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US Focus: Time for action

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History repeats itself, again. Just when politicians and pundits declared victory over systemic corporate wrongdoing and called for the rollback of protections for investors in US securities markets, it came as no surprise to learn that corporate malfeasance is alive and well. On 22 January, 2007, when defaults and delinquencies began to rise rapidly on subprime mortgages (heralding the beginning of the so-called subprime mortgage crisis), three prominent New York politicians held a press conference in City Hall declaring that the US' burdensome regulatory structure has undermined its own global competitiveness. These politicians identified the 'onerous' burdens of the Sarbanes-Oxley Act and private securities litigation as being behind increased competition from London to attract initial public offerings. Fast-forward to 31 March this year when, in the heat of the subprime mortgage crisis and following the federal government's rescue of Bear Stearns, the US treasury secretary announced a structural shift in the regulation of financial firms, expanding — not rolling back — the federal government's regulatory role. Embarrassed, the politicians calling for curbs on already limited private securities litigation had quietly moved on to other pressing matters.

Many well-intentioned tools are used to combat systemic corporate fraud — legislation, government enforcement, greater transparency, a better educated directorship and litigation — but it seems every few years widespread financial scandal develops. Since 2007, 72 of the world's largest banks and securities firms have experienced asset write-downs and credit losses totalling \$232bn (£117bn) stemming from the collapse of the US subprime mortgage market and the misuse of securities derived from these mortgages.

To redress losses from these frauds, as well as many other non-systemic instances of corporate wrongdoing, investors have increasingly turned to the US class action. While the subprime mortgage crisis has sparked a flurry of class action lawsuits by angry investors, UK and European investors' ability to participate in US class action recoveries simply as passive class members has been put into question by the decision of a US court in *In re: Vivendi Universal, Securities Litigation*. Now, more than ever, UK and European institutional investors need to actively inform themselves and to understand their rights to benefit from US class actions and individual actions.

THE SUBPRIME MORTGAGE CRISIS

Nearly 20% of all mortgages issued in 2006 were to subprime borrowers, a 5% rise from a few years earlier. In February and March 2007, defaults began to rise rapidly on 2005 and 2006 vintage subprime mortgages, the result of the resetting of adjustable teaser rates and mortgages defaulting in their first few payments.

The subprime mortgage crisis rapidly spread. Nearly 35 mortgage lenders went bankrupt, while others had significant amounts of loans put back to them. Countrywide Financial Corp, the US' largest subprime lender, was saved from bankruptcy by a merger agreement with Bank of America. Northern Rock, the UK's fifth-largest housing lender, with a \$10bn (£5.03bn) market capitalisation in February 2007, experienced a 1920s-style run on the bank in September 2007 when word got out that it asked the Bank of England for an emergency bail-out. On 17 February, 2008, the UK Government nationalised Northern Rock.

Investment banks, which securitised pools of subprime

loans and sold them to investors hungry for high-interest payments, have recorded huge write-downs known as collateralised debt obligations and mortgage-backed securities. Banks and securities firms have suffered \$232bn in asset write-downs and credit losses.

US CLASS ACTIONS AS A MEANS OF REDRESS

International investors have suffered losses estimated in the tens of billions of dollars, but the full effects have yet to be felt. Investors undoubtedly want to recover for losses attributable to corporate malfeasance. Already 48 subprime-related securities class actions have been filed in US courts. Why the US? While the UK and various European nations are first beginning to investigate procedures to permit a group or mass action litigation device, the US class action mechanism has more than four decades of successful use and provides for the efficient handling of large, complex lawsuits. Arguably the greatest advantage of the US class action over the UK is that plaintiffs whose claims do not prevail at any point in the litigation are not required to cover the winning defendant's costs. Indeed, under federal court practice, a losing plaintiff does not even need to cover its own counsel's costs, the so-called 'no-win, no-pay agreement'. The US legal system also provides certain institutional advantages: liberal discovery; securities laws which provide a statutory measure for determining damages; automatic inclusion of all investors in the class unless they choose to opt out; and a judiciary experienced in securities fraud class actions.

THE VIVENDI DECISION

Until last year, UK and European institutional investors were able to participate in US class action recoveries as passive class members, free to assume that those actions would be brought, prosecuted and settled on their behalf. But the decision of a US court in *In re: Vivendi Universal* rang a clarion bell. Previously, UK and European investors could count on a US lead plaintiff to seek certification of a worldwide class of purchasers of the defendants securities. The court in *Vivendi*, however, accepted the defendant's argument that the court could not simply certify a worldwide class unless it determined that the court of each class member's country was 'more likely than not' to grant preclusive effect to a US class action judgment or settlement. The court reasoned that it was fundamentally

unfair to bind the defendants to a judgment or settlement, while absent class members from certain countries might be able to re-litigate the claims in their home countries, if those courts refused to grant preclusive effect to the class action judgment (an issue known as *res judicata*). The lead plaintiffs in *Vivendi* were therefore required to prove, on a country-by-country basis, that each country's court would honour a US class action judgment. Due to cost and time constraints, the *Vivendi* lead plaintiffs decided to focus on five of the world's 192 United Nations member countries (England, France, the Netherlands, Germany and Austria). The court determined that only the first three were more likely than not to give *res judicata* effect to a judgment or settlement in the case. So from an initial application for a worldwide class, the *Vivendi* lead plaintiffs were left with a four country class (including the US), and investors in the remaining 188 countries had to find other means to secure a recovery of their *Vivendi* losses, assuming they somehow even learned about the dramatically curtailed class and their exclusion from it. In all events, they could no longer simply sit back and await a settlement of the class action and simply file a claim.

Now UK and European investors cannot assume their interests will automatically be represented in US class actions, they need to proactively assert themselves in cases where they have portfolio losses. UK and European investors need to obtain information as to which class actions are proceeding with them as part of the class and those from which their countries may have been excluded. They then need to seek legal advice as to what action is warranted if they are excluded from the class, in order to recover losses.

For example, more than 90 institutional investors from countries excluded from the *Vivendi* class action have now pursued separate litigation against *Vivendi*, ensuring that their claims will be adjudicated in the US alongside the class action. A UK or European investor also can step forward and file a motion to become the lead or co-lead plaintiff and attempt to control the course of the litigation, especially to ensure that the investor's country is included in the class. Since 2006, UK and European institutional investors have made applications for appointment as lead plaintiff in 41 US class actions.

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