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Outside Counsel

BY MARK P. ZIMMETT

A Primer on the ABCs of CDO Litigation

So, you got your first CDO case, and all you know about a CDO is how to spell it. Fear not! You have mastered (or at least came to grips with) other arcana in your career, from the rule against perpetuities and exceptions to the hearsay rule to multi-jurisdictional conflicts of law and the ISDA Master Agreement.

You can learn what you need to know about CDOs too.

Do not be discouraged that you are not a CDO specialist. Specialists will be useful to you and their counsel may even be necessary. But at the upper echelon of the legal profession, as in the military, is the generalist, as in general counsel, attorney general and general of the Army.

Ultimately, you may be called upon to explain CDO esoterica clearly and simply to a jury, to a board of directors, to a judge from a noncommercial practice background or to a general counsel who has no more experience with CDOs than you.

Remember this: "The power of clear statement is the great power at the bar," Daniel Webster.

With that introductory exhortation, let's begin.

What is it? "CDO" is the acronym for "collateralized debt obligation," often the misnomer used to describe an SPV (special purpose vehicle) or SPE (special purpose entity) that issues notes collateralized by a portfolio of diversified commercial loans, mortgages, bonds or other financial assets or a combination of them. The term "collateralized debt obligation" is a misnomer because an issuer is not an obligation. The notes it issues are obligations, but referring to a note as a collateralized debt obligation, as some do, is another grammatical offense—using a polysyllabic, extra-superfluous redundancy for a four-letter word.

A CDO's notes are issued in multiple tranches designated, for example, as senior, mezzanine and subordinate with an underlying equity tranche. Each tranche of debt has it own rating designating its priority of payment, with the more senior tranches having higher ratings, but lower yields. Cash flow from the portfolio is paid out first to the senior note holders, then to the mezzanine and subordinated note holders and then, assuming sufficient cash flow, to the equity investors. The ratings of the senior and mezzanine notes are higher than the average portfolio

Mark P. Zimmett, *of the Law Offices of Mark P. Zimmett (mzimmett@mpzlaw.com), practices general commercial, financial and international litigation.* **Herman Daniel Farrell III**, *Mr. Zimmett's associate, and* **Lauren A.B. Lipschitz,** *a paralegal assistant, helped with the preparation of this article.*

rating because of their greater assurance of payment, albeit at a lower yield. The junior note holders and equity investors bear a greater risk of nonpayment than the senior and mezzanine note holders, but they are paid at a higher yield.

CDOs are sometimes described according to why or how they are structured. For example, an arbitrage CDO is designed to generate equity payments and management fees from the hoped-for positive spread between the yield earned on the portfolio assets and the yield paid on the CDO's notes. A balance sheet CDO's portfolio contains assets transferred from the balance sheet of a sponsoring bank, which is thereby improved for purposes of calculating regulatory capital adequacy to support additional lending. A cash flow CDO is so designated because the value of its notes is dependent on the cash flow generated from the portfolio assets, whereas a market value CDO's notes are backed by the market value of its assets, and its assets may be more frequently sold to make note payments.

CDOs are also classified by the type of assets in their portfolios. To cite but few basic types of ABS (asset-backed security) CDOs, there are CBOs (collateralized bond obligations), CLOs (collateralized loan obligations) and CMOs (collateralized mortgage obligations) that may invest in RMBS (residential mortgage-backed securities) or CMBS (commercial mortgage-backed securities). In addition, there are CFOs that invest in private equity and hedge funds and TRUP CDOs that invest in trust-preferred securities.

At a more abstract level, there are CDO^2s, or CDOs-squared (CDOs that purchase the notes of other CDOs) and synthetic CDOs that invest in derivative contracts such as credit default swaps (CDSs), as distinct from cash CDOs backed by bonds and loans. A hybrid CDO has derivative contracts as well as cash assets (bonds and loans).

A multisector CDO is one with a portfolio having a combination of assets of different types or covering different market sectors.

Who Are Players in a CDO Transaction?

A CDO's structuring sponsor is typically a major commercial or investment bank, or its affiliate, with a reputation that lends credibility to the CDO, which helps to sell its notes.

The sponsor engages a manager, often its own affiliate, to manage the CDO's portfolio. Or the sponsor is found by a management firm to originate a CDO for the manager to manage.

The indenture trustee for a CDO's notes has rights, powers and responsibilities, as described in the indenture, with respect to the note holders and the portfolio assets in the event of a default. The trustee may also issue reports to the note holders and perform other administrative functions.

Monoline insurers, such as ACA Financial Guaranty Corp., Ambac Financial Group Inc., Financial Guaranty Insurance and MBIA Inc. are so-called because historically they generally issued only one type of coverage, municipal bond insurance. In recent years, however, the monolines also insured tens of billions of dollars of CDO notes by entering into credit default swaps with the CDO sponsors, sometimes the CDOs or occasionally the note holders. With the current debt crisis threatening CDO defaults, the monolines are in jeopardy of defaulting on billions of dollars of swap obligations far exceeding their capital and, therefore, their ability to honor their commitments.

The credit rating agencies (CRAs), of which Moody's, Standard & Poors and Fitch are the major players, rated the CDOs' portfolio securities and their notes. Their ratings were critical to the pricing and marketing of the notes. They were engaged by the CDOs' structuring sponsors and compensated from the proceeds of the sales of the notes, reportedly an increasing, and increasingly concentrated, source of their overall revenues.

CDO note purchasers and equity investors are qualified purchasers[1] that are qualified institutional buyers[2] (QIBs) or accredited investors,[3] often privately owned, but sometimes also publicly held, that purchase or invest through private placement offerings. They are supposed to have the financial sophistication and strength to assess and bear the risks of their investments. Often they make their investment decisions on the basis of sales presentations, pitch books and other marketing material before they have received the formal CDO transaction documents.

Not to be overlooked are the shareholders of publicly held investors and the beneficiaries of investments made by fiduciaries (such as pension plan investment mangers). Although, strictly

speaking, they are not direct participants in the CDO transaction, they can nevertheless be adversely affected by the investments and initiate lawsuits.[4]

Looking for Detailed Info?

Begin with the source recommended to me by CDO transactional specialists: Wikipedia. No kidding! It is readily accessible and provides useful leads. You would no more cite it as an authoritative source than AmJur, but it will give you a start and help you to decipher the acronyms.

You will find many articles in the financial press: the dailies, such as The Wall Street Journal and The Financial Times; other periodicals, such as those published by Institutional Investor and Euromoney; and academic journals such as business school publications. There are also presentation and program materials available from Web sites of industry groups, such as the American Securitization Forum, and think tanks, such as the Hudson Institute.

Credit rating agencies' publications are another useful source of information, although full access is limited to subscribers.

Congressional committees have held recent hearings; for example the House Committees on Financial Services and on the Budget and the Senate Banking, Housing and Urban Affairs Committee. Hearing transcripts and many witnesses' prepared materials are available on the Internet.

Court filings are available through Westlaw, Lexis, Pacer and the courts' Web sites.

Questions

And consult bankers, investment professionals, and transactional lawyers to ask questions and to test what you think you know. I asked a savvy friend with a long and distinguished investment career, "Why is it that because a first-time homeowner cannot afford his subprime mortgage, Cerberus' investment in the auto industry and Sam Zell's purchase of The Chicago Tribune should become more expensive? Is it that, packaged together in CDOs, one diseased debt infects the others? Are debt issuers seizing a pricing opportunity? Is it simply fear? None of these makes sense to me because the qualified investors are sophisticated players who can assess the different risks involved in different types of investments."

He responded, "Believe all three, but what you should not believe is that the investors know how to assess risk. Generally, they don't know what they're doing."

Oh my!

What to Look For?

If you are representing plaintiff investors or an investor's shareholders or beneficiaries, your clients probably will focus you on their specific concerns. If you are representing a defendant, the complaint will (should) state a claim that will focus your work.

That said, a number of allegations and reports have raised questions about conflicts, disclosures and valuation practices of various CDO sponsors and managers, including the following:

- Did the CDO's portfolio investments conform to the investment guidelines represented in the marketing materials and set forth in the transaction documents?
- Did the manager timely and adequately disclose and describe changes in the portfolio assets as required?
- Did the CDO sponsor or manager knowingly inflate the value of the portfolio, and, thereby, deflect or delay a covenant default, acceleration or exercise of other noteholder-creditors' rights, with, for example, mortgages on properties with inflated appraisals, or cross-sold derivatives at inflated values arranged between the CDO and its counter-party, or with securities of an affiliate of the CDO sponsor acquired and valued in a less-than-arm's-length transaction?
- Did the sponsor invest in its own CDO? If so, was it at the equity level or at a more senior tranche that gives it veto power or other control over the exercise of other noteholders' creditors' rights?
- Did the sponsor or manager, or their respective affiliates or officers, impermissibly withdraw their money invested in the CDO?
- While it was marketing its CDO(s), was the sponsor selling short the same type of securities that collateralize the CDO notes, similar securities or the ABX index? If so, was the short selling a legitimate hedging strategy or is it evidence of securities fraud?
- Is there other evidence (e.g., internal memoranda, reports, e-mails) that the sponsor or manager held a more negative opinion of the CDO portfolio assets than it disclosed to purchasers?

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To be sure, not all differences of opinion about valuation point to knavish manipulation. There may be many good faith disagreements, particularly about complex modeling and marking-to-market practices when there is no market or the market is so volatile that is roiling. Nevertheless, the questions above raise serious concerns about potential abuse and actionable wrongdoing.

Credit rating agencies generally have enjoyed immunity from civil liability under §11 of the Securities Act of 1933[5] by reason of Securities Act Rule 436(g).[6] In addition, they have claimed even broader protection under the First Amendment[7] as publishers of opinions. Nevertheless, two observers, critical of the credit rating agencies' role in structuring CDOs, have argued that their participation in the structuring process should subject them to liability as "underwriters" under the Securities Act.[8] The U.S. Securities and Exchange Commission is looking into the credit rating agencies' practices, including whether their role in the process of bringing subprime securities to market impaired their ability to be impartial.[9] And credit-rating agencies have themselves announced changes in their rating methodologies for various types of CDOs. *Quaere:* Are their own announced reforms tantamount to an admission of the inadequacy of their previous standards and practices?

An investor complaining about untimely or otherwise inadequate disclosures will have to grapple with such issues as scienter (Whether the defendants' alleged deception was intentional, reckless or negligent?), transaction causation (What induced the investor to invest?), loss causation (Did the loss result from the defendants' wrongdoing or from other factors, such as a drop in the market?) and the adequacy of the investor's own due diligence.

Conclusion

Well, that should be enough for a primer. Read, think, ask questions. When you get past the cryptogrammatic acronyms, this is not really all that complicated. Not so complicated, as one securities analyst put it, as fixing the automatic transmission on his uncle's old Buick.[10] Nor nearly so complicated as raising a child. You can do this. Now, get to it.

1. "Qualified purchaser" is a term defined by §2(a)(51) of the Investment Company Act of 1940, 15 U.S.C. §80 a-2(a)(51).
2. "Qualified institutional buyer" is a term defined by Rule 144A(a) under the Securities Act of 1933 (Securities Act), 15 U.S.C. §§77a et seq.; 17 C.F.R. §230.144A(a).
3. "Accredited investor" is a term defined by Rule 501(a) under the Securities Act, 17 C.F.R. §230.501(a).
4. See, e.g., *In re American Express Co. Securities Litigation*, No. 02 Civ. 5533 (WHP), 2004 WL 63270 (S.D.N.Y. March 31, 2004), vacated and remanded sub nom, *Slayton v. American Express Co.*, 460 F.3d 215 (2d Cir. 2006) (vacating a judgment dismissing a shareholders' class action for federal securities law fraud arising from the defendants' untimely and inadequate disclosure and write down of investments in high-yield, below-investment grade or "junk" bonds and CDOs); *Prudential Retirement Ins. and Annuity Co. v. State Street Bank and Trust Co.*, 07 CV 8488 (RJH) (S.D.N.Y., filed Oct. 1, 2007); *Unisystems Inc. Employees Profit Sharing Plan v. State Street Bank and Trust Co.*, No. 07 CV 9319 (RJH) (S.D.N.Y., filed Oct. 17, 2007); *The Andover Companies Employees Savings and Profit Sharing Plan v. State Street Bank and Trust Co.*, No. 07 CV 9687 (RJH) (S.D.N.Y., filed Oct. 31, 2007).
5. 15 U.S.C. §77k.
6. 17 C.F.R. §230.436(g).
7. U.S. Const. amend. I.
8. Joseph R. Mason & Joshua Rosner, "Where Did Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions" (Hudson Inst., Washington, D.C.), May 3, 2007, citing *Harden v. Raffensperger, Hughes & Co. Inc.*, 65 F.3d 1392 (7th Cir. 1995). *Harden* involved not a crediting rating agency, but a "qualified independent underwriter" under the rules of the National Association of Securities Dealers (NASD), which made minimum interest rate recommendations and participated in the preparation of the registration statement of the issuer's notes, but did not purchase or sell securities, assume any risk of sale of the securities or do other things commonly associated with an underwriter's role. The court held such an NASD "qualified independent underwriter" to be an "underwriter" within the meaning of §2(11) of the Securities Act, 15 U.S.C. §77b (11).
9. Christopher Cox, Chairman, U.S. Securities and Exchange Comm'n, Testimony: The State of the United States Economy and Financial Markets, Before the U.S. Senate Comm. on Banking, Housing and Urban Affairs (Feb. 14, 2008) at 4-6, www.sec.gov/news/testimony/2008/ts021408cc.htm.; Erik R. Sirri, Director, Division of Market Regulation, U.S. Securities and Exchange Comm'n, Remarks Before the SEC Open Meeting: Final Rules Implementing the Credit Rating Agency Reform Act of 2006 (May 23, 2007), www.sec.gov/news/speech/2007/spch052307ers.htm.
10. Mark Adelson, "CDOs in Plain English, a Summer Intern's Letter Home," Nomura Fixed Income Research (Nomura Securities Int'l Inc., New York, N.Y.), Sept. 13, 2004 at 7.

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