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1 UNITED STATES DISTRICT COURT
1 SOUTHERN DISTRICT OF NEW YORK
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2
3 IN RE LEHMAN BROTHERS
3 SECURITIES AND ERISA
4 LITIGATION,

5
5 09 MD 2017 (LAK)
6 08 CV 6762 (LAK)

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7 -----x

7 New York, N.Y.
8 January 26, 2010
8 2:15 p.m.

9 Before:

10 HON. LEWIS A. KAPLAN,

11 District Judge

12 APPEARANCES

13 COHEN MILSTEIN SELLERS & TOLL
14 Attorneys for Plaintiff

14 BY: JOEL P. LAITMAN
15 KENNETH M. REHNS
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17 Attorneys for Individual Defendants

18 BY: MARY E. McGARRY
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19 SATERLEE STEPHENS BURKE & BURKE
20 Attorneys for Moody's Investors Service, Inc.

20 BY: JOSHUA M. RUBINS

21 CAHILL GORDON & REINDEL
22 Attorneys for McGraw-Hill Companies, Inc.

22 BY: FLOYD ABRAMS
23 TAMMY LYNN ROY

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1 THE COURT: Mortgage bank. The defense.

2 MS. MCGARRY: Good afternoon, your Honor. Lynn
3 McGarry on behalf of the individual defendants in the mortgage
4 backed securities case.

5 I'd first like to address materiality and then statute
6 of limitations. I don't think we need to go back to standing
7 unless your Honor would like to return to that. We tried to
8 cover it this morning. And then the rating agencies will be
9 arguing separately.

10 THE COURT: I don't think I need to hear about the
11 statute of limitations in this case.

12 MS. MCGARRY: In this case the plaintiffs bought
13 securities backed by pools of mortgages. Whether they got the
14 payments they were hoping to get depended on two things: One,
15 the quality of those mortgages; and, two, the credit
16 enhancement. It was an assumption that you were going to have
17 some defaults on mortgages, so it was a matter of how much
18 overcollateralization you need, how many additional mortgages
19 to address that risk. In addition -- there was other
20 collateral credit enhancement, rather. There was insurance and
21 there were swaps to protect against the interest risk.

22 And the plaintiffs have -- two of their allegations
23 are really focused on this. One is that with respect to the
24 quality of the mortgages, there was systematic disregard of
25 underwriting standards. But that is not supported. I don't

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1 have to go over the pleading standards of Twombly and Iqbal for
2 your Honor, but their allegations simply don't rise to the
3 level. They say it's reasonable for your Honor to infer that
4 there was systematic disregard because there were a lot of
5 delinquencies and because the underwriters used poor
6 underwriting practices. That does not mean that they deviated
7 from their underwriting guidelines. Those are two different
8 things.

9 For example, in paragraph 133 of the complaint --
10 THE COURT: So their guidelines were that they were
11 going to, to use your words, I think, inadequate underwriting
12 standards. That was the rule.

13 MS. MCGARRY: Loosened underwriting standards
14 certainly departure from traditional underwriting standards.
15 The paragraph 133 of the complaint is a good example. It says:
16 First Franklin departed from its underwriting guidelines and
17 made exceptions because First Franklin utilized its proprietary
18 software in deciding what mortgages it issued. In other words,
19 they used their own software. That is not an exception to your
20 guidelines. Maybe it says something about your software, but
21 it doesn't say you're departing.

22 And if one happens to look at the disclosure, at the
23 guidelines, it is pretty complete when it tells people the
24 risks that they might be undertaking here. It tells you, for
25 instance, in one of the documents here, 70 percent of the

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1 mortgages are issued to people in California. Someone might
2 make -- decide that poses a certain risk having such
3 concentration. It also says here, we have 11 percent of the
4 loans are full documentation loans. That's traditional
5 underwriting type guidelines. 49 percent are limit
6 documentation loans. Then we have 31 percent stated
7 documentation, and 9 percent no documentation where we don't
8 even care about the person's income. All we care about is
9 their assets, and we take their word for it.

10 THE COURT: And the document from which you're quoting
11 is what?

12 MS. MCGARRY: This is from an Exhibit 3 to the McGarry
13 affidavit, which is a pricing supplement for one of the
14 offerings. In this particular offering it also describes the
15 particular underwriting guidelines. There are two underwriters
16 here. One was IndyMac. IndyMac has two principal underwriting
17 methods designed to be responsive to the needs of its mortgage
18 loan customers: Traditional underwriting and E-MITS,
19 electronic mortgage information and transaction system. E-MITS
20 is an automated Internet-based underwriting and risk-based
21 pricing system. I'm sure your Honor saw advertisements on
22 television during the height of the mortgage market where it
23 said, go on line, we will tell you based on a computer program
24 whether you can be granted a mortgage. You'll get your answer
25 in minutes. No documentation necessary.

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1 So here IndyMac has said, one of our criteria is just
2 based on, go to the Internet and fill out a form and that's how
3 we decide who gets mortgages. It describes under our no
4 income/no asset documentation program and the no-document
5 documentation program emphasis is placed on the credit score of
6 the prospective borrower and on the value of the adequacy of
7 the mortgage property is collateral rather than on the income
8 and assets of the prospective borrower. Mortgage loans
9 initiated through mortgage professional channels will be
10 submitted to E-MITS for assessment and subject to a full credit
11 review, and analysis mortgage loans that do not meet IndyMac's
12 guidelines may be manually reunderwritten and approved under an
13 exception to those underwriting guidelines, and similar
14 disclosure for Country Wide, which was the other mortgage
15 originator in that particular offering.

16 So I think investors were well aware that the
17 underwriting guidelines that would be used here were not the
18 type of traditional underwriting guidelines and they don't have
19 anything to establish that with systematic exceptions, let
20 alone more exceptions than people were told would be there. We
21 have cited extensively in our complaint where the offering
22 materials said our underwriting may make exceptions to the
23 guidelines. We are encouraging people to make exceptions to
24 the guidelines, maybe exceptions in substantial number of
25 cases.

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1 So the other aspect of are you going to get paid is
2 the credit enhancement, and that is how much additional
3 collateral is there to protect you against a certain level of
4 defaults. This is what went into the rating agencies. The
5 ratings were to determine not so much were any individual loan
6 good, but what's the mortgage pool that's backing your
7 security, is there enough collateral there.

8 The plaintiff's allegation there is that the models
9 were inadequate. There was no representation of fact that you
10 will get paid. It was, this is a credit rating, this is an
11 opinion of the rating agencies on what they expect, and we
12 prefer higher levels.

13 There were two mortgage pools in most cases. The
14 higher level is more protection and had a higher credit rating
15 than the lower level and the disclosure says, this may enhance
16 your chance of getting paid back, not that you are going to get
17 paid back, but I'll let cocounsel address the agency rating
18 further.

19 And there is also an important security regulation
20 relevant here. There was a similar decision that came down not
21 on this particular reg AP, but on a different reg. The Second
22 Circuit handed it down yesterday in the In Re Morgan Stanley
23 information case and the issue there, if you have a prospectus
24 and you have SEC guidelines on what information to include in
25 it, if you include the information and you don't make material

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1 misstatements, is there an omission.

2 And Section 11 and Section 12, it's clear, you're
3 liable if you make an affirmative misstatement or if you omit
4 some information that by law or regulation you are required to
5 disclose. And here there is a reg -- it wasn't SK. It was reg
6 AR. It says that there you must disclose the departures from
7 underwriting criteria or the extent to which they are
8 overwritten, quote, to the extent known. And that's clear from
9 the Morgan Stanley decision when it says -- when the regs say,
10 this is what you have to disclose, that's what applies. And it
11 isn't just, should you have known about exceptions if they
12 existed. It's did you in fact know. That was the decision in
13 Lansman. Again, we don't have any case under particular reg
14 AR, but there have been other cases where there are similar SEC
15 regs that say include this, or include this if known, trends if
16 known. If the party doesn't know them, it's no breach for
17 omitting them.

18 There are two other alleged nondisclosures. One is
19 conflicts and that's actually the alleged nondisclosure was in
20 Morgan Stanley, a conflict between the investment bank and the
21 broker dealer that they didn't say were affiliated, and we
22 cover some of these companies and a potential conflict of
23 interest.

24 Well, the SEC reg didn't require you to disclose that.
25 And as said in the -- In Re MS Tech repeated Judge Pollack's

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1 decision in In Re Merrill Lynch. It's not surprising that
2 there is no requirement to disclose the conflict because
3 everybody knows about it. Well, I think it's a similar case
4 here. There is no regulation that says if you're offering
5 securities that have been rated by a rating agency and you paid
6 that rating agency to do that work, that creates a potential
7 conflict of interest, you need to disclose. Not only is there
8 no reg, but this has been well known for a long, long time, as
9 demonstrated by many of the documents plaintiffs quoted in
10 their complaint.

11 Then the final misrepresentation is that the rating
12 agencies had a role allegedly in determining the structure of
13 the mortgage pools, and then structure of the securities. A
14 primary position here, your Honor, is that it's simply not
15 material. There is no requirement to disclose it, so it would
16 only be if there is a misstatement, and I don't think that the
17 statement that they allege in their complaint is a
18 misstatement, it actually misleads anyone. It doesn't say the
19 rather agencies have no role. I know this has gotten a lot of
20 play. I have heard people talking about it on the morning
21 show. But I'm actually mystified why this is so important.

22 When I moved to New York after the bar, I found an
23 apartment and they said, oh, Simpson Thacher, sorry, your
24 credit is not good enough. They could have sent me home and
25 say come back tomorrow, see what you come up with, and I could

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1 have come up with something the next day they rejected, and I
2 would come back and again and say, what if my parents cosigned
3 the lease. Bingo. But we didn't go through this exercise.
4 They just told me, your credit is not good enough, get your
5 parents to sign the lease.

6 And it's the same thing here. A bunch of mortgage
7 files are given to the rating agencies. They say, this group
8 of mortgages are not going to give you a triple A rating. You
9 need to add to it. If you put this in it, this additional
10 collateral, that's what it's going to take. So rather than go
11 through ten trips of around and around, is this good enough, is
12 that good enough, they just tell you, according to our model,
13 this is what you need.

14 So I just don't see why it's material, but, once
15 again, and this is in the statute of limitations argument, I
16 know your Honor doesn't need to hear about that, but this was
17 in many places in the public domain, even quoted in the
18 complaint that rating agencies do in fact have a role in
19 structuring the securities.

20 If your Honor doesn't have any questions, I will turn
21 it over to cocounsel.

22 THE COURT: Okay. Thank you.

23 Mr. Abrams.

24 MR. ABRAMS: Good afternoon, your Honor. I represent
25 the McGraw-Hill Companies and Standard & Poor's, which was a
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1 business unit of it.

2 I want to start with just a reference to one passage
3 in the opinion just mentioned by counsel in the Morgan Stanley
4 case, just to set the framework. The Court took a broad look
5 at what Section 11(a) was about and Section 12(b)(2) were about
6 in the statute. They said that they were sibling sections with
7 roughly similar elements. The Court said that in looking at
8 them the notable elements, the Court said, was the limitations
9 on the scope of these sections of the '33 Act and the in
10 terrorem impact that they have on prospective defendants.

11 I want to focus my argument on the scope of the '33
12 Act and in particular whether rating agencies such as Standard
13 & Poor's on the basis of the pleading in this case or otherwise
14 can be held liable under either Section 11(a) or 12(b)(2).

15 Section 11(a), we start with the proposition that they
16 cannot be held liable for their ratings. I don't think counsel
17 disagrees with that. I think they agree with that. And that's
18 because Rule 436(g), SEC rule, makes that very plain on the
19 face of it, that ratings are not deemed part of registration
20 statements in the first place.

21 So what section can there be liability and try to be
22 imposed? There is Section 11(a)(4), which does have an element
23 there which deals with experts and specifically identifies
24 attorneys and accountants who are named in the registration
25 statement and who have consented to be named. There is no

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1 argument here again by plaintiffs that the rating agencies were
2 named as having vouched for, certified anything in the
3 document, and there is no suggestion and it's just not true
4 that the rating agencies consented to their name being there.

5 Plaintiffs argue that Section 11(a)(4) is one they are
6 not relying on. They are relying instead on 11(a)(5) which
7 uses the words underwriters. The first thing that we say about
8 that is that Section 11(a)(4), as the McFarland case held,
9 11(a)(4), is not just a provision which allows liability to be
10 imposed on experts who consent to their names, et cetera, being
11 in the registration statement. It is a protection for experts
12 as well. In the words of the McFarland case, it limits
13 liability. And so if you want to sue an expert or potential
14 expert, it's really Section 11(a)(4) or it's nothing.

15 And that is what Judge Lynch suggested in the opinion
16 cited to you this morning by plaintiff's counsel, the Refco
17 case, where he said in so many words that 11(a)(4) would be the
18 place one would expect in that case a lawyer to be sued, and
19 then went on to say, but creative plaintiff's counsel there had
20 argued as well that the lawyer was an underwriter, that it
21 would be stranger still, he said, to say that an entity such as
22 this, which can't be sued under 11(a)(4), can be sued under
23 11(a)(5).

24 So we start with the proposition --

25 THE COURT: You are not suggesting that but for
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1 11(a)(4) your clients would be sueable under 11(a)(5).

2 MR. ABRAMS: Certainly not. I am coming to that next.
3 I am saying that because of 11(a)(4), they cannot be sued under
4 11(a)(5) for doing the very sorts of activities which could --

5 THE COURT: But I thought your argument was that they
6 can't be sued under 11(a)(5) even if 11(a) --

7 MR. ABRAMS: That is correct. That's what I come to
8 now. They can't be sued under 11(a)(5) because they are not an
9 underwriter. However, that term has been defined in the law.
10 In case after case the underwriter has been characterized,
11 described, explained as the entity involved in the ultimate
12 distribution process, not at the beginning of the line, not at
13 the start, not giving advice. That's the basic reason why, put
14 aside 11(a)(4) now. If there were no 11(a)(4), that's what a
15 lawyer who gives advice without which the deal couldn't go on,
16 an accountant who gives a financial statement without which the
17 deal can't go on is not an underwriter. And that is what the
18 Courts have said again and again and again.

19 Refco is just one of the cases, but on the face of it
20 the effort here to expand the notion of what an underwriter is
21 to include a rating agency, even taking again as a given
22 arguendo that what the plaintiffs say we did we did, even all
23 of that, it is not the distribution process unless you apply a
24 but for analysis which is so sweepingly broad that it would
25 rope in as a matter of course all the entities that take action

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1 which have something to do with and without which these
2 transactions could not proceed at all. No Court has ever done
3 that.

4 Plaintiffs rely on a Seventh Circuit case, the Harden
5 case, involving a qualified independent underwriter, a
6 situation where there is that special designation of an entity
7 which represents that it will perform all the obligations of an
8 underwriter and be responsible in every way legally that an
9 underwriter would be. That case, 15 years old, has never been
10 cited here and indeed never been cited for the proposition that
11 the test to be used is simply whether the transaction was one
12 in which an entity played a role which had to be played.

13 So our position then is that there is no claim against
14 our client under Section 11 and that there is no claim against
15 our client under Section 12(a)(2). Section 12(a)(2) in which
16 they characterize our client as a "seller" runs into the
17 repeatedly articulation of law that a seller is an entity that
18 is part of or often central to the solicitation process.
19 That's what the U.S. Supreme Court said in the Pinter case.
20 That's what the Second Circuit said in the Wilson case. That's
21 what happened in the Second Circuit in the Capri case and there
22 is language after language which these courts are saying, it is
23 insufficient to make one a seller because one played an
24 important role at the beginning of an entity's foundation. The
25 sort of language that is used routinely is to just that effect.

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1 And the Capri case, the Second Circuit case, has an
2 interesting comparison there. Two entities there were held
3 liable for being sellers because they were absolutely central
4 to and indeed the only parties that prepared and distributed
5 promotional materials. One was not. And why was the one not?
6 Because it was insufficient, I'm quoting from the Court now, to
7 say and to conclude that it played a major role in setting up
8 the venture.

9 So even if the rule of the rating agencies here,
10 Standard & Poor's and others was major, even if it wouldn't
11 have gone ahead without them, neither section applies based on
12 the relevant case law.

13 And the only other thing I would add to that is that
14 the attempt here to expand liability of rating agencies is one
15 which finds absolutely no support in either the legislative
16 history or the case law. We know what underwriters are. We
17 know what sellers are, used in common parlance or in legal
18 parlance, and we urge you, therefore, to rule that there is no
19 claim which can be asserted and/or sustained against our client
20 under either Section 11 or Section 12, and that what follows
21 from that is that there is therefore no Section 15 claim
22 either. Thank you, your Honor.

23 THE COURT: One question. Because this is a '33 Act
24 case, if I were to dismiss this case I don't have to deal with
25 the sanctions issue that arises in '34 Act cases that are

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1 dismissed on a motion, right?

2 MR. ABRAMS: That is correct, your Honor. I should
3 have mentioned that the comparison between '33 Act and '34 Act
4 cases are telling here. Anyone can be sued who does the wrong
5 things that the '34 Act deals with. Rating agencies, other
6 entities can be sued under the '34 Act. The whole thrust of
7 the '33 Act precisely because of what the Wilson case called
8 its draconian nature, the whole thrust of it is that only
9 identified entities in the '33 Act list five entities can be
10 sued and that it's simply not present here. Thank you, your
11 Honor.

12 THE COURT: Plaintiffs. We have another defendant who
13 wants to argue.

14 MR. RUBINS: I'm Joshua Rubins for Moody's Investors
15 Service.

16 I would say at the outset, your Honor, that Mr. Abrams
17 speaks for both his client and mine. I'm here only if your
18 Honor wanted to hear further discussion on Section 15, which
19 Mr. Abrams did not go into any detail on. If you don't need
20 that, I won't beg your ear.

21 And, similarly, I know your Honor spoke to the statute
22 of limitations with respect to the individual defendants.
23 There is a different statute of limitations inquiry date if you
24 wanted to hear. You don't.

25 THE COURT: No need.

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1 MR. RUBINS: Thank you, your Honor.
2 THE COURT: Plaintiffs.
3 MR. LAITMAN: Joel Laitman from the law firm of Cohen
4 Milstein Sellers & Toll.
5 THE COURT: Mr. Laitman.
6 MR. LAITMAN: I just want to go back to the standing
7 issue that was raised earlier this morning because I did not
8 have an opportunity to respond to that.
9 THE COURT: I don't think you have to go there.
10 You've got even more basic problems.
11 MR. LAITMAN: I wanted to just mention, in terms of
12 our case --
13 THE COURT: I shouldn't cut you off at the pass like
14 that on that issue because I may actually have to address
15 standing in this case, regardless of what I do on the rest of
16 it.
17 MR. LAITMAN: I think it was mentioned that in our
18 case the complaint does not center on registration statement,
19 alleged misstatements and omissions, that it's the underwriting
20 guidelines and that those are found in the prospectus
21 supplements, so there is no common causation.
22 Under the standing decision in Hoff, which we believe
23 is applicable and defendants also referenced, you need an
24 injury in fact causation. And causation is that there is a
25 fairly traceable connection between the asserted injury in fact

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1 and the alleged actions of the defendant.

2 Here, we allege that there are two core misstatements
3 and omissions in the registration statement. One is the
4 assertion of the roles of Lehman versus the rating agencies;
5 that is, Lehman structured the securitizations and the rating
6 agencies rated them, and we believe that that's a misstatement
7 because, in fact, and we try to lay out clearly that the rating
8 agencies were involved in structuring even before the loans
9 were in the process of acquiring the underlying loans, they
10 were very much involved in the bidding in auction to buy the
11 loans and then ultimately joined with Lehman together to
12 securitize the loans, and we allege that they were acting as
13 coach and referee. And the statement in the registration
14 statement says that they are completely separate, that the
15 Lehman's act is structure and rather agencies act to rate after
16 the fact.

17 And, by the way, that's not just the plaintiff saying
18 it. In July of 2007, the SEC commenced a year-long
19 investigation into the role of the rating agencies in
20 connection with the residential mortgage-backed securities.
21 They interviewed 50 former employees of Moody's and S&P and
22 reviewed millions of documents. And in July of 2008, they
23 issued a report which we cited in the complaint.

24 One of the things they found was this structuring role
25 which we allege in the complaint. More importantly, they

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1 allege that the structuring function, they suggest that the new
2 policy should be that rating agencies that rate securities
3 should not be permitted to structure them. I think defense
4 counsel said that this is an immaterial fact. If it was so
5 immaterial, a year-long investigation by the SEC into this
6 precise conduct wouldn't have concluded that it's a practice
7 that shouldn't go on.

8 THE COURT: What is material to the SEC in regulating
9 the securities business in general is not necessarily the same
10 thing that's material to somebody who is buying a security.

11 MR. LAITMAN: Right. We allege, however, that an
12 investor would want to know that they are acting jointly. And,
13 similarly, we allege that there were rating shopping practices
14 that were not disclosed, and that is -- and this was the
15 subject of an investigation by the attorney general of the
16 State of New York that was settled in June of 2008, again,
17 during this same time frame, and sought to put an end to the
18 process by which rating agencies would give a rating of the
19 collateral and the securitization before they were actually
20 engaged to rate the securitization. And, again, our argument
21 is that a reasonable investor would have wanted to know that
22 the rating agency is actually proffering a rating before it's
23 engaged.

24 THE COURT: Why?

25 MR. LAITMAN: Because it shows a lack of independence.

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1 I mean, it's as if a lawyer would give an opinion before they
2 were hired to research and analyze it. And the context of
3 rating shopping is that --

4 THE COURT: I'll bet your office does it every day,
5 just like every other lawyer in town. Guy walks in, says I'm
6 considering hiring lawyers, here are the facts. Tell me what
7 you think and how you handle the case.

8 MR. LAITMAN: As the rating shopping was defined by
9 the attorney general and the defendants here signed onto that
10 settlement --

11 THE COURT: If this was like any settlement I ever
12 saw, they signed onto without admitting or denying that they
13 were rating agencies, let alone --

14 MR. LAITMAN: However, in the context of the rating
15 shopping, as we allege, the firms that were competing for the
16 engagement would be aware of each other's bids, and so
17 essentially the rating of the securitization was used as a
18 bargaining chip by Lehman to get the best rating on the
19 collateral.

20 THE COURT: Do you think the world would have been in
21 any way different if that was all done secretly and the guy who
22 lost out on getting the rating business for bond issue A
23 understood that the other guy rated him higher and maybe that's
24 why he lost out, so on the next time he does a little better?
25 You think the world would have been any different?

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1 MR. LAITMAN: First of all, to an investor, I believe,
2 a reasonable investor would care whether or not the rating was
3 being given before the engagement.

4 THE COURT: Why?

5 MR. LAITMAN: Because the rating is supposedly to be
6 the subject of complex expertise.

7 THE COURT: Let's talk about the real world. The real
8 world is, everybody knows the issuer is paying for the rating.
9 So right away, independence is a joke, always has been a joke.
10 And so if you are an investor who says notwithstanding the fact
11 that the rating agency is getting paid by the guy who is
12 selling me the thing, I put credence in it. The fact that
13 there was some indication to the issuer of what the rating
14 would be in advance wouldn't change the world at all. And if
15 you're somebody who says, look, I trust Moody's and Standard &
16 Poor's and whoever else to give an honest view, even though
17 they are hired by the issuer, then you are going to trust them
18 anyway. What's the difference?

19 MR. LAITMAN: Your Honor, I think what we allege and
20 what the SEC found specifically was that this competitive
21 rating shopping incentivized the rating agencies not to update
22 the models that they used, and that's another nondisclosure.
23 And I believe that's extremely --

24 THE COURT: You've got a massive problem on standing.
25 But if you didn't have a massive problem on standing, it seems

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1 to me you have no underwriter and no seller. And here we are
2 worried about the foliage on the trees.

3 MR. LAITMAN: We are suing the individual signatories
4 on the registration statement. And these are two misstatements
5 that are in the registration statement that every -- there is a
6 direct line between our plaintiff that bought pursuant to that
7 registration statement and those alleged misstatements and
8 omissions and every other plaintiff that bought pursuant to
9 misstatements and omissions.

10 And, frankly, your statement that everybody knows that
11 the independence is a joke is very much, I believe, the product
12 of these massive governmental investigations that occurred only
13 after the collapse of these bonds. That was really not the
14 perception on Wall Street, certainly by pension funds that
15 bought these bonds.

16 And in terms of our allegations that the underwriting
17 guidelines --

18 THE COURT: Could we go back to something you said a
19 minute ago?

20 MR. LAITMAN: Yes.

21 THE COURT: If you have no seller and you have no
22 underwriter, how are you helped, or am I missing something if
23 you're suing somebody that signed the registration statement?

24 MR. LAITMAN: Because under Section 11, the
25 signatories to the registration statement are under Section

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1 11(a)(1), they are directly and strictly liable for the
2 misstatements and omissions. And the liability here, your
3 Honor, even if you don't go the way of finding the rating
4 agencies as underwriters, they were, following the allegations
5 in this complaint, they were control persons of the trust. The
6 trust, as we have alleged it, are nothing more than a shell
7 that contains the securitization, and we allege that the rating
8 agencies, acting jointly with Lehman, created the
9 securitizations, created all the rights and duties and
10 obligations that flow from those securitizations, and control
11 under Section 15 is an intensive issue of fact, and I believe
12 we have more than alleged sufficient control of the rating
13 agency, of a primarily liable issuer; that is, the trust.

14 Just turning to the underwriting guidelines, and
15 basically what we have tried to lay out is the factual
16 nonconclusory basis for inferring that the guidelines were
17 systematically disregarded.

18 The first factor is the fact that 80 percent of these
19 bonds issued during this time frame were triple A rated, that
20 is maximum security; shortly after issuance these bonds
21 collapsed in the rating to 60 percent being junk bonds, which
22 is certainly an unprecedented class-wide collapse.

23 However, what's more important for us is that the
24 reasoning the rating agencies gave for that collapse, they did
25 not say, we are downgrading these from triple A junk because of

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1 an economic crisis, a credit crisis and the economy has
2 imploded. What they said was, we are conducting this downgrade
3 because the underwriting of the underlying loans was abusive
4 and aggressive.

5 Now, clearly, those were not disclosed. It's not
6 those terms, but they go into detail that they were
7 misrepresented data. And, clearly, the rating agencies, you
8 saw all the disclosures the defendants try to rely on now.
9 Certainly had those disclosures been made, they wouldn't have
10 to change their methodology and drop the rating of the bonds
11 from triple A to C, but that's precisely what happened. And
12 certainly that factor alone, and this affected every category
13 of these bonds, no matter who the originator was, across the
14 board, these bonds, 60 percent, going from 80 percent triple A,
15 60 percent became junk bonds for the reason of the actual,
16 undisclosed underwriting practices.

17 We then looked at the exponential increase of
18 delinquency and foreclosures after the issuance, shortly after.
19 It was exponentially increased. We also looked at the original
20 originator and what investigations took place with respect to
21 each originator as to whether there was -- a systematic
22 disregard of underwriting guidelines. And it is true that
23 there were exceptions. But consistently from the registration,
24 through every prospectus supplement, there was a standard.
25 Basically, there was a review of borrower credit worthiness,

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1 there were standard appraisals and there were no doc loans or
2 loans with less documentation. But those type of loans, what
3 the prospectus supplement said was, those were only given to
4 those with good credit histories, and there were restrictive
5 loan terms and that was repeated often in each specific
6 prospectus, as well as in the registration statement.

7 We tried to go into this in our brief, but the
8 defendants try to rely on these risk disclosures. But when you
9 compare them, the risk disclosure to what was actually said in
10 the prospectus, there is no match. The Olke case and the Flag
11 case require that the cautionary language be specific,
12 prominent, and relate directly to the risk.

13 There was no such disclosure. The regulation that the
14 defendants are relying upon where you have to have actual
15 knowledge is when there is an allegation that there were
16 specific loans that didn't comply. But here we have the
17 factual allegation that across the board, no matter when the
18 offering occurred, you have 60 percent of these triple A bonds
19 collapsing to junk bonds as a result of underwriting,
20 undisclosed underwriting problems. That alone raises the fact
21 that whatever warnings there were, they couldn't possibly have
22 been sufficient if the rating agencies who were closer to the
23 deal than anyone, have to totally revamp their methodology to
24 account for the reality of how these loans were originated.

25 The other point that I would make just on that, I

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1 guess it's SEC Rule 1111, is that that relates to a duty to
2 speak when the case is based on pure omissions. But that's not
3 what our alleged misstatements and omissions are based on.
4 Here we have misstatements. By the way, the case that was
5 decided yesterday by the Second Circuit was a case of pure
6 omissions. There wasn't any misstatement anywhere that was
7 being challenged.

8 I don't think it makes sense to go into the
9 underwriter support because your Honor seems to have been --
10 seems to have a view on that. It's in our brief. But I would
11 say our argument is that even if you don't reach that, there is
12 control, personal liability under Section 15, because the
13 issuer is the trust and the trust was formed as alleged and, as
14 the SEC found, in concert between the rating agency and Lehman.

15 THE COURT: The SEC really found that?

16 MR. LAITMAN: Yes. Not in those words.

17 THE COURT: Tell me what the words were.

18 MR. LAITMAN: That there was an iterative process
19 between the two parties where Lehman would come forward with a
20 group of loans. The rating agency would give a rating. Either
21 they would fix the loans, make changes to get that rating, or
22 there would be some communication back and forth as to why the
23 rating, the triple A rating should stick. 80 percent of
24 those --

25 THE COURT: And then Lehman put the loans into a trust

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1 which Lehman organized, right?

2 MR. LAITMAN: Right. But the control is the
3 management and policies of a primary violator. Those
4 management and policies are defined by the securitization. How
5 many classes there are, is there overcollaterallization, is
6 there an excess spread. All of those facts are the credit
7 enhancement that the rating agency determined.

8 THE COURT: Anything else?

9 MR. LAITMAN: No.

10 THE COURT: Thank you.

11 I am going to grant the motions of the rating agency
12 defendants in their entirety. An opinion will follow in due
13 course.

14 My present intention is to grant the motion of the
15 individual defendants to the extent of dismissing the Section
16 11 claims, first of all, with respect to the certificates that
17 were not purchased by main plaintiffs and also to the extent
18 that the claims are based on the rating agencies' relationships
19 with the issuer and denied in all other respects. There will
20 be a memorandum on that soon, too.

21 Thank you all very much. We are adjourned.

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