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Case & Project Experience

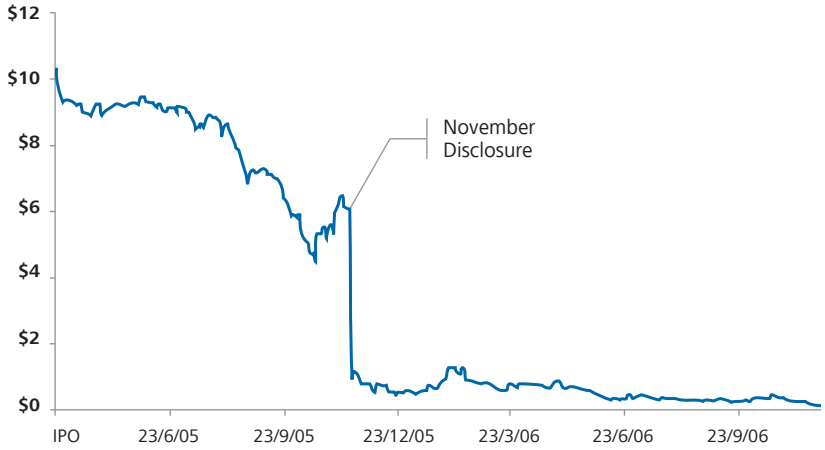
The Canary in the Coal Mine: NERA Experts Provide Damage Analysis in Support of Settlement of Class Action Involving a Subprime Mortgage Lender

Background

On 24 March 2005, FMF Capital Group Ltd. (FMF) conducted an initial public offering of income participating securities (IPSs) at $10 per IPS.[1] FMF raised $197.5 million through the IPO and used the proceeds to acquire an indirect interest in the US subprime mortgage business of Michigan Fidelity Acceptance Corporation (MFAC), the promoter of the FMF offering.

MFAC offered high interest mortgage loans to borrowers with low credit ratings. FMF generated revenues by making mortgage loans to subprime purchasers of residential property (through MFAC), and then bundling and reselling these mortgage loans to institutional buyers at a premium. This process of origination and securitization was repeated, creating a flow of revenue for FMF.

Figure 1: **FMF IPS Price**
IPO (24 March 2005) to 27 November 2006



FMF's prospectus contemplated monthly distributions totaling $1.10 per IPS per year (a portion of which represented interest on the subordinated notes and the remainder a dividend on the common shares).[2] FMF made monthly distributions through October 2005. However, in its quarterly earnings press release issued after the close of trading on 14 November 2005, and a related analyst conference call on the morning of 15 November 2005 (together the "November Disclosure"), FMF announced that it was suspending monthly distributions indefinitely some eight months after its IPO.

The market price of the IPSs dropped from $6.15 at the close of trading on 14 November 2005 to $1.43 at the close of trading on 15 November 2005 and to $0.94 at the close of trading on 16 November 2005 (in total, a $5.21, or 76.8% decline). The market price of the IPSs did not recover (see Figure 1). FMF eventually ceased operations in the months following the settlement of this case.

It turns out that FMF may have been the proverbial "canary in the coal mine" for the current credit crisis which has since precipitated the collapse of the US market for subprime mortgage loans.

Allegations

Plaintiffs alleged that the company "secretly and methodically dismantled MFAC's underwriting standards" in an effort to maintain growth in loan originations, and concealed from institutional loan purchasers and investors materially adverse information respecting its bad mortgage loans and its degraded underwriting practices.[3]

FMF pointed to industry-wide factors including rising interest rates and increased defaults as the cause of its inability to continue to securitize its mortgage loans to finance the distributions.

NERA's Role

NERA experts Mark Berenblut and Brad Heys were retained as neutral experts for the purposes of a settlement approval hearing to assist the court in understanding the full context of the quantum of damages in light of the allegations and known facts of the case.

A proposed settlement of a class action litigation places a court in a challenging position. The court must determine whether or not the interests of the class are adequately addressed by the proposed settlement. As articulated by the court in this case, during a settlement proceeding it does not have the benefit of a hearing of the issues from both the plaintiff and the defendant perspectives. This is in contrast to most legal proceedings where the presumption is that the adversarial process will ensure that the interests of all parties are vigorously defended.

Defendants to a class action case have an interest in settling for as little as possible. Class counsel have an interest in achieving a large settlement, but may be seen to make settlement decisions based on the investment required to prosecute the case and the expected return on that investment in the form of fees they expect to collect (usually based on some percentage of the settlement amount). Therefore, the court may be concerned about the appearance of a conflict of interest between class counsel and the class members they represent.

To determine whether the settlement is reasonable, the court must make an independent assessment of the *prima facie* merits of the case in light of the settlement amount and the risks and costs involved in pursing the litigation further.

Mr. Berenblut and Mr. Heys prepared an expert report setting out the issues with respect to economic damage quantification in a securities class action and provided a range of possible damages which could have been found had the case gone to trial.

Damage Quantification

The central issue with respect to the measure of damages in this case (an issue which is typical to most purchaser securities fraud cases), was whether the negative information released by the company reflected information which was known, but not disclosed, at an earlier date (e.g., at the beginning of the class period) or reflected new information which could not have been known or disclosed at an earlier date.[4]

NERA's role in this case was not to make such an assessment of the nature of the disclosure, but rather to quantify the range of damages which could arise depending on the court's assessment of the disclosure(s). On the one hand, all of the disclosure may have been corrective in nature, implying that most or all of the security price impact reflected the impact of the alleged misrepresentations, and therefore represented an appropriate benchmark for an estimate of the price inflation during the class period. On the other hand, the court could have determined that the disclosure consisted of largely new information, and therefore that the decline in the security price following the November disclosure was far greater than the inflation, if any, in the security price during the class period.

Reasonable Settlement

Our analysis demonstrated that the settlement amount of $29 million fell within the range of potential damages given the possible interpretation of the nature of the disclosures. This allowed the court to assess, given the risks of the litigation and its own preliminary assessment of the allegations, whether the settlement was in the best interests of the class members.

On 11 April 2007, the Ontario Superior Court of Justice approved the proposed settlement.

Experts Involved

Mark L. Berenblut, Senior Vice President

Mr. Berenblut's expertise is in finance, economics, valuation, and dispute resolution. He is qualified, and serves clients, in the US, Canada, and internationally. He has 25 years of experience in major securities and antitrust class actions, securities and business valuation, damage quantification, financial investigation, and complex litigation. Mr. Berenblut is frequently qualified by the courts as an expert witness at trial and arbitration and has been appointed as an arbitrator and as a mediator. He leads teams in the analysis of a variety of economic, business, and financial matters on behalf of law firms, investment banks, public and private companies, government, and not-for-profit entities. Mr. Berenblut is also

an Accredited Senior Appraiser, a Chartered Accountant, a Chartered Business Valuator, a Certified Mediator, and a Certified Fraud Examiner.

Bradley A. Heys, Vice President

Mr. Heys' expertise is in the fields of economics, finance, and financial investigations. He performs economic analyses for securities litigations, antitrust class actions, and other complex commercial litigations, and has conducted financial investigations of public companies for both class action and criminal matters. Mr. Heys also conducts business and securities valuations for corporate and public sector clients. He teaches a graduate level course in Economic Analysis of Law at the University of Toronto. Mr. Heys is a Certified Fraud Examiner.

NERA'S Securities and Finance Practice

NERA is widely recognized as a leading firm in the economics of securities, finance, and commerce. Our experts apply their skills in these areas to assist clients in securities and product liability litigation, commercial disputes, and risk management. We bring to bear a thorough understanding of securities, the markets in which they trade, and the regulatory institutions that govern them.

NERA economists provide answers to difficult questions arising in areas including subprime lending, bankruptcy and fraudulent conveyance, broker-customer disputes, class actions and opt-out suits involving individual securities and funds, derivative suits, ERISA actions, complex commercial disputes, economic analyses of materiality, reliance, and loss causation, forensic accounting, hedge fund litigation, insider trading and manipulation cases, insurance litigation, and valuations of fixed income and derivative products.

Our experts' knowledge spans equity and commodity markets; US government, corporate, municipal, and mortgage securities; bonds and currencies of global and emerging markets; and warrants, futures, forwards, swaps, options, and other derivatives.

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

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Notes:

[1] Each IPS was a hybrid equity and debt security consisted of one common share and $6.524 principal amount of 14.5% subordinated notes.

[2] FMF Capital Group Ltd. Final Prospectus, 24 March 2005.

[3] Second Amended Class Action Complaint, *T. Gould, et al v. FMF Capital Group Ltd., et al*, filed with the Ontario Superior Court of Justice, 25 January 2006.

[4] For more discussion of this issue see "Risk Disclosures and Damages Measurement in Securities Fraud Cases," by Dr. David Tabak, NERA Economic Consulting, published in *Securities Reform Act Litigation Reporter*, April 2006.