

UNITED STATES DISTRICT COURT  
EASTERN DISTRICT OF NEW YORK

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CITY OF ANN ARBOR EMPLOYEES'  
RETIREMENT SYSTEM, Individually and  
on behalf of all others similarly situated,

MEMORANDUM AND ORDER

Plaintiffs,

CV 08-1418

-against-

(Wexler, J.)

CITIGROUP MORTGAGE LOAN  
TRUST INC., et al.,

Defendants.

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APPEARANCES:

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WEXLER, District Judge

This is a class action alleging violation of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (the "1933 Act"). Presently before the court is Defendants' motion, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, to dismiss Plaintiffs' Second Amended Complaint ("SAC") for failure to state a claim upon which relief can be granted. For the reasons that follow, the motion is denied.

## BACKGROUND

### I. The Parties

In this action there are two lead plaintiffs, the City of Ann Arbor Employees' Retirement System (Ann Arbor) and the Greater Kansas City Labor Pension Fund ("Kansas City"). Both lead plaintiffs bring this action on their own behalf, as well as on behalf of a class of individual investors, as described below (the "Plaintiff Class")(collectively "Plaintiffs").

Named as a defendant here, as well as in the complaint previously before the court (the "First Amended Complaint" or the "FAC") is Citigroup Mortgage Loan Trust, Inc., ("Citigroup Mortgage"), a Delaware corporation formed for the purpose of acquiring, owning and transferring mortgage loan assets, and selling interests in them. The FAC named as Defendants eighteen mortgage loan trusts established by Citigroup Mortgage. The SAC names only two trusts – those that survived the first motion to dismiss. These two trusts are Citigroup Mortgage Loan Trust 2007-AR5 (the "AR5 Trust") and Citigroup Mortgage Loan Trust 2007-WFHE2 (the "WFHE2 Trust") (collectively the "Trusts").

The Trusts are common law trusts that are alleged to have issued "Mortgage Pass-Through Certificates and Asset Backed Pass-Through Certificates of Citigroup Mortgage Loan Trust" (the "Certificates"). Ann Arbor purchased Certificates issued by the AR5 Trust. Kansas City purchased Certificates issued by the WFHE2 Trust. Ann Arbor asserts that it sold its Certificates, at a loss, approximately six months after they were purchased. Kansas City continues to hold its Certificates, but asserts that they are now worth "significantly less" than when purchased. The Plaintiff Class is alleged to consist of individuals and entities that acquired Certificates from the Trusts, and suffered financial losses as a result of the acts set forth in the

complaint. All of the mortgages underlying the Trusts were issued by Wells Fargo Bank, N.A. (“Wells Fargo”). Also remaining as Defendants are certain individuals who are alleged to have signed disclosure documents relating to investment in the Certificates (collectively the “Individual Defendants”).

II. Mortgage Industry Practices Underlying the Allegations of the SAC

The general facts set forth in the SAC are the same as those set forth in the FAC. Familiarity with those allegations, as detailed in this court’s prior opinion, is assumed. See City of Ann Arbor Employees' Retirement System v. Citigroup Mortg. Loan Trust, Inc., 703 F. Supp.2d 253 (E.D.N.Y. 2010). Briefly stated, both the FAC and the SAC detail historical practices of the mortgage industry, as well as the more recent practice of packaging mortgages for sale into the financial markets. The latter practice refers to securitizing groups of mortgages into pools that are thereafter transformed into securities known as mortgage backed securities.

Both the FAC and the SAC refer to the lending practices of loan originators, the growth of the sub-prime lending market, and the ways in which the lending institutions at issue evaluated the risk of lending to certain homeowners. As noted, the only lending institution at issue with respect to the Trusts described in the SAC is Wells Fargo.

III. The Alleged Securities Act Violations

Plaintiffs’ complaint is based upon alleged violations of Sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the “1933 Act”). 15 U.S.C. §§77k, 77l(a)(2), and 77o. The Sections 11 and 12(a)(2) claims assert false statements and/or omissions. Section 11 applies to statements made in Registration Statements, and Section 12(a)(2) applies to statements made in Prospectuses. See In re Morgan Stanley Information Fund Securities Litigation, 592 F.3d 347,

358 (2d Cir. 2010). Plaintiff's third cause of action, alleged pursuant to Section 15 of the 1933 Act, 15 U.S.C. § 77o, is asserted against the Individual Defendants and Citigroup Mortgage. The Individual Defendants are alleged to have been "control persons" of Citigroup Mortgage and the Trusts, by virtue of their positions as directors and/or senior officers of Citigroup Mortgage. Liability against the Individual Defendants is alleged on the ground that they signed and, along with Citigroup Mortgage, were responsible for the preparation of the false disclosure documents.

The Section 11 claim set forth in the SAC, which asserts misstatements and/or omissions with respect to the Registration Statement, makes clear that Plaintiffs proceed only pursuant to the 1933 Act, and that they "expressly exclude any allegation that could be construed as alleging fraud or intentional or reckless misconduct." SAC ¶175. Each Defendant is alleged to be strictly liable under Section 11 as a signer of a registration statement. Citigroup Mortgage is alleged to be liable as an underwriter that sold the Certificates and marketed them to members of the Plaintiff Class. Each Defendant is alleged to have failed to make any reasonable investigation to ensure that statements made were true and not misleading. SAC ¶180. As to damages, the Section 11 claim asserts that "Plaintiffs and the Class have sustained damages as the value of the Certificates has declined substantially subsequent to the disclosures of defendants' conduct." SAC ¶184.

The Section 12 claim set forth in the SAC, alleges false or misleading statements and/or omissions in the Prospectus Supplements, and similarly disavows any allegation that could be construed as alleging fraud or other intentional conduct. SAC ¶186. As to damages, the Section 12 claim asserts that Plaintiffs and the members of the Plaintiff Class have sustained substantial damages and "have the right to rescind and recover the consideration paid for their shares, and

thereby tender their Certificates” to Defendants. Those class members who have sold shares seek damages “to the extent provided by law.” SAC ¶190.

Finally, the Section 15 claim is asserted against the Individual Defendants and Citigroup Mortgage. It alleges that each Individual is a “control person” of Citigroup Mortgage who is responsible as a signer of the Registration Statement. SAC ¶194. Citigroup Mortgage is alleged to be liable as an issuer of the Registration Statement. SAC ¶ 196.

As to all of their 1933 Act claims, Plaintiffs allege that the offering documents misrepresented, and more specifically, under-represented, the risk profile of the investment described. Plaintiffs focus specifically on statements regarding the underwriting standards represented to have been used in connection with the underlying mortgages, including statements regarding: (1) the origination of the underlying mortgage loans; (2) the maximum loan to value (“LTV”) ratio used to qualify home buyers; (3) the appraisals of properties underlying the mortgage loans and, (4) the debt to income ratios permitted in the granting of the loans.

#### IV. Prior Proceedings

The filing of the SAC follows this court’s dismissal, for lack of standing, of sixteen of the eighteen trusts named in the FAC. City of Ann Arbor, 703 F. Supp.2d at 260. As to the two trusts remaining, this court granted leave to re-plead, and directed Plaintiffs to set forth more specific allegations. In particular, the court held that the new pleading was to set forth only allegations with respect to the two remaining trusts. With respect thereto, the court held that the new pleading shall identify the tranches in which Plaintiffs made their purchases, and the false statements forming the basis of their claims. The court also directed Plaintiffs to set forth the basis for their claims of damage.

V. New Allegations in the SAC

The SAC sets forth the same general allegations as the FAC with respect to mortgage industry practices and statements describing the nature of the allegedly material misstatements and/or omissions. The SAC differs from the FAC in that it refers only to the two remaining trusts, and focuses on the specific mortgages (all issued by Wells Fargo), that are contained therein. With respect to those mortgages, Plaintiffs have delved into the documentation for several of the loans packaged therein, and detail the basis for their claims that “no apparent determination was made to ensure that” the loans met the underwriting standards described in the offering documents.

In particular, Plaintiffs state that they have conducted a review of the documentation underlying 64 loans backing the AR5 Trust, and 72 loans backing the WFHE2 Trust. The SAC contains specific facts supporting Plaintiffs’ allegations with respect to debt to income ratios and borrower income. For example, the SAC describes the case of a particular borrower on one mortgage packaged into the AR5 Trust. In October 2006, that borrower is alleged to have received mortgages totaling more than \$590,000. The securitization report for that borrower states a debt to income ratio of 41.09%, and that the borrower occupied the mortgaged property in the State of Florida. Bankruptcy court filings obtained by Plaintiffs show, however: (1) that the borrower reported a self employment income loss of \$56,801 in 2006, and no income for 2007, and (2) that the borrower resided in the State of Indiana. Plaintiffs therefore allege that there could be no support for the stated debt to income ratio, or for the claim that the borrower occupied the mortgaged property in the State of Florida. The SAC also includes specific examples of mortgages based upon inflated property appraisals, resulting in understated LTV

ratios.

Because the mortgages packaged within the Trusts number in the thousands, the SAC does not detail the facts underlying each and every mortgage that was re-packaged into the Trusts. It does, however, detail additional similar factual situations to that described above in support of the conclusion that Defendants filed statements in violation of the securities laws. Nonetheless, the specific allegations of the SAC represent only a tiny fraction of the mortgages underlying the securities purchased by the Plaintiffs and the members of the Plaintiff Class.

V. The Motion

Defendants move to dismiss the SAC in its entirety. First, it is argued that neither Ann Arbor nor Kansas City have standing to sue under Section 12. Even assuming standing, Defendants argue that despite the additional factual pleading, the SAC falls continues to fall below the standard of pleading required to state a claim. It is further argued that dismissal is required because Defendants promised only that they would repurchase or substitute mortgage loans for those packaged in the Trusts, and Plaintiffs do not allege failure to comply with that promise. Finally, Defendants argue that Plaintiffs fail to properly allege damages because they cannot state any economic loss.

DISCUSSION

I. Standards on Motion to Dismiss

The standards applicable to this motion to dismiss are set forth in this court's prior opinion and are applied herein. See City of Ann Arbor, 703 F. Supp.2d at 258. Because the court's earlier opinion did not discuss whether to apply the general pleading standards of Rule 8 of the Federal Rules of Civil Procedure ("Rule 8"), or the heightened pleading standards of Rule

9 of those rules ("Rule9"), the court makes clear here that the pleading issue is not dependent upon whether a claim is made pursuant to the 1933 Act (which is alleged here) or the Securities Exchange Act of 1934 (the "1934 Act") (which is not alleged here). The issue is whether plaintiff's claims are "premised on fraud." If that is the case, Rule 9 pleading standards apply. See In re Morgan Stanley Information Fund Securities Litigation, 592 F.3d 347, 358 (2d Cir. 2010); New Jersey Carpenters Health Fund v. Residential Capital, LLC, 2010 WL 1257528 \*3 (S.D.N.Y. 2010). Where a Section 11 complaint sets forth nothing more than non-compliance with the 1933 Act, by alleging the making of material misstatements and/or omissions, it is not deemed to allege fraud sufficient to trigger the pleading requirements of Rule 9. See In re CitiGroup Inc. Bond Litigation, 2010 WL 2772439 \*16 (S.D.N.Y. 2010).

The court has reviewed the SAC and concludes that its allegations do not sound in fraud, and therefore the enhanced pleading requirements of Rule 9 do not apply. In light of this holding, the court applies the notice pleading standard of Rule 8 of the Federal Rules to assess the sufficiency of the SAC. See Morgan Stanley, 592 F.3d at 358; Charter Tp. of Clinton Police and Fire Retirement System v. KKR Financial, 2010 WL 4642554 \*12-13 (S.D.N.Y. 2010).

## II. Pleading Violations of Securities Act of 1933

The standards for stating the various claims alleged under the 1933 Act, and the damages provision of that statute, are set forth in this court's prior decision, and amplified herein.

The 1933 Act imposes liability on those who sign certain false and/or misleading disclosure documents. As noted, Section 11 applies to disclosures made in connection with registration statements, while Section 12(a)(2) applies to disclosures made in connection with prospectuses. See 15 U.S.C. §§ 77k, 77l(a)(2). Section 15 provides for liability to be imposed

on individuals that are alleged to have signed unlawful disclosure documents. See 15 U.S.C. § 77o. Liability under Section 15 is, for the most part, contingent upon the imposition of liability under either Sections 11 or 12(a)(2). See Morgan Stanley, 592 F.3d at 358.

Section 11 provides that every signer and underwriter may be held liable for a registration statement which “includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading.” 15 U.S.C. §77k; see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976). A proper Section 11 claim must allege: (1) the purchase of a “registered security, either directly from the issuer or in the aftermarket following the offering;” (2) that the named defendant participated in the offering in a manner sufficient to give rise to liability under Section 11; and (3) that the registration statement “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” In re Morgan Stanley, 592 F.3d at 358.

Section 12(a)(2) similarly imposes liability on any person who “offers or sells” a security by means of, inter alia, a prospectus containing a materially false statement or that “omits to state a material fact necessary to make the statements, in the light of the circumstances under which they were made, not misleading.” 15 U.S.C. § 77l (a)(2). To be liable under Section 12(a)(2), the named defendant must be a “statutory seller.” A “statutory seller” is one who: (1) “passed title, or other interest in the security, to the buyer for value,” or (2) “successfully solicit[ed] the purchase [of a security], motivated at least in part by a desire to serve his own financial interests or those of the securities['] owner.” In re Morgan Stanley, 592 F.3d at 358 (citations omitted).

Liability pursuant to Sections 11 and 12(a)(2) is imposed only if the statements or

omissions relied upon are “material.” A statement or omission is deemed material if “taken together and in context,” it “would have misled a reasonable investor.” *Id.* at 360. The Second Circuit has observed that materiality is “a mixed question of law and fact.” Thus, it has been stated, dismissal on the ground of materiality is not warranted “unless [the statements and/or omissions] are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.” *Id.* (citations omitted).

The liability imposed upon issuers under Section 11 is “virtually absolute,” and liability can be imposed upon other defendants under sections 11 and 12(a)(2) “for mere negligence.” *Morgan Stanley*, 592 F3d at 359 (citation omitted). Unlike claims brought pursuant to the 1934 Act, claims under the 1933 Act need allege neither scienter, reliance or loss causation. *Id.* Claims under these acts also differ in terms of the availability of certain affirmative defenses. *Id.* at 360.

As to damages, a 1933 Act plaintiff may recover damages that:

represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought.

15 U.S.C. §77k(e). To survive a motion to dismiss, Plaintiffs need not plead their exact damages. They must, however, plead allegations supporting some theory, as described in the statute, pursuant to which damages may be awarded. *See NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, 2010 WL 4054149 \*2-3 (S.D.N.Y. 2010).

III. Disposition of the Motion

A. Standing Under Section 12

The court addresses first the issue of whether Plaintiffs have standing to assert their Section 12 claims. As to this statute, standing exists, as noted, where a plaintiff alleges a purchase from a statutory seller. A statutory seller includes one who, “in an initial public offering, either transferred title to the purchaser or successfully solicited it for financial gain.” In re IndyMac Mortgage-Backed Securities Litigation, 718 F. Supp.2d 495, 501 (S.D.N.Y. 2010). The SAC’s allegations regarding the purchase of the Trusts at issue are sufficient to allege Section 12 standing. Accord id. The court therefore declines to dismiss the Section 12 claims on the ground that Plaintiffs lack standing.

B. The SAC States Facts Sufficient To State A Claim

The court holds that the SAC is factually sufficient to state a claim for the 1933 Act violations alleged. The present complaint not only sets forth the general basis for Plaintiffs’ claims regarding underwriting standards, but also sets forth, with a degree of particularity, factual instances supporting Plaintiffs’ allegations. Plaintiffs have complied with the court’s directive to tie the allegedly misleading statements to their particular investments. In particular, they plead factual circumstances to support their claims of departure from underwriting standards disclosed. Such pleading is sufficient to support the theory that the offering documents were materially misleading in their disclosures with respect to such standards. Accord In re Lehman Bros. Securities and Erisa Litigation, 684 F. Supp.2d 485, 493 (S.D.N.Y. 2010).

This is not to say that the claims are strong, or that they will necessarily succeed. As noted in this court’s prior opinion, the offering documents at issue are replete with specific

warnings regarding the quality and liquidity of the investments. It will be for the trier of fact to decide whether the disclosures made were sufficient. The court is unwilling to hold, however, in the context of this motion, that such statements are sufficient, as a matter of law, to negate Plaintiffs' claims.

C. The Alleged Failure to Perform Does Not Require Dismissal

The court also rejects the argument seeking dismissal on the ground that Plaintiffs failed to exercise their options, as set forth in the Trusts, to have Citigroup Mortgage either repurchase or substitute for non-conforming mortgages. This argument is based completely on the decision of the Fifth Circuit Court of Appeals in Lone Star Fund V (U.S.), L.P. v. Barclays Bank PLC, 594 F.3d 383, 389-90 (5<sup>th</sup> Cir. 2010). Initially, the court rejects this argument on the ground that the case here is factually different from Lone Star. There, Plaintiffs pointed to a limited number of loans that failed to conform to the representation regarding their default status. Unlike the claim in Lone Star, Plaintiffs here do not claim that the Trusts contain a small number of non-conforming loans. Instead, Plaintiffs here claim securities laws disclosure violations in the form of widespread misrepresentations regarding the nature of the underwriting practices described in the offering documents. The court therefore finds that Lone Star does not apply because it is factually distinguishable.

Perhaps more importantly, the court further rejects reliance on Lone Star on the ground that the Second Circuit has never accepted that court's approach. Indeed, in the court's view, Lone Star is at odds with the anti-waiver provision of the securities laws which states that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the

Commission shall be void.” 15 U.S.C. §77n. It is likely that the Second Circuit would hold that the Trust language relied upon by Defendants violates this anti-waiver provision of the 1933 Act. See McMahan & Co. v. Wherehouse Entertainment, Inc., 65 F.3d 1044, 1050-51 (2d Cir. 1995) (broadly interpreting anti-waiver provision). The court therefore declines to dismiss this action based upon Lone Star.

D. The SAC Is Sufficient In Its Pleading of Damages

Finally, the court holds that the SAC is sufficient in its allegations regarding damages. Plaintiffs allege that they have suffered damage in the form of a drop in the value of their investments. Their allegations track precisely the language set forth in the damages provision of the 1933 Act. While it remains to be seen whether Plaintiffs can prove their damages, they need not set forth any more with respect to damages at the pleading stage.

CONCLUSION

For the foregoing reasons, the motion to dismiss the Second Amended Complaint is denied.

SO ORDERED.

  
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LEONARD D. WEXLER  
UNITED STATES DISTRICT JUDGE

Dated: Central Islip, New York  
December 23, 2010