Structured Notes Litigation

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It is axiomatic that steep declines in securities prices draw out the securities plaintiffs bar, especially when securities sold to retail customers are at issue. Since January 2008, U.S. equity markets have fallen more than 30% with overseas markets following suit. That alone would be sufficient to fuel plaintiffs' appetite to seek redress for their market losses. But in this economic downturn, plaintiffs attorneys have a new target to shoot at — structured derivative notes sold to retail customers.

What are Structured Notes?

Structured notes are derivative products that provide investors a specified return based on the performance of another security — for example a foreign or domestic market index — sometimes with "full" or partial principal protection. Such products are akin to general obligation bonds for the issuer in that the proceeds can be used by the issuer for general business purposes at its discretion. Upon bankruptcy of the issuer, the owner of the structured notes becomes an unsecured creditor of the issuer. Thus, retail investors who bought structured notes issued by the now bankrupt Lehman Brothers Holdings Inc. own an unsecured right in the Lehman bankruptcy queue. And the other financial institutions who sold Lehman's products are being sued as the "deep pocket" defendants.

Even the financial institutions who did not sell Lehman's structured products, but rather issued their own, are vulnerable to legal attack. While the structured notes issued by solvent financial institutions are still performing, the steep decline in the products' return due to the market decline, coupled with the lack of liquidity and fallen prices could also attract suits by unhappy investors.

The structured notes market more than doubled in 2008. Last year, $114 billion of structured notes were sold. $34 billion of such products were sold to retail investors. Eight billion dollars in notes issued by Lehman were outstanding as of September, including notes sold as late as August of this year — long after the credit markets had come under fire. Recently, such Lehman notes were trading at 10 to 14 cents on the dollar, according to press reports.

Plaintiffs Attorneys Targeting Structured Notes

Plaintiffs attorneys have already focused on structured notes as a source of potential litigation. At least three putative class actions against UBS and certain officers and directors of Lehman recently have been filed in the Southern District of New York, alleging Sections 11 and 12 liability for misstatements and omissions regarding Lehman's financial position in the offering documents for the notes. (These matters are discussed in greater detail below.) Over a dozen plaintiffs firms have posted on the Internet, advertising their interest in representing investors who purchased such notes. For example, plaintiff counsel Jake Zamansky posts on his firm's Internet site:

> [O]ver the past few months Wall Street had trouble selling traditional bonds at attractive interest rates. So instead, as sub-prime losses mounted, they concocted structured products that masked the risk by tying them to other securities, indexes or some other basket of stocks or bonds. Indeed, Lehman Brothers was one of the most prodigious issuers of principal protected notes and UBS was one of the biggest brokers selling them.
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> The selling points of Lehman Brothers principal protected notes were that the principal was "100 percent guaranteed" and they had "uncapped appreciation potential." This was as close — investors were told by their brokers — to a "sure thing" that ever comes along. But the problem was that the guarantee was only good so long as the issuer remained solvent. ...
>
> Look for Lehman Brothers principal protected notes to be a headline grabber in the weeks to

come. If you have lost money in a Lehman structured note, or principal protected note or structured product issued by another brokerage firm please call Jake Zamansky for a free consultation.

There can be no doubt that these structured products could potentially lead to class-action lawsuits, customer arbitrations and state and Federal regulatory actions. We believe it is important for financial institutions involved in the underwriting and sales of these products to stand ready to address all three fronts.

To best assess the risk and defense of potential litigation in this area, we suggest taking the time up front to understand how your firm marketed structured products externally (if it did) as well as how it evaluated the associated risks internally, especially if you were involved in the underwriting of Lehman Structured Products. In developing the facts, you may want to consider the types of facts plaintiffs have explored and exploited in prior structured product litigation including:

- Any potential inconsistencies between public-facing marketing materials and internal company analyses, statements or reports regarding the credit worthiness of Lehman and the viability or merits of the Lehman Structured Products. For example, what recommendations did bond and equity analysts make for Lehman during the relevant time period and how did these compare to the marketing materials? What did the individuals involved in the underwriting say in their internal emails?

- Firm compensation for the sale of the products can also come under fire, especially in regulatory actions and arbitrations. How were brokers paid to sell structured products? What incentives did they have to sell the various products?

- Another area of potential inquiry concerns the marketing materials and information the selling brokers had in hand. What information was provided to customers? Was the material kept current?

- What due diligence was conducted? Where a firm was an underwriter but not the issuer, it could have a due diligence defense. It is important to understand what documentation exists regarding the firm's evaluation of its underwriting risk, along with the reasons it decided to sell, not sell, or limit its sales of structured products, including Lehman-issued products, over time. By preparing a detailed chronology, a firm can understand what it knew at the time of each new issuance. This is key as securities claims must be evaluated based on what the parties knew at the time of sale, not in hindsight.

- What valuations were provided to customers? Were the valuations marked to market or marked to model? It is also important to understand how defendant financial institutions valued any securities held on their own books and records, and whether these internal valuations were consistent with those provided to customers. In addition, plaintiffs lawyers like to focus on potential inconsistencies between a firm's proprietary trading and the sale of these securities to clients.

- Plaintiffs lawyers also like to employ New York state law's "duty to disclose based on superior knowledge" in structured products cases. The case law says, in essence, that a party who has superior knowledge of a fact and knows that its counterparty is relying to its detriment on a contrary fact must disclose the fact. *See Bank of New York v. Bram Mfg. Corp.,* 803 N.Y.S.2d 17 (N.Y. Sup. 2005); *Societe Nationale D'Exploitation Industrielle Des Tabacs et Allumettes, v. Salomon Brothers,* No. 113154/96, 1998 WL 35183123 at *1 (N.Y. Sup. 1998); conf'd, 268 A.D.2d 373, 274 (1st Dep't 2000). Defenses to this claim focus on rejecting the imposition of such a duty — the defendant firm did not have any superior knowledge, it had no knowledge that plaintiff was relying on anything contrary to that "superior knowledge," plaintiff had the requisite information, and/or there was no reasonable reliance.

Illustrative Actions

Since October 31, 2008, at least three actions have been filed against UBS in the Southern District of New York based on its underwriting of Lehman

Structured Products. On October 31, 2008, the Lovell Stewart Halebian firm filed a purported class against UBS and the officers and directors of Lehman Brothers on behalf of Anthony Peyser based on Section 11 claims for the purchase of a Return Optimization Securities with Partial Protection issued in March 2008. In the *Peyser* complaint, plaintiff alleges that the statements in Lehman's registration statements were materially inaccurate because at the time of the offering "Lehman was already suffering from severe adverse factors that were not adequately disclosed in the Prospectus or any public filings incorporated therein by reference."

Similarly, on November 6, 2008, the Kaplan Fox & Kilsheimer firm filed a purported class action complaint on behalf of Stephen Gott. The *Gott* complaint seeks Section 11 and 12 liability against UBS and the officers and directors of Lehman Brothers based on 100% Principal Protection Notes issued in May 2008. Plaintiff alleges that UBS filed offering documents "which materially misstated or omitted certain material facts relating to an investment in Lehman Principal Protection Notes including the risk that LBHI would be unable to repay at maturity the guaranteed return of principal on the Lehman Principal Protection Notes."

Finally, on November 19, 2008, the firm of Zwerling, Schecter & Zwerling, LLP, filed a purported class action on behalf of Enrique Azpiazu. The *Azpiazu* complaint asserts Section 11 and 12 liability against UBS and the officers and directors of Lehman Brothers based on 100% Principal Protection Notes that were issued in May 2008. Plaintiff alleges that UBS and the other defendants "fail[ed] to disseminate a Registration Statement and Prospectus ... that fully and accurately disclosed to investors all material facts relating to investing in the Principal Protection Notes and regarding the financial condition of Lehman, the issuing company." In addition, plaintiff alleges that defendant filed offering documents that contained "materially inaccurate statements and omissions relating to Lehman's true financial condition and the risks of investing in the Principal Protection Notes."

These complaints are likely to be the first of multiple claims filed by the plaintiffs bar, which will be subject to lead plaintiff motion practice and possible amendment before the claims take their final form.

Overview of Section 11 and Section 12(a)(2)

Section 11 and 12 claims are a favorite weapon of the plaintiffs bar because, in their pure form, they do not require many of the trickier elements required to prove securities fraud claims, such as scienter or causation. Under Section 11, the plaintiff must establish that a material fact in the registration statements was false or misleading, or that material information required to be included in the registration statements was omitted. Securities Act § 11(a), 15 U.S.C. § 77k(a) (2000).

Purchasers from the issuer generally need not show reliance, and consequently, need not have read the registration statement or prospectus to establish Section 11 liability. *See In re U.S. Fin. Sec. Litig.*, 64 F.R.D. 443, 455 (S.D. Cal. 1974). An open market purchaser, however, who purchases any time after the company has generally made available income statements covering the period of 12 months immediately following the effective date of the registration statement must establish reliance. *See* Securities Act § 11(a), 15 U.S.C. § 77k(a) (2000). Reliance here does not require that purchasers actually read the registration statement — the plaintiff need only establish that the misstatements or omissions in the registration statement were a substantial factor in their purchase of the security. *Id.*

Under Section 12(a)(2), a claim which often accompanies Section 11 claims, the plaintiff must establish that the prospectus was false or misleading with respect to a material fact, or that material information required to be included in the prospectus was omitted. *See* Securities Act § 12(a)(2),15 U.S.C. § 77l(a)(2) (2003).

Possible Defenses

A. <u>Plaintiff's Claims Sound in Fraud</u>

A threshold argument may be made that the complaints are in essence fraud claims, and as such must still be plead under the heightened pleading standards for fraud. *See Rombach v. Chang,* 355

F.3d 164, 170-71 (2d Cir. 2004) ("while a plaintiff need allege no more than negligence to proceed under Section 11, claims that do rely upon averments of fraud are subject to the test of Rule 9(b)"). Importantly, where a Section 11 claim sounds in fraud, Rule 9(b) may require that plaintiffs make a proper allegation of fraudulent intent. *Id.* at 170; *In re Philip Services Corp. Sec. Litig.,* 383 F.Supp.2d 463, 481 (S.D.N.Y. 2004) ("the considerations for applying Rule 9(b) to a conventional fraud claim 'apply with equal force' to Section 11 claims [sounding in fraud]…The Second Circuit has interpreted Rule 9(b) to require that a securities fraud complaint allege, inter alia, facts giving rise to 'a strong inference of fraudulent intent' and state with particularity the facts constituting the alleged fraudulent conduct.").

For example, defendants may analogize these three complaints with the complaint in *Lamden Partners,* a case wherein the court applied the heightened pleading standards of Rule 9(b) to Section 11 and 12 claims against underwriter defendants because the underlying theory of liability sounded in fraud. *See Ladmen Partners, Inc. v. Globalstar, Inc.,* No. 07 Civ. 0976 (LAP), 2008 WL 4449280 at *12-13 (S.D.N.Y. Sept. 30, 2008). The district court held that the allegations against the underwriter defendants were "inextricably interwoven with suggestions that they deliberately turned a blind eye to known deficiencies in Globalstar's satellite network." *Id.* In a number of allegations of essentially fraudulent conduct, the complaint made "no effort whatsoever to distinguish the Underwriter Defendants from Globalstar and the Individual Defendants." *Id.* And there is, of course, the chance that subsequent complaints on the horizon will allege fraud, exposing defendant firms to potential Section 10(b) and Rule 10b-5 liability.

B. <u>No Materiality</u>

Claims may be dismissed at an early stage where a plaintiff fails to show that the misstatement or omission in the offering documents was of a "material fact." To establish liability, the omitted information or the alleged truth misstated in the offering documents would have to have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. *Schoenhaut v. American Sensors,* 986 F.Supp. 785, 790 (S.D.N.Y. 1997). Courts have dismissed Section 11 and Section 12(a)(2) claims on "immateriality" grounds in the following relevant contexts:

- Alleged nondisclosure of a trend that was observable to an investor through publicly available information.
- Alleged failure to disclose management "concerns" that were contingent or speculative.

Analysis can be done to determine whether the misstatements alleged were either observable through publicly available information or speculative at the time the securities were issued.

C. <u>Adequate Disclosure</u>

Defendants may argue that the offering documents were not misleading because they disclosed the risks involved. For example, defendants can point to the fact that the security at issue in *Peyser,* the 424B Pricing Supplement filed on March 28, 2008, warned investors that "[a]n investment in the Notes will be subject to the credit risk of Lehman Brothers Holding Inc., and the actual and perceived creditworthiness of Lehman Brothers Holdings Inc. may affect the market value of the Notes." (March 28, 2008 424B Pricing Supplement at 5.) The security at issue in *Gott,* the 424B Pricing Supplement filed on January 1, 2008, disclosed the same (January 1, 2008 424B Pricing Supplement at 6), as did the security at issue in *Azpiazu*. (January 30, 2008 Form 424B2 Pricing Supplement at 6.)

D. <u>Forward Looking Statements</u>

If the alleged misrepresentations are forward-looking statements accompanied by cautionary language as defined by the Private Securities Litigation Reform Act ("PSLRA"), they may fall into the PSLRA safe harbor and be subject to dismissal. Forward-looking statements include (1) statements containing a projection of revenues, (2) statements of the plans and objectives of management for future operations, and (3) statements of future economic performance. Even if statements or omissions at issue technically do not fall into the PSLRA safe harbor, statements that are projections of future performance or opinions are not material "facts" that can be false under a Section 11 claim. *Rombach v. Chang,* 355

F.3d 164, 173 (2d Cir. 2004) (alleged misrepresentations, including opinions or projections, are "immaterial as a matter of law" in Section 11 claims "[if] it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same offering.") (*quoting Halperin v. eBanker USA.com,* Inc., 295 F.3d 352, 357 (2d Cir. 2002).) In the *Peyser* complaint, plaintiff asserts that the "Prospectus failed to disclose that the weakening credit and mortgage markets ***could*** result in the potential that Lehman had overvalued billions of dollars of its asset positions and the effect that ***would*** have on Lehman's credit rating." (Complaint at para 32; emphasis added.) One can argue that such alleged omissions are the type of forward-looking statements that cannot constitute an omission of material fact.

E. <u>Due Diligence</u>

Defendants other than the issuer possess an affirmative due diligence defense. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 208 n. 26 (1976). Under the due diligence defense, a defendant underwriter can escape liability if it can demonstrate that "reasonable steps" were taken to verify that which was reasonably verifiable. *Escott v. BarChris,* 283 F.Supp. 643, 682 (S.D.N.Y. 1968); *see also Feit v. Leasco Data Processing Equip. Corp.,* 332 F.Supp. 544, 576-77 (E.D.N.Y. 1971). Underwriters must demonstrate that a reasonable investigation was made based on its own inquiry of that which was reasonably verifiable.

F. <u>Class Certification</u>

Arguments against class certification in Section 11 and Section 12(a)(2) cases focus on defeating typicality, commonality, predominance, and adequate representation requirements. In other words, the arguments focus on individualized issues of how plaintiffs differ from the purported class, and how members of the purported class differ from each other. Some potential arguments include:

- Differences in the disclosures available to various plaintiffs. Were different marketing materials or valuations available to different purchasers? After-market purchasers would have received materials at different times and potentially from different financial institutions.
- Showing that the lead plaintiffs or members of the class knew the "truth" may potentially defeat the adequacy of representation or commonality requirements. The fact that public information about Lehman's financial condition changed over time and that after market purchasers are included in the class and could have bought after the "truth" was disclosed helps these arguments.
- Differences in purchase/sale dates. Courts have frequently declined to exclude "in and out" traders from a class at the certification stage. *See, e.g. In re Flag Telecom Holdings, Ltd. Securities Litigation,* 308 F.Supp.2d 249 (S.D.N.Y. 2007). However, material differences in purchases and sales — for example, sales before the alleged fraud was discovered and before the concurrent price drop, or purchases before the alleged misrepresentation — may have some bearing on shaping the class.

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Given current market conditions, additional lawsuits, investor arbitrations and possible regulatory action involving the sales of structured products may soon emerge. Kirkland & Ellis LLP is positioned to address the various litigation and regulatory risks arising from the issuance and sale of structured notes and other derivative products that are the subject of attack as a result of current market conditions. We can provide a deep bench in all areas of concern as we have extensive experience in (a) litigation of structured products and class actions, (b) defense of retail securities arbitrations, (c) representation of financial institutions before a myriad of federal and state regulators, and (d) coordinating matters across these legal arenas in an effective and efficient manner.

Indeed, Kirkland has handled more than a hundred securities arbitrations dealing with a wide variety of claims including issues of concentration, options, margin, lockups, conflicts of interest, research, sales practices, fraud, suitability, supervision, and fiduciary duty. We have successfully litigated in federal and state courts the sale and marketing of even more complex structured products such as CBOs and CLOs (among others) to individual investors. We also have a wealth of regulatory experience, ranging from representing financial institutions before the various federal and state securities regulators, to handling trials against the Massachusetts Securities Division and the Delaware Securities Commission.

We would be interested in discussing with you in greater depth the issues discussed above. We look forward to the opportunity to provide greater strategic insight and guidance on these very important issues.

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