Private Civil Litigation Involving Collateralized Debt Obligations

Happy families are all alike; every unhappy family is unhappy in its own way.
—Leo Tolstoy, Anna Karenina

As the subprime meltdown metastasized into a generalized credit and liquidity crisis, there occurred an explosion of litigation involving securitizations and synthetic credit risk transfers. A significant focus of this litigation has been the market for collateralized debt obligations (CDOs), which from modest beginnings in the mid-1990s had grown to approximately $200 billion in annual funded issuance by the end of 2007. One year later approximately 250 CDOs had experienced events of default, and close to $70 billion of assets were liquidated, often in fire sales. Participants in CDOs have brought suit in a variety of contexts to avoid losses or seek recoveries.

CDO litigation has several basic themes. One theme involves disputes among investors and other stakeholders in CDOs over the interpretation of contractual provisions following an event of default. These arguments lay bare the conflicting interests of different tranches with distinct levels of seniority where the aggregate amount of claims exceeds the assets available for distribution. Another theme of CDO litigation involves claims by investors against underwriters, rating agencies, and investment advisers. These cases typically contain allegations of negligence, fraud, and violations of the securities laws. The third broad category of cases involves claims brought by corporate shareholders and others who did not invest in or participate in CDOs but who allege that they suffered losses caused by the defendants’ involvement in CDOs as investors, rating agencies, or in other capacities.

This article provides a brief overview of some salient structural characteristics of the market for CDOs and similar structured products that have been relevant in litigation. It then addresses some of particular types of issues relevant to lawsuits brought by investors and other stakeholders in CDOs.

Structural Characteristics of CDOs

A CDO is a closed-end pooled investment vehicle that issues multiple tranches of limited-recourse debt and equity securities and uses the offering proceeds to acquire fixed-income securities (or collateralize synthetic exposure to fixed income securities). The CDO market emerged in the mid-1990s as a means to provide investors with rated and/or leveraged exposure to professionally managed pools of fixed-income assets. CDOs can be distinguished by style. One demarcation line is between “cash” transactions, which acquire ownership or participation interests in financial assets, and “synthetic” transactions, which acquire credit or total return exposure through derivative transactions.
(Many recent CDOs are hybrids, which have both cash assets and synthetic exposures.) Another dividing line is between “market-value” transactions, which have portfolios of highly liquid short-term assets and seek to maximize the net asset value (subject to liquidation if net asset value falls below a predetermined floor), and “cash-flow” transactions, which have performance tests based on par amount and seek to minimize exposure to market value fluctuations.

The issuing entity for a CDO is excluded from the registration requirements of the Investment Company Act of 1940, typically in reliance on Section 3(c)(1) or Section 3(c)(7) thereof. Because these exclusions are available only if the issuer is not engaged in or contemplating a public offering of its securities, funded CDO tranches are typically issued and sold to qualified institutional investors in private offerings pursuant to Rule 144A under the Securities Act of 1933 and in offshore transactions pursuant to Regulation S under the Securities Act of 1933. Each tranche of debt is assigned a rating by one or more rating agencies based on the agencies’ assessment of the creditworthiness of the tranche considering the characteristics of the investment portfolio, the credit enhancement for tranche, and structural features of the CDO, with the most senior class of term obligations typically being rated in the highest rating category by one or more rating agencies at inception of the transaction.4

CDOs involve a complex web of contractual relationships, as illustrated in the exhibit to this article. Parties to a CDO typically include an indenture trustee who acts as the secured parties’ representative, performs administrative functions prior to an event of default, had has enforcement duties following an event of default. A collateral manager is engaged to select and monitor the CDO’s asset portfolio on the issuer’s behalf, to trade the portfolio investments in accordance with the restrictions contained in the indenture, and to reinvest principal payments from portfolio investments during a defined investment period that typically lasts for three to five years. Other parties to a CDO typically include a collateral administrator and derivatives counterparties, and a broker-dealer that arranges the CDO and markets the securities to investors.

Available funds are paid to CDO investors (and other parties such as service providers and swap counterparties pursuant to a contractual priority of payments. Cash flow on the investment portfolio is generally paid in order of seniority, with write-downs or realized losses generally being applied in reverse order of seniority, and with cash flow to subordinate bonds being cut off in many cases following the occurrence of an event of default. As in any other securitization, a CDO contains embedded within its structure significant potential conflicts of interest that may include conflicts between senior and subordinate investors, investors and derivative counterparties, the arranger and the collateral manager, or other service providers.

Following the occurrence of an event of default under the indenture for a CDO, the indenture trustee is normally required to liquidate the collateral if the proceeds of liquidation would suffice to pay off all obligations of the CDO above the equity. Otherwise, it is generally required to hold the collateral and apply proceeds to payment of the notes unless certain noteholders direct the trustee to liquidate the collateral notwithstanding that the liquidation proceeds may be insufficient to pay off all of the noteholders in full. Normally, the right to direct liquidation and certain other decisions belongs to the most senior class of noteholders, or the “controlling class.” The controlling class also has the right to direct other actions, such as whether to accelerate the notes following certain events of default. Notwithstanding the senior creditors’ control over remedies, many CDOs have retained collateral assets following an event of default, if only because there was no market into which to sell the assets at a reasonable price.

CDO investment portfolios have traditionally consisted of corporate bonds and loans, emerging-markets obligations, leveraged loans, and mortgage- and asset-backed securities. Beginning about 2003, many CDOs concentrated their investment portfolios predominantly in illiquid residential and commercial mortgage-backed securities. This development coincided with the beginning of the housing bubble, as policy makers sought to expand home ownership opportunities in unprecedented ways and the financial markets facilitated this objective. CDOs became important sources of liquidity for the expanded home lending market as
they increasingly concentrated their portfolios in mortgage-backed securities and ultimately in other CDOs backed by mezzanine tranches of mortgage-backed securities.\(^6\) The leveraged mezzanine tranches allowed collateral managers to enhance the arbitrage between the assets and the liabilities of CDOs, which was an increasingly important objective in an environment of very low yields and credit spreads that were associated with low interest rates and deceptively benign credit conditions after 2002.

By 2005 and 2006, structured finance CDOs tended to consist largely of Alt-A and subprime residential mortgage-backed securities as well as asset-backed securities (ABS) backed by home equity loans and lines of credit. This same period saw an explosion in the volume of synthetic and hybrid CDOs, which acquired all or a material part of the investment portfolio synthetically through credit-default swaps referencing exposures rather than through direct investments in such exposures.\(^7\)

**Selected Litigation Issues**

Although problems with CDOs have given rise to a wide variety of litigation, the most frequently disputed issues involve conflicting claims of stakeholders to assets of CDOs as well as allegations of fraud or other tortuous conduct against arrangers and other participants in structuring and marketing CDOs.

**Tranche Warfare**

Most CDO litigation has involved disputes among investors and other claimants to cash flows of structured finance CDOs following events of default. A wave of these disputes was unleashed following mass downgrades of residential mortgage-backed securities that occurred in late 2007 after Moody’s, Standard & Poor’s, Fitch, and other rating agencies determined that the loss and recovery assumptions in their models were materially flawed.\(^8\) The downgrades had a domino effect on CDOs backed by such securities because of a curious feature of many CDOs. Even though structured finance CDOs are cash-flow transactions designed to minimize the security holders’ exposure to fluctuations in the market value of the assets in the portfolio by generally requiring that the collateral be valued at par, the par amount of downgraded collateral obligations was subject to adjustment for purposes of calculating compliance with asset coverage tests. The discount for collateral obligations that have been downgraded is based on a factor that takes into effect the market value of the obligation, with the discount increasing as the downgrade deepens until in extreme cases the par value is superseded entirely by the market value for purposes of calculating compliance with coverage tests. The failure to satisfy the over-collateralization tests can result in an event of default even if the collateral is performing on a cash-flow basis.

As a result of this mechanism, many of the assets backing structured finance CDOs were required to be marked entirely to their market value at a time when the cash market saw no bids and the only observable inputs for inferring market prices were trades on the ABX credit default swap index, which largely were driven by short sentiment. In over 150 transactions, par amount adjustments of downgraded collateral obligations led to the triggering of overcollateralization tests, which in turn led to events of default. Because in many cases the downgraded tranches were still performing on a cash-flow basis or it was impossible to effect a liquidation, the event of default gave rise to a classic conflict between senior classes, which had an interest in rapidly liquidating their positions before they would incur losses, and subordinate classes that would lose all or a portion of principal if the portfolio were liquidated at distressed prices. Where collateral could not be liquidated, the senior classes sought to have cash flow cut off to subordinate tranches until the senior classes were paid in full, while subordinate investors sought to receive at least their interest from available funds. These inter-class conflicts highlight that CDO documents were in many cases ambiguous, in some cases containing mutually inconsistent rules to govern the same determination. For example, in some cases the subordination provisions of the indenture, which are generally regarded as important but boilerplate provisions, would contain language purporting to override the specific priority of payments section. This gave rise to extreme scrutiny of transaction documents for many structured finance CDOs.

These disputes assumed greater urgency in synthetic or hybrid deals where the occurrence of the event of default under the indenture entitled the counterparty
to credit default swaps under which the issuing entity had sold protection (i.e., gone long credit risk) to declare an early termination date. Because the long side of these credit default swaps was deeply out of the money, considering the market conditions at the time, the issuing entity was obligated to pay its counterparty a substantial termination payment, calculated based on the market value of the transaction. In transactions where the issuing entity had purchased protection under a super-senior credit default swap, the counterparty of that swap was typically obligated to pay such termination payments subject to reimbursement from liquidation proceeds or other amounts received as the collateral. In many of those transactions the most senior class of bonds, rated in the highest category, suffered serious erosion of principal, often in excess of 70%.

In synthetic CDOs or other transactions with derivative components, the swap counterparties are generally entitled to be paid pursuant to the same waterfall as investors. Claims of swap counterparties have lent an additional dimension to the contests over payment priority discussed above, and one case in particular has raised some very interesting issues. On February 3, 2009, Lehman Brothers Special Financing (LBSF) filed suit for declaratory judgment against Ballyrock 2007-1 CDO (Ballyrock) seeking to challenge the termination of a credit default swap and to enjoin the trustee from distributing the amount of the termination payment to Ballyrock’s investors—i.e., effectively challenging the contractual subordination of termination payments owing by Ballyrock to LBSF.

Ballyrock had entered into a credit default swap with LBSF pursuant to which LBSF bought credit protection from Ballyrock. Lehman Brothers Holdings Inc. (LBHI) had provided a guaranty for LBSF’s obligations, so an event of default occurred under the credit default swap between Ballyrock and LBSF when LBHI filed for bankruptcy protection. Shortly afterwards, Ballyrock exercised its contractual right to terminate the credit default swap, and the trustee sought to liquidate Ballyrock’s remaining assets and distribute the liquidation proceeds in accordance with the priority of payments set forth in the indenture. LBSF was contractually entitled to receive a significant termination payment because its side of the credit default transaction was deeply in the money. However, the indenture contained a standard provision that subordinated termination payments owing to a swap counterparty where the termination was owing to an event of default to which the counterparty was the defaulting party. The effect of this standard subordination provision was that the cash distributed through the waterfall would be sufficient to pay security holders but would not be sufficient to pay any part of the termination payment owing to LBSF.

LBSF claimed, *inter alia*, that the proposed distribution of funds by the indenture trustee would violate the automatic stay imposed by the Bankruptcy Code, and it raised several grounds for LBSF’s entitlement to receive the termination payment prior to holders. These included 1) that a bankruptcy of a credit support provider to the in-the-money counterparty should not be permitted to give rise to an event of default because the other side of the transaction that was out of the money was not actually relying on the credit support, 2) that a contractual provision that eliminates the in-the-money party’s gains under the swap agreement simply because the credit support provider files for bankruptcy is unenforceable because it does not attempt to approximate actual damages, but rather creates a substantial windfall to the out-of-the-money counterparty, and 3) that the subordination of its termination payment is unenforceable it because it seeks to take property of the debtor as a result of a bankruptcy filing.

This case has raised several large question marks for managers, sponsors, and investors in CDOs and other securitizations. Issues include the extent to which the Bankruptcy Code’s safe harbor from the automatic stay applies to swaps that are imbedded in securitizations with complex documentation that may govern settlement and payments outside of the four corners of the swap agreement itself. The challenge to the enforceability of the subordination of termination payments owing to a swap counterparty that is the defaulting party or sole affected party throws into question is a common feature in CDOs and other securitization transactions.

**Claims against Underwriters and Others**

Another broad category of cases brought by CDO investors involves a broad variety of claims against arrangers, rating agencies, and others involved in
structuring and managing transactions. Cases filed by investors have included “garden variety” claims that securities were mis-sold to unsuitable investors. However, they have also included a broad range of allegations of breach of contract, unjust enrichment, common law fraud and misrepresentation, tortuous breach of a duty of care, common-law fraud, and violations of the anti-fraud provisions of the securities laws. An example is a lawsuit filed on August 25, 2008 by the Abu Dhabi Commercial Bank on behalf of itself and other investors in a failed structured investment vehicle that issued notes backed by subprime mortgages. The lawsuit names as defendants Morgan Stanley, Bank of New York Mellon Corp., Moody’s, and Standard & Poor’s. The allegations include claims that the defendants misled investors about the quality of assets the structured investment vehicle bought and held, and it specifically alleges fraud, negligent misrepresentation, and unjust enrichment. Among the allegations is that the arranging bank used the structured investment vehicle as a place to dump exposures that it sought to jettison. This allegation has been central to several of the lawsuits filed.

Courts have tended to dismiss securities fraud claims arising from CDOs because of the limitations of securities law liability that attaches to the sale of securities in transactions that are exempt from the registration requirements of the Securities Act of 1933. As a result of these limitations, the purchaser of a CDO tranche is not able to assert the typical claims against the sponsor or underwriter of the CDO that it would be able to assert under Section 11 or Section 12(a)(2) of the Securities Act of 1933, were the securities sold in registered offerings. Therefore, the only effective basis for a CDO investor to state a viable claim of fraud under federal securities law is Section 10(b) of the Securities Act of 1934 and Rule 10b-5 thereunder. Under these provisions an aggrieved investor may recover damages if it can prove that the disclosures on the basis of which the investor relied were materially misleading and that the defendant knew or should have been aware of such deficiency—in legal parlance that it had scienter—and that such deficient disclosure was the proximate cause of the investor’s losses.

However, a recent decision of the United States Supreme Court has further limited this narrow basis of federal securities law liability arising from sales and purchases of CDO tranches. In the Tellabs case the Supreme Court held that the inference of scienter under the Private Securities Litigation Reform Act of 1995 must be "cogent and at least as compelling as any opposing reference of nonfraudulent intent." As a result of this heightened standard for pleading scienter in a securities fraud class action, plaintiffs have tended to allege that self-dealing and conflicts of interest, inadequate disclosure, breach of applicable portfolio investment guidelines, and the like constitute grounds for negligent misrepresentation, breach of contract, or tortious interference. However, the bar is high and cases filed so far in the United States have tended to dismiss federal securities law claims. Still, in some cases in which federal securities fraud claims have been dismissed, the court has permitted them to proceed under state “blue sky” securities law or other theories.

While litigation against those arranging or managing CDOs has involved the application of familiar legal theories in securities cases to exotic and unusually complex instruments, the defendants can be different from those in the classic securities case, as can the choice of forum in which litigation occurs. In particular, rating agencies have been central focuses of litigation. Historically, claims against rating agencies did not figure prominently in litigation arising from the offer and sale of securities because the rating agencies were generally not considered underwriters, benefited from protections under the First Amendment, and generally had few liability concerns. In the past year that state of events has been turned on its head because of the central role that the rating agencies played in rating the subprime securities at the heart of the credit crisis and because their alleged involvement in structuring transactions has facilitated theories of liability. To date, efforts to expand the liability of rating agencies have had mixed results. However, it remains to be seen whether litigation against the rating agencies will be affected by damaging disclosures that arose from the investigation by the Securities and Exchange Commission into the role of credit rating agencies in the subprime crisis. It may be worth noting that in early September 2009 the court hearing the Bank of Abu Dhabi case
rejected defenses by the rating agency defendants based on ratings being non-actionable opinions protected by the First Amendment.\(^\text{20}\)

### Conclusion

Litigation involving participants in CDOs constitutes an interesting subset of the litigation arising from securitization activity. Although in many respects similar to litigation arising from other types of securitization, it raises distinct issues. To the extent that CDOs have structural features that are distinct from those of other types of securitization, the allegations and the resolution of disputes have followed a unique path. The cases so far have shown how the distinct structural features have often had a determinative influence on the likelihood of success on the merits of particular claims. That is, of course, the nature of the beast in any litigation that turns on unique contractual provisions. Even within the same product type, individual transactions differ substantially enough that it is, and will likely remain, difficult to generalize too much about the type of claims made or their ultimate resolution.

### Endnotes

1 Many CDOs have been plaintiffs in actions against underwriters and others involved in the structuring and sale of the securities acquired by those CDOs. CDO investments have also featured in securities class action cases alleging that financial institutions did not properly disclose the extent of the risks of their participation in CDOs. This article does not address those cases.

2 A close variant is a structured investment vehicle, or “SIV,” which is principally funded with short-term obligations rather than term debt.

3 Although Rule 2a-7 under the Investment Company Act of 1940 provides a basis for exclusion from investment company status of issuers of asset-backed securities that meet certain requirements, this is very rarely relied on for managed CDOs because one of the requirements of Rule 2a-7 is that the issuer not acquire or dispose of assets for the purpose of realizing gain or avoiding a loss. This requirement is incompatible with the discretionary trading that is a normal aspect of a managed CDO.

4 In many transactions the liabilities include a class of obligations that is senior in priority to the most senior class of term obligations issued at inception. In funded form, this super-senior class would consist of a commercial paper tranche or a repurchase facility and in synthetic transactions it is often a super-senior credit default swap. Super-senior credit default swaps were often structured to absorb both credit losses on the portfolio in excess of the funded notes and termination payments owed by the issuing entity on other derivatives to which the issuing entity was party, including any credit default swaps pursuant to which it sold protection. In many cases, the super-senior swap counterparty becomes the controlling class to the extent that it has funded, and it is entitled to reimbursement before the most senior class of notes.

5 Although the first structured finance CDOs tended to include assets backed by both residential and commercial mortgage loans, this period saw the bifurcation of the structured finance CDO into two components, one of which was concentrated in securities backed by residential mortgages and home equity loans and the other of which was backed by a mix of commercial mortgage loans and mezzanine loans to commercial mortgagors as well as commercial mortgage-backed securities.

6 This concentration affected both their vulnerability to events of default and the complexion of those events of default. By late 2008 approximately 250 CDO transactions had experienced events of default. Of those, approximately 65% were structured finance CDOs that had events of default occur when downgrades of underlying mortgage-backed securities caused the portfolios to be valued at less than par, thus causing the CDOs to breach overcollateralization requirements.

7 This development began in earnest in 2005 when the International Swaps and Derivatives Association (ISDA) first published the “pay-as-you-go” form of credit default swap confirmation referencing mortgage-backed and asset-backed securities.

8 This has had follow-on consequences, including legislative proposals to increase regulation of rating agencies and to reduce the regulatory role of ratings.
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10 Section 362(b)(17) and Section 560 of the Bankruptcy Code exempt from the automatic stay certain setoff rights as well as the right to cause the liquidation, termination, or acceleration of a swap agreement in certain circumstances. Section 501(a) of the Bankruptcy Code provides that subordination arrangements are generally enforceable in bankruptcy.


14 Section 11 is by its terms applicable only to misstatements or omissions in a registration statement filed with the Securities and Exchange Commission. The United States Supreme Court has limited liability under Section 12(a)(2) to misrepresentations and omissions committed in connection with public offerings of securities. See *Gustafson vs. Alloyd Co.*, 513 U.S. 561 (1995).

15 Section 10(b) and Rule 10b-5 thereunder prohibit manipulative and deceptive conduct in connection with the purchase and sale of a security without regard to whether it is registered. The elements of a private claim under Rule 10b-5 require a showing of materiality, reliance, loss causation, and scienter. See *Aaron v. SEC*, 446 U.S. 680 (1980); *Ernst and Ernst v. Hochfelder*, 425 U.S. 185 (1976).


18 For an interesting complaint directed by a prominent investor exclusively against rating agencies, see *California Public Employees Retirement Systems v. Moody’s Corp.* et al. (Cal. Super., filed 2009).

19 Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis of the United States Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies* (July 2008). Among other information disclosed by this report was one exchange of internal communications between two analysts at one rating agency, who were concerned about whether they should be rating a particular deal. One analyst repeatedly expressed concern that her firm’s model did not capture “half” of the deal’s risk, but that “it could be structured by cows and we would rate it.”

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