Silence is Golden: *Stoneridge* Decision Deals a Blow to Investors’ Scheme Liability Claims

*By Jai K. Chandrasekhar*

On January 15, 2008, the Supreme Court issued a significant and, unfortunately, anti-investor decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06-43, about the scope of “scheme liability” claims against third parties for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Regrettably, the Supreme Court affirmed — by five to three, with one Justice not participating — the dismissal of investors’ claims against defendants who engaged in sham transactions that had the purpose and effect of enabling a company to issue false financial statements. The majority opinion is, we believe, poorly reasoned, contrary to law, and driven by the majority’s acceptance of misguided policy arguments from corporate lobbyists who waged an aggressive political campaign to restrict investors’ rights.

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The Supreme Court majority in *Stoneridge* engaged in illogical, circular reasoning. Investors’ right to sue under Rule 10b-5 is an “implied” cause of action, that is, the 1934 Act does not expressly provide for private suits under Section 10(b), but the courts — including the Supreme Court — have recognized for decades that Congress intended to allow investors to bring private actions under this statute. The question in *Stoneridge* was whether that longstanding cause of action applies to third parties who defraud investors. The majority of the Court, however, simply assumed that the cause of action does not apply to those third parties, repeatedly suggesting the investor to issue false financial statements. The majority opinion is, we believe, poorly reasoned, contrary to law, and driven by the majority’s acceptance of misguided policy arguments from corporate lobbyists who waged an aggressive political campaign to restrict investors’ rights. Despite this disappointing, anti-investor result, which is likely to prevent victims of fraud from recovering their losses in many meritorious cases, we believe that the Court’s opinion should not prevent investors from recovering their losses in some scheme liability cases with facts different from those of *Stoneridge*.
plaintiffs were trying to “expand” the scope of the law. Thus, the majority’s reasoning began from a false premise.

The majority also rested its decision on the theory that the investors, when they decided to buy the issuer’s securities, did not “rely” on the third parties’ conduct. This theory was not argued by the defendants in the lower courts, was not the basis of the lower courts’ rulings, and was not the focus of defendants’ brief in the Supreme Court. Rather, this theory was introduced only at the last minute in a brief by the Solicitor General of the United States, who rejected the Securities and Exchange Commission’s request that the government file a pro-investor brief in Stoneridge, and instead filed an anti-investor brief. Thus, the investor plaintiffs were not given a fair opportunity to develop their arguments against this theory. As Justice Stevens’ forceful and well reasoned dissent pointed out, the fair and proper course for the Supreme Court would have been to remand the case for the lower courts to reconsider under the majority’s new standard. Instead, the majority affirmed the final dismissal of the case without allowing the investors a fair chance to argue their position.

The Supreme Court majority also devoted considerable space in its opinion to parroting arguments by corporate interest groups, who argued that allowing investors to sue fraudsters will somehow harm the American capital markets. But liability for parties that commit securities fraud does not harm American competitiveness; rather, investors’ faith in the integrity and safety of U.S. markets is what makes those markets strong.

The impact of the Supreme Court’s Stoneridge decision will only become known as lower courts interpret and apply it in other cases. The ambiguities, faulty reasoning, and anti-investor rhetoric of the majority opinion may lead lower courts to interpret Stoneridge as a broad repudiation of investor rights. Judges who interpret Stoneridge broadly may dismiss meritorious cases.

Continued on page 11.
By Tony Gelderman and Bruce W. Leppla

As we look back at 2007, we see historic meltdowns in the United States financial sector. The S&P Financial Index declined over 20% for the year and many of the largest investment banks lost nearly 50% of their market capitalization (see chart at right). The collapse of our financial sector has caused a major credit crisis and recessionary worries throughout the economy worldwide.

These declines in value, and the billions of dollars of associated investor losses, are not linked to classic Adam Smith notions of business cycle expansion and contraction, but rather are the direct consequence of the current “subprime loan” scandal — a completely “man-made” economic fiasco. This fiasco has been driven by a chain of greed — starting with the loan underwriters and their sales force that pushed inappropriate home loans on consumers, to the complicit appraisers who conjured up values to ensure that consumers could qualify for such loans, to the bankers who were willing to ignore underwriting standards to book such loans and earn commissions, ending with the investment bankers who packaged and sold the doomed loans to investors without disclosing the associated risks. In other words, the current wave of massive investor losses is not the result of a failed business model, or a paradigm shift in technology, or some other, natural economic force, but rather was caused by the market’s gradual realization that Wall Street bankers have been knowingly and fraudulently selling into the market CDOs and similar securities backed by worthless or near worthless subprime loan collateral.

In total, the major investment banks have taken nearly $80 billion in subprime-related writedowns to date — with potentially more to come.

However, it will be shareholders who bear the brunt of the losses — not the Wall Street executives who facilitated the fiasco. Investment firms and public companies will continue to pay their top executives oversized bonuses. For example, a Bloomberg article recently estimated that the bonus pool at the five largest investment banks would total a record $39 billion for 2007 — a year in which the shareholders in the securities industry lost over $200 billion in equity. These firms include Merrill Lynch and Bear Stearns, both of which experienced huge losses in subprime related securities. To be sure, at least three high-profile firms have dismissed their chief executives but, with Charles Prince and Stanley O’Neal receiving some $40 million and $162 million in stock awards and pension benefits, respectively, on their departures, it can hardly be said that heads have rolled.

These breathtaking payouts underscore the need for reform in executive compensation in order to return accountability to corporate America. For example:

- O’Neal’s payout at Merrill Lynch is only in the middle of the top 10 “golden goodbyes” for corporate CEOs, shown in the table on page 4. Incredibly, executives from at least 4 of these 10 firms departed because of mismanagement (Home Depot and Merrill), outright scandal (UnitedHealth), or bringing a company to the brink of bankruptcy (Conseco).

- More shocking — the top executives at 16 firms with potential subprime losses have contracts that entitle them to severance packages totaling $1 billion, or more than $60 million each, on average. This figure takes into account the decline in stock value seen so far and its impact on executive stock-based compensation.

- A Forbes article published in May 2007 concluded that the chief executives of America’s 500 largest companies received a collective pay raise of 38% in 2006 alone even though the total return on the S&P 500 was only 15.8% in that same year. In dollar terms, the average CEO received a $15.2 million raise.

Unquestionably, companies have become increasingly more generous to executives, with outsized salary, options and severance packages. But, how did executive compensation become so untethered to...
The firms paying these bonuses and the individuals receiving the largest figures are those at the highest levels — the very people who failed to exercise due diligence in vetting the credit and underwriting standards and practices of sub-prime lenders in recent years.

These same firms and individuals aggressively and knowingly sold high-risk investments to pension funds without fully disclosing the investments’ inherent risks.

Against this backdrop, the effort to undermine shareholder rights and loosen corporate accountability measures has gained traction. In the past year, at least four high-profile quasi-public interest groups, funded by Wall Street investment banks or their lobbyists, published “studies” concluding that the U.S. financial markets are becoming less competitive than foreign markets because of overly restrictive regulation or excessive litigation. All four recommend similar “solutions” to this crisis, including liability caps for auditors, more lenient standards for outside directors, “clarification” of several elements of securities fraud to favor corporate defendants, and the possibility of requiring arbitration in securities litigations. One group even advocates jettisoning rules-based accounting in favor of “principles-based” accounting, where auditors would apply a sort of “sniff test” to a company’s presentation of its financial results. Taken together, the recommendations — if adopted — could substantially weaken options for legal action when fraud occurs. At bottom, the recommendations only serve to further insulate corporate executives and directors from accountability.

While the subprime scandal continues to wipe out billions of dollars of shareholder value creating the most illiquid, distressed markets in years, the investment banking industry shamelessly takes care of itself. Now, as before, better oversight, governance and regulation remain the most important safeguards to keep our markets open, fair, and honest against those who would profit through exploitation.

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Top Ten Golden Goodbyes

<table>
<thead>
<tr>
<th>Company</th>
<th>CEO</th>
<th>Year</th>
<th>Est. Payout in $ millions</th>
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<tbody>
<tr>
<td>Exxon Mobil Corp.</td>
<td>Lee Raymond</td>
<td>2006</td>
<td>$351</td>
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<tr>
<td>Pfizer Inc.</td>
<td>Hank McKinnell</td>
<td>2006</td>
<td>213</td>
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<tr>
<td>Home Depot, Inc.</td>
<td>Robert Nardelli</td>
<td>2007</td>
<td>210</td>
</tr>
<tr>
<td>Gillette Co.</td>
<td>James Kilts</td>
<td>2005</td>
<td>165</td>
</tr>
<tr>
<td>Merrill Lynch &amp; Co., Inc.</td>
<td>Stanley O Neal</td>
<td>2007</td>
<td>162</td>
</tr>
<tr>
<td>UnitedHealth Group Inc.</td>
<td>William McGuire</td>
<td>2006</td>
<td>153</td>
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<tr>
<td>WellPoint Health Networks</td>
<td>Leonard Schaeffer</td>
<td>2005</td>
<td>137</td>
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<td>SouthTrust Bank</td>
<td>Wallace Malone</td>
<td>2006</td>
<td>135</td>
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<tr>
<td>Morgan Stanley</td>
<td>Philip Purcell</td>
<td>2005</td>
<td>94</td>
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<tr>
<td>Conseco Inc.</td>
<td>Stephen Hilbert</td>
<td>2000</td>
<td>73</td>
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4 of 10 departed for mismanagement, scandal or bringing company to brink of bankruptcy.
The SEC Pulls the Rug out From Under Investors

By Deval R. Karina Zaveri

Although investors of financial stocks have endured one of the toughest years on record, hope of being able to replace directors at poorly performing companies was shattered on November 28, 2007, when the Securities and Exchange Commission (the “SEC”) adopted an amendment to SEC Rule 14a. The new amendment limits shareholder access to company proxies by allowing companies to prevent shareholders from nominating their own director candidates.

Shareholder access to director ballots, or “proxies” — a protection long sought after by shareholder advocacy groups — is especially important because it is the most efficient and cost-effective way for shareholders to hold directors accountable for their performance. Without such access, shareholders must propose their own separate slate of directors in their own proxy, a prohibitively expensive endeavor. This amendment is a particularly devastating blow because, as set forth below, it occurred right after shareholders had made significant progress in winning proxy access rights after a lengthy legal battle.

In December 2004, the American Federation of State, County & Municipal Employees Pension Plan (“AFSCME”) submitted a proposal to AIG for inclusion in the company’s 2005 proxy statement. The proposal, had it been adopted by a majority of AIG shareholders, would have amended AIG’s bylaws to require AIG to publish the names of shareholder-nominated candidates for director positions. AIG sought input from the SEC’s Division of Corporate Finance, the group within the SEC that handles investor disclosure matters, regarding whether it could exclude AFSCME’s proposal from its proxy statement. The Division issued a “no-action” letter indicating that under Rule 14a-8(i)(8), AIG was free to exclude the investor proposal. AIG did just that. AFSCME then filed a lawsuit in the U.S. District Court for the Southern District of New York seeking to compel AIG to include the proposal in its proxy statement. The District Court ruled against AFSCME and AFSCME appealed to the Second Circuit.

The Second Circuit reversed the District Court and pointed out that from 1976, when the SEC last amended Rule 14a-8(i)(8), through the early 1990s, the SEC interpreted the Rule as AFSCME did, to only limit shareholder proposals “dealing with an identified board seat in an upcoming election.” According to the Court, the SEC changed course without explanation in the late 1990s, and in its amicus brief advanced the position that the Rule applied to proxy access proposals. Because the SEC offered no explanation for the change of course, the Court concluded it was most prudent to defer to the SEC’s original interpretation of the Rule and permit shareholder access to proxy statements.

Shortly after the AIG decision, business lobbying groups began a campaign to get the SEC to amend Rule 14a. In response, the SEC publicly announced that the ruling was causing “uncertainty” and, on that basis, hosted three public roundtable discussions. Notably, only three companies had filed no-action requests with the Division regarding shareholder proxy proposals after the AIG decision. Two of the three companies withdrew their requests, and the Division took a “no view” position on the third request. The company that submitted the third request ultimately included the proxy access proposal on its ballot, and it did not receive a majority of shareholder votes. Despite this record, the SEC never explained the basis for the “uncertainty” it attributed to the AIG decision.

Based on the public roundtable discussions, two diametrically opposed proposals were submitted to the SEC. One proposal advocated limiting proxy access to shareholders with a 5% stake in the company. The Council of Institutional Investors argued that “a measured right of [proxy] access would invigorate board elections and would make boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors, and more vigilant in their oversight of companies.” The other proposal, supported by the Business Roundtable and U.S. Chamber of Commerce, sought to abolish shareholder proxy access altogether. The corporate lobbying groups disingenuously claimed that increased proxy access would favor unidentified “special interest groups” and would hurt individual investors.

Having heard testimony from both sides, the Commissioners voted 3-1 in favor of the amendment to limit shareholder access. The new Rule 14a-8(ii)(8), which became effective January 10, 2008, allows corporations to exclude a

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Continued on page 12.
Nov. 19, 2007

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Office ("GAO") has concluded that the concentration of the
A recently published report by the Government Accountability
with 208 deals compared with 202 in New York. The Financial
time frames this year, according to a
percent increase from the year before. Bloomberg News,
royal capital markets, New York is set to surpass London in the IPO
SEC Sanctions Fall to the Lowest Levels Since 2002
In 2007, the SEC, led by Chairman Christopher Cox extracted
$1.6 billion in fines and illicit profits compared with more than
$3 billion in each of the previous three years, according to a
report issued by Cox. The steep decline is likely attributable to
the impact of the Paulson Committee, Cox, and Republican
Commissioner Paul Atkins’s strong belief that the costs of fines
are borne by shareholders. The Commission now weighs "the
presence or absence of a direct benefit to the corporation and
the degree to which the penalty will recompense or further
harm injured shareholders." The decline may also be partially
attributable to a procedure set up this year which requires that
the agency’s enforcement staff seek approval from commis-
sioners before negotiating corporate fines. Previously, SEC
attorneys could enter into settlement talks without obtaining
permission in advance. Significantly, former Commissioner
Campos, who stepped down in September, does not believe
that the lower penalties imposed by the SEC indicate that there
is less fraud. Indeed, the SEC brought 656 cases in 2007, a 14
percent increase from the year before. Bloomberg News,
November 19, 2007

New York Raising More Money than London Through IPO’s
Despite falling slightly behind London in raising money
through IPO’s in the past three years and great turmoil in the
capital markets, New York is set to surpass London in the IPO
race for 2007. New York has raised more than $52 billion on the
NYSE and Nasdaq through stock market debuts — a level not
seen since the dotcom boom, while London has raised more
than $4 billion through debuts on the London Stock Exchange
and AIM. However, London did surpass New York in terms of
the number of companies that have come to market this year,
with 208 deals compared with 202 in New York. The Financial
Times Limited, November 25, 2007

GAO Recommends No Limits to Auditor Liability
A recently published report by the Government Accountability
Office ("GAO") has concluded that the concentration of the
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Deloitte, PricewaterhouseCoopers, KPMG, Ernst & Young and
other accounting firms, the GAO concluded that legal liability

Poison Pill Disappearing
The poison pill, a device designed to allow corporations to
fend off unwanted acquirers by flooding the market with
shares to dilute their stakes, but also used by corporations to
prevent shareholders from removing directors, is disappearing
from many Fortune 500 companies. Only 20% of Fortune 500
companies still have a poison pill, and one-third of those are
up for renewal in the coming year. The disappearance of poi-
son pills can be attributed, at least partially, to institutional
investors and activist shareholders, who, because they regard
poison pills as unfriendly and potentially harmful to share-
holders, have voted to remove such poison pills from

PCAOB Orders $1 Million Fine Against Deloitte & Touche LLP
in First-Ever Enforcement Case Against a Big Four Accounting
Firm
In its first-ever enforcement action against a Big Four accounting
firm, the Public Company Accounting Oversight Board ("PCAOB") fined Deloitte & Touche LLP ("Deloitte") $1 million and
censured the firm in connection with its audit work of
Ligand Pharmaceuticals Inc. ("Ligand"). Deloitte had signed
off on Ligand’s financial statements for fiscal year 2003, but
Ligand later restated its financial results for 2003 and other
periods because its recognition of revenue on product ship-
ments did not comply with GAAP. Ligand’s restatement
slashed its reported revenue by about $59 million and boosted
its net loss in 2003 by more than 2 1/2 times. The PCAOB found
that Deloitte had failed to exercise due professional care in the
performance of the audit and failed to obtain sufficient comp-
petent evidential matter to support the opinion expressed in
the audit report. Specifically, the PCAOB found that Deloitte
did not conduct the required audit procedures to analyze
Ligand’s ability to make reasonable estimates of future prod-
uct returns. Since its formation in 2003, the PCAOB has
brought 14 enforcement actions against individuals and 10
against firms, all of which involved smaller accounting firms.
The Wall Street Journal, November 11, 2007

Corporate Whistleblowers Get Raw Deal
Since the passage of the Sarbanes-Oxley Act in 2002 — which
offers corporate whistleblowers protection from retaliation —
approximately 1,000 claims have been filed by employees
alleging that they suffered retaliation after reporting misconduct,
but only 17 have been found to have merit, according to U.S. Department of Labor. Of those 17 cases, only six have been upheld after full hearings before administrative law judges. To obtain relief under Sarbanes-Oxley, an employee claiming retaliation for reporting corporate fraud must first file a claim with the Occupational Safety and Health Administration (“OSHA”), the agency charged with investigating initial complaints. Employees can proceed to federal court if OSHA has not issued a final decision after 180 days, or they can appeal to an administrative law judge if they disagree with OSHA’s finding. In order to be protected, information from corporate whistleblowers must relate to one of three things: (1) a violation of securities fraud; (2) a fraud on shareholders; or (3) a violation of rules and regulations set by the SEC. The law specifies, however, that an actual violation does not need to be reported, only that an employee must “reasonably believe” that a violation occurred. The National Law Journal, October 29, 2007

U.S. Stock Exchanges Losing Immunity

Traditionally, U.S. stock exchanges have been shielded from liability purportedly because they were serving a quasi-governmental function. Recently, however, U.S. stock exchanges have become publicly traded companies with market capitalizations in the billions of dollars. As a result, courts such as the U.S. Court of Appeals for the 11th Circuit and the U.S District Court for the Northern District of California have held that U.S. stock exchanges no longer have immunity from investor claims of losses. In the 11th Circuit case, a shareholder claimed that it would not have invested in WorldCom if Nasdaq had not touted WorldCom as a good investment in newspaper and television ads, despite knowing that WorldCom failed to meet Nasdaq’s listing standards, and that Nasdaq failed to disclose its potential financial interest in touting WorldCom stock. The shareholder claimed that by touting WorldCom as an investment, it was no longer acting as a regulatory organization and instead was acting as an organization that markets stock in order to encourage and maintain listings. The 11th Circuit agreed, and held that Nasdaq was not protected by absolute immunity. Similarly, in the California case, a private investment partnership sued Nasdaq, claiming that it lost millions when Nasdaq inaccurately calculated its Nasdaq-100 Index. The California court held that, because Nasdaq’s activity with regard to the Nasdaq-100 Index was neither regulatory nor adjudicatory, but for the purpose of generating trading volume and profit, it was not entitled to immunity. Dow Jones, October 31, 2007

Turnover Rate for CEOs and CFOs Tied to Restatements

According to a report entitled “Corporate Governance Consequences of Accounting Scandals: Evidence from Top Management, CFO and Auditor Turnover” by two University of Alabama professors, there is nearly a 10 percentage point gap between the adjusted turnover rate for finance chiefs at companies reporting lower earnings in a restatement (50.4%), compared to CFOs at non-restating companies (46.17%) and a 14% difference among CEOs (46.17% versus 31.73%). The magnitudes of these effects were found to be even larger for restatements that are more serious, have worse effects on stock prices, or result in negative restated earnings. However, according to the report, audit firms are no more likely to be replaced by a company that restates. The report examined a sample of 518 U.S. public companies that announced earnings-decreasing restatements during the 1997-2002 period and compared it to a sampling of similarly situated (in terms of both industry and size) companies that had not issued restatements. CFO.com, November 19, 2007

U.S. Companies Allowed to Used GAAP instead of IFRS in European Union

The Commissioner of the European Union International Market has announced that the EU will allow American companies based in Europe to continue to use GAAP instead of switching to internal accounting standards. Earlier this year, the SEC announced that it would accept International Financial Reporting Standards (“IFRS”) for foreign companies based in the United States. AccountingWEB.com, November 29, 2007

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The Fingerprints of Fraud in the Mortgage Mess

By Jon Worm

The subprime mortgage meltdown over the past year has sent shockwaves throughout financial markets worldwide, wiping out billions of dollars in investor equity, ruining personal credit and, all too often, putting people out of their homes. Did the U.S. housing market experience an “irrational exuberance” of its own or were more sinister forces at work. As the morass deepens, it is becoming clear that the problems can be traced back to a decade ago when the mortgage lending industry underwent a period of radical change and rapid growth, presenting irresistible opportunities for fraud.

Beginning in the early 1980s, regulations and business practices in the mortgage industry changed significantly. Lenders made billions by selling ill-suited financial products to over-extended or unworthy borrowers while subverting — or ignoring altogether — their own lending standards. Lenders and investment banks packaged the doomed loans, securitized them, and sold the mortgage-backed securities (“MBSs”) off to unsuspecting investors. These investors have lost massive sums of money as their investments were nowhere near as solid as the bond issuers originally represented.

The subprime crisis has led to a tightening of credit in the capital markets in the U.S. and worldwide, and many experts predict the subprime meltdown will leave the country in recession. Over the past year, the Federal Reserve has struggled to stave off recession by lowering the prime interest rate three times, and most recently taking additional drastic measures. Unfortunately, the impact on global capital markets is likely to get worse before recovery can begin. Currently, more than 15 percent of subprime adjustable rate mortgages are more than 90 days past due, and the number of foreclosures has risen sharply over the past several quarters. Subprime mortgages originated from late 2005 to early 2007 are performing the worst. Projections indicate that over 1.5 million adjustable rate subprime mortgages are scheduled to reset to higher interest rates over the next year. Various estimates suggest that up to two million homeowners are in danger of losing their homes through 2009.

While the fallout from the subprime meltdown worsens, the true extent of the corporate malfeasance at its root is just beginning to be revealed.

The Securitization of Subprime Mortgages

Until recently, the mortgage market consisted almost exclusively of traditional banks lending money to creditworthy borrowers for 30-year terms and at fixed interest rates, under very conservative loan-to-value ratios. In contrast to these “prime” mortgages, after changes to applicable laws and regulations in the early 1980s, lenders began loaning to borrowers who had a higher credit risk. Beginning in the mid-1990s, the “subprime” mortgage industry exploded, with subprime loans making up approximately 20 percent of the $3 trillion mortgage market as of 2006. The origination and servicing fees from these loans — and the profits for banks and lenders — were enormous.

Other factors contributed to the explosion in subprime lending. Technological advances made assessing risk easier and reduced the cost of lending to higher risk borrowers. More importantly, however, the secondary market for selling mortgages expanded significantly, introducing complexity, shifting risk, and adding players to the process.

Wall Street also began to set up more complicated derivative structures, known as collateralized debt obligations (“CDOs”). As a simple example, to form a CDO, a bank would pool large numbers of MBSs, combine them with other asset backed securities, and securitize them again into bonds. The CDOs are split into tranches, each offering a bond with a different level of risk and return. The riskiest tranches suffered the first
losses when the underlying loans defaulted, while bonds from the least risky tranches were rated as very safe, even though at base they were backed by subprime loans.

Mortgage lenders were able to sell huge numbers of loans by introducing a dizzying array of financial products, each more exotic and risky than the last. Such products include:

- **Adjustable Rate and Interest Only Loans** — Allow people to get into homes they may not be able to afford by keeping their monthly payments low for a short period (5 years or less).

- **Low or No Documentation Loans** — Also called “stated income” or “liar loans,” these products rely on income and asset information provided by the borrower without independent verification. About 45 percent of subprime loans originated in 2006 were not fully documented.

- **Negative Amortization Mortgages** — Also called “pay option” mortgages, these products permit borrowers to make payments that do not pay the entire interest payment or any principal, as the unpaid interest is added to the principal.

Lenders also relaxed other important lending criteria, such as increasing the loan-to-value ratio for loans, sometimes originating mortgages for more than one hundred percent of the value of the property, and selling multiple products — such as a primary note and a home equity line of credit — to the same borrower secured by the same asset.

**Fraud Begets Crisis**

The expansion of the secondary market for mortgages allowed unregulated lenders to enter the industry, as securitization allowed lenders to finance themselves by selling their loans to investors, expanding the market to non-depository institutions. Similarly, mortgage brokers play a large role in subprime origination, connecting borrowers with lenders, especially with regard to borderline borrowers. As of 2005, stand-alone mortgage companies and mortgage brokers, unregulated by the federal government, originated over half of all subprime mortgages. Lack of federal oversight likely contributed to loosening of lending standards.

Along with the lack of oversight, the new lending paradigm created strong financial incentives for lenders to weaken or ignore underwriting standards and originate and sell more loans. The loans were quickly sold off to third parties, shifting the risk of default to purchasers of the mortgages and, subsequently, to investors in MBSs. Similarly, because mortgage brokers and lenders’ in-house originators worked on commission, they were incentivized to originate as many loans as possible, regardless of quality. Appraisers colluded with loan originators by validating inflated home values, as originators pressured appraisers to appraise homes at exaggerated values that would allow loans to close, thereby increasing loan volume. All of these players had the incentive to originate as many loans as possible, and many resorted to improper conduct. Put simply, 

While the fallout from the subprime meltdown worsens, the true extent of the corporate malfeasance at its root is just beginning to be revealed. The pattern is eerily similar to past abuses, such as misuse of reserves (Computer Associates), use of off-balance sheet entities to hide losses (Enron), improper capitalization practices to hide ordinary line costs (WorldCom), and more recently, backdating of stock options (UnitedHealth). Will the subprime era come to be known as the next wave of corporate fraud?
a significant portion of borrowers entered into loans that they had no hope of repaying.

Investment banks and other financial institutions joined in the frenzy with their increasing need for mortgages to securitize and sell. Historically low interest rates forced investors to seek higher returns from low risk investments, and traditionally risk-averse investors began to purchase large numbers of CDO bonds, which were marketed as safe. Thus, thanks to increasingly complicated securitization into MBS and CDO structures, and thanks to aggressive marketing of the bonds by Wall Street, subprime originators had a market for even their riskiest mortgages. Along the way, firms collected huge fees, leading to higher stock prices and massive executive compensation.

Additionally, investment banks invested directly in the subprime mortgage business. Some purchased companies that originated and serviced mortgages, and some formed complex off-balance sheet investment vehicles, which in turn invested in mortgages and securities backed by mortgages.

The Collapse

The entire subprime machine churned along as rapidly appreciating home prices and low interest rates masked the burgeoning problems — even if a borrower could not afford to make his or her payment, he or she could refinance into a new mortgage or sell. The machinery screeched to a halt, however, once home price appreciation slowed and interest rates rose. Mortgage defaults shot up, and lenders and investment banks revealed that they had underestimated the risks of default.

As a result, the market for CDO bonds dried up, and banks were stuck with subprime mortgages and CDOs that they could not sell. Given the multiple levels of repackaging, the CDOs and other complex investment vehicles were relatively illiquid, and banks had resorted to mathematical models to price them. As it turns out, the banks had overvalued the mortgages and related securities. These overly positive valuations allowed for inflated earnings, causing share prices to increase and executives to collect massive compensation packages that were largely tied to stock performance. Once mortgages started to fail at increased rates, however, banks were forced to disclose their exposure to the subprime market and began to take losses. Some revealed that they had created off-balance sheet entities to invest in the subprime mortgage market. In many instances, banks were required to bring losses from these entities onto their balance sheets, compounding losses.

The market has reacted drastically to these disclosures. For example, following Citigroup’s writedown of billions of dollars tied to mortgage-backed investments, its stock declined 30 percent, wiping out roughly $70 billion of market capitalization. Merrill Lynch’s stock price also sharply declined following similar disclosures and writedowns.

The Aftermath

While the extent of the meltdown is still unsettled, the scramble to staunch the bleeding has begun. President Bush and Treasury Secretary Paulson recently announced an agreement with the mortgage industry to freeze interest rates for up to five years for some homeowners who bought homes with subprime loans over the past couple of years. The plan contains many limitations, however,
We believe, however, that Stoneridge, if properly interpreted by the lower courts, should allow investors to pursue securities fraud claims against third parties that engage in deceptive conduct, as long as information about the defendants’ deceptive conduct is publicly disclosed and relied on by investors. The Supreme Court held in Stoneridge that “the implied right of action in Section 10(b) continues to cover secondary actors who commit primary violations.” Thus, Stoneridge affirms that Section 10(b) and Rule 10b-5 impose primary liability on secondary actors who engage in deceptive conduct upon which investors rely. Such claims may be viable against financial market participants such as investment banks, accountants, and lawyers that join an issuer in engaging in deceptive conduct about which public disclosures are made to investors.

The defendants in Stoneridge were outside “suppliers” and “customers” of the issuer of the securities in question in that case, and the outside parties “had no role in preparing or disseminating [the issuer’s] financial statements.” Accordingly, the Court held that “[i]n these circumstances the investors cannot be said to have relied upon any of [the vendors’ and customers’] deceptive acts in the decision to purchase or sell securities.”

Thus, Stoneridge primarily addresses the question whether scheme liability is a viable theory to hold a commercial counterparty liable for knowingly engaging in transactions that enable an issuer to misrepresent its financial statements. The Supreme Court’s decision appears to place some weight on the Stoneridge defendants’ status as suppliers and customers acting “in the marketplace for goods and services, not in the investment sphere.” Stoneridge also states that the defendants were “remote” from investors in the issuer with which they did business: “[W]e conclude [defendants’] deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was [the issuer], not [the issuer’s customers and vendors], that misled its auditor and filed fraudulent financial statements; nothing [the customers and vendors] did made it necessary or inevitable for [the issuer] to record the transactions as it did.” Thus, Stoneridge might not preclude claims against financial market professionals, as opposed to commercial customers and suppliers.

The Supreme Court also held in Stoneridge that there need not be “a specific oral or written statement before there could be liability under Section 10(b) or Rule 10b-5.” Rather, the Court held that “[c]onduct itself can be deceptive.” By acknowledging that non-verbal conduct can give rise to liability under Section 10(b), the Supreme Court rejected earlier rulings by the 8th Circuit and 5th Circuit Courts of Appeals that liability requires either a false statement, or an omission by a defendant who has a duty to speak. This aspect of the Supreme Court’s decision might allow securities fraud claims against third parties such as accountants, lawyers, and investment bankers who actively structure sham transactions for an issuer without themselves making false statements to the investing public.

It is also worth noting that Stoneridge does not limit in any way the 10b-5 liability of a securities issuer itself, and its officers and directors, when the issuer and its officers and directors make false statements to the investing public. Nor does Stoneridge in any way limit investors’ right to sue issuers, officers and directors, auditors, and underwriters for materially misleading statements in registration statements and prospectuses for public offerings of securities under the Securities Act of 1933. Stoneridge only concerns the scope of 10b-5 liability of parties other than the issuer for securities fraud affecting aftermarket trading.

In sum, we believe that Stoneridge was wrongly decided and represents an unfortunate diminution in investors’ rights, which will deny investors any recovery in many cases of serious fraud. However, the decision in this case should not prevent investors from vindicating their rights in all cases.

Hopefully, members of Congress will see the exposure innocent, defrauded investors will face in light of this decision and will act quickly to restore their remedies through legislation.

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Commissioner Annette Nazareth did not hide her disgust with the vote of Chairman Cox and her other Republican SEC colleagues, stating: “I do not see a principled way to vote for the [amendment] and claim to be supportive of shareholder rights in the longer term.”

Chairman Cox promised that the SEC will revisit the issue next year when the Commission is back to full strength. When the Commission vote was announced, Robert Feckner, President of the Board of Directors of the California Public Employees’ Retirement System, stated that “[t]his [vote] is a serious wrong turn from the Commission’s duty to adopt regulations that ‘do no harm’ to investors.” Commissioner Nazareth did not hide her disgust, stating: “I do not see a principled way to vote for the [amendment] and claim to be supportive of shareholder rights in the longer term.” Unfortunately, Commissioner Nazareth has announced plans to leave the Commission by year-end, leaving investors without their lone supportive voice.

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FINGERPRINTS OF FRAUD

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and preliminary estimates suggest that it will only reach a small percentage of recent subprime borrowers. Further, critics note that freezing the rate will only postpone the risk of default until the freeze is lifted.

Others look to punish the wrongdoers. Both California and Illinois are investigating the lending practices of mortgage bankers and brokers. Recent revelations also indicate that the bond issuers and servicers knew of the impending meltdown much earlier than they disclosed, while continuing to market their securities as safe investments. New York’s Attorney General, Andrew Cuomo, has subpoenaed major Wall Street firms, looking for details regarding their pooling and selling of subprime mortgages. He is reportedly looking into how closely the banks and bond rating agencies evaluated MBSs. Further, the SEC is investigating how companies valued their own holdings of complex debt instruments. Numerous civil suits have been filed against lenders and investment banks seeking individual and class-wide relief for investors. Meanwhile, countless homeowners are simply trying to hold onto their homes.

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