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## Subprime Fallout Will Yield More Fund Suits: Attorneys

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By Beagan Wilcox

Subprime losses have yielded a slew of lawsuits.

At last count there were 113 lawsuits of all kinds stemming from the subprime mess, according to a report recently released by **Advisen**, a firm that provides data to the global commercial insurance industry.

But only seven of those suits were brought against mutual fund groups. Still, industry attorneys and plaintiff's attorneys alike say it's only a matter of time before more subprime suits are filed against fund complexes.

"If we're really in a recession, what we're seeing with subprime will carry over to other sectors," says a fund attorney at a top securities law firm who is involved in subprime litigation.

The funds that have been sued so far are the ones sustaining large subprime losses. **Regions Morgan Keegan**, for example, has seen steep losses in several of its bond funds. Its Select High Income Fund was down 59.7% in 2007; its Select Intermediate Bond Fund was down 50% for the year, according to Morningstar.

Suits against Morgan Keegan claim that disclosure about the funds' exposure to the subprime market was false and misleading. The directors are named as defendants in the suits, along with the advisor, the chief compliance officer and others.

**State Street Global Advisors** also faces five lawsuits involving some of the firm's actively managed bond funds. Its ultrashort bond fund, the SSgA Yield Plus Fund, was down 13.4% in 2007, according to Morningstar.

State Street announced it will record a net charge after taxes of \$279 million in the fourth quarter. That charge will cover a \$618 million reserve to address legal issues stemming from the funds with subprime exposure, a press release states.

But it's up for debate as to whether other fund groups will have subprime losses as large as those at Morgan Keegan and State Street in the weeks and months to come.

If we are indeed in a recession, junk bonds, for instance, will be affected, and there will be downward pressure on price through a lot of other fixed-income asset classes as well, says the fund attorney involved in subprime litigation.

Thomas Hargett, a partner with **Maddox Hargett & Caruso**, says investors are starting to tell his firm that other investment categories will be affected by subprime problems.

His firm was one of four that issued a press release in early January announcing they were investigating losses from subprime exposure in Morgan Keegan funds.

Hargett says his firm also is “looking hard” at other investment advisors for potential subprime-related losses in their mutual funds.

“I can tell you that it will be shocking if other debt mutual funds in particular do not sustain substantial losses because of this mortgage meltdown,” adds Hargett.

**Coughlin Stoia Geller Rudman & Robbins**, a law firm representing plaintiffs in one of the Morgan Keegan suits, has been contacted by several dozen pension funds from around the world about the subprime mess, says Darren Robbins, a partner at the firm.

“The fact that there are in many mutual fund families short-term government bond funds which were sold as triple-A-rated conservative investments to some of the most conservative pension funds across the world...Those pension funds essentially bought a pig in a poke,” says Robbins.

Robbins says he believes his firm will bring cases against mutual fund groups on behalf of a number of pension funds.

Would fund directors be named in those suits?

“Absolutely,” replies Robbins.

Industry attorneys say that even if fund groups ultimately do get picked up in the subprime litigation, they probably won't be the prime quarry. Wall Street investment banks with more than \$130 billion in subprime losses likely will reserve that post. And fund directors should have limited liability, as long as they had appropriate disclosure and proper policies and procedures for pricing.

“Directors are usually collateral after everybody else has been sued,” says the fund attorney.

Others are skeptical that the fund industry will see large future subprime losses that could be the basis for future lawsuits.

“I would say that it would be unlikely to see a new slew of funds get injured by subprime troubles specifically,” says Lawrence Jones, fund analyst at **Morningstar**. “If some other part of the market began to implode very quickly like the subprime [market] did in 2007, then, sure, there could be other funds.”

Furthermore, the regulatory requirements for mutual funds may protect them from subprime litigation, says one industry insider.

“A fund cannot have more than 5% of its assets in any one security or one issuer,” says Larry Maffia, president of **ICI Mutual**, the industry's insurance company. “They're pretty diversified pools of assets. So I think that's a significant protection,” he says.

Another key factor may play into future subprime litigation for the fund industry: the SEC's sweep investigation of the pricing of “complex instruments,” which several agency officials spoke about last November.

“Complex instruments” is code for investment vehicles tied to subprime mortgages, such as structured investment vehicles and collateralized debt obligations. If the SEC brings an enforcement case against a mutual fund group for valuation issues, then lawsuits will inevitably follow, say attorneys.

It does appear there have been valuation problems at some groups. Just last week, the SEC said it will update rules for valuing assets when trading prices aren't available, according to Bloomberg.

“Funds seem to be relying on stale pricing on several occasions,” Douglas Scheidt, an associate director in the SEC’s investment management division, told Bloomberg. “They were continuing to value the securities at prior levels” even though “facts would suggest that the price would have gone down.”

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