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Investor **Alert**

Derivatives and structured finance investments - redress for institutional investors in CDOs and other complex debt instruments

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Given the serious and continuing effect of the credit crisis on the performance and valuation of structured finance products since the onset of the global credit crisis in August 2007, many investors are now actively considering whether they have any claims in relation to losses which they have suffered. This is a process which is gathering pace. The SEC proceedings against Goldman Sachs over the ABACUS CDO have brought the structuring and sale of such products to centre stage. Moreover, certainly so far as English law is concerned, there may well be relevant time limits approaching after which it will not be possible for investors to issue proceedings. Accordingly, investors who wish to investigate whether any potential claims exist would be well advised to commence that process now to avoid having a limitation defence raised against them in the future.

In this respect, it may be helpful for investors to understand the sort of claims which might arise under English law in relation to defaulted or poorly performing structured finance products. Broadly speaking, the claims which might arise in relation to structured finance products are likely to fall into four categories, as follows:

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

In this Investor Alert we set out a short consideration of the first two of these heads of claim: mis-selling and contractual disputes. Our next Investor Alert will examine issues of mismanagement and mis-pricing and mis-valuation. It will be apparent from this and our next Alert that many of these claims are factually complicated and involve complex legal issues. Accordingly, what is set out in these Alerts can only be a broad summary of the claims available and those investors wishing to investigate potential claims should seek legal advice at the earliest possible time.

Comments

This Alert is simply an overview of two of the sort of claims which arise in relation to structured finance transactions. 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.

Mis-selling

The essential allegations in a mis-selling claim would generally be one or more of the following:

- that a product has been sold to an investor which does not meet that investor's investment objectives or its risk profile[1] (other situations can arise in structured finance, such as a complaint that a product was sold with a promise that the arranging bank would always make a market and provide liquidity); and/or
- that an important and material factor key to the transaction has not been disclosed[2]; and/or
- that statements made in the sales process are materially incorrect, for instance about how parties to the transaction will act (eg how a manager will manage the reference portfolio).

Such claims can be framed as a claim for breach of a duty to advise arising either in an advisory contract or at common law. In the context of a more straightforward sales relationship, the claim will revolve around misrepresentation or actionable non-disclosure (in this context a failure to disclose which distorts a positive representation or a partial non-disclosure) or misstatement.

In order to succeed on such a claim, an investor will need to show that there has been a statement of fact, or of opinion which carries with it an implication that it is based on a reasonable view of the facts. The representation must be one which no reasonably competent banker could have made, which has been relied upon by the investor in reaching its decision to invest and which has caused loss. It should be noted that a misrepresentation need not be the only cause of making the investment. It merely needs to be a substantial cause.

It will be apparent that in order to found such a claim it is necessary for there to be a relatively detailed factual reconstruction of the selling process, which will involve a review of the documentation received from the selling bank, email and other correspondence and, ideally, discussion with those involved in making the investment decision.

Investors should certainly have in mind the terms of their contractual documentation in relation to these claims. Many of the documents will include non-reliance clauses (ie an acknowledgment by an investor that it has not relied on a pre-contractual representation when entering into the contract) and the trend in the English courts is to be sympathetic towards such clauses. A typical clause might read as follows:

> *"[The buyer] acknowledges and confirms that it is not entering into this agreement in reliance upon any statement (other than expressly set out herein) or silence on the part of [the seller] …in connection with this agreement."*

In all cases, a close analysis of the circumstances giving rise to the signature of such documentation is important. A misrepresentation can be negligent but there are also claims for fraudulent misrepresentation which may be available. The latter claim is a powerful weapon for an investor, if it can properly be founded. It essentially requires showing that the representation was made by a party who either knew that it was false or was reckless as to whether it was true or false. There are huge advantages to such a claim, notably in precluding any reliance on contractual disclaimers and in relation to the more substantial and generous approach to damages which is available for a fraud claim.

Claims in respect of mis-selling under English law (and any equivalent claim under New York law) are likely to have a six-year limitation period. The effect of this would be to bar mis-selling claims in respect of structured debt instruments created and sold prior to the relevant cut-off point in 2004. However, the general consensus seems to be that most of the worst toxic structured finance investments post-date 2004. Nevertheless, it is important that investors start to look now at strategies to assess any claims they may have for assets acquired after the relevant cut-off point in 2004. On this point, it is worth noting that the proper law of claims and the correct (and best) jurisdiction in which to advance them in the context of multiple parties to interlocking contracts often gives rise to complex legal and strategic issues which need to be addressed at the outset.

Contractual disputes

The documentation underlying structured finance transactions is generally highly complicated and involves a number of interlinking contracts. An increasingly visible issue is that such documentation is often unclear and open to a number of interpretations which have very different financial consequences for the participants in a transaction. The proper interpretation of those contracts is therefore often highly controversial and investors should always look carefully at whether the interpretation of those contracts put forward by other parties to the transaction is correct. There can be a real incentive (particularly in synthetic CDO transactions where the arranging bank is also the swap counterparty) for an arranging bank, which was often the party drafting the contracts in the first place, to advance arguments on interpretation which are detrimental to the interests of investors. But there is no reason for investors to accept the arranging bank's arguments as authoritative and investors can often benefit significantly by pursuing their own independent interpretation of the documents.

There is always scope for significant conflict in structured finance transactions. Without a doubt the greatest scope for conflicts to arise between arranging banks and investors is in the synthetic CDO markets. What is interesting about these transactions is that the greater the profit in the transaction for the arranging bank, the greater the corresponding loss suffered by investors. It entails more than any other financial transaction a direct conflict of interest between the bank and the investor.

As more and more drafting issues come to light, and as the very real competing interests in different interpretations become apparent, it is no surprise that trustees in structured finance transactions are presently besieged by requests for modifications or amendments to transactional documentation. Broadly speaking, a trustee is only entitled to amend or modify documents unilaterally (ie without Noteholder (investor) consent) if the amendment would not, in its opinion, materially prejudice the Noteholder or the amendment is minor and to correct an obvious mistake.

Investors should be very wary of attempts by other parties to modify structured finance documentation. Trustees are increasingly unwilling to exercise their discretion in relation to modification and are instead seeking the directions of the court as to the proper interpretation of documents. This is often coupled with an application to rectify the documents in a way which is highly disadvantageous to the investor. It is essential that investors ensure that everything is done in those proceedings to persuade the court of an interpretation of the documents which is favourable to investors or to ensure that any arguments over rectification of the documents properly reflect the investors' interests. This may well involve a Noteholder or representative Noteholder becoming a party to those proceedings.

In particular, investors cannot rely on trustees to make the arguments for them or to pursue arguments with the vigour which would be expected from a party which has a direct financial interest in the outcome of the proceedings. Trustees will wish to adopt a neutral stance and will not necessarily wish to advocate an investor's case for it. An interesting example of this approach, and the court's reaction to it, is to be found in the very recent decision of *State Street Bank and Trust Company v Sompo Japan Insurance Inc.*[3] There the trustee had issued an application seeking directions from the court and there was also an application to rectify. No Noteholder had participated and the trustee had sought permission simply to remain neutral. But the court held that the trustee is expected in such circumstances to assist the court by bringing to its attention any relevant points or arguments on behalf of investors even though the trustee was neutral as between competing classes of Noteholders.

While that approach may assist to some extent, it is plainly better for investors to identify their arguments for themselves and to pursue them vigorously.

(1) The most well-known example of such a claim is *JPMorgan Chase & Others v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm).

(2) Such allegations formed the basis of the SEC proceedings against Goldman Sachs in relation to the sale of the ABACUS CDO. The essential complaint was the failure to disclose the alleged role of the hedge fund, Paulson & Co, in selecting the RMBS in the reference portfolio when Paulson had a bearish view of the market and intended to short the ABACUS CDO.

(3) [2010] EWHC 1461 (Ch).

This is a summary of certain matters of English law. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the authors.

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Tom Hibbert specialises in financial disputes and heads RPC's financial disputes team. He was formerly co-head of banking litigation at Richards Butler and then, after the merger, at Reed Smith. 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
- "*frank, pragmatic and calm*" – Chambers UK, 2010
- "*straightforward... good manner with clients*" – The Legal 500, 2009
- "*noted for his derivatives litigation expertise*" – The Legal 500, 2009
- "*an absolute joy to work with... always prepared for what's next*" – Chambers UK, 2009
- '*Thomas Hibbert was singled out for his "intelligence and commercial attitude,"* – Chambers UK, 2008
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David Doble qualified as a solicitor in the UK in 1988. Prior to establishing David Doble Solicitors, 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 founding this firm, 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. In recent years his practice has focused on advising institutional investors in connection with the private restructurings of their structured credit portfolios.

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

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