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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Trends In Credit Crisis Settlements

By **Faten Sabry, Sungi Lee and Linh Nguyen**

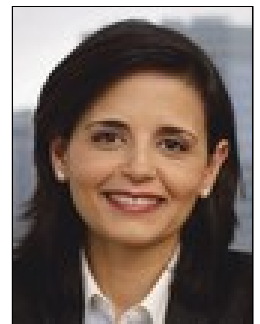
A decade after we saw the first signs of the credit crisis in 2007, the financial industry continues to grapple with the regulatory reforms, litigation and enforcement actions that have followed. Just last week, the U.S. Department of Justice brought crisis-related fraud claims against a former Deutsche Bank trader, and the House of Representatives passed a spending bill that would curtail the Consumer Financial Protection Bureau and cut back the U.S. Securities and Exchange Commission's reach under the Dodd-Frank Act. Over the next few weeks, this Expert Analysis special series will look back at the crisis and where we stand today.

Between 2007 and July 2017, credit crisis-related settlements totaled \$133.2 billion.[1] While settlements related to the credit crisis are no longer near their 2014 peak, in 2016 alone there were \$25.4 billion in settlements, and another \$7.8 billion in settlements recorded in the first seven months of 2017. These findings are based on a proprietary database developed by NERA Economic Consulting to provide insight to litigations and the ensuing settlements related to the financial crisis.[2]

This article discusses trends in credit crisis-related settlements since 2007 and presents an analysis of the "settlement ratio" for select mortgage-backed securities (MBS) settlements, defined as the ratio of the settlement amounts to the original principal balances of the securities at issue. The settlement ratios vary notably based on the type of plaintiff and the type of litigation involved. Even controlling for these factors, the settlement ratios vary considerably depending on the facts and circumstances, including individual negotiations between parties. Based on an analysis of 50 MBS settlements that covered over 16,000 securities, government agencies and monoline insurers were able to recover at rates that are 10 to 14 times as high, on average, as settlements in securities class actions.[3] On average, settlements with government agencies, including the Federal Deposit Insurance Corp., the Federal Housing Finance Agency and the National Credit Union Administration, represented 12.3 percent of the original balances of the covered MBS certificates. The average settlement ratio for cases involving monoline insurers was 16.8 percent, while the average ratio was only 1.2 percent in class action settlements. The settlement ratio estimates do not address issues of liability or causation, which would require a detailed case-by-case analysis and is beyond the scope of this article.[4]

Trends in Credit Crisis-Related Settlements

In total, we identified nearly 300 credit crisis-related settlements with publicly available dollar amounts for a total of \$133.2 billion during the period January 2007 through July 2017.[5] The settlements are almost evenly split between litigation-related settlements, \$64.8 billion (49 percent), and nonlitigation settlements, \$68.4 billion (51 percent).[6] Exhibit 1 breaks down credit crisis-related settlement amounts by type and year. Total settlements peaked at \$44.3 billion in 2014, dropped to \$5.5 billion in 2015, and increased to \$25.4 billion in 2016. Settlements from January through July 2017 totaled \$7.8 billion.



Faten Sabry



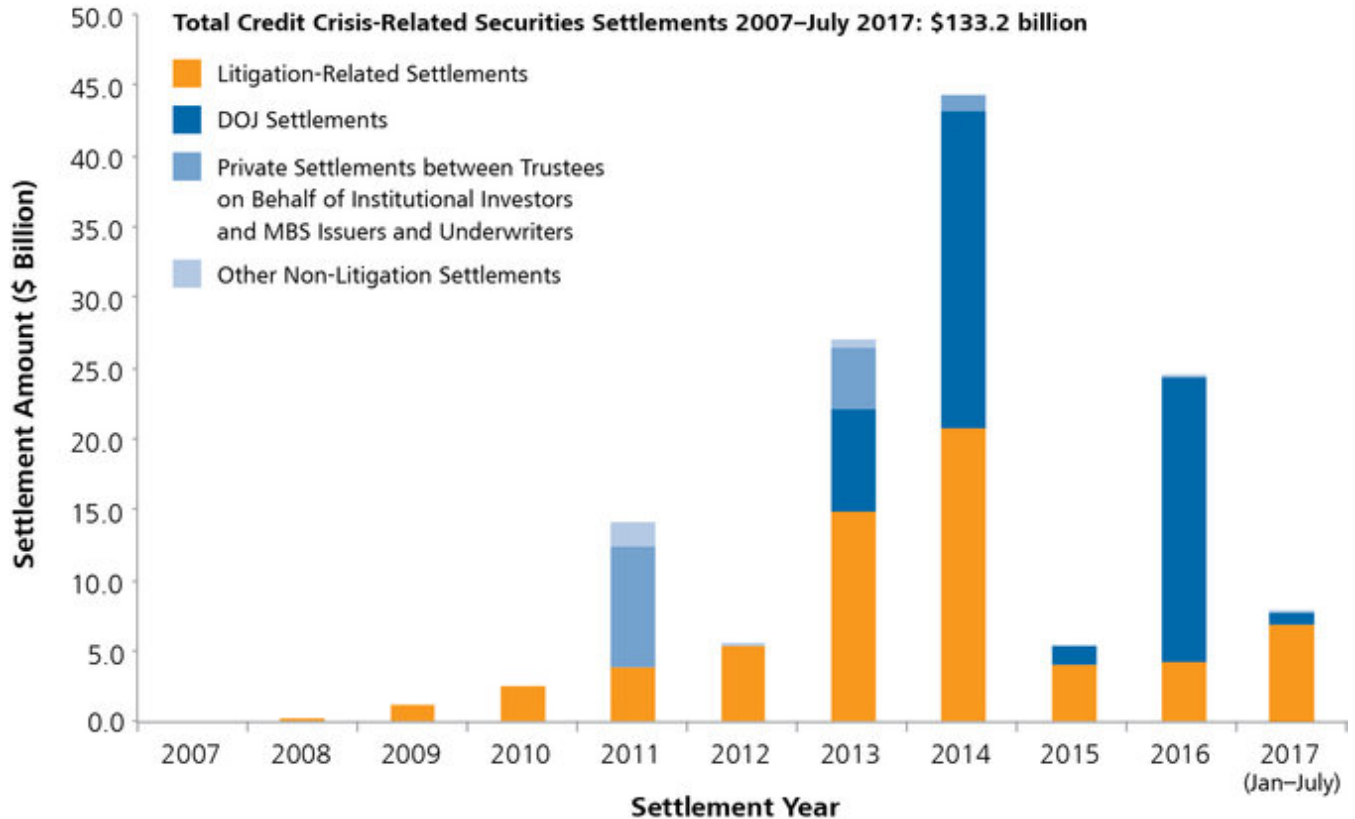
Sungi Lee



Linh Nguyen

The settlements in 2016 and 2017 included settlements with the U.S. Department of Justice, NCUA, and FHFA, among others.

Exhibit 1. **Credit Crisis-Related Settlement Amounts by Year: 2007–July 2017**



Litigation-related settlements increased every year from 2007 to 2014 and peaked at \$20.8 billion in 2014. That year, the FHFA settled lawsuits with nine banks for \$15.8 billion. Litigation-related settlements leveled off in the next two years, totaling \$4.1 billion in 2015 and \$5.1 billion in 2016. Litigation-related settlements continued on an upward trend as there have been \$6.8 billion in total settlements between January and July 2017. On the other hand, nonlitigation settlements represented 72 percent of the total settlements in 2011, 45 percent in 2013, 53 percent in 2014, and 80 percent in 2016. Certain landmark settlements reached by both the DOJ and MBS trustees with MBS issuers and underwriters account for most of the settlement dollars during those selected years.[7]

We also examined the types of lawsuits and parties involved in the settlements of litigation matters. Exhibit 2 breaks down litigation-related settlements into four categories based on the type of lawsuit and the type of plaintiffs.

- **Government agency settlements:** These include lawsuits filed by the FHFA as the conservator for Fannie Mae and Freddie Mac, NCUA as the liquidating agent for certain credit unions, and FDIC as the receiver for certain failed banks. These cases typically allege breaches of representations and warranties by MBS issuers and underwriters.
- **Monoline settlements:** These relate to allegations by monoline insurers against the issuers and underwriters of the insured securities for alleged breaches of representations and warranties and breaches of contract.
- **Securities class action settlements:** These cover derivative class actions, shareholder class actions, Employee Retirement Income Security Act (ERISA) lawsuits, and other lawsuits filed by classes of investors in MBS, collateralized debt obligations (CDOs), hedge funds, mutual funds, and other special investment vehicles (SIV) against the securities issuers and underwriters or

fund managers.

- Other litigation-related settlements: These include settlements between investors and MBS issuers and underwriters in non-class action matters involving Sections 11 and 12 allegations, and settlements with the U.S. Securities and Exchange Commission, among others. Examples of other litigation-related settlements include a settlement between five Wisconsin school districts and a brokerage firm related to investments in CDOs and a dispute between two large banks over a credit default swap (CDS) contract.[8]

Exhibit 2. **Litigation-Related Settlements by Type of Litigation: 2007–July 2017**

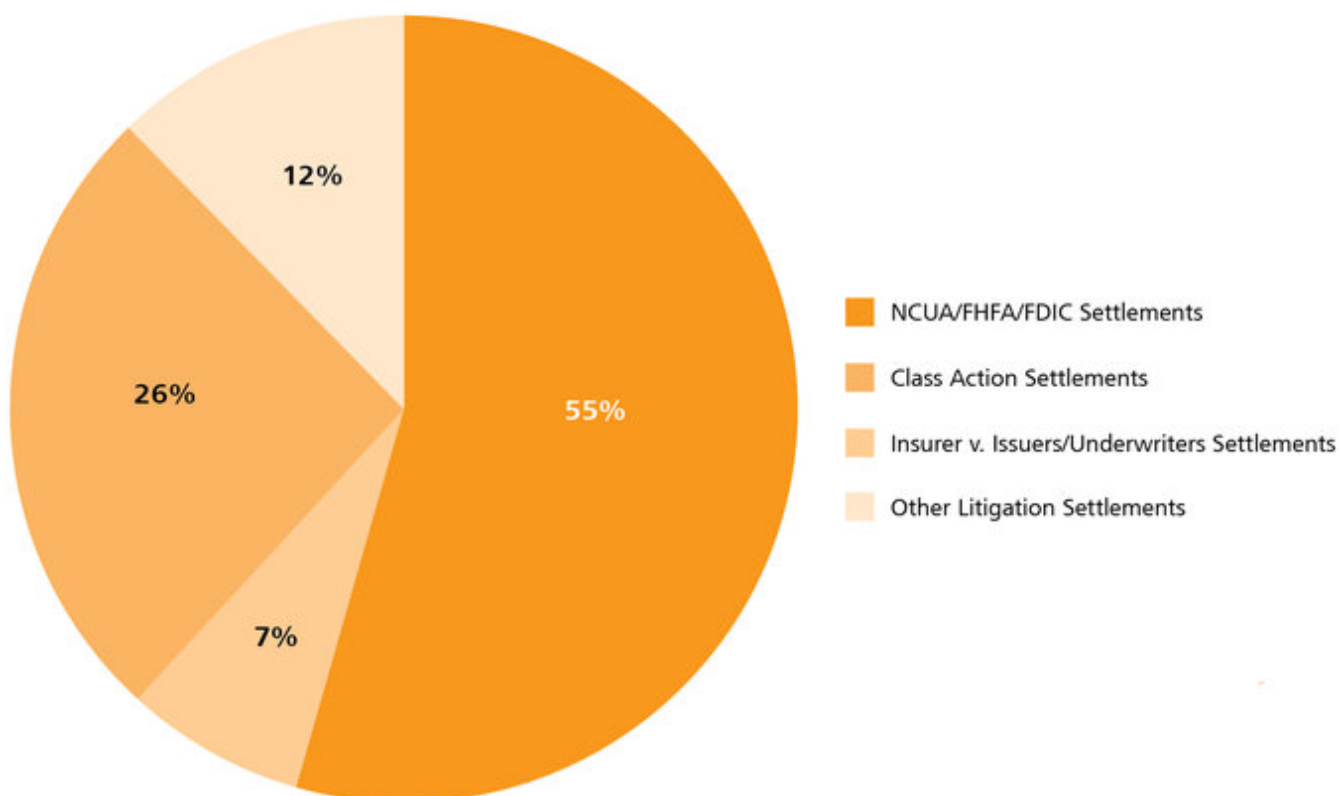
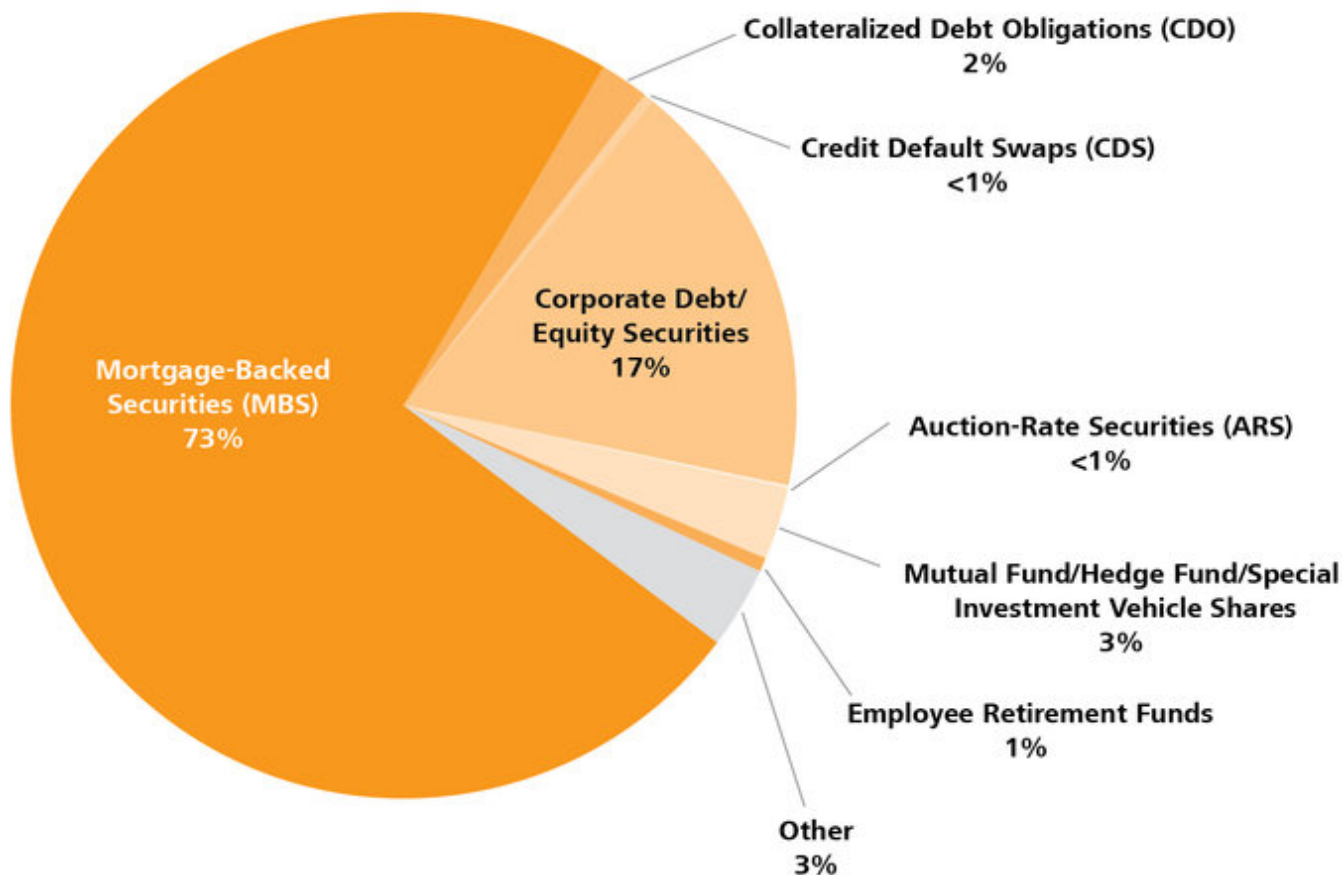


Exhibit 3 breaks down the litigation-related settlements by the primary type of financial product at issue based on the allegations in the complaints. Out of the \$64.8 billion in litigation-related settlements, settlements involving MBS accounted for about 73 percent of the total.

Exhibit 3. Litigation-Related Settlements by Type of Securities: 2007–July 2017



Of the \$68.4 billion in nonlitigation settlements, \$51.9 billion was associated with 11 DOJ settlements, \$14.1 billion in three private settlements between MBS trustees acting on behalf of institutional investors and banks, and \$2.4 billion in other settlements, such as an out-of-court negotiation between a monoline insurer and an MBS issuer in 2011, and a private settlement between the state of Connecticut and a large bank in 2016.[9]

Settlement Ratios for MBS Settlements

For the period from January 2007 to July 2017, there were 113 MBS settlements, totaling \$47.4 billion, to resolve disputes involving allegations related to the investment in, issuance/underwriting, sale or guaranty of MBS certificates. Of these, we identified the settlement documents and agreements that disclose the settlement amounts and the lists of covered securities for 50 settlements. These 50 settlements totaled \$37.8 billion and covered more than 16,000 MBS securities, the principal balances of which totaled more than \$1 trillion. We then compiled data on the original principal balance of each covered MBS certificate and calculated the ratio between the settlement amount and the original principal balance of the covered MBS certificates.[10]

The settlements were then categorized according to the type of lawsuit (i.e., class action or non-class action) and plaintiff (e.g., government agencies, monoline insurers, etc.) using information from the complaints and other publicly available documents. The 50 settlements broke into three groups: 21 government agency settlements, five monoline settlements, and 24 securities class action settlements.[11] Exhibit 4 summarizes the 50 MBS settlements that we analyzed by year and type of lawsuit.

Exhibit 4. **Summary of 50 MBS Settlements Included in Analysis of Settlement Amount as Percentage of Original Principal Balance of Covered MBS Certificates**

Settlement Year (1)	Government Agency Settlements		Monoline Settlements		Class Action Settlements		All Settlements Analyzed	
	Number of Settlements (2)	Settlement Amount (3) --- \$ Billion ---	Number of Settlements (4)	Settlement Amount (5) --- \$ Billion ---	Number of Settlements (6)	Settlement Amount (7) --- \$ Billion ---	Number of Settlements (8)	Settlement Amount (9) --- \$ Billion ---
2011	0	\$0.0	0	\$0.0	2	\$0.4	2	\$0.4
2012	0	0.0	0	0.0	6	0.1	6	0.1
2013	4	7.3	3	2.2	4	0.6	11	10.1
2014	11	17.0	2	1.0	6	1.1	19	19.1
2015	2	0.0	0	0.0	5	1.5	7	1.5
2016	3	0.8	0	0.0	0	0.0	3	0.8
2017	1	5.5	0	0.0	1	0.2	2	5.7
Overall	21	\$30.7	5	\$3.2	24	\$3.9	50	\$37.8

The 21 government agency settlements resolved lawsuits that were filed by the FHFA, NCUA or FDIC to address allegations of violations of Sections 11 and 12 of the Securities Act of 1933. The allegations related to the sale of MBS certificates to Fannie Mae and Freddie Mac, credit unions, and banks. These settlements totaled \$30.7 billion and covered 1,007 MBS certificates that were issued during the period 2004 to 2007 period with a total original note balance of \$233.4 billion. The average settlement ratio across these 21 settlements is 12.3 percent, and the median is 11 percent.

The five monoline settlements in our sample of 50 settlements resolved mainly breach of contract litigations. The monoline insurers entered into financial guaranty contracts for certain MBS certificates, agreeing, for a fee, to make investors of those certificates whole with regards to any unpaid interest and principal payments. Such MBS certificates are known as "wrapped notes." The settlements with the monoline insurers resolved allegations of breaches of representations and warranties and breaches of contract against the issuers and underwriters of the wrapped MBS notes. These five settlements totaled \$3.2 billion and covered 99 wrapped MBS notes issued between 2004 and 2007 with a total original note balance of \$36.9 billion. The average settlement ratio is 16.8 percent, and the median is 10 percent.

The 24 securities class action settlements resolved lawsuits filed by classes of MBS investors alleging violations of Sections 11 and 12 of the Securities Act of 1933. The class action settlements have, on average, much lower settlement ratios than settlements with the government agencies or monoline insurers. The 24 MBS class action settlements in our sample totaled \$3.9 billion and covered 15,651 MBS certificates issued between 2004 and 2007 with a total original note balance of \$801 billion. On average, the ratio between the settlement amount and original principal balance of the covered MBS certificates across these 24 settlements is 1.2 percent, and the median is 1.2 percent.

Looking Ahead

Although the pace of litigation-related settlements has slowed down in recent years and the DOJ has already reached settlements with many banks and rating agencies, several notable credit crisis-related lawsuits and investigations remain outstanding. For example, there are many outstanding lawsuits against financial institutions and trustees and public sources note ongoing investigations by the DOJ. [12]

Since 2014, there has been a surge in filings against MBS trustees alleging breach of fiduciary duty, breach of contract, and violation of the Trust Indenture Act of 1939, among other claims. By the end of July 2017, the trustees have prevailed at trial in one case where Judge Steven E. Martin in the Court of Common Pleas of Hamilton County, Ohio, ruled in favor of the defendant.[13] In addition, another lawsuit against the trustees has been dismissed in the Southern District of New York and several other cases are at the stage of litigating class certification and discovery issues.[14]

Our review of the 2016 annual reports for 11 major banks shows that some banks reported future liabilities related to MBS litigation, totaling \$5.3 billion, and most discussed their outstanding MBS lawsuits without reporting an estimate of their exposure.[15]

Dr. Faten Sabry is managing director and chairwoman of the bankruptcy practice at NERA Economic Consulting. Sungi Lee is a consultant and Linh Nguyen is a senior analyst at NERA.

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[1] A credit crisis-related settlement is defined as a settlement to resolve a securities lawsuit (i.e., a lawsuit related to the purchase, ownership, sale, or guaranty of securities), a state or federal investigation, or a private negotiation related to the downturn in the financial and mortgage markets that began in 2007. For the purpose of this article, we categorized the credit crisis settlements as either litigation-related or nonlitigation settlements. Litigation-related settlements are those that resolve securities lawsuits related to the downturn in the financial and mortgage markets during the credit crisis. Our count of credit crisis lawsuits includes ERISA claims, shareholder derivative actions, individual state and federal cases, international cases, and state and federal shareholder class actions, among other cases. For example, we classified all but one FHFA settlements as litigation-related settlements, as it occurred after FHFA filed lawsuits against certain mortgage-backed securities (MBS) issuers and underwriters. For example, see: "Settlement Agreement," <https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FHFA-RBS-Settlement-Agreement.pdf>. We defined nonlitigation settlements as ones where the parties agreed to settle without any lawsuits, including settlements resulting from state and/or federal investigations, government enforcement actions, or private negotiations between the MBS trustees acting on behalf of institutional investors and the MBS issuers. For example, we classified the U.S. Department of Justice settlements with several MBS issuers and underwriters, and several rating agencies as nonlitigation settlements because the DOJ opted to coordinate with the entities until settlements were reached instead of litigating. For example, see: U.S. Department of Justice, "Goldman Sachs Settlement Agreement," <https://www.justice.gov/opa/file/839891/download>.

[2] There is no public source or comprehensive reporting on credit crisis-related lawsuits, regulatory investigations or settlements. We compiled data from various sources such as Bloomberg, Factiva, RiskMetrics Group/Securities Class Action Services, SEC filings, and case dockets from January 2007 through July 2017. Our database does not include settlements related to predatory lending, consumer finance, foreclosure proceedings, Ponzi schemes, Libor suits or arbitration claims.

[3] The government agencies include the Federal Housing Finance Agency (FHFA), the National Credit Union Administration (NCUA), and the Federal Deposit Insurance Corp. (FDIC).

[4] We do not have data on the dollar amounts that each investor purchased and held in the covered MBS certificates. Therefore, the settlement ratios that we present in this article are based on the aggregate original balances of all securities listed in each relevant settlement agreement.

[5] We have identified 56 other settlements for which we could not acquire the settlement amounts from public sources.

[6] See note 2 for definitions of litigation-related and nonlitigation settlements. Among the nonlitigation settlements, the DOJ settlements not only resolved various state and federal claims against financial institutions, they also included penalties under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and provided relief to homeowners. Some of the DOJ settlements also addressed claims from outstanding litigation and we retained the division of the settlement amounts accordingly. For example, a \$7 billion settlement between the DOJ and a large financial institution included the \$208 million settlement of an FDIC lawsuit. The \$208 million FDIC

settlement is considered a litigation-related settlement, so we adjusted the nonlitigation settlement amount to \$6.8 billion to avoid double-counting. U.S. Department of Justice, "Citigroup Settlement Agreement," <https://www.justice.gov/iso/opa/resources/471201471413656848428.pdf>.

[7] For example, The Bank of New York Mellon, as trustee or indenture trustee of 530 MBS trusts reached an \$8.5 billion settlement with Bank of America in 2011. See: "Settlement Agreement," <http://www.cwrmbssettlement.com/docs/Exh%20B.pdf>. Also, for example, the DOJ and Credit Suisse reached a \$5.3 billion settlement in 2016. See: U.S. Department of Justice, "Credit Suisse Settlement Agreement," <https://www.justice.gov/opa/press-release/file/928521/download>.

[8] Respectively see: *Kenosha Unified School District et al. v. Royal Bank of Canada Europe Ltd. et al.*, No. 2008CV013726 (Wis. Cir. Ct., Milwaukee County) and *SEC v. Stifel Nicolaus & Co. Inc. et al.*, No. 2:11-cv-00755 (E.D. Wis.); and *Citibank NA v. Morgan Stanley & Co.*, No. 11-2592 (2d Cir.).

[9] Derek Hawkins, "Assured, BofA Strike \$1.6B Deal Over MBS Claims," Law360, <https://www.law360.com/articles/239395>; Connecticut Department of Banking, "RBS enters \$120M Settlement with State of Connecticut to Resolve RMBS Investigation," <http://www.ct.gov/dob/cwp/view.asp?a=2245&q=586254>.

[10] Information regarding the purchase price paid by the plaintiffs in MBS litigation is generally not available in the settlement documents. As such, the settlement amount is compared to the original principal balance of the covered MBS certificates in each settlement.

[11] Besides the 50 settlements for which we have the necessary data, we have identified 16 other government agency MBS settlements, seven other monoline MBS settlements, and one other MBS securities class action settlement for which we could not acquire the list of covered MBS certificates using public sources. In addition, there are other non-class action settlements between investors or MBS trustee acting on behalf of the investors and MBS issuers and underwriters. Due to the lack of publicly available information on these settlements, our analysis of settlement ratios does not include these settlements.

[12] For example, see: Evan Weinberger, "US Sues Barclays Over Pre-Crisis Mortgage Securities," Law360, <https://www.law360.com/articles/876275>.

[13] See: Final Judgment Entry and Findings of Fact and Conclusions of Law, *The Western and Southern Life Insurance Company et al. v. The Bank of New York Mellon*, No. A1302490 (Court of Common Pleas, Hamilton County, Ohio).

[14] See: Order of Dismissal, *Retirement Board of The Policemen's Annuity and Benefit Fund of The City of Chicago et al. v. The Bank of New York Mellon Corp.*, No. 1:11-cv-05459 (S.D.N.Y.).

[15] We reviewed the financial statements of the following banks: Bank of America, Barclays, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, Morgan Stanley, Nomura, RBS, UBS and Wells Fargo.