

IN THE CIRCUIT COURT OF KANAWHA COUNTY, WEST VIRGINIA

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KATHY S. GATSON, CLERK
KANAWHA CO. CIRCUIT COURT

WEST VIRGINIA INVESTMENT
MANAGEMENT BOARD,

Plaintiff,

v.

Civil Action Number: 10-C-412
Judge Jennifer F. Bailey

RESIDENTIAL ACCREDITED LOANS,
INC.; RESIDENTIAL FUNDING COMPANY,
LLC; DEUTSCHE BANK SECURITIES,
INC.; and CREDIT SUISSE SECURITIES
(USA) LLC,

Defendants.

ORDER DENYING MOTIONS TO DISMISS

This matter came before the Court on December 7, 2010, for a hearing on the Defendants' motions to dismiss Plaintiff's complaint pursuant to Rule 12(b)(6) of the West Virginia Rules of Civil Procedure. The plaintiff, the West Virginia Investment Management Board ("WVIMB"), appeared by counsel Joshua I. Barrett and Jacqueline Sailer. The Defendants, Residential Accredited Loans, Inc. ("RALI"), Residential Funding Company, LLC f/k/a Residential Funding Corporation ("RFC"; with RALI, the "RALI Defendants"), appeared by counsel Robert P. Martin and Jeffrey A. Lipps. The Defendants, Deutsche Bank Securities ("DBS"), and Credit Suisse Securities (USA) LLC ("CSS"), appeared by counsel Thomas V. Flaherty and Stephanie Goldstein.

The Court has considered the motions, the Plaintiff's response, the supporting memoranda of law, heard the arguments of counsel, and reviewed pertinent legal authorities. As a result of these deliberations, the Court has concluded the Defendant has failed to establish a basis for the dismissal of the Plaintiffs' claims.

Procedural and Factual Background

The Court accepts all allegations set forth in the complaint as true for purposes of the pending motions to dismiss. In summary, the complaint alleges the following:

On or about December 27, 2005, Defendant RALI publicly offered \$549,541,100 in face amount of RALI Mortgage Asset-Backed Pass-Through Certificates, Series 2005-QA13, pursuant to a publicly-filed shelf registration statement and prospectus supplement dated December 27, 2005. Defendant DBS was the underwriter for the offering. Complaint at ¶ 1. The credit rating agencies Moody's Investor Service, Inc., and Standard & Poor's Ratings provided the credit ratings for this offering, and rated most if not all of the other RALI public offerings of similar residential mortgages backed securities ("RMBS"). *Id.*

In August 2007, Defendants DBS and CSS sold Plaintiff over 16.6 million certificates (specifically Class II-A-1) which, nearly two years after the offering, were still rated triple-A by the rating agencies. Complaint at ¶¶ 1, 14. The certificates represented the right to receive a portion of the cash flows generated by the pooled residential mortgage loans. Complaint at ¶ 2.

Defendants adopted the triple-A rating assigned to over 95% of the classes making up the certificates, incorporated it into the offering documents, and used it in marketing and selling the certificates to establish the financial credibility of (a) the certificates, (b) the structure of the transaction, including the different classes' credit enhancement, and (c) the pricing of the certificates in the minds of prospective investors such as the West Virginia IMB who make risk-oriented decisions based on an investment's economic viability. Complaint at ¶ 9. Unbeknownst to Plaintiff

when it purchased the triple-A rated Certificates, the credit risk associated with the certificates was vastly understated and did not comport with the nearly nonexistent level of risk indicated by the assigned triple-A rating. Complaint at ¶ 10.

In fact, the mortgage loans underlying the certificates were originated in a manner that disregarded applicable underwriting guidelines, and were acquired and placed in a collateral pool by RFC, RALI, and DBS without regard for compliance with such underwriting guidelines. The structure of the offering failed to compensate for the poor-quality collateral with sufficient credit enhancement. Consequently, the certificates did not, in fact, meet the high level of creditworthiness that was indicated by the triple-A rating. Thus, Defendants' issuance and sale of the certificates as triple-A rated was a material misrepresentation of their true nature and value. Complaint at ¶ 10.

RFC engaged in a systematic pattern and practice whereby it provided its affiliates, including RALI, mortgage loans that did not comport with applicable underwriting standards, and were improperly underwritten, of poor quality, and likely to default. Complaint at ¶ 74. RFC encouraged its employees to adopt a cavalier approach to the quality of loans that it acquired for securitizations. RFC's sales force was paid commissions that were based on volume and not quality of loans acquired from originators and others. Complaint at ¶ 75. RALI's and RFC's President and CEO Bruce Paradis directly encouraged RFC traders who had reservations about the quality of an originator's loans to buy the loans anyway. As one former RFC pricing analyst reported, "it was not uncommon for Paradis to go down to the desk, put his arm around the trader, and say, 'come on, why not,'" because Paradis wanted to keep

the loan vendors happy, particularly the big ones whom “RFC bought billions of loans from. It was hard to say no.” Complaint at ¶ 78.

RFC systematically engaged in the following improper practices that caused the loans to fail to conform to its mortgage underwriting guidelines and resulted in the loans in the collateral pool experiencing extraordinarily high rates of delinquencies and default: (1) RFC entered into “negotiated commitments,” whereby it committed to purchase mortgage loans from a loan originator that failed to comply with RFC’s underwriting guidelines; (2) RFC participated in “bulk purchase programs” whereby RFC purchased from a seller a bulk amount of previously-originated mortgage loans that were owned by that seller; and (3) RFC used an automated electronic loan underwriting program that failed to analyze proposed mortgage loans on the basis of its underwriting guidelines, which led to violations of its underwriting guidelines. Complaint at ¶¶ 79-82.

RFC obtained loans from various underwriters who systematically disregarded underwriting guidelines, including originator Homecomings Financial LLC (“HFN”), an affiliate whose management overlapped significantly with that of ResCap, RFC and RALI. Complaint at ¶ 51. HFN provided 29.2% of the loans underlying the certificates, and engaged in numerous violations in connection with the mortgage loans it originated. Complaint at ¶ 85. In mid-2008, the Federal Trade Commission (the “FTC”) commenced an investigation into HFN’s policies and practices after an FTC staff review of HFN’s mortgage loan data report pursuant to the Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801-2810, indicated that African American and Hispanic borrowers paid more for mortgage loans than non-Hispanic Whites. Before

the FTC could complete its investigation, ResCap announced that it was shutting its wholesale mortgage origination operations and closing HFN. Complaint at ¶¶ 88-89.

Originator First National Bank of Nevada (“FNB Nevada”), who provided 26.1% of the mortgage loans underlying the certificates, was plagued by poor underwriting standards and high-risk mortgage lending activities, according to a federal investigation. As a result of this and other problems, in December 2007 the OCC determined that “formal action needed to be taken” against the bank. In 2008, before such formal action could be taken, FNB Nevada was dissolved. Complaint at ¶¶ 91-97.

Originator American Mortgage Network, Inc. provided 14.6% of the mortgage loans underlying the certificates. In 2009 it was sued in federal court in Colorado for breach of contract for allegedly supplying mortgage loans that were underwritten as a result of material misstatements and omissions. Complaint at ¶ 98.

The delinquency rates for loans underlying the certificates dramatically increased in the two years after West Virginia IMB bought the certificates. Between August 2007 and December 2009, the percentage of such loans in default had tripled from 5% to 15%, while the foreclosure rates had grown from 1.9% to nearly 18%, an increase by a factor of ten. Complaint at ¶ 108.

The certificates purchased from DBS and CSS have since dropped in value by over 50%, and have been downgraded by the rating agencies to below investment grade, i.e., the level of junk. Complaint at ¶ 13. A rating downgrade of even one level, such as, for example, from Aaa to Aa (Moody’s scale), is considered material to the financial condition of the rated security or entity and can wreak havoc on its

business prospects. Here, the magnitude of the rating downgrade was extraordinary: in the case of Moody's, a rating downgrade by 17 levels over the course of only five months, and, in the case of S&P, by 17 levels in one downgrade. In a relatively short time, Moody's downgraded the certificates from Aaa, meaning virtually no default and maximum safety, to Caa2, meaning below investment grade and in poor standing. S&P reduced its estimate of the Certificates' creditworthiness in one fell swoop, dropping it from the maximum safety of AAA all the way down to D, meaning the security is in default. In other words, Moody's and S&P considered the Certificates to be junk bonds. Complaint at ¶ 123.

DISCUSSION

The standard applied to Rule 12(b)(6) motions is well established. "The trial court, in appraising the sufficiency of a complaint on a Rule 12(b)(6) motion, should not dismiss the complaint unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Syllabus, *Flowers v. City of Morgantown*, 166 W.Va. 92, 272 S.E.2d 663 (1980).

The RALI Defendants move the Court to dismiss all counts of the Complaint directed against them, specifically Count II for negligent misrepresentation and Count III for common law fraud. In support of the motion, these defendants assert that: 1) these claims are barred as a matter of law by the applicable statute of limitations, and 2) plaintiff as a matter of law cannot establish the materiality of any of the purported misrepresentations alleged in the complaint. Defendants DBS and CSS move to dismiss all counts of the Complaint directed against them, specifically Count I under W.Va. Code §324-410(a)(2)

and Count II for negligent misrepresentation. In support of the motions, these defendants assert that the plaintiff has not pled an actionable claim against them.

The Court concludes that WVIMB has pled its negligent misrepresentation and West Virginia Uniform Securities Act claims in accordance with Rules 8(a) and 12(b)(6), and has pled its fraud claim in accordance with Rule 9(b).

A. It is not appropriate at this stage for the Court to determine if the claims against the defendants are barred by the applicable statute of limitations.

The statute of limitations for the WVIMB's common law fraud and negligent misrepresentation claims is two years. W.Va. Code §55-2-12. The WVIMB alleges that it purchased the certificates on August 23, 2007. The instant action was filed on March 4, 2010, more than two years after the date of purchase.

The West Virginia Supreme Court of Appeals, in Syllabus Point 5, *Dunn v. Rockwell*, 225 W. Va. 43, 689 S.E.2d 255, 258 (2009), promulgated a five-part test to determine whether a tort claim is time-barred:

A five-step analysis should be applied to determine whether a cause of action is time-barred. First, the court should identify the applicable statute of limitation for each cause of action. Second, the court (or, if questions of material fact exist, the jury) should identify when the requisite elements of the cause of action occurred. Third, the discovery rule should be applied to determine when the statute of limitation began to run by determining when the plaintiff knew, or by the exercise of reasonable diligence should have known, of the elements of a possible cause of action, as set forth in Syllabus Point 4 of *Gaither v. City Hosp., Inc.*, 199 W. Va. 706, 487 S.E.2d 901 (1997). Fourth, if the plaintiff is not entitled to the benefit of the discovery rule, then determine whether the defendant fraudulently concealed facts that prevented the plaintiff from discovering or pursuing the cause of action. Whenever a plaintiff is able to show that the defendant fraudulently concealed facts which prevented the plaintiff from discovering or pursuing the potential cause of action, the statute of limitation is tolled. And fifth, the court or the jury should determine if the statute of limitation period was arrested by some other tolling doctrine. **Only the first step is purely a question of law; the resolution of steps**

two through five will generally involve questions of material fact that will need to be resolved by the trier of fact.

Id. (emphasis added).¹ Accordingly, a statute of limitations determination is rarely appropriate on a motion to dismiss. The two-year statute of limitations governing the common law claims of fraud and negligent misrepresentation is undisputed, but the Court finds the facts required to be analyzed in the remaining four steps of the *Dunn* analysis are in dispute and thus these four steps cannot be determined by the Court at the pleading stage.

The RALI Defendants' primary argument rests on a theory put forth in *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162-63 (4th Cir. 1994), a sixteen year-old Fourth Circuit opinion that never has been cited by the West Virginia Supreme Court of Appeals. *Brumbaugh* is cited by Defendants for the proposition that when a prospectus sufficiently discloses the risks inherent in an investment, the investor is on inquiry notice of his claims and the limitations period begins to run from the date of sale on claims of fraud in that prospectus.

The Court finds that *Brumbaugh* does not apply to the instant action. It is factually distinguishable because, in that case, the court analyzed various statements in the offering document that specifically disclosed the possibility that the IRS would disallow tax deductions from the investment at issue, and found such language in fact "warned of the possible occurrence of each of the events that [plaintiff] now alleges were fraudulently concealed." *Id.* at 163.

¹ Syllabus Point 4, *Gaither*, 487 S.E.2d at 903, states that "[i]n tort actions, unless there is a clear statutory prohibition to its application, under the discovery rule the statute of limitations begins to run when the plaintiff knows, or by the exercise of reasonable diligence, should know (1) that the plaintiff has been injured, (2) the identity of the entity who owed the plaintiff a duty to act with due care, and who may have engaged in conduct that breached that duty, and (3) that the conduct of that entity has a causal relation to the injury."

The Court concludes that, in contrast to *Brumbaugh*, the purported cautionary statements in the Offering Documents did not warn investors of any of the risks that form Plaintiff's claim, namely the systematic disregard of underwriting guidelines in the selection of mortgage loans for the collateral pools. Therefore, the plaintiff was not on inquiry notice of its potential claims against the defendant on the date the certificates were purchased.

B. Plaintiff has established the materiality of purported representations alleged in the complaint.

The RALI Defendants argue further that the same so-called cautionary language that they contend triggers the statute of limitations also renders any misrepresentations immaterial. A misrepresentation is considered material if “there is a substantial likelihood that a reasonable purchaser or seller of a security (1) would consider the fact important in deciding whether to buy or sell the security or (2) would have viewed the total mix of information made available to be significantly altered by disclosure of the fact.” *Dunn v. Borta*, 369 F.3d 421, 427 (4th Cir. 2007). Determining issues of materiality at this stage is “disfavored in light of the fact-intensive nature of the materiality inquiry[.]” *In re Sourcefire, Inc. Sec. Litig.*, Civil No. 07-1210, 2008 WL 1827484, at *1 (D. Md. Apr. 23, 2008).

Plaintiff argues that a cautionary statement does not render a misrepresentation immaterial unless the cautionary language is specifically tailored to directly address the statement at issue. Defendants cite *Gasner v. Board of Supervisors*, 103 F.3d 351, 358 (4th Cir. 1996), for the proposition that cautionary language immunizes the Defendants from any liability regarding the risks of investment in the Certificates. In *Gasner*, the

court found that the offering statement at issue was “replete with cautionary language” warning of the very risk that came to pass – that the defendants could lose their source of revenues from commercial waste hauling, and would be unable to make payments under the note at issue. *Id.* at 358-59. By contrast, here, the Court concludes that the purportedly “cautionary” statements cited by Defendants are not specifically tailored and the Court concludes that the Complaint’s allegations, if proved, are sufficient for the trier of fact to find that the cautionary statements fail to address the key allegations here, that the underwriting guidelines were systematically disregarded, rendering the triple-A rating misleading. The Court finds persuasive the reasoning of *In re Sourcefire, Inc. Sec. Litig.*, 2008 WL 1827484, at *5, where it was stated that dismissals based on cautionary language “generally are limited to cases where the complaint attempts to turn economic forecasts or corporate goals into actionable misrepresentations.”

C. The Plaintiff has pled actionable claims against both Credit Suisse Securities (USA) LLC and Deutsche Bank Securities, Inc

Defendants CSS and DBS further challenge the negligent misrepresentation claim, arguing that the claim is not sufficiently particularized and that reliance has not been adequately pled. The Court disagrees with the Defendants’ contention that the claim for common law negligent representation should be pled with particularity under Rule 9(b). The Court declines to extend the “sounds in fraud” theory set forth by the defendants to West Virginia common law negligent misrepresentation claims.

The Court concludes that the Complaint’s allegations satisfy the pleading requirements for negligent misrepresentation under West Virginia law. West Virginia follows Restatement (Second) of Torts § 552 (“Restatement § 552”) for claims of

negligent misrepresentation. *First Nat'l Bank of Bluefield v. Crawford*, 182 W. Va. 107, 110, 386 S.E.2d 310, 313 n.5 (1989). Under Restatement § 552(1), liability attaches to:

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Plaintiff alleges, *inter alia*: (1) the RALI Defendants and DBS “misrepresented . . . that the mortgage loans underlying the Certificates were originated pursuant to applicable underwriting standards,” Complaint at ¶ 165; (2) because all Defendants either participated in the offering of the Certificates and/or other RALI Offerings, each Defendant had reason to know that, for the reasons set forth above, the triple-A rating on the Certificates was unwarranted, and each Defendant misrepresented that the triple-A rating of the Certificates was an accurate representation of the creditworthiness of the Certificates, Complaint at ¶¶ 165-68; (3) the West Virginia IMB justifiably relied on these representations; and (4) was damaged thereby. Complaint at ¶ 169.

The Court finds that the allegations in the complaint, if proved, are sufficient for the trier of fact to conclude both the offering documents and the triple-A rating used to market the Certificates were specifically created with the sole purpose that investors, like the West Virginia IMB, would rely on them in purchasing the certificates, and defendants were aware that they would be relied upon.

The Court also finds that the plaintiff has adequately pled material representations in connection with its purchase of the certificates. The complaint alleges in detail the falsity of Defendants' representations. The complaint has pled sufficiently that these material representations were a factor that induced the plaintiff to purchase the certificates.

CSS and DBS also argue that Plaintiff's allegations regarding the credit ratings are not actionable because they are mere statements of opinion. However, the Court concludes that if opinions are without a basis in fact, they may nonetheless be actionable. *See Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F. Supp. 2d 155, 177 (S.D.N.Y. 2009) (upholding fraud claims based on rating agency ratings). Even assuming *arguendo* that the ratings are statements of the Rating Agencies' opinions as to the Certificates' credit quality, the Court finds that the allegations in the Complaint, if proved, are sufficient for the trier of fact to conclude Defendants each had reason to know of the systematic disregard of the underwriting guidelines, which rendered the Certificates' top ratings inaccurate and misleading. Complaint at ¶¶ 167-68. The allegations in the Complaint, if proved, are sufficient for the trier of fact to conclude the Defendants persisted in incorporating the triple-A ratings into the Offering Documents and in using the top ratings as a marketing tool to facilitate the sales of the Certificates at higher prices than could otherwise have been obtained. Accordingly, the allegations in the Complaint, if proved, are sufficient for the trier of fact to conclude Defendants each had reason to know that the triple-A rating on the Certificates was inaccurate. Complaint at ¶¶ 165, 173. *See Abu Dhabi*, 651 F. Supp. 2d at 177; *IKB*, 2010 WL 4366191, at *5.

The Court concludes the West Virginia IMB has stated a claim under Section 410(a)(2) in that it alleges that Defendants DBS and CSS sold it the Certificates by means

of the alleged material misrepresentations, i.e., a false and misleading triple-A rating. Complaint at ¶ 159. This Court finds that nothing more is required at this stage of the proceedings.

The sellers of the Certificates, Defendants DBS and CSS, argue that Plaintiff lacks standing to assert the claim under W. Va. Code §32-4-410 because, they contend, the purchases of the Certificate were made by its investment advisor. The Court rejects this argument. Liability under Section 410(a)(2) is “to the person buying the security from him.” W. Va. Code §32-4-410(a)(2). Section 410(a) does not define the clause “person buying the security,” and no state or federal court in West Virginia has addressed the question. However, as the Fourth Circuit has held, discussing the Virginia Securities Act, the purpose of the Uniform Securities Act is “to protect investors from fraudulent sales of securities. It is therefore proper to construe a statutory ambiguity, if any exists, in favor of the investor.” *Dunn*, 369 F.3d at 433 (internal quotations and citations omitted).

The Court concludes that it is consistent with the foregoing statutory purpose to hold that “investors need not actually perform the mechanics of sale to meet the definition of purchaser.” *Medline Indus., Inc. v. Blunt, Ellis & Loewi, Inc.*, NO 89 C 4851, 1993 WL 13436, at *2 (N.D. Ill. Jan. 21, 1993).

It is, moreover, a well-established principal of agency law that a principal and agent are both parties to a contract, so both should be considered purchasers for purposes of Section 410 of the WVUSA. At the very least this issue raises fact questions surrounding the circumstances of the West Virginia IMB’s purchase of the Certificates, such as whether the trade confirmation for the purchase is in the West Virginia IMB’s name, that are not appropriate for this motion. *See In re Royal Ahold N.V. Sec. & ERISA*

Litig., 384 F. Supp. 2d 838, 841 (D. Md. 2005) (court refused to find, at the pleading stage, that non-purchasing beneficiary lacked standing, and holding that the relationship between the beneficiary of a stock purchase and an agent who actually made the purchase can “be determined through discovery and resolved on a fuller factual record”).

The court concludes that the Complaint has sufficiently pled that the West Virginia IMB purchased the Certificates, and that Plaintiff has standing to bring a claim under W. Va. Code §32-4-410(a)(2).

CONCLUSION

For all of the foregoing reasons, the Court hereby **ORDERS** that Defendants’ motions to dismiss should be and hereby are **DENIED**.

ENTERED: February 2, 2011

Jennifer F. Bailey
Hon. Jennifer F. Bailey, Judge

STATE OF WEST VIRGINIA
COUNTY OF KANAWHA, SS
I, CATHY S. GATSON, CLERK OF THE CIRCUIT COURT OF SAID COUNTY
AND IN SAID STATE, DO HEREBY CERTIFY THAT THE FOREGOING
IS A TRUE COPY FROM THE RECORDS OF SAID COURT
GIVEN UNDER MY HAND AND SEAL OF SAID COURT THIS 4
DAY OF February, 2011
Cathy S. Gatson CLERK
CIRCUIT COURT OF KANAWHA COUNTY, WEST VIRGINIA