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**PARALLEL LEGAL SESSION**

**Investment Opportunities Amid Financial Turmoil**

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## I CAPITAL MARKETS IN DISARRAY

*The collapse of the mortgage-backed securities market has had a profound impact on a wide range of credit-linked investment structures, and on the debt markets and the equity markets generally. Longstanding valuation models are in question, creating a paralysis within the investment community.*

***How could such a circumstance have been triggered? Several scholarly efforts have been made to explain all of this. In lieu of such a presentation, see the "Subprime Primer", which provides a more intuitive analysis.***

## II INSTITUTIONAL INVESTORS CHANGE THEIR TACTICS

*To an extent almost unthinkable before, institutional investors are putting long-standing relationships aside and taking on major investment and commercial banks to recover investment losses, including lost investment opportunities. The Supreme Court has curbed the liability of Wall Street institutions for securities fraud, but, as the current Clear Channel litigation demonstrates, state court recourse is alive, and well, and extremely dangerous. Also see the recent article by Herrick attorneys which explores prospective trends in institutional investment strategies.*

***The Supreme Court makes the world safer for securities fraud defendants by rejecting "scheme liability".***

In 1993, the Supreme Court held, in its *Central Bank* decision, that the private right of action for securities fraud, long maintained by federal courts under Section 10(b) of the U.S. Securities Exchange Act of 1934 and Rule 10b-5 thereunder, did not incorporate aider and abettor liability. As a result, institutions and companies only secondarily involved with the public offering of an issuer could no longer be sued in connection with material misstatements of fact and omissions of material fact made in connection with such public offerings. Rather, a



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defendant could only be held liable under Rule 10b-5 if its separate conduct satisfied each element necessary for the establishment of securities fraud liability under Rule 10b-5.

The *Central Bank* decision came as a great disappointment to plaintiffs (and their counsel) seeking a "deep pocket" to cover losses from investment in the securities of an issuer which was often insolvent by the time fraud claims were asserted. Over the years since *Central Bank,* several legal theories seeking to make secondary actors liable as primary violators of Rule 10b-5 have advanced through the federal court system. One of the more prominent theories is that of "scheme liability"; *i.e.* that secondary actors should be liable under Rule 10b-5 when they engage in conduct with the purpose and effect of creating a misrepresentation of material fact to further a scheme to make material misrepresentations to investors. Rule 10b-5 liability should hold against such secondary actors, it is argued, even when the actors themselves did not make direct misrepresentations to the investors--normally a requisite element of liability.

In January of this year, the Supreme Court soundly rejected the doctrine of scheme liability, maintaining, in accordance with *Central Bank,* that the separate conduct of each party liable under Rule 10b-5 must satisfy all of the requisite elements for a violation of Rule 10b-5. *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc., et al.* was filed by investors of Charter Communications, Inc., a cable operator, who alleged that Charter fraudulently inflated its stock price by engaging in a "sham transaction" so that its quarterly financial statements would meet Wall Street expectations for cable subscriber growth and operating cash flow. The plaintiffs claimed that Charter executives, realizing the company would miss its projected operating cash flow numbers by $20 million, decided to meet the shortfall by entering into arrangements with two of Charter's cable box suppliers whereby Charter would overpay the cable box vendors by $20 million, with the condition that the vendors would return the overpayment by purchasing advertising from Charter at a price higher than fair value which Charter then recorded as revenue. Charter capitalized the purchase of the cable boxes in violation of generally accepted accounting principles, which allowed the company to mislead its auditor into approving its financial statements showing that Charter had met its projected revenue and operating cash flow numbers.

Charter's stock price fell when it was disclosed that the company faced criminal investigation for alleged fraudulent activities. Plaintiffs filed suit against the *vendors* alleging that they entered into the sham transactions knowing that Charter intended to account for them improperly, thereby violating Section 10(b) and Rule 10b-5.

The issue before the Court was the meaning of Section 10(b) and Rule 10b-5 which bars market actors from using any "manipulative or deceptive device or contrivance…in connection with the purchase or sale of any security…." The Rule prohibits the use of "any device, scheme or artifice to defraud" and makes it unlawful to engage in any act or course of business which operates or would operate as a fraud or deceit upon any person," in connection with the sale or purchase of stock.

The plaintiffs argued that the law permitted it to sue the vendors who participated in the fraudulent scheme, not as aiders or abettors, but as "primary violators" who were ultimately tied to the market movements in Charter's stock price. The defendants, on the other hand, argued that although they participated in the transactions, they had no involvement in the preparation or review of Charter's financial statements and further that they did not make any statements to Charter's investors or accountants and had no duty to do so.

The Court found that the defendants had no duty to disclose; and that their deceptive acts were not communicated to the public. Further, no member of the investing public had knowledge, either actual or presumed, of the defendant's deceptive acts during the relevant times. The Court noted that it was Charter, not the defendants, that misled its auditor and filed fraudulent financial statements and nothing defendants did made it necessary or inevitable for Charter to record the transactions as it did. As a result, plaintiffs could not show reliance upon any of defendant's actions except in an indirect chain that the Court found too remote.

This decision reflected the Court's intent to limit exposure to private securities fraud class action litigation to those who are directly responsible for making false or misleading statements to the investing public. The Court noted that a ruling to the contrary would have improperly extended liability from conduct connected to the securities markets and the financing of companies "into the realm of ordinary business operations," meaning the whole marketplace in which a company does business.

In making its decision, the Court was influenced by the practical consequences of permitting such an expansion, the effects of which would expose a new class of defendants to risks of securities litigation. As a result, contracting parties might find it necessary to protect against these threats which would raise the costs of doing business. The Court also noted that a decision to the contrary could result in overseas firms with no prior exposure to U.S. securities laws being deterred from doing business in the United States which would ultimately raise the cost of being a publicly traded company under U.S. law and shift securities offerings away from domestic capital markets.

***The Clear Channel Investors Chase the Banks into State Court.***

In coordinated legal actions filed in state courts in New York and Texas, Clear Channel and the several major private equity investor groups sponsoring its leveraged buyout have brought suit against several major financial institutions which had committed to provide the financing for the proposed transaction. In the New York filing, the plaintiffs allege that the defendant banks breached their contract, made in the form of a commitment letter in 2006, to provide $22 billion in financing for the $26 billion acquisition of Clear Channel, a major radio media and outdoor advertising firm based in San Antonio, Texas. According to the complaint, the defendant banks agreed to underwrite the leveraged financing in a highly detailed commitment letter which contained no conditions relating to material adverse changes in the capital markets. Moreover, the defendant banks agreed to maintain their commitment for the transaction until June 2008, thus assuming the risk of market deterioration through such time. The plaintiffs awarded the financing mandate to the defendant banks on the basis of their superior bid; apparently no other lending group submitted a financing bid without a market condition. In exchange for their commitment, the defendant banks obtained the right to payment of transactional fees in the aggregate amount of $400 million.

The plaintiffs allege that, after the capital markets began to deteriorate in June of 2007, the defendant banks employed several tactics for the purpose of reneging on their lending commitments: first, by threatening to interfere with independent transactions between the plaintiff equity groups and the defendant banks; second, by trying to renegotiate the terms of the lending commitments, which were conceded by the banks to be binding; and third, by presenting credit documentation which was materially inconsistent with the terms of the commitment letter.

Alleging that capital market degradation has rendered the lending commitments of the defendant banks "unique" in the marketplace, the plaintiffs have requested the court to award specific performance; i.e. a court order compelling the defendant banks to honor their lending commitments in accordance with their terms. Alternatively, the plaintiffs have demanded an award of damages, principally for breach of contract. Although the claim for damages is open-ended, the plaintiffs allege that breach of contract by the defendants will result in the liability of the plaintiff investor groups to Clear Channel for a $500 million merger termination fee. The companion action filed in Texas state court cites much of the same behavior but frames the claim as an action in tort for tortious interference with the merger agreement, thus opening the door to a claim, to be presented to a jury, for punitive damages.

The defendants have yet to respond to these allegations, and truth generally lies somewhere between adverse litigation parties. But the request of the plaintiffs in the first instance for a court to order the transactions to be consummated, and only secondarily for damages, lends a significant amount of credibility to their claims. This leaves us with questions: Why would the defendant banks risk liability for breach of contract damages in excess of $500 million? Why would the defendant banks risk liability for an award of punitive damages by a jury? And why would the defendant banks risk damage to their valuable franchises as leading, reputable financial institutions?

The answer may lie in a cold, calculated evaluation of comparative risk: the defendant banks allegedly informed the plaintiffs in January 2008 that consummation of the transactions would result in immediate losses to the banks of approximately $2.65 billion, based upon their likely inability to resell the leveraged loans in the current market environment and based upon their obligation to "mark to market" loans retained on their balance sheets to prevailing secondary prices for comparable leveraged loans. Such losses would far outstrip the quantifiable damages alleged by the plaintiffs.

Alternatively, it may be that the defendant banks presumed, erroneously, that major private equity firms with established institutional relationships and a history of collaboration on dozens of deals would never confront the banks with such serious legal actions. In fact, it is common knowledge that in other times equity investor groups have acceded to lender requests for modification or discharge of lending commitments on the basis of changes in the market, even when the banks had no contractual rights supporting such requests. The Clear Channel litigation therefore represents a notable change of strategy for the equity investor groups as well: instead of deferring to established lender relationships and the prospects of future investment collaborations, the investor groups insisted upon reaping the benefits of the bargain in this one deal, without regard to the preservation of institutional relationships.

Although the Supreme Court has curbed the liability of Wall Street institutions and other third parties for securities fraud, the Clear Channel litigation demonstrates that state court recourse is alive and well.

## III THE REGULATORS LOOK FOR REGULATORY SOLUTIONS

*The capital markets crisis generally, and most immediately the government-sponsored "bail-out" of Bear Stearns, prompted the release by the U.S. Department of Treasury of a proposal for a comprehensive restructuring of the regulation of the financial markets in the United States. Meanwhile, the U.S. Securities and Exchange Commission, never shy over jurisdictional matters, is expected to increase its surveillance over "unregulated" hedge funds and their "unregulated" investment managers.*

***The U.S. Treasury proposes an "objectives-based" regulatory approach for the financial markets.***

The Treasury proposal published in the wake of the Bear Stearns bail-out would replace the current functional system, which focuses on the type of financial service business being regulated, with an "objectives-based" system which would focus on the regulation of distinct forms of systemic risk.

Under the optimal regulatory structure envisioned by the Treasury, three distinct regulators would focus solely on financial institutions: a market stability regulator, a prudential financial regulator, and a business conduct regulator. In addition, there would be a separate corporate finance regulator.

The Treasury recommends several initial and intermediate steps. First, the Treasury proposal supports the formation of a new Mortgage Origination Commission to oversee state regulation of mortgage originators. The Treasury also recommends consolidation of federal regulatory functions for federal thrift institutions and for state-chartered banks. A new regulatory function should be created for oversight of payment and settlement systems in the financial markets. Federal regulation of insurance companies should be instituted. The Securities and Exchange Commission and the Commodity Futures and Trading Commission should be merged in order to consolidate federal regulation of securities and commodity futures.

In connection with the last intermediate proposal, Treasury is essentially suggesting that the SEC be conformed to the regulatory model of the CFTC. That would entail conversion from a rules-based regulatory model to a principles-based model, expanded reliance on self-regulatory organizations ("SROs") and their rule-making processes, and liberalization of the Investment Company Act to permit public trading of investment funds and products currently available in the U.S. and other world markets. Treasury also advocates the overhaul of regulation of investment advisers to conform to the regulatory model for broker-dealers, including the establishment of an SRO.

The Treasury proposals have already come under attack from proponents of enhanced market regulation who interpret them in part as an evisceration of regulatory protections currently in place. There is no assurance at this time that they will be taken up by Congress in their present form.

***The SEC seeks to expand the scope of civil liability for unregistered investment advisers.***

In July 2007, the SEC adopted Rule 206(4)-8 under the Investment Advisers Act of 1940. This new anti-fraud rule prohibits both registered and unregistered investment advisers from (1) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (2) otherwise defrauding these investors.

This regulatory initiative followed an earlier effort by the SEC to extend its regulatory oversight to most investment managers of hedge funds. The SEC had sought to eliminate the "private investment adviser" exemption for hedge fund managers by requiring them to count the investors in their hedge funds, rather than the hedge funds themselves, as "clients" for purposes of the 15-client threshold which triggers the adviser registration requirement. The federal courts rebuffed the SEC in *Goldstein v. Securities and Exchange Commission,* holding that the SEC had exceeded its authority in imposing this new counting rule on investment managers. The *Goldstein* decision not only created uncertainty with respect to the SEC's authority to regulate hedge fund advisers but also called into doubt the SEC's ability to rely on the general anti-fraud provisions of the Advisers Act to bring actions where investors in hedge funds, for example, were defrauded by the advisers to the funds.

Rule 206(4)-8 is the SEC's response to *Goldstein* and is intended to prohibit any and all fraudulent acts perpetrated by any investment manager, registered or unregistered, on investors in any managed fund, registered or unregistered. Under the Rule, "it shall constitute a fraudulent, deceptive or manipulative act, practice, or course of business...for any investment adviser to a pooled investment vehicle to...(1) make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

The SEC thus seeks to circumvent the *Goldstein* decision by an expansive interpretation of its enforcement, rather than its supervisory, authority. In its release adopting the Rule, the SEC interpreted the Rule to hold investment managers to a standard of conduct based on negligence, rather than willful misconduct or reckless disregard. Such an interpretation is inconsistent with common law concepts of fraud and also with the Supreme Court's interpretation of virtually identical language in Rule 10b-5. Moreover, it raises the likelihood of more confrontational exchanges between unregistered investment managers and the SEC, because the SEC lacks the option of investigating adviser conduct through its supervisory powers to conduct inspections. Finally, there is at least a suspicion among the investment management bar that the SEC may be tempted to use the pretext of a negligence-based enforcement proceeding to impose regulatory-type conditions on unregistered advisers; *e.g.* is it "negligent" for an unregistered investment adviser not to have the written compliance policies required of registered investment advisers, or to maintain the books and records which registered investment advisers are required to maintain?

## IV INVESTMENT MANAGER LIABILITY EXPOSURE MAY BE TRENDING UPWARD

*Thanks to a 1979 Supreme Court case interpreting the Investment Advisers Act, investment managers for unregistered funds and for managed accounts have not worried too much about the risk of lawsuits brought by private plaintiffs. Will that lack of concern continue to be justified as potential plaintiffs (and their potential counsel) digest the recent holding of the Supreme Court in LaRue v. DeWolff, Boberg & Associates, Inc.?*

***The Supreme Court permits participants in ERISA plans to sue plan fiduciaries for personal investment losses.***

Recognizing a change in the landscape regarding the relationship between employers administering employee benefit plans and the plan participants, a recent decision by the U.S. Supreme Court unanimously held that *individual participants* of defined contribution plans, such as 401(k) plans, may sue fiduciaries for personal losses under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which regulates most corporate employee benefit plans in the United States. This decision reverses that of the Fourth Circuit, which held that only suits to recover losses on behalf of an entire plan, rather than losses to a participant's individual account, are permitted under ERISA.

*The Case.* In *LaRue v. DeWolff, Boberg & Associates, Inc.*, James LaRue sued his employer, DeWolff, Boberg & Associates, Inc. ("DeWolff"), as plan administrator of the company's 401(k) plan. He claimed that DeWolff breached its fiduciary duties under ERISA when it failed to follow LaRue's investment directions for his 401(k) plan account, and caused the account to lose approximately $150,000.

*Fourth Circuit.* Relying on language in the Supreme Court's 1985 decision *Massachusetts Mutual Life Ins. Co. v. Russell*, the Fourth Circuit held that Section 502(a)(2) of ERISA provides remedies only for entire plans, not for individuals. The Fourth Circuit reasoned that LaRue was seeking relief only to recover losses to his individual account and not for the entire plan.

*Supreme Court.* Writing for the Court, Justice Stevens drew a distinction between traditional defined benefit plans and the defined contribution plan maintained by DeWolff. Justice Stevens noted that both the disability plan involved in *Russell* and the typical pension plan promise participants a fixed benefit. Misconduct by an administrator of a defined benefit plan will not affect an individual's entitlement to a benefit unless it creates or enhances the risk of default by the entire plan. For defined contribution plans, however, fiduciary misconduct need not threaten the solvency of the entire plan to reduce a participant's benefit.

The Court explained that defined contribution plans now "dominate" the landscape of retirement plans and that the "entire plan" language, which does not appear anywhere in Section 502(a)(2) of ERISA, does not apply to defined contribution plans. The Court noted that fiduciaries would not have any liability for losses in an individual account if it concluded otherwise. Accordingly, the Court held that Section 502(a)(2) of ERISA does authorize individual participants to sue for breaches of fiduciary duty that impair the value of plan assets in a participant's individual account.

*Implications for Investment Managers.* Once upon a time, investment managers for U.S. clients did not focus much concern on the risk of private suits by advisory clients for investment losses. A long-standing Supreme Court case holds that advisory clients do not have a private right of action to sue investment managers under the U.S. Investment Advisers Act. Moreover, relatively few investment managers were subject to the fiduciary standards of ERISA. An ERISA fiduciary includes investment managers who manage assets of ERISA plans, but the assets of mutual funds and other registered funds are deemed not to be ERISA plan assets. Moreover, hedge funds were traditionally structured to limit ERISA plan investors to less than 25% of fund assets, thereby exempting the fund from the definition of "plan assets" and the fund manager from the ERISA fiduciary rules. Therefore, for the most part, only investment managers who managed the accounts of ERISA plans would be considered ERISA fiduciaries, and recourse of plan participants was limited under prior law as described above.

However, investment managers now aggressively seek investment mandates from ERISA funds, both by expanding their managed accounts business and also by opening hedge funds to unlimited investment by ERISA plans. Concurrently, 401(k) plans protected under ERISA increasingly offer separate managed accounts and hedge fund investments on their "investment menus". In light of *LaRue*, a prudent investment manager should now take into account, in managing its own liability risks, the prospect of private plaintiff suits, and class actions, arising from investments of 401(k) plan participants.

## V REFERENCE MATERIALS TO BE MADE AVAILABLE BY TAGLAW ONLINE

A The Subprime Primer.

B *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc.,* 552 U.S. ___ (2008).

C *BT Triple Crown Merger Co., Inc. et al. v. Citigroup Global Markets Inc., et al.,* Verified Comp., March 26, 2008.

D Irwin A. Kishner and Brooke E. Crescenti, "US private equity firms forced to re-evaluate strategies", *Financier Worldwide,* Mar. 2008.

E Executive Summary, *The Department of Treasury Blueprint for a Modernized Financial Regulatory Structure,* Mar. 2008.

F Pooled Investment Vehicles Rule, 17 C.F.R . §275.206(4)-8 (2007).

G *LaRue v. DeWolff, Boberg & Associates, Inc., et al.,* 128 S. Ct. 1020 (2008).