thus, while the court elides this locational distinction, the plaintiff in *NECA-IBEW* appears to have alleged that the shelf registration statement and the supplemental prospectuses were uniquely misleading. In circumstances such as these, how does the proposed test operate? Do the uniquely misleading supplemental prospectuses poison class standing that would otherwise be validated by misstatements in a common shelf registration statement?

Harsh though it may seem, the answer should be *yes*—the plaintiff lacks standing to represent the claims of purchasers from other offerings whose supplemental prospectuses are alleged to be uniquely misleading, and the test does not proceed.<sup>253</sup> This outcome is justified by its behavioral impact: If the allegedly misleading content of the supplemental prospectuses is not integral to the case, class members can simply tailor their claims by asserting that the common shelf registration statement alone is misleading, thereby proceeding to step two.<sup>254</sup> If, on the other hand, class members rely so heavily on the uniquely misleading

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<sup>246</sup> This does *not* include the case in which the supplemental prospectus merely repeats allegedly misleading information from the shelf registration statement. See note 236.

<sup>247</sup> See *NECA-IBEW*, 693 F3d at 162–63.

<sup>248</sup> *Id.* at 149.

<sup>249</sup> *Id.*

<sup>250</sup> The court probably failed to analyze this claim because, under the Second Circuit’s test, the location of the representations is irrelevant. See *id.* at 162–63.

<sup>251</sup> *NECA-IBEW*, 693 F3d at 151, 153.

<sup>252</sup> *Id.* at 157.

<sup>253</sup> Note that the proposed test ignores substantial repetitions of information from the shelf registration statement in supplemental prospectuses. See note 236.

<sup>254</sup> See text accompanying notes 237–43.

information in the supplemental prospectus that they must include it, then they are better off bringing separate actions, because the named plaintiff would neither have the “same incentive” to litigate on their behalf nor the “same set of concerns.” In short, the named plaintiff would have no “personal stake” in proving that unique supplemental prospectuses from other offerings were misleading.<sup>255</sup> Indeed, doing so would merely detract resources from the claim relevant to the named plaintiff, and the only conceivable benefit to them—enlarged class size—would be indirect and uncertain.

One might argue that the screening performed by this test—or any incarnation of class action standing—is duplicative of Rule 23 certification. For instance, since a securities-fraud class action would typically proceed as a Rule 23(b)(3) action,<sup>256</sup> plaintiffs would be required to show “that the questions of law or fact common to class members predominate over any questions affecting only individual members.”<sup>257</sup> Like the proposed two-step test, this would seem to screen out instances in which certain class members rely heavily on uniquely misleading information in supplemental prospectuses. Or, at the settlement stage, sophisticated class members being shortchanged by a lead plaintiff might receive notice and opt out (thus screening themselves out of the class) under Rule 23(e)(4).

This is not to say, however, that the proposed test is superfluous. First, the historical trend has been toward an almost automatic certification of securities-fraud class actions,<sup>258</sup> suggesting that a tailored class standing test could screen out plaintiffs that might be missed at the certification stage. Second, and more importantly, even reaching that stage can be quite costly, because “[g]enerally, prior to the class certification decision, plaintiffs seek expansive general discovery into the class claims.”<sup>259</sup> Indeed, “the class certification process has become increasingly burdensome and costly. . . . [P]roceeding with the class certification

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<sup>255</sup> See *Baker v Carr*, 369 US 186, 204 (1962) (stating that whether the plaintiff has “a personal stake in the outcome of the controversy” is “the gist of the question of standing”).

<sup>256</sup> See, for example, *New Jersey Carpenters Health Fund v Residential Capital, LLC*, 272 FRD 160, 168–71 (SDNY 2011) (conducting a Rule 23(b)(3) analysis).

<sup>257</sup> FRCP 23(b)(3).

<sup>258</sup> See Margaret Anne Caulfield, Note, *Class Action Certification in Private Securities Litigation: Endangered Species?*, 14 Suffolk J Trial & App Advoc 94, 109 (2009) (“[H]istorically, securities class actions were almost always certified.”).

<sup>259</sup> Linda S. Mullenix, *Dropping the Spear: The Case for Enhanced Summary Judgment Prior to Class Certification*, 43 Akron L Rev 1197, 1236 (2010).

process entails *massive* transaction costs involved with pre-certification discovery and motion practice.”<sup>260</sup> Thus, properly applied class standing analysis acts as a frontline screen that reduces costs for all parties. If anything, the possibility that some plaintiffs would be screened out during certification *increases* the need for a functional class standing test on the front end: if eventual screening of certain plaintiffs is inevitable, they—and their costly motions and discovery requests—should be removed as soon as possible.

The proposed rule forces the plaintiff to weigh the economic benefit of certifying a larger class against the cost of narrowing claims to common elements. A looser rule—like that endorsed by the Second Circuit, which explicitly declines to make the locational distinction that step one does<sup>261</sup>—would basically make the certification of larger classes costless and therefore prove odious to defendants, who would face greater pressure to settle.<sup>262</sup> It would also jeopardize the interests of class members claiming harm from different statements, who might receive inadequate representation under the Second Circuit’s more lenient analysis. While determining with certainty whether the statements in the supplemental prospectuses in *NECA-IBEW* were in fact essentially repeated is impossible based on the Second Circuit’s scant analysis of that question,<sup>263</sup> the proposed test, if applied there, likely would have required whittling the claims down to those pertaining to a common registration statement. This could significantly reduce class size, forcing claimants whose evidence primarily concerns statements in supplemental prospectuses to proceed singly, in a smaller class of their own, or not at all. Thus, by examining the location of the allegedly misleading statement, step one adds an essential layer of scrutiny that *NECA-IBEW* lacks.

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<sup>260</sup> Id at 1235 (emphasis added).

<sup>261</sup> The Second Circuit stated that “the location of the representations has no effect on a given purchaser’s assertion that the representation was misleading.” *NECA-IBEW*, 693 F3d at 162–63. By contrast, step one is entirely focused on the location of the representations—it is outcome determinative.

<sup>262</sup> These are often referred to as “blackmail settlements.” See *Matter of Rhone-Poulenc Rorer, Inc*, 51 F3d 1293, 1298 (7th Cir 1995) (defining blackmail settlements as “settlements induced by a small probability of an immense judgment in a class action”).

<sup>263</sup> See text accompanying notes 247–52.

## 2. Step two: originator commonality.

Assuming that the class survives step one by alleging that only the shelf registration statement common to a batch of securities is misleading,<sup>264</sup> the court should then apply a version of the common-originator test.<sup>265</sup> This will pare down classes wherein the named plaintiff's interests are aligned with those of the class as far as the common *statement*—because they passed step one—but not with respect to the originators' underlying conduct that actually makes the statement fraudulent. Again, underlying conduct is a bad act undertaken by an originator in granting loans;<sup>266</sup> it has the capacity to make statements in the offering documents—drafted by issuers, who are on the hook for misstatements—untrue and therefore actionable under the '33 Act.<sup>267</sup> Such screening is desirable because the plaintiff should develop the case evenly; that is, without some common originators, the plaintiff would lack any incentive to prove wrongdoing by originators with whom it did not deal. Thus, working in conjunction with step one, the common-originator test ensures that the named plaintiffs' interests and incentives align with those of the class members that they represent—both in terms of the allegedly fraudulent statement and the underlying conduct that renders it illicit.

This step confers standing on only those claims concerning offerings backed by “at least some” of the same originators implicated in the offerings purchased by the named plaintiff.<sup>268</sup> Commonality is relevant only insofar as it concerns allegedly bad underlying conduct. In other words, a common but blameless originator cannot bind together two claims relying on the underlying conduct of other, noncommon originators.<sup>269</sup> To illustrate the

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<sup>264</sup> Bearing in mind the substantial-textual-similarity exception. See note 237.

<sup>265</sup> See *NECA-IBEW*, 693 F3d at 164. Note that using the common-originator test does not amount to adopting the Second Circuit's position, for two reasons: (1) it is preceded by step one, which makes the locational distinction that the Second Circuit explicitly rejected (see note 261) and thereby screens out a different set of claimants; (2) it defines “at least some,” something that the Second Circuit neglected to do. See text accompanying notes 282–83.

<sup>266</sup> Examples of bad underlying conduct include: failing to verify the homebuyer's income or coaching them to falsely inflate it, generating inaccurate property appraisals, approving loans at rates higher than the buyer can afford, and so forth. See *NECA-IBEW*, 693 F3d at 151–52. See also Part I.B.1.

<sup>267</sup> See Part I.B.1.

<sup>268</sup> See *NECA-IBEW*, 693 F3d at 164.

<sup>269</sup> For example, imagine a situation with two faulty originators, A and C, and one innocent originator, B. Offering 1 involves originators A and B, while offering 2 involves

test:<sup>270</sup> Imagine that the named plaintiff purchased securities from an offering involving originators A, B, and C. Class member 1 purchased from another offering involving originators A, B, and D; class member 2 purchased from another offering involving originators A, E, and F; and class member 3 purchased from yet another offering involving originators G, H, and I. The named plaintiff has standing to represent class member 1 because he or she purchased from an offering backed by loans from common originators A and B. The named plaintiff also has standing with respect to class member 2, due to common originator A. However, class member 3 purchased from an offering involving *entirely different* originators; thus, the named plaintiff lacks standing with respect to class member 3's claim.

Such a line must be drawn between facially identical statements made by issuers because the underlying conduct of originators is precisely what transforms those statements into misrepresentations and therefore comprises a critical component of what must be proven.<sup>271</sup> In the example above, proving that originators A, B, and C engaged in unscrupulous lending practices belied by the shelf registration statement will have no bearing on the exact same statement made about originators G, H, and I,<sup>272</sup> though such proof is the lynchpin of the named plaintiff's case. Accordingly, class member 3's claim will not be advanced by such proof, and therefore he or she would fare better if represented by a named plaintiff with parallel allegations. This crucial distinction serves as the basis for step two.

Difficulty lies in assigning a value to "at least some," which the Second Circuit failed to do.<sup>273</sup> If taken literally, as that court may have intended,<sup>274</sup> "at least some" common originators means

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B and C. If the named plaintiff purchased from offering 1, he or she cannot thereby represent purchasers from offering 2, because the only commonality is with respect to B, who is innocent.

<sup>270</sup> This example assumes that all the offerings are covered by a common shelf registration statement (or substantially similar statements), that all originators engaged in bad underlying conduct, and that step one is satisfied.

<sup>271</sup> See *National Credit Union Administration Board v RBS Securities, Inc.*, 900 F Supp 2d 1222, 1254 (D Kan 2012) ("Proof that other originators deviated from underwriting guidelines or that it was a general problem within the industry is not sufficient by itself.").

<sup>272</sup> G, H, and I may, indeed, have done nothing wrong, despite being covered by the same registration statement.

<sup>273</sup> See *FDIC v Countrywide Financial Corp.*, 2012 WL 5900973, \*12 (CD Cal) ("*NECA-IBEW* does not mention any limitation on its origination rule.").

<sup>274</sup> See Goldman Petition at \*29 (cited in note 11) (stating that the Second Circuit held that NECA could pursue claims involving one trust even though only 9 percent of the loans backing it derived from a common originator).



that a hypothetical claim related to a mortgage-backed security with 0.1 percent of its loans originated by B would be swept into the class so long as B was also involved in the offering that the named plaintiff purchased from, and provided that both securities were covered by a common shelf registration statement. While it appears extreme, this scenario nevertheless contemplates underlying conduct—albeit in only 0.1 percent of the loans backing the hypothetical security—that allegedly renders its offering documents fraudulent.<sup>275</sup> Given the strict liability nature of §§ 11 and 12 of the '33 Act,<sup>276</sup> allowing any quantum of securities fraud, however slight, is anomalous. An obvious counterargument would be that purchasers from such a hypothetical offering did not meaningfully rely on the allegedly fraudulent statement, which was, according to this argument, true 99.9 percent of the time. A defendant would attempt to cast these purchasers as improperly seeking ex post facto insurance against what only turned out to be, in hindsight, a bad investment. An insolvent defendant might even argue that allowing such plaintiffs to proceed would rob more deserving plaintiffs of a full recovery. The flaw with this line of reasoning is that the '33 Act is a strict liability regime,<sup>277</sup> meaning that proof of fault—here, knowledge that the investment was bad—is simply unnecessary.<sup>278</sup> By creating a strict liability regime, Congress chose to effectively make issuers wear an insurer hat as well. Even if a judge were sympathetic to such pleas, standing—an up-front, categorical bar to the claim—would hardly be the remedy of choice. It would be much more sensible to adjust recovery at a later stage of the proceedings, bringing it in line with the ratio of offending loans.<sup>279</sup> Accordingly, the common-originator analysis, as applied in step two of this test, means *any* commonality.

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<sup>275</sup> With the caveats about certification noted in Part III.B.1, defendants can take solace in the likelihood that claims with such minimal commonality would be screened out during certification. See FRCP 23(b)(3).

<sup>276</sup> See text accompanying notes 65–71.

<sup>277</sup> See *Herman & MacLean v Huddleston*, 459 US 375, 381 (1983) (noting that § 11 is “designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability”). See also Marc I. Steinberg and Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 Rutgers L Rev 1, 10 (2010) (describing § 11’s “virtually absolute strict liability against the issuer” and “minimal pleading requirements”).

<sup>278</sup> See Dan B. Dobbs, Paul T. Hayden, and Ellen M. Bublick, *Dobbs’ Law of Torts* § 437 (Reuters 2014).

<sup>279</sup> See, for example, Robert Elkin and Robert J. Bluhm, *Indirect Purchaser Standing in Antitrust Actions: Duplicative Liability in the Energy Industry*, 11 Ener L J 185,

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How would this test look in practice? Imagine a hypothetical case<sup>280</sup> wherein the named plaintiff has purchased only from offering 1 but seeks to represent purchasers from offerings 2 and 3 as well. All three offerings are covered by a common, allegedly misleading shelf registration statement and share 20 percent originator commonality. Offerings 1 and 2 also contain unique, allegedly misleading statements in their supplemental prospectuses.<sup>281</sup> Unlike the Second Circuit, which would confer standing to represent all these purchasers,<sup>282</sup> step one of the proposed solution knocks out purchasers from offering 2, because their claim partly relies on uniquely misleading statements in their supplemental prospectus.<sup>283</sup> Buyers of offering 3 reach step two because the allegedly misleading statements are located only in a shelf registration statement shared with offering 1. Step two diverges from the First Circuit's analysis, which would require an identical originator mix,<sup>284</sup> thereby eliminating purchasers from all offerings except offering 1. Unlike the First Circuit's approach, step two would allow claims related to offering 3 to proceed, because they share "at least some" originator commonality with offering 1. Both phases of the proposed test would operate differently than did either of these courts' approaches, meticulously ensuring that named plaintiffs share an actual alignment of interests and incentives with the class members.

#### CONCLUSION

The present circuit split has thrown mortgage-backed securities class standing into disarray. Supreme Court decisions, as both the First and Second Circuits noted, have thus far shed little

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209–10 (1990) (discussing the possibility of adjusting damages so as to avoid duplicative awards resulting from differing treatment of standing in parallel state and federal utility-regulation regimes).

<sup>280</sup> This hypothetical is loosely based on the facts of *Nomura*, as developed in the district court. See *Plumbers' Union Local No. 12 Pension Fund v Nomura Asset Acceptance Corp.*, 658 F Supp 2d 299, 305–09 (D Mass 2009).

<sup>281</sup> These are not substantial repetitions of the registration statement. See note 236.

<sup>282</sup> The Second Circuit ignores the location of allegedly fraudulent statements, allowing claims partly based on misleading supplemental prospectuses to proceed. See note 261.

<sup>283</sup> If they desired to remain part of the class, they could tailor their claim to remove such additional allegations, relying instead on the common registration statement. See text accompanying notes 254–55.

<sup>284</sup> See *Nomura*, 632 F3d at 771.

light on the question of class standing, even in general terms.<sup>285</sup> This Comment has proposed a solution drawn from common ground between *Nomura* and *NECA-IBEW*. Rather than simply denying or granting standing class-wide, as some district courts have attempted to do,<sup>286</sup> the proposed test screens for standing in two stages. First, it asks where the allegedly misleading information is located in order to ensure that the named plaintiff has a personal stake in litigating the same statements as other class members. Second, it looks for originator commonality, thereby establishing that the lead plaintiff has an interest in proving at least some of the same underlying conduct that renders such statements fraudulent. Accordingly, this two-step test captures cases that the First or Second Circuits' approaches operating alone would miss.<sup>287</sup> The proposed test is neither as restrictive as *Nomura*, because it elaborates on the qualification hinted at there, nor as broad as *NECA-IBEW*, because it would disallow claims predicated on meaningfully different allegations. Thus, the proposed solution more delicately balances the respective interests of named plaintiffs and class members, ensuring that the former will not be given undue bargaining power and the latter will not be inadequately represented.

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<sup>285</sup> See *NECA-IBEW*, 693 F3d at 160; *Nomura*, 632 F3d at 769–70.

<sup>286</sup> For a blanket grant of standing based on a court's interpretation of "registration statement," see *In re Countrywide Financial Corp Securities Litigation*, 588 F Supp 2d 1132, 1164–66 (CD Cal 2008). For a blanket denial based on a narrower interpretation of the exact same phrase, see *In re Washington Mutual, Inc Securities, Derivative & ERISA Litigation*, 259 FRD 490, 504 (WD Wash 2009).

<sup>287</sup> See text accompanying notes 280–84.