New York Law Journal
A NEW YORK LAW JOURNAL SPECIAL SECTION
An incisivemedia publication

Litigation

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MONDAY, JULY 20, 2009

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Actions Heat Up Over CDO Transactions

Contractual and interpleader claims are most prevalent.

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NOT SURPRISINGLY, the dramatic downturn in the housing markets and the broader credit markets generally has resulted in a wave of litigation involving a variety of complex financial products as market participants scramble to limit or recoup losses. This article focuses on recent litigation arising from one such financial product, the collateralized debt obligation (or CDO).

Generally, CDO-related litigation falls into two broad categories: (i) suits brought to resolve contract disputes between transaction participants and (ii) suits wherein investors essentially allege, among other things, that the CDOs at issue were actually schemes perpetrated by the transaction's sponsors to dupe investors out of their money. A basic understanding of a CDO transaction is necessary to understand these disputes. Due to the complexity of, and variations among, CDO transactions, the following descriptions are necessarily general in nature.

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Overview of CDO Transactions

Although features of CDOs vary, in simplest terms, a CDO is a securitization transaction wherein a special purpose entity is formed (generally referred to as the "issuer") and then (i) issues multiple classes of debt securities and a class of equity securities and (ii) uses the proceeds of the issuance to acquire an asset portfolio of debt instruments (e.g., bonds, loans, etc.) and/or credit default swaps that reference debt instruments (such credit default swaps are often referred to as "synthetic assets").

A CDO issuer typically also enters into agreements with third parties (generally large financial institutions) to minimize or "hedge" against various risks (e.g., interest rate movement, lack of liquidity, etc.). Each class of securities issued by a CDO has a different seniority relative to the others; in other words, holders of each class bear a different level of risk that distributions thereon will be reduced if the transaction becomes distressed and cash flows from the issuer's asset portfolio are diminished. Of course, the greater the seniority of the class (and therefore the less risk), the lower the potential return on the investment.

During the life of a CDO, the issuer's asset portfolio and the cash flows it generates serve as collateral for the issuer's secured obligations and are the main source of funds to satisfy the issuer's payment obligations, including those owed under its securities and related agreements. As one would expect, CDOs hardest hit by the financial crisis include those with asset portfolios

consisting predominantly of residential mortgage-backed securities and/or credit default swaps that reference such securities.

While a detailed description of all participants in a CDO transaction is beyond the scope of this article, the following summarizes the basic roles of those participants principally involved in recent litigation:

• *Collateral Manager*: The collateral manager is an asset management firm responsible for choosing the issuer's initial asset portfolio and managing that portfolio after the closing of the transaction.

• *Investment Bank/Underwriter*: The investment bank (i) "structures" the CDO by working with the collateral manager, rating agencies and investors to determine the appropriate capital structure and hedging strategy to be put in place upon the CDO's closing and (ii) thereafter markets and sells the securities issued by the CDO. The investment bank may also provide a warehousing facility to finance the acquisition or "ramp-up" of the CDO's initial asset portfolio prior to closing.

• *Rating Agencies*: The rating agencies assign ratings to each of a CDO's debt tranches that indicate the rating agencies' assessment of the issuer's ability to satisfy its payment obligations on the debt tranche.

• *Swap Counterparties*: Swap counterparties generally are highly rated financial institutions that enter into swap agreements with the issuer at closing. The purposes of those swap agreements can include hedging against risks inherent in the transaction structure and providing the issuer with "synthetic" exposure to debt securities.

• *Trustee*: Pursuant to the indenture governing a CDO, the trustee holds the issuer's asset portfolio in trust for the benefit of certain transaction participants and ensures the covenants in various transaction agreements are honored.

• *Investors*: The investors are the parties that acquire the securities issued as part of a CDO.

It is not uncommon for affiliated parties to have more than one of the aforementioned roles in a given CDO transaction.

Current CDO Contract Disputes

The rights and obligations of the CDO transaction participants generally are set forth in multiple complex and interrelated agreements. Most CDO-related litigation involves issues regarding the proper interpretation of those agreements in distressed transactions.

Warehouse Disputes. As set forth above, it is common for the investment bank/underwriter to enter into a warehousing agreement with the collateral manager whereby, prior to closing, the investment bank finances the acquisition of the initial asset portfolio selected by the collateral manager. The intention is that the issuer will use the proceeds raised at the closing of the CDO to purchase the asset portfolio from the warehouse.

At least one case has arisen regarding who bears the risk of loss if warehoused assets deteriorate such that the contemplated CDO fails to close. In *UBS Securities LLC and UBS AG, London Branch v. Highland Capital Management, L.P.*, the investment bank providing the warehouse alleged that the collateral manager is responsible for all losses resulting from the depreciation in value of warehoused assets. The collateral manager has moved to dismiss the complaint on the grounds that, inter alia, the investment bank misinterpreted the contract and the parties had no "reasonable expectation" the collateral manager would bear the risk of losses in the warehousing facility.[1]

Payment Rights in Distressed CDO Transactions. Perhaps the most prevalent dispute in litigation involving CDOs has been the extent to which losses caused by diminished cash flows will be borne by holders of the junior classes before the issuer's payment obligations to the senior classes are impaired.

CDO indentures generally provide for an "event of default" upon the occurrence of a number of specified events negatively affecting the transaction. In practice, the occurrence of an event of default typically indicates a significant reduction in the likelihood the cash flows generated by the issuer's asset portfolio will be sufficient to satisfy its payment obligations. Many of these suits are interpleader actions commenced by a trustee faced with competing claims from transaction participants as to how CDO cash flows must be distributed under the indenture after an event of default, acceleration and/or liquidation of the transaction.

> The rights and obligations of the transaction participants in the **financial product** known as a collateralized debt obligation are generally set forth in **multiple complex** and **interrelated agreements**; most CDO-related litigation involves the proper **interpretation** of those agreements in **distressed transactions**.

One litigated issue in this class of disputes is whether, as a threshold matter, an event of default has actually occurred. Some events of default are straightforward, such as the failure by the issuer to make payments when due, while others are more complex with increased potential for litigation.

For example, some CDOs have experienced an event of default due to the failure to maintain a minimum ratio comparing the value of the issuer's asset portfolio to the outstanding amount of certain specified senior obligations (an "over-collateralization ratio").[2] The interpleader action *Wells Fargo v. CALYON et al.* involves, inter alia, a dispute between a holder of a junior class and the holder of the senior class concerning the calculation of the over-collateralization ratio event of default trigger.[3] Another recent interpleader action, *Deutsche Bank Trust Company Americas v. Elliott International, L.P., et al.*, arose from a dispute between senior noteholders and junior noteholders regarding whether the acquisition of certain assets by the issuer constituted an event of default under the indenture.[4]

Many disputes also have arisen between senior and junior classes with respect to how certain proceeds generated by the issuer's asset portfolio must be distributed following an event of default and acceleration, but prior to liquidation of the issuer's assets.[5]

A major consequence of an event of default in most CDOs is that the senior class gains increased control over the transaction, often including the right to accelerate the notes (i.e., declare all principal and interest thereon due and payable) and, subsequent to such acceleration, the right to direct the liquidation of the CDO's assets. Although one might expect liquidation generally would promptly follow acceleration, the current market has resulted in many situations where the controlling class has chosen to accelerate the notes but not liquidate the CDO's collateral.[6] Litigation has also arisen from disputes relating to the right to direct the liquidation of the issuer's asset portfolio and the priority of various parties receiving liquidation proceeds.[7]

M&T Bank Corporation v. LaSalle Bank National Association, et al. is one of the few suits regarding payment rights in distressed CDO transactions not brought as an interpleader action. In that case, a junior noteholder commenced an action against the trustee and other parties after the trustee interpreted the indenture to require payment in full of the senior class before further payments to junior classes.[8]

Litigation Related to Synthetic Securities. A variety of contract litigation has arisen from disputes relating to the ability of the issuer to terminate its "synthetic asset" credit default swaps, and thus avoid payment of significant amounts to the synthetic asset counterparty.

Pursuant to the terms of the swap agreements, the issuer, in exchange for a periodic fee, is required to make payments to the synthetic asset counterparty if certain negative "credit events" (e.g., a payment default) occur with respect to the referenced obligations (e.g., debt securities identified in the swap agreements). Hence, if the referenced obligations perform poorly (which in many cases they have), the amount the issuer owes to the swap counterparty under the credit default swaps increases.

In *Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Limited and Wells Fargo Bank, N.A., Trustee*, one of the most prominent of these cases, the plaintiff (who is the synthetic asset counterparty) brought a claim for declaratory and injunctive relief, challenging as improper under New York and bankruptcy law the issuer's early termination of its swap agreement based on the bankruptcy

of Lehman Brothers Holdings Inc. (the parent and credit support provider of the synthetic asset counterparty).[9] Similar cases have arisen with respect to early termination events arising from a ratings downgrade of the synthetic asset counterparty or its affiliates.[10]

Litigation concerning synthetic assets of a CDO has also arisen outside the context of termination events. In *LaSalle Bank National Association v. Goldman Sachs International and Peloton Partners LLP*, the trustee brought an interpleader action to resolve a contractual dispute regarding which transaction participant had the right to determine the manner in which assets should be released from an account of the issuer collateralizing its obligations under the credit default swaps.[11]

Litigation Related to Hedging and Other Swap Agreements. The issuer's swap transactions for hedging and other purposes have also given rise to a number of contractual disputes. For example, in *Marathon Structured Finance Fund, LP v. Eastman Hill Funding I, Ltd., et al.*, a holder of subordinate notes brought an action alleging certain swap transactions that modified the timing of cash flows from the issuer's assets did not comply with the indenture and improperly diverted funds from junior noteholders to senior noteholders.[12]

Coöperatieve Centrale Raiffeisen-Boerenleenbank, B.A. (Rabobank) v. Tahoma CDO II, Ltd., et al. also arose out of swap agreements relating to the timing of cash flows. Rabobank, as counterparty to the swaps at issue, brought suit against the issuers, the synthetic asset counterparty and the collateral manager, in connection with a dispute regarding the amounts payable by Rabobank pursuant to the relevant agreements.[13]

Coöperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Brookville CDO I Ltd. and Wells Fargo Bank, N.A. as Trustee, arose out of a dispute regarding whether the collateral manager's piecemeal sale of certain debt securities from the issuer's asset portfolio constituted a liquidation giving rise to Rabobank's right to terminate an interest rate swap agreement with the issuer.[14]

Pending Business Tort Cases

Although most of the CDO-related litigation is focused on contractual claims, plaintiffs in a small number of cases have expanded their claims to include tort causes of action. Although the specific allegations and legal theories in these suits vary, the recurring theme centers around allegations that the investment bank/underwriter and/or the collateral manager somehow deceived the investor.

For example, in *Bank of the West v. UBS AG, et al.*, investors in junior classes of a CDO accused the investment bank/underwriter of structuring the transaction in such a way that it had the incentive to direct a liquidation of the CDO's assets prematurely, effectively usurping the investment of the junior noteholders to pay itself.[15] Similarly, in *HSH Nordbank AG v. UBS AG and UBS Securities, LLC*, an investor accused the collateral manager, who was also the synthetic asset counterparty, of knowingly selecting "inferior quality" assets to trigger protection payments to itself under synthetic asset agreements with the issuer.[16] In *M&T Bank Corp. v. Gemstone CDO VII, Ltd.*, a junior investor in a CDO alleged, inter alia, that the investment bank/underwriter had inadequately disclosed the risks associated with investment.[17]

Motions to dismiss the complaint in two of the aforementioned cases have led to differing results. Whereas the *HSH Nordbank* court dismissed all but one of the plaintiff's tort claims, the *M&T Bank Corp.* court allowed many similar claims to proceed.[18] Of course, the complaints in the two cases were distinct, and as a motion to dismiss challenges only the sufficiency of the complaint, it remains to be seen under which circumstances a plaintiff's fraud or related claims actually will lead to recovery in the CDO context.

Suits External to the Transactions

The preceding cases represent a general cross-section of the types of disputes that can arise from within a CDO transaction, but litigation has also arisen from disputes external to the deals themselves.

Most prominently, Citigroup shareholders recently filed a class action securities fraud suit alleging that the company damaged investors by concealing the extent of its ownership of CDOs backed by nonprime mortgages and the risks associated with them.[19] This suit follows a previous derivative action by Citigroup shareholders, struck down by the Delaware Chancery Court earlier this year, in which they alleged that current and former directors and officers had exposed the company to massive losses in connection with its CDO involvement.[20]

A class action suit was also filed against Moody's Corporation in 2007 where the plaintiffs alleged, inter alia, that Moody's "assigned excessively high ratings to bonds backed by risky subprime mortgages—including bonds packaged as collateralized debt obligations… ."[21]

Conclusion

Most CDO-related litigation is still in the early stages, and neither the bar nor the market yet knows how these disputes will ultimately be resolved. As is generally the case, many of the suits will likely be settled to avoid uncertain outcomes affecting vast sums of money. One certain outcome, however, is that the resolutions achieved through the litigation arising out of this market disruption will impact how these sorts of financial products are developed, structured and sold in the years to come.

1. *UBS Securities LLC and UBS AG, London Branch v. Highland Capital Management, L.P., et al*, No. 650097/2009 (N.Y. Sup. Ct. filed Feb. 24, 2009).
2. See, e.g., "Cash Flow and Hybrid CDO of ABS Event of Default Notices Received as of May 26, 2009," Standard & Poor's RatingsDirect (May 27, 2009).
3. *Wells Fargo v. CALYON, et al.*, No. 1:08-cv-01297 (S.D.N.Y. filed Feb. 8, 2008) (the author and his firm represent interpleader defendant CALYON.).
4. *Deutsche Bank Trust Company Americas v. Elliott International, L.P., et al.*, No. 1:09-cv-05242 (S.D.N.Y. filed June 4, 2009).
5. See, e.g., *US Bank v. MBIA Ins. Corp., et al.*, No. 1:08-cv-04791 (S.D.N.Y. filed May 21, 2008) (the author and his firm represent interpleader defendants MBIA Insurance Corporation and KBC Investments Hong Kong Ltd.); *LaSalle Bank v. BNP Paribas, et al.*, No. 1:08-cv-6134 (S.D.N.Y filed July 3, 2008); *LaSalle Bank National Association v. Citigroup Global Markets Limited, et al.*, No. 1:08-cv-06294 (S.D.N.Y., filed July 11, 2008); *Deutsche Bank v. LaCrosse Fin. Products LLC et al.*, No. 1:08-cv-00955, (S.D.N.Y. filed Jan. 29, 2008) (the author and his firm represent interpleader defendant LaCrosse Financial Products, LLC); *Wells Fargo v. CALYON et al.*, supra.
6. See "Cash Flow and Hybrid CDO of ABS Event of Default Notices Received as of May 26, 2009," Standard & Poor's RatingsDirect (May 27, 2009).
7. *LaSalle Bank National Association v. UBS AG, London Branch and Merrill Lynch International*, No. 1:08-cv-03692 (S.D.N.Y filed April 17, 2008) (controlling class directed liquidation pursuant to section 5.5(a)(ii) of indenture and subordinate class cited same provision for ability to block liquidation).
8. *M&T Bank Corporation v. LaSalle Bank National Association, et al.*, No. 1:08-cv-00581 (WMS) (W.D.N.Y. filed Aug. 5, 2008).
9. *Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Limited and Wells Fargo Bank, N.A.*, No. 1:09-cv-01032 (S.D.N.Y. filed Feb. 3, 2009).
10. *U.S. Bank National Association v. Barclays Bank PLC and Morgan Stanley Capital Services Inc.*, No. 1:09-CV-00462 (S.D.N.Y. filed Jan. 16, 2009); *Davis Square Funding I, Ltd et al v. AIG Financial Products Corp.*, No. 1:09-cv-02062 (S.D.N.Y. filed March 6, 2009, discontinued without prejudice May 29, 2009).
11. *LaSalle Bank National Association v. Goldman Sachs International and Peloton Partners LLP*, No. 650325/2007 (N.Y. Sup. Ct. filed Nov. 13, 2007).
12. *Marathon Structured Finance Fund, LP v. Eastman Hill Funding I, Ltd., et al.*, No. 602695/2008 (N.Y. Sup. Ct. filed Sep. 17, 2008).
13. *Coöperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Tahoma CDO II, Ltd., et al.*, No. 601173/2009 (N.Y. Sup. Ct. filed April 17, 2009).
14. *Coöperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Brookville CDO I Ltd. and Wells Fargo Bank, N.A.*, No. 1:08-cv-09565 (S.D.N.Y. filed Nov. 6, 2008).
15. *Bank of the West v. UBS AG, et al.*, No. CGC-09-489590 (Cal. Super. Court filed June 18, 2009).
16 *HSH Nordbank AG v. UBS AG and UBS Securities, LLC*, No. 600562/2008 (N.Y. Sup. Ct. filed Feb. 25, 2008).
17. *M&T Bank Corp. v. Gemstone CDO VII, Ltd., et al.*, No. 7064/08 (N.Y. Sup. Ct. filed June 16, 2008).
18. Compare *HSH Nordbank AG*, No. 600562/2008 (N.Y. Sup. Ct. Oct. 21, 2008) (order granting motion to dismiss in part) with *M&T Bank Corp.*, No. 7064/08, 2009 WL 921381, at *12 (N.Y. Sup. Ct. April 7, 2009) (order denying motion to dismiss in part).
19. *In re Citigroup Sec. Litig.*, No. 1:07-cv-09901 (S.D.N.Y. filed Feb. 20, 2009).
20. See *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009).
21. *Teamsters Local 282 Pension Trust Fund v. Moody's Corporation, et al.*, No. 1:07-civ-8375 (S.D.N.Y. filed Sep. 26, 2007).

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