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# Investor **Alert**

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## What claims might be available to institutional investors in the structured finance and derivatives markets?

### Part Two

**As we said at the start of our September Investor Alert, the serious and continuing effect of the credit crisis on the performance and valuation of structured finance products sold prior to August 2007 has led many investors to actively consider whether they have any claims in relation to losses which they have suffered.**

There are undoubtedly many good claims which exist and which would result in a much better recovery than simply relying on the market to take its course, and certainly so far as English law is concerned, sufficient time has now passed to bring limitation concerns into sharp focus. Institutional investors who have not yet started a detailed analysis of what legal claims they may have available to maximise their recoveries ought now to be starting that process to ensure that valuable claims are not barred by statutory or contractual limitation periods.

In our September Investor Alert, we divided the sort of claims that might arise under English law in relation to defaulted or poorly performing structured finance product claims, very broadly, into four categories, which were:

- Mis-selling.
- Contractual disputes arising from the interpretation of documents.
- Mismanagement.
- Pricing/valuation disputes.

In the September edition, we considered the first two of those heads of claim: mis-selling and contractual disputes. In this edition, we will examine the third category of claim: mismanagement. We will cover the fourth category, mispricing/misvaluation, in a concluding edition in this series.

Like the instruments themselves, these cases have complex facts and involve complex legal issues. Accordingly, these Investor Alerts can only provide a broad summary of the claims that may be available. Those investors who wish to investigate potential claims of order to maximise their economic return should seek legal advice as early as possible.

## Mismanagement claims

Mismanagement claims, in a structured product context, can take three broad (and often overlapping) forms. The first is where there is an issue about whether assets under management fall within the portfolio guidelines set out in the contractual documentation. The second is where the assets meet the formal contractual requirements, but have been chosen negligently (for example, in relation to excess concentration). These first two categories might be characterised as claims concerned with incompetent management. The third category is where the assets in question meet the letter of the contractual specifications, but where it is believed that the formally compliant assets have been selected to further the interests of the investment manager, swap counterparty (buying credit protection under the related CDS) or connected parties, at the cost of the Noteholders.

The immediate remedy for investors in a transaction whose assets are being mismanaged is to remove the Investment Manager. Obviously that requires careful legal analysis to ensure that the removal is achieved lawfully, but it will not, of itself, compensate investors for any loss which is suffered as a result of the mismanagement prior to the dismissal of the Investment Manager. That will require a claim to be brought against the Investment Manager for damages, which might be framed in terms of breach of contractual duty or – if such a claim is available - in tort (e.g. for negligence).

## Who can claim?

In the context of CDOs or like transactions (whether cash or synthetic) there may also be issues in establishing the investor's right to sue the Investment Manager directly in contract. In most of these types of transaction, all contractual rights against the Investment Manager are assigned by way of security by the Issuer to the Trustee to hold on trust for the benefit of Noteholders. The issue of which types of Noteholders are entitled to benefit from any recovery achieved by the Trustee in respect of the relevant assigned contractual rights is not clear in law – for instance, is an ex-Noteholder which sold an asset at an impaired value entitled to recover through the Trustee, even though it is no longer a Noteholder when the Trustee takes action and recovers for the breach of contractual duty against the Investment Manager?

There are equivalent questions in respect of claims framed in tort. It is certainly arguable that an Investment Manager assumes a responsibility towards Noteholders sufficient to create a duty of care in tort, but whether that extends to all Noteholders, however transient their holding, is not so clear.

The factual variations on these themes are many and varied. These issues as to the substantive rights of action which a Noteholder may be able to employ (or be entitled to rely on the Trustee to employ on its behalf) are complex, and largely untested in the courts. We intend to address these in more detail in a future Investor Alert.

## Structurally incentivised mismanagement/asset selection

The root cause of this type of mismanagement claim is generally that the Investment Manager's interests are not aligned with those of the investor, and/or that the parameters within which the portfolio can be managed have been set from the outset to the disadvantage of the investors.

For structured products with fixed reference portfolios, issues are most likely to stem from the initial selection of the reference assets (although it is possible that issues may arise in relation to the management of any exceptional changes permitted within the contractual scheme).

It was this type of initial asset selection which lay at the heart of the SEC's well-publicised case against Goldman Sachs in relation to the Abacus CDO. It was there alleged that Goldman Sachs had acted in conjunction with the hedge fund Paulson & Co to select a portfolio which was likely to perform badly and that it persuaded ACA Capital, the Investment Manager, to endorse the portfolio (there was no claim by the SEC against either Paulson & Co or ACA).

The SEC continues to investigate similar practices in the CDO arena, the latest of which to become public is an investigation into the Class V Funding III CDO, which was arranged by Citibank and asset-managed by Credit Suisse Alternative Capital. This CDO-squared was issued in February 2007 and reportedly invested in, amongst other things, around 15 CDO assets which had themselves been structured with the input of another hedge fund, Magnetar Capital LLC, which also is alleged to have adopted a sub-prime CDO-shorting trading strategy.

Where the reference portfolio is an actively managed portfolio which permits reference assets to be traded in and out of the portfolio, there is obviously significant scope for mismanagement to arise after completion, and during the term, of a structured Note.

As yet, few of this type of mismanagement claim have been litigated to trial. We expect that to change, as the first wave of credit crisis litigation takes hold. However, an earlier example stemming from 2001-2 was the HSH Nordbank litigation against Barclays in relation to its 'Corvus' CDO. The central allegation advanced by HSH Nordbank (which also advanced a mis-selling claim) was that Barclays had used its portfolio management powers in a way which benefited its own interests rather than that of the Noteholders.

Significantly, in the Corvus case, much emphasis was placed on allegations of breach of duty which went beyond the strict terms of the contract, and included an allegation that Barclays owed a duty of good faith to the Noteholders. These allegations were framed to deal with asset substitutions which met strict contractual investment criteria, but which, it was said, Barclays should have known would subsequently underperform. A pleaded example was the substitution into the portfolio of a substantial number of aircraft finance securitisations three weeks after 9/11. Another major complaint was that there was an alleged over-concentration of tranches of other Barclays-issued CDOs in the Corvus reference portfolio, creating a 'domino effect' which accelerated the rating downgrades in the web of inter-linked and cross-referenced Barclays CDOs. The matter settled just before trial, in February 2004, on terms which are confidential.

It seems certain that, at least in some cases, investors understood the term "managed CDO" to mean that it would be managed to the advantage, and in the best interests, of the Noteholders. In fact, many of those transactions (where arranging bank and credit default swap counterparty may or may not be the same entity or affiliated) are alleged to have been "managed" directly against the interests of the investors with a view to increasing the likelihood of Credit Events occurring within the Reference Portfolio. One of the most often made criticisms of these structures has been the leeway allowed to the credit protection buyer under the portfolio CDS transaction to use timing mismatches – the invariable delay between the deterioration of a particular credit and any subsequent ratings downgrade – to introduce assets of deteriorating quality into the portfolio at a moment in time where they still met the applicable eligibility criteria (so-called "ratings arbitrage").

An example of such a claim which has reached the public arena again involves HSH Nordbank, which is now suing UBS (in New York) over its management of the North Street 2002-4 hybrid CDO. Nordbank alleges UBS engaged in precisely the kind of "ratings arbitrage" outlined above. For example, one allegation is that in February 2007 (after the sub-prime market turned, but before lagging credit ratings caught up) UBS removed $555m of "stable credits" from the portfolio, substituting them for the equivalent value of two securities linked to the ABX sub-prime index.

It will be apparent that these claims rely heavily on expert analysis of complex factual circumstances, against the backdrop of the legal duties in play. Such analysis is essential both to identify the breaches of duty, and to quantify the loss which resulted (which in itself is a complex issue).

## Conclusion

The above is simply an overview of one of the sort of claims which arise in relation to structured finance transactions. Two others were covered in our earlier September edition and the fourth – mispricing/misvaluation – will be covered in the concluding edition of this series. As noted, these are complicated areas where detailed legal and expert assistance is required. Accordingly, investors should seek such assistance at an early stage when considering what claims may arise as a result of losses incurred on structured finance transactions.

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**Tom Hibbert** specialises in financial disputes and heads RPC's financial disputes team. He specialises particularly in claims in the investment banking and fund management sphere, particularly in the capital markets. He is a co-author of "Banking Litigation" which is published by Sweet & Maxwell.

Generally, Tom acts on the buy side for institutional investors such as continental banks, pension funds, hedge funds and investment vehicles for high net worth individuals. He has been involved in significant litigation arising from financial crises over the last 15 years. He is recommended in both Chambers and the Legal 500.

**Selected directory listings:**

- *"Tom Hibbert of Reynolds Porter Chamberlain LLP is chosen by clients 'to run big pieces of litigation'. They note his ability to 'co-ordinate work effortlessly, while also maintaining a strong presence as an individual litigator.' "*
– Chambers UK, 2011
- *"one of the small handful of litigation lawyers in London who understand how complex financial instruments like synthetic CDOs and other structured notes work"* – Legal 500, 2010
- *"frank, pragmatic and calm"* – Chambers UK, 2010

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**David Doble** qualified as a solicitor in the UK in 1988. He was a partner at the international law firm of Allen & Overy LLP, and a member of the international capital markets department. He has specialised over the past decade in the field of securitised derivatives, repackagings, CDOs credit-linked and equity-linked notes and a variety of hybrid structured instruments. In particular, he advised (from 2003) a syndicate of international banks in developing the iTraxx (credit index-linked) note product that has emerged as the international benchmark for credit-linked products. His clients during that period included many of the major financial institutions involved in developing and structuring such transactions and products.

Since 2005, David has acted exclusively for institutional investors including some of the world's largest savings banks, state banks, regional banks, insurance companies and pension funds. David advises on a range of non-contentious matters through DDS. In recent years his practice has focussed on advising institutional investors in connection with the private restructurings of their structured credit portfolios.

**Selected directory listings:**

David was cited as an expert in the field of credit derivatives in the inaugural edition of The Creditflux Inside Guide to Who's Who in Structured Credit and Credit Derivatives.

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David Doble Solicitors was established in London in 2005 to provide legal advice to institutions, within Europe and beyond, investing in complex structured financial instruments.