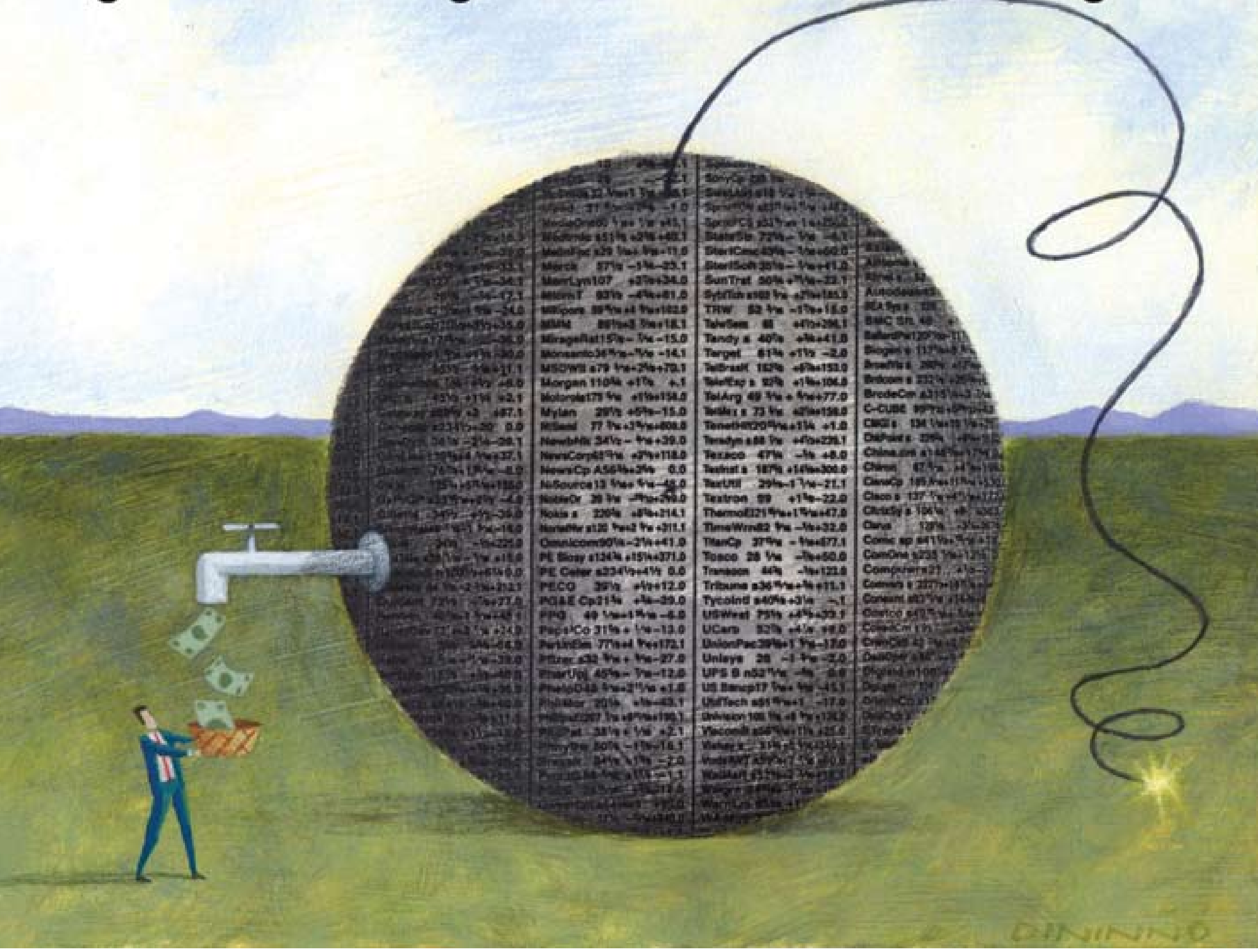
COLLATERAL DAMAGE:
Litigation Involving Collateralized Debt Obligations



By

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The past few years have seen a surge of investor interest in complex structured investments known as "collateralized debt obligations" ("CDOs"). By some measures, CDOs have attracted more than $1 trillion in investment capital, mostly from institutional and high-net-worth individual investors. This article identifies and discusses some of the principal litigation risks facing CDOs and professional organizations that create, market, manage, and administer CDOs, such as investment banks, securities firms, asset managers, and administrative agents. The article reviews some recent litigation involving CDOs and analyzes novel litigation risks implicated by the sale of CDO securities to high-net-worth individual investors.

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CDO BASICS

A CDO is an investment structure of securities whose cash flows are linked to a portfolio of underlying obligations. The underlying obligations may include bank loans, lines of credit, corporate bonds, and various other forms of debt instruments. The cash flows from these various loans and bonds are used to meet the payment obligations of various classes of CDO securities. Using a priority-of-distribution formula, the CDO structure redistributes the credit risk of the underlying portfolio to the different classes of CDO securities. By repackaging and structuring the payment stream from the underlying portfolio of loans and bonds, the CDO structure is able to create customized securities with a range of risk-return profiles that can appeal to a wide range of investors.

The complexity of CDO structures has grown along with their popularity. Addressing all the unique features and risks of the various types of CDO structures is well beyond the scope of this article. Instead, this article focuses on "cash CDOs," in which a special purpose vehicle ("SPV") uses a pool of investment capital to purchase outright a portfolio of corporate debt and loans of varying credit risk and maturity and, against this portfolio, issues two or more tranches of debt securities to the investors. *(See Figure 1.)*

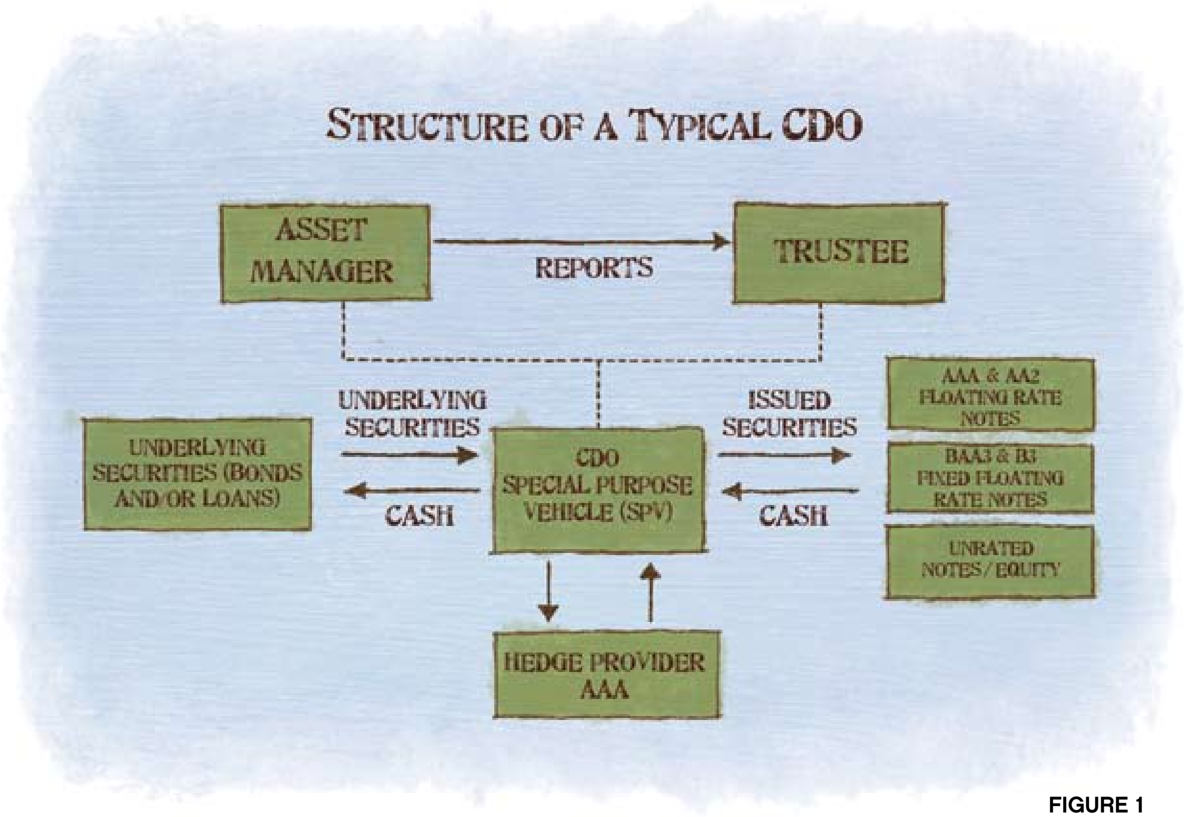

FIGURE 1

The investment pool is managed by a portfolio manager, and the structure is promoted and administered by a bank or securities firm. The SPV is a bankruptcy-remote vehicle and often is organized in a jurisdiction with a favorable regulatory and tax regime. The senior tranche of securities issued by the SPV typically carries an investment-grade credit rating from a rating agency, provides for a fixed rate of return, and is secured by the assets in the investment portfolio. The junior, or subordinated, tranche of securities issued by the SPV is unrated, provides for no fixed rate of return, and is unsecured; however, it offers investors the opportunity of upside returns far in excess of most individual fixed-income debt investments. The subordinated tranche enjoys the prospect of higher potential returns but is more exposed to losses in the investment portfolio. While many CDO structures provide a threshold level of defaults that are absorbed by the sponsor or issuer before the subordinated tranche is financially affected, once that threshold is reached, the brunt of each default is borne entirely by the subordinated tranche.

CDO LITIGATION

To date, there have been few reported cases involving CDOs, and they have been filed almost exclusively by investors who purchased subordinated tranche securities issued by cash CDOs that had been created and marketed in the late 1990s. In the period 2000 through 2002, the corporate debt markets experienced levels of default that were largely unprecedented in the 20th century—indeed, the levels of corporate default experienced in 2000–2002 had been exceeded only twice before: in the Great Depression and in the recession of the early 1990s. *(See Figure 2.)*

Following this period of heightened corporate defaults, junior tranche investors found that not only had their periodic interest payments ceased but, in many instances, their original investment capital had been significantly diminished or entirely lost shortly after these investments were made. These investors, typically small and medium-sized banks and financial institutions, as well as some high-net-worth

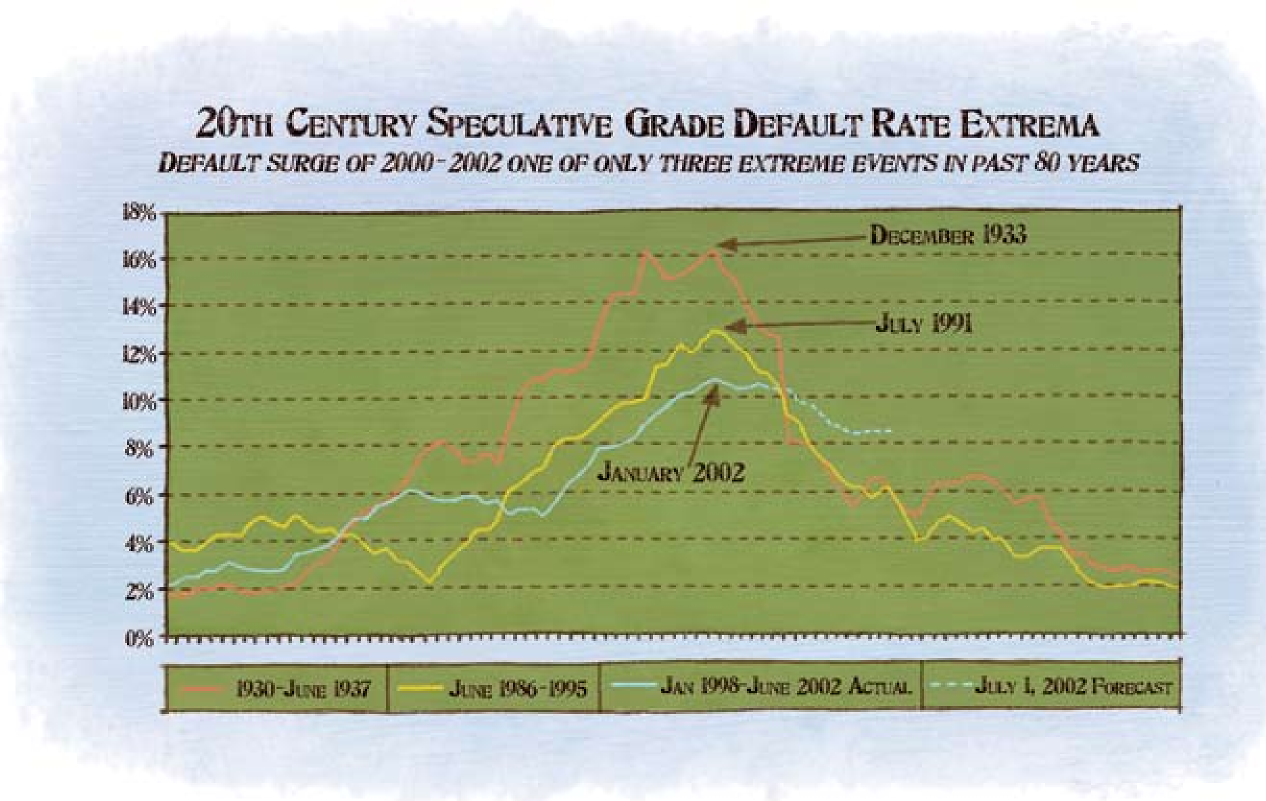

FIGURE 2

individuals, filed claims against (i) the SPVs that had issued the securities, (ii) the investment banks that had sponsored and/or marketed the CDOs, (iii) the portfolio managers and administrative agents of the SPVs, and (iv) in some cases, individual directors and officers of the SPVs. Discussed below are two of these recent cases: *SNS Bank N.V. v. Citibank, N.A.*, filed in New York state court, and *Banco Espirito Santo de Investimento v. Citibank, N.A.*, filed in New York federal court.

SNS Bank N.V. v. Citibank, N.A., et al.

In 1996, SNS Bank, a regional Dutch bank, purchased $15 million in subordinated and unsecured income notes issued by a Cayman Islands CDO fund. The fund invested in primarily United States corporate loans and debt obligations. In 2000–2002, the portfolio suffered significant losses because of multiple corporate defaults across many industries, including airlines, energy, telecommunications, and high technology. In an effort to improve the portfolio's performance, the administrative agent replaced the portfolio manager with an entity that was affiliated with the administrative agent. The portfolio losses nevertheless continued to mount as the market continued to deteriorate.

In 2002, facing a near-total loss of its principal investment, SNS Bank filed suit in New York state court against: (i) the Cayman Islands SPV that had issued the securities, (ii) Citibank, which had served as placement agent for the securities and as administrative agent for the SPV, (iii) the officers and directors of the SPV, and (iv) the individual Citibank officers who had served on the administrative committee of the SPV. SNS Bank alleged a wide range of claims against all of these defendants, including breach of fiduciary duty and breach of the transaction documents and unjust enrichment.

The trial court dismissed all the claims with prejudice, and that dismissal was affirmed on appeal by the New York Appellate Division, First Department. *SNS Bank, N.V. v. Citibank et al.*, 777 N.Y.S.2d 62 (1st Dept. 2004). The outcome in *SNS Bank* is significant to the entire CDO industry because many CDO transactions are governed by New York law and the New York Appellate Division rejected, as a matter of law, the typical claims that are made by disappointed CDO investors. The primary holdings in *SNS Bank* are as follows:

- Ordinarily, the SPV, the SPV's officers and directors, the placement agent, the administrative agent, and its employees owe *no fiduciary duty* to an investor who purchases debt securities from a CDO fund.

- CDO investors have *no third-party beneficiary standing* to seek to enforce contracts between the SPV on the one hand and the administrative agent and the portfolio manager on the other hand.

- Ordinarily, the SPV, the administrative agent, and the portfolio manager have *no general duty to disclose* to the investors any information beyond the obligations specifically undertaken in the transaction documents.

- The *Investment Company Act of 1940 is inapplicable* because the issuer of the securities, the SPV, was not required to be registered under the Act and disclosed that fact in the transaction documents.

Banco Espirito Santo de Investimento v. Citibank

The protections afforded to the CDO industry by the ruling in *SNS Bank* were expanded and bolstered by the district court decision in *Banco Espirito Santo de Investimento ("BESI") v. Citibank*. BESI was an investment bank and part of a substantial financial conglomerate in Portugal. In the late 1990s, it had invested about $25 million in subordinated and unsecured income notes issued by two different Cayman Islands CDO funds. The surge in corporate defaults in 2000–2002 all but wiped out BESI's investment. Like SNS Bank, BESI elected to sue Citibank to recover its investment losses; unlike SNS Bank, BESI did not assert any claims against the SPV, its officers, or any individual employees of Citibank. BESI filed its claims in New York federal court, asserting claims of breach of contract, breach of fiduciary duty, misrepresentation, and unjust enrichment.

While many of BESI's claims were quite similar to those asserted by SNS Bank, there was one theory of liability that was quite distinct. BESI attempted to impose obligations upon Citibank beyond those imposed by the transaction documents by alleging that Citibank had made a series of

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oral and written promises to BESI during the course of the marketing process for the securities. BESI sought to enforce those promises or, in the alternative, sought to recover reliance damages from Citibank for alleged misrepresentations in those communications. Citibank moved to dismiss, relying in substantial part on the extensive disclaimers in the marketing materials and the offering memoranda that investors were not to rely on any oral or written statements outside the offering memoranda and that no parties had been authorized to make any oral or written representations outside of or contrary to those in the offering memoranda.

The district court (Chief Judge Muksasey) dismissed all of BESI's claims with prejudice. *BESI v. Citibank*, 2003 WL 23018888 (S.D.N.Y. Dec. 22, 2003), *aff'd*, 110 Fed. Appx. 191 (2d Cir. Oct. 6, 2004). In dismissing BESI's claims of oral and written promises during the marketing of the securities, the district court ruled that "disclaimers in the marketing presentations, the Offering Memoranda, and the letter of intent [signed by BESI] 'constitute objective signs' of Citibank's 'expressed intentions' not to be bound by any statements outside of the Offering Memoranda." Further, the court ruled that it was clear from the transaction documents that Citibank intended to be bound only by a written agreement and the only written agreement would be the offering memoranda. The court dismissed the remaining claims on grounds largely similar to those relied upon by the court in dismissing the *SNS Bank* claims. The Second Circuit summarily affirmed that dismissal less than one year later.

WHAT LIES AHEAD

The clear rejection of the claims filed by SNS Bank and BESI was a vindication of CDO investment structures in which the roles of each participant are clearly described and delineated, the market risks clearly spelled out, and disclaimers of reliance prominently displayed. These rulings pose a significant hurdle for other disgruntled investors seeking to recoup their investment losses by pursuing claims against either the SPV or the placement agent and other intermediaries. These two cases will be valuable and binding precedent in any New York litigation in seeking dismissal of investor claims premised on theories of (i) fiduciary duty, (ii) third-party beneficiary standing, and (iii) oral and written representations outside the offering memoranda, provided appropriate disclaimers were provided. As a consequence, investors may elect to pursue their claims in other jurisdictions, away from New York and the United States. Indeed, SNS Bank and BESI could well have brought their claims in their home jurisdictions of the Netherlands and Portugal, respectively. Such non-U.S. jurisdictions could afford local investors a substantial strategic benefit. One way for CDO industry participants to preserve their litigation advantage, on a going-forward basis, would be to provide for mandatory forum-selection clauses that would require investors to bring their claims in New York state and federal courts. Such a clause may be particularly appropriate where CDO investments are marketed to investors in jurisdictions that have weak, ill-developed, or corruptible legal regimes.

In addition to claims by institutional investors in non-U.S. jurisdictions, participants in the CDO industry are likely to face, with increasing frequency, claims by individual investors both in the United States and abroad. The sale of junior tranche securities to such investors in other countries has accelerated at a tremendous pace. Absent mandatory forum-selection clauses, disgruntled investors in these countries may well choose to pursue their claims locally as opposed to in the United States. Even were they to pursue their claims in the United States, they would seek to avoid early dismissal of their claims by focusing on their status as individual investors, as opposed to institutions. As a threshold matter, individual investors may be in a position to allege with greater credibility and specificity the existence of a broader fiduciary relationship with the placement agent or others involved in the sale of the CDO securities. This is especially the case where the investor can allege a long-standing business relationship in which it has reposed trust and confidence in the placement agent or other agent of the SPV and has relied on that person to provide objective investment advice. Even in the absence of such circumstances, an individual investor is more likely to be afforded the benefit of any doubt before his or her claim is dismissed.

While we are aware of no reported New York decisions involving individual investors in the CDO investment context, state and federal courts in New York have been rather permissive in allowing even sophisticated high-net-worth individual investors to pursue claims involving complex derivatives and currency trading investments, where the claims of a similarly situated institutional investor likely would have been dismissed. *See Caiola v. Citibank*, 295 F.3d 312 (2d Cir. 2002). In *Caiola*, the Second Circuit held, among other things, that broad disclaimers of reliance in transaction documents concerning extensive physical and synthetic equity investments did not preclude the plaintiff from pursuing claims premised on alleged oral misrepresentations. For the disclaimers to have been effective, in the analysis of the Second Circuit, they were required to track the substance of the alleged misrepresentation. The effect of *Caiola* on potential claims by CDO investors can be addressed if, at the inception of the investment, the investor executed disclaimers that clearly disavow reliance on oral and written representations outside the transaction documents concerning specific topics, such as investment risk, the structure of the investment, the priority of payments, projected performance of the CDO fund, and the role of the placement agent and other intermediaries.

Given the more than $1 trillion estimated to be invested in CDOs, further litigation is a foregone conclusion. The question is not *whether* such claims will be filed, but *when*. Some of the CDOs that were affected by the default surge in 2000–2002 are still in business and not yet closed out. It is quite possible that some investors may await the maturity of those CDOs before asserting their claims. Moreover, all investors who are invested in CDOs are exposed to the risk of another increase in default rates during the next downturn in the business cycle. The financial press has forecasted a surge in defaults in 2007, and some analysts have predicted default rates in excess of those experienced only five years ago. The recent rise of defaults in the subprime mortgage market has already affected residential mortgage CDOs. If the downturn deepens or broadens and affects a number of different industries, investors could once again experience significant impairment of their invested principal, resulting, undoubtedly, in the assertion of new claims. ■

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