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A case for experienced legal counsel on COVID-Era financial markets and products litigation

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INTRODUCTION

While remaining deeply mindful of the human toll wrought by the COVID-19 pandemic, it is incumbent upon litigators, in-house counsel, asset managers and experts to begin preparing for the flurry of litigation that will surely come next.

Litigation is inevitable: institutional and retail investors alike litigated extensively after the 2007-2009 global Financial Crisis, alleging claims for misconduct of all varieties by Wall Street that resulted in settlements and judgments amounting to tens of billions of dollars.

> Some of the poor financial market architecture that existed pre-Financial Crisis lingers on today.

Similar claims may return during, and in the aftermath of, the current crisis. The exact financial instruments at issue may differ, certainly. But many of the same principles and considerations will apply, meaning that lessons learned from our experience during prior crises will prove invaluable.

In this article, we detail some of the additional complexities that come with litigating claims arising from or during a crisis, and we draw parallels between Financial Crisis-era cases and the types of litigation expected to arise out of distress caused by the COVID-19 pandemic.

We also highlight the value of experienced crisis-litigation counsel and experts in the court battles to come.

PANDEMIC-ERA LITIGATION

Pursuing crisis-era litigation can bring with it its own challenges.

When a building collapses in ordinary conditions, we might readily point our fingers at the architect or the construction company.

But if the same building were to collapse in the midst of a hurricane or other unprecedented weather conditions, how would we know whether it fell down because of the inclement weather or because it was poorly constructed? The analysis can be tricky.

During an economic expansion with asset price inflation, misconduct might go unnoticed and can sometimes be obscured, for example by combining it with positive news. Profiting investors are seldom litigious, even if in theory they could have profited more "but-for" the misconduct.

In a crisis, the opposite is true. Investors become motivated to identify any potential wrongdoing that may enable them to recoup some or all of their losses.

Among COVID-era litigation, we expect to see the same types of issues we saw following the last crisis, only in a different form; and the same issues we see between crises, only with heightened regularity.

Where investors in RMBS and related CDOs were among the core plaintiffs in post-Financial Crisis litigation, we might find that CLO or CMBS investors, or other groups of investors entirely, become repeat litigants seeking redress for misconduct exposed or exacerbated by COVID-19.

The Financial Crisis was a narrow but deep crisis primarily centered on malfeasance in the origination and securitization of mortgages. The COVID-19 crisis is different in that financial institutions have no obvious party to blame for the inciting event — a pandemic.

This time, plaintiffs and their legal teams will have to disentangle the harm attributable to defendants from the harm caused by a market contraction — or identify claims that do not depend on any such distinction.

In addition to the unique stresses caused by COVID-19 itself, financial market-based mechanisms designed to protect market integrity (like ratings downgrades and margin calls) sometimes achieve the opposite effect in a crisis situation, destabilizing companies and exacerbating any COVID-related difficulties.

Some of the poor financial market architecture that existed pre-Financial Crisis lingers on today.

Companies across most sectors and industries, including financial institutions, have already been damaged and have seen their equity valuations fluctuate wildly.

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On the debt and credit side of the equation, many companies have seen their debt downgraded or their funding costs raised, and some have already defaulted on their debt.

In March, several leveraged entities, including real estate investment trusts ("REITs") such as Invesco Mortgage Capital, MFA Financial, and New York Mortgage Trust failed to meet their margin calls.

MFA (NYSE: MFA), which traded around $7.50 per share entering March, hit an end-of-day low of $0.36 on March 24, a drop of roughly 95%. Subsequent difficulties at investment firms including CQS and H2O Asset Management have also garnered the media's attention.

HIRING STRONG LITIGATORS

The authors, frequently retained on Financial Crisis-era cases by investor-plaintiffs as lead counsel (in the case of Mazin and Hendler) and in a strategic consulting capacity (in the case of Phillips), can tell you first-hand that much of the wide disparity in outcomes achieved was directly attributable to the strengths or weaknesses of the litigation teams.

In complex financial litigation, where most cases settle, a law firm's ability to maneuver in discovery can determine its client's ultimate settlement outcome.

We watched as many hastily-constructed cases failed to survive early dispositive motions. Arguments made were often emotive rather than analytically sound, leaving experts unable to bridge the gap by providing the support necessary to back up lofty or groundless claims.

On the other hand, better-prepared and more vigorous legal teams achieved handsome verdicts and settlements, in many cases several multiples of those reached by their less-capable counterparts.

In pursuing or defending COVID-era litigation, plaintiffs and defendants will therefore want to hire battle-hardened litigators to represent them — litigators who bring with them a keen appreciation for corporate environments, financial market pressures, and corporate conduct during a crisis.

The most successful litigators in COVID-era financial litigation will be both masters of complex litigation procedure, as well as fluent in the substantive factual issues at play in financial markets.

On the procedural side, the size and stakes of these cases often demand highly technical and extensive fact discovery. In complex financial litigation, where most cases settle, a law firm's ability to maneuver in discovery can determine its client's ultimate settlement outcome.

But the importance of a savvy approach to discovery does not diminish the need for trial expertise. Plaintiff-side financial litigators must also be capable and willing trial lawyers, if only because their adversary is unlikely to be. Clients with capable trial attorneys will feel secure, while the opposing clients will feel the opposite.

As for substantive expertise, each market and submarket in our increasingly specialized economy has its own unique language and dynamics. The best financial litigators invest the time to become fluent in the broader ecosystem of each case.

As leaders in RMBS litigation arising out of the Financial Crisis, we can identify numerous examples of how marrying substantive and procedural expertise yields tangible benefits for investor clients.

One such illustration can be found in the battle among RMBS plaintiffs and defendants over the viability of statistical sampling as a method to prove defendants' liability and damages at trial.

The central question in these cases is whether thousands of loans in the subject RMBS trusts comported with defendants' representations and warranties about those loans' quality and characteristics.

The prospect of investigating and putting on evidence at trial of every single at-issue loan is daunting for both plaintiff and judge alike. That is precisely why RMBS defendants uniformly inveighed against the use of sampling as inconsistent with the contractual repurchase remedy.

But plaintiffs' counsel, backstopped by the right experts and consultants, who maintained faith in its utility, have to date won every battle in the New York State courts (the epicenter of RMBS repurchase litigation) on this issue.

The cost-savings, both in terms of money and time, of investigating and proving breaches in 400 sampled loans versus 5,000 total loans is self-evident.

Law firms like McKool Smith that have been on the front lines of Financial Crisis-era litigation will have a leg-up in the post-COVID era. The disputes we expect to see among the various players in the CMBS space is one such example.

In response to post-2008 RMBS litigation, transactional attorneys adjusted CMBS contracts to defang some of the provisions trustees and investors relied on to seek recourse from banks in the RMBS context.

Though the banks have improved their defenses, litigators steeped in RMBS and CMBS (like us) are already leveraging their expertise to identify opportunities for CMBS investors, and other securitization parties, now facing losses.

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TAKING ADVANTAGE OF THE SKILLS OF INDUSTRY EXPERTS

Industry experts are often most helpful — either as strategic consultants alongside legal teams or in complementing the evidence of academic experts — when the practicalities of the situation are more complex or when conduct, best practices, or market norms become important elements for the legal team to analyze.

Crises tend to bring with them complexities that demand attention from market professionals who have experience in real-world applications and market environments.

Under ordinary conditions, scientific experts can apply familiar mathematical models to a set of facts. But in a crisis, analyses like these often fail, both because the "facts" can become murky and the mathematical models can break down.

The looming crisis will expose pre-COVID shortcomings in the construction, marketing, trading, rating, pricing, and sale of financial products to intense scrutiny.

Markets work differently during a crisis, meaning that when some products may generally move in lock-step (or be highly-correlated) in ordinary conditions, they may become uncorrelated or even inversely-correlated during a crisis.

Industry experts understand the nature of the products involved and the dynamics of the markets, not just the theory, enabling them to access a more comprehensive toolkit when analyzing market conditions during a crisis, or when developing models for liability or damages.

Legal teams will want to have experienced industry experts to lean on to understand the practicalities of how financial instruments were created, packaged, marketed, and sold, and what relationships (and duties) exist between and among the various market participants (*e.g.*, the investment banks that structure the assets, the rating agencies that rate the assets, the trustees and other administrative agents that facilitate the transacting in and warehousing of the assets, and the asset managers and other investment funds that purchase them).

One prominent example comes in the requirement to show that damages were causally linked to the alleged misconduct, a challenge that in the context of a crisis often requires the deft touch of an industry expert. So too are industry experts instrumental in establishing reliance.

In the context of class actions, reliance can sometimes be inferred upon a demonstration of market efficiency, but demonstrating that a market efficiently incorporated new information is no mean feat during an inherently volatile crisis.

Even if one can demonstrate efficiency, the separating out of any misconduct-based damages in an event study demands a trained hand, given the overlapping effects of the crisis itself on any real or supposed corrective disclosure.

To press arguments of reliance and damage causation, or to build reliable models or contest their veracity, litigators will need to work with savvy financial market professionals.

To borrow from microfinance pioneer and Nobel Laureate Muhammad Yunus, when tackling a complex problem with a purely theoretical toolkit, one tends to approach it like an academic, with a *bird's eye view*.

Having the right industry experts available to address or interpret complex events adds the *worm's eye view*, which can make all the difference.

CLOSING REMARKS

The looming crisis will expose pre-COVID shortcomings in the construction, marketing, trading, rating, pricing, and sale of financial products to intense scrutiny.

Faulty disclosures (or omissions), including any failures to accurately describe the true nature of the investments or the risks involved, will also be subjected to a focused lens.

Any potential for self-dealing may similarly garner increased attention, as will any unconsented-to risk-taking by financial advisers — especially to the degree that their clients' monies, subjected to crisis-era underperformance, had been earmarked for investment in low-risk assets or opportunities.

It will not always be clear to the untrained eye whether damages were caused by misconduct or by a significant correction in financial or economic market conditions.

This line is sometimes fine, and even more so in a crisis, which creates a compelling need for litigants to seek out high quality representation as they seek to separate the stronger claims from the weaker ones (on the plaintiff side) and to assert solid grounds for dismissing the weaker claims (on the defense side).

While post-COVID financial litigation is likely to take on different forms than the post-Financial Crisis litigation, the fundamentals will remain the same. The litigators that prevailed in the prior wave of crisis litigation will define the next wave, and are already preparing to do so.

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