EXECUTIVE RISKS PRACTICE

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UNCERTAINTY OVER SCHEME LIABILITY

ISSUE

Don't cut back on your legal team just yet. Scheme liability may not be gone, as many financial institutions (FIs) have been hoping. A 2008 Supreme Court decision limited the liability of FIs when clients or business partners are allegedly involved in securities fraud (scheme liability), but subsequent case law has not applied the decision as widely as expected.

Many hailed the Court's ruling in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.* as a watershed, pro-business decision. Bankers and other financial advisers (as well as lawyers and accountants) were "virtually immune from lawsuits brought by disgruntled shareholders"[1] if fraud was alleged at a third party.

The celebrations may have been premature. Case in point: the recent decision in *In Re HealthSouth Corporation Securities Litigation*, where the federal district court denied defendant UBS's motion to dismiss based on *Stoneridge*. In *HealthSouth*, the court explicitly rejected the notion that *Stoneridge* "abolished all theories of liability against 'secondary actors'" and acknowledged the existence of potential liability against outside advisers "who commit a primary violation that is communicated to the public."[2] While the global banking giant UBS plans to appeal, this decision is sobering news for FIs whose services have historically made them a prime target of scheme liability claims.

IMPACT

Banks and other financial services companies that advise public companies may still be targeted in securities claims involving clients or business partners where their advice or service has been publicly disclosed or disseminated. An exposure that financial institutions had hoped was behind them may, in fact, not be.

ACTION

Risk managers for financial services firms must recognize that potential exposure to scheme liability may play a significant role in an enterprise risk management exercise, a Basel II assessment or a simple risk profile analysis in preparation for insurance renewals. Risk managers should review their insurance policies to see if they have protection for scheme liability losses. Specific issues worth noting include:

- **Professional Liability or Errors & Omissions (E&O)** policies can have numerous exclusions, including those against claims arising out of investment banking-like activities, broker-dealer activities or liabilities related to or arising out of Securities Exchange Act exposures. Some policies simply will not include such activities in their professional services definition. Modifications to these provisions can be negotiated in certain circumstances.
- **Directors & Officers Liability** policies may contain broad exclusions that may limit any claims that "arise out of or are based upon" the ultimate financial damage incurred by a financial institution that gets trapped in a significant scheme liability situation. Unless a policy is drafted properly to minimize the effect of the exclusion, an insured may find itself unexpectedly without protection from the claims of its own shareholders.

- Given that FIs face a very tough market for some of these coverages (investment banking E&O coverage, for example), this may be a good moment for FIs to explore alternative solutions such as captives and structured placements.

The scheme liability situation may change, however, as this case makes it way through the appeals process.

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[1] "Stoneridge Ruling Shields Third Party Advisers," *BusinessWeek*, Legal Issues, January 15, 2008.

[2] *In Re HealthSouth Corporation Securities Litigation*, USDC, ND Alabama, Southern Division, Memorandum Opinion, March 31, 2009.