The Assignability of 10b-5 Claims in the Context of the Purchase and Sale of Distressed Securities

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This Client Alert may be of interest to anyone touched by the subprime/credit crunch meltdown, and especially purchasers and sellers of distressed securities. As distressed securities trade with greater frequency, some purchasers and sellers are beginning to investigate the feasibility of also including related potential securities law claims as part of the trade. If the proposed federal "Bailout Bill" passes and has its intended effect, one would expect to see markedly increased interest in this topic.

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Unsurprisingly, the credit crunch has precipitated a large number of lawsuits. According to a recent study by Navigant Consulting, in the US alone, 607 cases were filed relating to the subprime mortgage meltdown during the 18-month period ending in June of 2008. That study only covers the federal courts; adding up the number of lawsuits in the state courts as well could be staggering.

It is likely, however, that the lawsuits which have been filed thus far represent only a small percentage of the universe of investors harboring potential claims. Many investors may not have the financial wherewithal or the inclination – perhaps due to other business reasons – to file an action, even if the investor has fairly solid grounds upon which to bring a claim.

For example, suppose that an investor purchased a $1,000,000 bond, at par, in a primary offering. Suppose further, for the sake of argument, that there were material misstatements or omissions in the prospectus for that bond's issuance, that the bond's current market value is $400,000, and that the entirety of such difference is a loss solely due to the facts misstated or omitted (and not due to any other circumstances such as general market conditions, for purposes of this hypothetical). Finally, assume that at least one of the potential defendants in this scenario is creditworthy.

On these facts, it would appear that the investor has two assets: the bond (which we are further assuming for simplicity remains at $1,000,000 in face amount), worth $400,000, and a potential litigation claim (ignoring transaction costs and the inherent risks of litigation) worth $600,000.

Since we have stipulated that the investor's 10b-5 claim is both meritorious and against a creditworthy defendant, the options for such investor are as follows:

1) do nothing, and either suffer the loss or hope that someone else brings a class action;

2) bring an action; or

3) sell or assign the claim.

It has been our observation that many potential plaintiffs do not pursue Option 2 – bringing an action themselves. They view litigation as too troublesome, too expensive, or – and this is quite common – they are reluctant to sue for fear of disrupting other business relationships they may have with the potential defendant or tarnishing their good reputation. Since Option 1 leads to either no recovery or an uncertain one, we focus now on Option 3.

By assigning the claim as specified in Option 3, the assignor could presumably collect a price from the assignee (as consideration for the sale/assignment of such a claim), perhaps without the resulting damage to its other business interests, such as reputation and goodwill, which might flow from pursuing the claim itself. From the assignee's perspective, if other business interests are not a concern, there is an incentive to pursue the newly-acquired claim. Option 3 thereby may provide a mechanism for parties who are reluctant to sue, as well as parties who are eager to do so, to maximize value. As both assignor and assignee have strong motivations to create such an assignment, regardless of the unsettled state of the law on this subject (as discussed below), all parties should be cognizant of such an assignment's utility *and* inherent limitations.

Somewhat surprisingly, there is rather little case law on the assignability of 10b-5 claims. Neither the legislative history of the Securities Exchange Act of 1934 nor the Rule's Adopting Release from 1942 provide much guidance on this question. Two preliminary issues do arise in the case law and are fairly quickly dispensed with by the courts. First, is the assignability of a 10b-5 claim a matter of state law (basically under the theory that such claim is a property right and the transfer of property is usually a state law matter) or a matter of federal law? Although there turns out to be fairly strong arguments that state law should control, the weight of authority is that the assignability of 10b-5 claims is governed by federal law.

Second, is the assignment of a 10b-5 claim "automatic" when an investor sells its bond, or does the assignment need to be express? The authorities here are a bit more divided than on the state versus federal law question above, the courts have generally concluded that an assignment of a 10b-5 claim needs to be express. Certainly, in a situation where the intent of the parties was to assign the claim to the bond's buyer, it would be imprudent for the parties to rely on a theory of an "automatic" assignment", i.e., that the claims "run with the bond".

Two other more substantive issues must also be addressed: whether 10b-5 claims are in fact assignable under federal law, even if the assignment is express, and whether such an assignment is barred by the common law doctrine of champerty.

The case law on the basic issue of assignability is relatively sparse, and those cases which do exist show the state of the law to be highly unsettled. However, the existing cases underscore the potential assignability of 10b-5 claims and recognize that such an assignment could create different benefits and burdens for various transaction and litigation parties. The leading case on point, Lowry v. The Baltimore and Ohio Railroad Company (707 F.2d 721), a Third Circuit case from 1983, resulted in the Third Circuit en banc delivering a per curium opinion along with four other opinions having various degrees of concurrence and dissent. The decision is a real treat to read, and the authors of this Client Alert commend it to your attention, although it is by no means dispositive of any issues.

The key case, although not directly on point, is the Supreme Court's 1975 decision in Blue Chip Stamps v. Manor Drug Stores (421 U.S. 723). The stylized facts in Blue Chip Stamps are essentially these: a company issued a misleadingly negative prospectus and, on the basis of the overly negative disclosures, a potential investor did not buy the stock in question. The stock then took off, and the potential investor sued, alleging that it *would have* bought the stock had the prospectus been accurate. The District Court dismissed the complaint, but was reversed by the Ninth Circuit, which agreed with the potential investor and let the action proceed. On certiorari, the Supreme Court reversed, holding that a 10b-5 claim can only be maintained by a "purchaser" or a "seller" of the security, and not by a "disappointed offeree". The Court's principal reasons for dismissing the action were two-fold: first, to do otherwise would arguably expand the class of 10b-5 plaintiffs to all market participants, and, second, so expanding the class would lead to insurmountable issues of evidence – how can one prove that one "would have bought" a security had one known the truth?

Although not an assignability case, Blue Chip Stamps is the Supreme Court case closest to the issue, and would likely figure prominently in a defendant's motion to dismiss. That motion would argue that the claim must be barred since the assignee itself is not a purchaser who purchased in reliance on the misrepresentation in question. Additionally, such a defendant would argue that the misrepresentation clearly did not "cause" the assignee to purchase the security in question, and that the assignee lacked a "detrimental reliance" on the misrepresentation (if such assignee paid a post-corrective disclosure market price for the security). Regardless, the handful of assignability cases since Blue Chip Stamps all discuss that case as key jurisprudence on the issue, and they also typically discuss the tortious claim of misrepresentation (considering whether anyone other than the person actually harmed can press a tort claim).

In a case from 1991, Amerifirst Bank v. Bomar (757 F. Supp. 1365), which directly considers Blue Chip Stamps in an assignability context, the trial court in Florida distin-

guishes the questions of standing and assignment (the court characterized Blue Chip Stamps as a "standing" decision rather than an "assignability" decision). The Amerifirst court also concludes that, in any event, permitting assignability would probably not lead to the two evils identified in Blue Chip Stamps. Namely, permitting assignability would not extend the plaintiff class, it just permits Y (the assignee), in its own name, to litigate X's (the assignor) claim (which can presumably no longer be litigated by X itself).

Secondly, there would be no additional evidentiary burdens involved, since Y would be relying upon evidence produced by X and access to documents and witnesses provided by X as part of X's obligations under an effective assignment (ostensibly the same evidence, documents and witnesses X itself would have produced to pursue X's own claim). In New York (the state whose law is most likely to apply), as well as many other states, it is well settled in the common law that an assignee steps into the shoes of its assignor (see, e.g., Federal Financial Co. v. Levine, 679 N.Y.S. 2d 679 (1998)) and gains all the assignor's claims and defenses (unless otherwise stipulated under the applicable assignment). That general tenet supports the Amerifirst court's finding that the assignability of a 10b-5 claim would not open up a plaintiff class too broadly, nor would it create excessive evidentiary burdens on an assignee. Rather, the assignment simply substitutes one party (the assignee) into the same position as another once stood (the assignor).

In summary, the uncertain case law since Blue Chip Stamps seems to support the notion that 10b-5 claims may indeed be assignable in certain situations, especially when the assignment was express. The founder of modern securities law and late Harvard law professor, Louis Loss, comes to the same conclusion in his seminal treatise Securities Regulation (Louis Loss, Joel Seligman & Troy Paredes, Chapter 11, Section D(5)). Also, as Judge Gibbons writes in his opinion in Lowry, summarizing the points supporting assignability:

> The effect of making [10b-5 claims] for practical purposes unassignable will be that the marketplace cannot take into account any incremental market value which might have resulted from public information about the existence of the claim. It is true that [in the absence of assignability] the seller will retain the claim and can proceed with his own suit or await the outcome of a class action brought by someone else. That will be cold comfort, however, to a holder of a security who wants, and perhaps even needs, to sell it. Some investors can afford to speculate on the incremental market value which may be added to a security as a result of litigation, and can even afford to finance such litigation…For others in more necessitous circumstances the only practical alternative will be to realize in the marketplace what the security will bring here and now…[If 10b-5 claims are not assignable] once the sale has occurred the seller will have almost no incentive to pursue the claim.

The other substantive issue regarding assignability is the common law doctrine of champerty. For those not familiar with the doctrine, it prohibits the acquisition of claims for the purpose of litigating them, subject to many exceptions. Black's law dictionary defines champerty as:

> [A]n agreement between an officious intermeddler in a lawsuit and a litigant by which the intermeddler helps pursue the litigant's claim as consideration for receiving part of any judgment proceeds.

There is no federal law doctrine of champerty – there is a Supreme Court case from 1920 holding that federal law looks to state law with regard to champerty.

In New York (the state whose law is most likely to apply), the doctrine has been codified as Section 489 of the Judiciary Law. The case law (largely mooted for the purposes of this discussion by a 2004 amendment to Section 489, discussed further below) is fairly consistent over an almost 200 year stretch, and basically holds that an assignment is champertous only if done with the sole intent of bringing suit. Nevertheless, raising champerty as a defense could be effective, as the issue may turn on questions of intent and state of mind, which can invariably be difficult to prove.

In 2004, the Judiciary Law in New York was amended to make the champerty defense unavailable if raised in connection with a security having a purchase price of $500,000 or more. As a result, unless a 10b-5 claim is being nakedly assigned – as distinguished from being assigned along with the bond related to the claim – champerty is unlikely to be a successful defense.

Revisiting the hypothetical discussed above, the investor holding a $1,000,000 face amount bond with a market value of $400,000 and a potential litigation claim worth $600,000 may not wish to overlook the value of that claim, even if the investor itself is unable or unwilling to pursue it. To ignore the asset may be leaving a potential claim unenforced. On the flip side, any potential defendant should not necessarily feel relieved once it sees a seller sell a distressed security to a third party and thus rid itself of the investment – an investor's failure to litigate in the present will not necessarily preclude that investor's assignee from litigating vigorously at a future time.

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This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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