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Client Alert

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Federal Court Dismisses Claims Based on "Repackaged" Asset-Backed Securities

Introduction

On January 10, 2006, a federal district court dismissed class action claims asserting violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 based on alleged omissions from a prospectus for asset-backed securities offered by Lehman Brothers Inc. and other members of an underwriting syndicate. *Halberstein Investment Ltd. v. Lehman Brothers Inc.*, Case No. 04-22517 (S.D. Fla. Jan. 10, 2006). Latham & Watkins represented Lehman and the syndicate.

At issue in the litigation was a particular type of asset-backed securities — sometimes known as "repackaged" securities or "repacks"—in which corporate debt is placed into a trust which then sells certificates representing an interest in the corporate debt. The repackaged securities in this case were based on corporate debentures issued by GE Global Insurance Holding Corp. (GEGI), a subsidiary of General Electric Co. Several months after the repackaged offering, GEGI ceased filing periodic information with the SEC, an event known as an "SEC Reporting Failure," which caused the trust to be terminated. Plaintiffs brought claims on behalf of all purchasers of the GEGI trust certificates, contending that the prospectus failed to disclose the "nature and extent" of the risk of such an event. Judge Patricia A. Seitz of the United States District Court for the Southern District of Florida dismissed those claims with prejudice. The opinion is important because, although a significant number of financial institutions issue repackaged securities, only a handful of court decisions consider Securities Act claims based on such securities. This opinion provides comfort concerning the disclosure obligations relating to these securities and supports the principle that appropriate cautionary disclosures in a prospectus can help shield an issuer of repackaged securities from liability.

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Repackaged Securities

Repackaged securities are typically established using a trust that, through the secondary market, acquires securities in an issuer (the "underlying securities issuer"), and which then sells certificates representing an interest in the underlying securities. Repackaged securities enable investors to participate in the corporate bond market at attractive interest rates by issuing trust certificates in amounts smaller than the denominations of the underlying bonds (which are often $1,000 or more). Although these securities have existed for a number of years, and the SEC had issued guidance expressing approval of them, it was not until January 2005 that the SEC issued formal rules governing

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the disclosures of these and other asset-backed securities. *See* Asset-Backed Securities, 70 Fed. Reg. 1506, 1509-11 (Jan. 7, 2005).

Unlike other types of securitizations (such as securities backed by home mortgages or student loans), these transactions involve the securitization of previously issued corporate bonds that are traded on the secondary market and which have been issued by a company that files periodic reports and audited financial statements with the SEC, all of which are available to the investing public. The company issuing the underlying corporate securities generally does not participate in the offering, does not receive any of the proceeds of the offering and is not involved in structuring or marketing the transaction. As a result, the trust issuing certificates and the underwriters have no more access to information concerning the underlying securities than the public.

The SEC's rules recognize the unique aspects of these securities, including "the practical difficulties" involved in obtaining and evaluating information about an issuer with no affiliation with the re-packaging transaction. Accordingly, because the issuer of the underlying securities is required by law to make periodic disclosures in SEC filings that are publicly available to investors (*e.g.*, registration statements and Forms 10-K and 10-Q), the SEC permits, under certain circumstances, the repackaging issuer's disclosure filings to "refer to the filings of the underlying securities issuer . . . in lieu of providing the required financial information [regarding the underlying securities issuer] in the filing."

The repackaged securities' express reliance on the SEC disclosures of the underlying securities issuer is appropriate so long as the underlying issuer continues to make such filings. The SEC rules recognize the possibility that any issuer may seek to cease making SEC filings, and that a repackaging issuer would not have access to that information ahead of time:

> [I]f . . . financial information [for the underlying security] is not available, the transaction, or a portion of the transaction, would terminate, such as by distributing the pool assets to investors or selling the pool assets and liquidating the asset-backed securities. The option to terminate has developed through market practice where it is believed that the alternative of including the information in the . . . repackaging filing might become impractical or impossible.

The GEGI Repackaged Securities

The repackaged securities at issue in this case were the "Corporate Backed Trust Certificates, GE Global Insurance Note-Backed Series 2003-19, Class A-1." These securities, issued by a trust established by Lehman, represent an undivided interest in certain GEGI debt. Pursuant to a shelf registration statement and a prospectus, 1,520,000 GEGI CBTCs having $25 par value and paying 6 percent interest were issued in December 2003.

Consistent with the SEC rules, the prospectus made clear that "[a]ll information contained herein with respect to the Underlying Securities Issuer and the Underlying Securities is derived from publicly available documents." The prospectus also informed potential investors of the possibility that GEGI could elect to cease making public filings with the SEC:

> **SEC Reporting Failure**
> If the Underlying Securities Issuer either (x) states in writing that it intends permanently to cease filing periodic reports required under the Exchange Act or (y) fails to file all periodic reports for one full year (each, an "SEC Reporting Failure") and the Call Warrant Holders do not

> elect to exercise their call rights, the Depositor shall within a reasonable period of time instruct the Trustee to sell the Underlying Securities and allocate the proceeds of such . . .

Potential investors were also warned of the consequences of an SEC Reporting Failure:

> If the Underlying Securities are redeemed, prepaid or liquidated in whole or in part due to an Underlying Securities Event of Default or an SEC Reporting Failure, funds received by the Trust will be allocated to the holders of the Class A-1 and the Class A-2 Certificates in accordance with a formula which is based on the present value of the amounts due, or to become due, on such certificates. Any such allocation of funds may cause the holders of Class A-1 Certificates to receive less than they would have received if payments on the Underlying Securities were made as scheduled.

Furthermore, the prospectus included numerous cautionary statements making clear that it contained no disclosures about GEGI, and that potential investors should obtain and evaluate that information directly for themselves. It cautioned, for example:

> The prospectus supplement does not provide information with respect to the Underlying Securities Issuer. No investigation of the Underlying Securities Issuer (including, without limitation, any investigation as to its financial condition or creditworthiness) or of the Underlying Securities (including, without limitation, any investigation as to their ratings) has been made. Potential certificateholders should obtain and evaluate the same information concerning the Underlying Securities Issuer as they would obtain and evaluate if they were investing directly in the Underlying Securities or other securities issued by the Underlying Securities Issuer.

On March 16, 2004, three months after the offering of the GEGI repackaged certificates, GEGI announced, without warning, its intention to cease filing periodic reports with the SEC in order "to simplify and streamline its reporting." Lehman subsequently announced that the trust would be terminated, consistent with the prospectus. Because of market interest rate fluctuations, the value of the underlying GEGI bonds had declined at the time of the trust termination. As a result, the trust liquidation yielded $23.33 for each CBTC (which had $25 par value).

The GEGI Repack Litigation

Following the liquidation of the trust, plaintiffs initiated this litigation, contending that the prospectus omitted "the nature and extent of the risk" of an SEC Reporting Failure. Plaintiffs did not allege that Lehman or the other syndicate members had access to non-public information about GEGI. Instead, they alleged that the prospectus should have disclosed: (i) that GEGI is a wholly-owned subsidiary; (ii) that GEGI had or could have had less than 300 holders of record and thus could cease SEC filings under the applicable rules; and (iii) that the negative incentives arising from compliance with the Sarbanes-Oxley Act increased the risk of an "SEC Reporting Failure" with respect to GEGI.

Lehman and the other syndicate members moved to dismiss the claims with prejudice. The motion first argued that the certificate issuers had no duty to disclose information about GEGI, an unaffiliated entity. The case law is clear that, in order to state a claim based upon an alleged omission, a plaintiff must plead facts demonstrating that the omitted information was material and known or available to the defendant. Because these re-packaged securities represented a secondary market transaction in which GEGI was not involved, Lehman was privy to no non-

public information about GEGI or the likelihood that it could cease SEC filings. The SEC guidance existing at the time the certificates were offered, and the rules that were issued later, both support this position. The motion also relied on the extensive cautionary language in the prospectus making clear that it contained no disclosures about GEGI, and that investors should obtain such information from GEGI's public filings. In light of those cautions, Lehman and the other defendants argued that no reasonable investor could have looked to the prospectus for any information about GEGI, much less information about the possibility that GEGI could cease its SEC filings.

The Decision on the Motion to Dismiss

Judge Seitz held that plaintiffs had stated no claim under Sections 11, 12(a)(2) and 15, despite the relatively lax Rule 8 pleading standards generally applicable to such claims, because "Defendants did not have a duty to disclose the alleged omissions." The court began its analysis by explaining that a material omission is actionable only if there was a duty to disclose it, that "there is no duty to disclose, in a prospectus, all information material to the offering [of securities], and that this duty question is properly stated as 'whether defendants had a specific obligation to disclose information of the type that plaintiffs claim was omitted.'" Applying these principles to the omissions on which plaintiffs based their claims (set forth above), the court dismissed plaintiffs' claims.

First, the court reasoned that "Defendants did not have a duty to disclose that GEGI was a wholly owned subsidiary because such information was publicly available," citing well-established law. Second, the court held that "the Complaint fails to allege even one fact indicating that defendants knew or could have known that GEGI, an unrelated third party, had less than 300 holders of record." Third, the court explained that the purported omission of the increased risk of an SEC Reporting Failure because of Sarbanes-Oxley Act compliance "would require Defendants to hypothecate as to what might impact an unrelated third party's decision to cease its SEC filings," and there is no duty to do so. Moreover, because the prospectus "did not purport to assess the risks of an SEC Reporting Failure, but rather advised Plaintiffs that they should evaluate GEGI on their own," no reasonable investor could have been misled by the omission of information concerning the risk that GEGI would cease SEC filings. Based on these findings, Judge Seitz dismissed the claims with prejudice.[1]

Implications of this Decision

This decision is significant for issuers and underwriters of asset-backed securities such as the repackaged corporate bonds at issue in this case. These repackaged securities transactions would not be feasible if those issuing and underwriting them were required to make extensive disclosures regarding the underlying security issuer (which does not participate in the transaction).[2] This decision reaffirms the principle that such disclosure is not required. This ruling is critical because a contrary holding could create a duty of due diligence for repackaged securities which could not be fulfilled because the underlying securities issuer is not involved in the repackaging transaction and provides no non-public information to those issuing such securities. The decision also provides comfort that cautionary disclosures in the offering documents, making clear that no diligence was conducted and no disclosures are made about the underlying securities, can shield the issuer and underwriters of the repackaged securities from liability.

Endnotes

[1] The court also considered and rejected an argument that the prospectus failed adequately to disclose that holders of Class A-1 certificates would have their interests diluted in the event the trust liquidated because the proceeds would be shared with the Class A-2 certificate holders.

[2] It is important to note that the SEC rules set out specific circumstances in which issuers of re-packaged securities can rely on the periodic filings of the underlying securities issuer.

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If you have any questions about this *Client Alert*, please contact James E. Brandt at (212) 906-1278 or Jeff G. Hammel at (212) 906-1260 in our New York office or any of the following attorneys.

Brussels
Jean Paul Poitras
+32 (0)2 788 60 00

Chicago
John P. Lynch
Kevin A. Russell
Kenneth G. Schuler
+1-312-876-7700

Frankfurt
Bernd-Wilhelm Schmitz
+49-69-60 62 60 00

Hamburg
Ulrich Börger
+49-40-41 40 30

Hong Kong
Joseph A. Bevash
+852-2522-7886

London
John A. Hull
+44-20-7710-1000

Los Angeles
Daniel S. Schecter
Jamie L. Wine
+1-213-485-1234

Milan
Michael S. Immordino
+39 02-3046-2000

Moscow
Anya Goldin
+7-501-785-1234

Munich
+49 89 20 80 3 8000

New Jersey
James E. Tyrrell, Jr.
+1-973-639-1234

New York
James E. Brandt
Jeff G. Hammel
+1-212-906-1200

Orange County
Jon D. Anderson
+1-714-540-1235

Paris
Patrick Dunaud
John P. Lynch
+33 (0)1 40 62 20 00

San Diego
Michael J. Weaver
+1-619-236-1234

San Francisco
Darius C. Ogloza
+1-415-391-0600

Shanghai
Rowland Cheng
+86 21 6101-6000

Silicon Valley
Patrick E. Gibbs
Matthew B. Lehr
+1-650-328-4600

Singapore
Mark A. Nelson
+65-6536-1161

Tokyo
David L. Shapiro
+81-3-6212-7800

Washington, D.C.
Richard P. Bress
Kip Johnson, Jr.
+1-202-637-2200