



JONES DAY  
**COMMENTARY**

## COMMERCIAL REAL ESTATE CDO LITIGATION: THE CREDIT CRISIS' NEXT WAVE?

Could the next wave of the credit crisis flood court-houses with commercial real estate securities lawsuits? *The Wall Street Journal* recently reported nearly unprecedented delinquency rates for the \$700 billion of securitized loans backed by commercial real property assets and warned of alarming default and loss rates, particularly given the current climate for refinancing commercial mortgages.<sup>1</sup> Standard & Poor's has announced that it intends to place on negative ratings watch an array of structured financial products backed by commercial real estate assets.<sup>2</sup> Similar developments in the residential real estate market released a flood of litigation a little more than a year ago. Even if the commercial real estate market manages to keep its head above water, litigation is likely.

Among those in line to get soaked: collateralized debt obligations backed by commercial real estate assets ("CRE CDOs") and the institutions and professionals

that have structured, managed, and marketed them. CRE CDOs were a common financing mechanism for commercial real estate's explosive growth in the middle of the decade. But faced with a perfect storm similar to that which struck the residential real estate market—plummeting asset values, rising default rates, and tight credit markets—CRE CDOs will likely face lawsuits similar to those now dogging CDOs backed by residential real estate assets. Further, unique features of CRE CDOs might generate their own litigation risks. In this *Commentary*, we highlight those litigation risks and discuss some potential defenses.

### CDOS—A BRIEF INTRODUCTION

A CDO is a structured financial product in which debt and equity are issued to finance the purchase of a pool of assets (the "collateral pool"), and income from

1. See Lingling Wei, "Commercial Property Faces Crisis," *Wall St. J.*, Mar. 26, 2009, at A1.

2. See Jay Miller, "S&P Warns on CMBS," *Wall St. J.*, Apr. 7, 2009, at C8.

the collateral pool is used to service the debt. The assets in the collateral pool are selected according to investment guidelines set forth in the CDO's documentation and generally include financial assets, such as loans or debt securities, or securitized assets, such as asset-backed securities or securities issued by other CDOs.

CDO debt is issued in classes or tranches of notes that receive principal and interest payments according to a priority-of-payment protocol. Senior notes typically are investment-grade, and the noteholders generally are entitled to receive their full distribution of interest (or principal and interest) payments before any distribution to the subordinated noteholders. Subordinated notes typically are issued at the lowest investment grades, or below investment grade, and offer an attractive yield relative to senior notes to compensate for their junior status. This tiered distribution structure redistributes the collateral pool's credit risk among the noteholders. The equity tranche of the CDO, which might be retained by the collateral manager (discussed below) or sold to an investor, generally receives distributions last and is the first to suffer losses if the collateral pool's assets fail to generate the anticipated income.

Before the credit crisis, CDOs were attractive to investors—principally financial institutions, insurance companies, pension funds, and hedge funds—for several reasons. CDOs provided investors with exposure to asset classes that they did not want to hold directly or could not hold directly due to their own investment guidelines. CDOs provided investors with regularly scheduled distributions that could match an investor's own payment obligations. And CDOs provided an attractive rate of return, with yields superior to those on comparably rated debt.

CDOs were also attractive to the professionals and institutions that brought them to market and that have administered them. The entities that sponsored and structured CDOs included financial institutions and asset managers. Not only did they earn fees for their effort, but they also accomplished other goals, such as selling assets into the

CDO to raise capital or to manage their balance sheets. CDO trustees—typically banks—have earned fees for holding the collateral pool assets in trust for the benefit of the noteholders and certain other persons, enforcing the terms of the CDO, and acting as a collection agent to collect payments from the assets in the collateral pool and distribute payments to the noteholders. In a managed—as opposed to a static—CDO, an investment advisor, acting as a collateral manager, trades collateral in and out of the collateral pool to manage risk and performance. The collateral manager earns a fee for its services.<sup>3</sup>

## DISTINGUISHING FEATURES OF CRE CDOs

CRE CDOs differ from other CDOs in at least three ways. First, the collateral pools of CRE CDOs consist mainly of commercial real estate assets. When static CRE CDOs were first marketed in the late 1990s, their collateral pools comprised mainly commercial mortgage-backed securities and debt issued by real estate investment trusts. By the mid-2000s, managed CRE CDOs had emerged, and their collateral pools often included less liquid real estate assets such as whole loans, B notes, mezzanine loans, and preferred equity.

Second, the offering documents for CRE CDOs often include asset-specific disclosures because a single asset in the collateral pool often accounts for greater than five percent of the collateral pool's aggregate principal balance. This is in contrast to the offering documents for other CDOs, which generally do not contain asset-specific disclosures because concentration limits generally prohibit a single asset from accounting for a large portion of the collateral pool. In those transactions, asset class disclosures and investment guidelines are viewed as providing sufficient information to investors. Similarly, the transaction documentation for CRE CDOs often includes asset-specific representations and warranties.

Finally, the lineup of institutions that administer CRE CDOs sometimes includes a special servicer and master servicer,

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3. Another entity involved in bringing a CDO to market is the issuer, a bankruptcy remote entity typically organized in a non-U.S. jurisdiction that has a favorable regulatory and tax regime. The issuer issues the debt and equity of the CDO and pledges the collateral pool's assets and their income to a trust (administered by the trustee) for the benefit of the noteholders and certain other persons.

roles that do not exist in most other CDOs. The special servicer manages distressed assets in the collateral pool. The master servicer, rather than the trustee, collects payments from certain assets in the collateral pool. These parties were added to CRE CDO deals at the request of rating agencies and investors due to the specialized nature of the collateral pool's assets.

## LITIGATION RISKS

The current wave of litigation involving CDOs backed by residential real estate assets suggests what might be in store for CRE CDOs. In one type of lawsuit, CDO investors have leveled claims against issuers, structuring agents, dealers, trustees, and collateral managers for (i) fraud and negligent misrepresentation based on allegedly misleading statements about collateral pools, deal protections, or market risk; (ii) breach of fiduciary duty for mismanaging collateral pools; and (iii) breach of contract for failure to live up to the terms of the transactions.<sup>4</sup>

Lawsuits by investors in CRE CDOs are not the only possibility. Current credit crisis litigation includes shareholder suits against financial institutions to recover losses allegedly caused by the institutions' structured finance activities and investments.<sup>5</sup> CDOs have featured prominently in these lawsuits, even though the claims are not tied directly to a particular CDO's performance. Rising commercial real estate defaults—and the ensuing stress on CRE CDOs—could fortify these lawsuits or trigger a new wave.

In a third type of lawsuit, known as an interpleader action, a party holding a specific asset asks the court to determine who among two or more competing claimants is entitled to that asset. Disputes involving the distribution of CDO assets seem almost tailor-made for resolution by interpleader because of

the CDO structure, in which a trustee holds assets for the benefit of the investors. Indeed, several CDO trustees have initiated interpleader actions as a result of allegedly ambiguous transaction documentation concerning the proper distribution of CDO assets following an event of default.<sup>6</sup>

## LITIGATION RISKS UNIQUE TO CRE CDOs

The distinguishing features of CRE CDOs, described above, might themselves be a source of litigation risk. For example, asset-specific disclosures could be fertile ground for allegations of misrepresentations and omissions, and asset-specific representations and warranties might provide a platform for breach of contract claims. This risk is not inherent in other CDOs because, generally, their documentation does not include asset-specific disclosures or asset-specific representations and warranties.

Asset-specific disclosures also might present a problem to defendants on the element of materiality. The fact that one asset, as opposed to another, is highlighted in the transaction documentation could prevent defendants from successfully arguing that alleged misstatements about the asset were immaterial, at least on a motion to dismiss. Asset-specific disclosures also could help investors craft complaints that can survive challenges to the specificity of the pleading.<sup>7</sup> When an asset is identified in some detail in the offering document, an investor can focus its pre-litigation diligence and its pleadings on that asset. Investors in other types of CDOs do not have that luxury because disclosures in the documentation for those transactions usually stop at the asset class level.

Another potential litigation risk comes from the involvement of a special servicer, a role that does not exist in other types of CDOs. Poor CRE CDO performance could prompt

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4. See, e.g., Complaint, *M&T Bank Corp. v. Gemstone CDO VII, Ltd.*, Index No. 2008-007064 (N.Y. Sup. Ct. Erie Cty. June 16, 2008).

5. See, e.g., *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009) (dismissing a shareholder derivative action).

6. See, e.g., Amended Interpleader Complaint, *Deutsche Bank Co. Americas v. Lacrosse Fin. Prods, LLC*, No. 08-civ-0955 (S.D.N.Y. Nov. 5, 2008). Faced with alleged ambiguity in the transaction documentation, an investor in one CDO simply sued the co-issuers, trustee, and broker-dealer under various common law theories. See Complaint, *M&T Bank Corp. v. LaSalle Bank Nat'l Ass'n*, No. 08-cv-00581 (W.D.N.Y. removed Aug. 6, 2008).

7. Under the federal and state rules that control how a complaint must be pleaded, allegations of fraud (and, in some states such as New York, negligent misrepresentation) must be pleaded with specificity. See Fed. R. Civ. P. 9(b); N.Y. C.P.L.R. 3016(b).

investors to test—in court—the latitude that special servicers generally are given to work out troubled assets. Such second-guessing lawsuits might prove too fact-specific for resolution on a motion to dismiss. Litigation risk also is heightened by the perilous state of commercial real estate and credit markets, which could further constrain the workout options available to special servicers.

## SOME DEFENSES

Certain arguments that have gained traction in recent credit crisis litigation could prove helpful in defending against CRE CDO lawsuits. One argument focuses on the element of loss causation, that is, proof that an investor's loss was caused by the defendant's alleged malfeasance. Companies have defeated shareholder securities fraud actions at the motion to dismiss stage by demonstrating that alleged misrepresentations in their disclosures were not the cause of share price declines. Rather, they argue, an unforeseen, unprecedented collapse of credit markets and housing prices caused a market-wide contraction that unavoidably affected the companies' share prices.<sup>8</sup>

Whether defendants in CRE CDO lawsuits can successfully advance this loss causation argument remains to be seen. One potential hurdle is that, even if distress in the commercial real estate market proves to be unprecedented, market participants might not be able to demonstrate that the stress was unforeseeable. This hurdle might be especially high for managed CRE CDOs because collateral managers arguably will have had more time than their residential real estate colleagues ever had to anticipate market stress and manage collateral accordingly. That said, disrupted credit markets—hardly the fault of a collateral manager—arguably have

limited collateral managers' options. A CDO's own investment and trading guidelines might further constrain a collateral manager's options in an unstable market.

Another argument concerns the element of scienter—proof of a wrongful state of mind, such as an intent to deceive. Courts have held that an executive who loses money alongside shareholders logically lacked an intent to deceive those shareholders. The reasoning: An executive would not have invested in the company if she knew the company was a sham.<sup>9</sup> Collateral managers that hold junior investments in a CDO transaction may advance that same argument against plaintiffs that hold more senior positions because the collateral managers almost certainly suffered losses before the more senior noteholders. The argument should have even greater force in CRE CDO lawsuits, because in many CRE CDO transactions, the collateral managers often bought or otherwise retained the equity tranche, as well as all non-investment grade tranches of notes.

## CONCLUSION

CRE CDOs—and the institutions and professionals that have structured, managed, and marketed them—are potential targets in the next wave of credit crisis litigation. That litigation might mirror litigation currently underway against non-CRE CDOs, and certain distinct features of CRE CDOs might be the fulcrum for further litigation. Defenses that have proved helpful in the current wave of litigation could prove helpful in defending against the next wave. It certainly is not too early (or too late) for investors, dealers, collateral managers, and trustees to review their CRE CDO transaction documentation to assess any material weaknesses, to evaluate litigation risks and opportunities, and to prepare accordingly.

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8. See, e.g., *In re 2007 Novastar Fin., Inc. Sec. Litig.*, No. 07-0139-CV-W-ODS, 2008 WL 2354367, at \*3 (W.D. Mo. June 4, 2008) (dismissing a federal securities fraud complaint brought by shareholders of a mortgage originator: “[N]othing in the Complaint demonstrates a connection between these changes [to the company’s internal controls and underwriting standards] and the Company’s later misfortunes, particularly in light of the economic downturn described [in the Complaint].”). See also *Pittleman v. Impac Mortgage Holdings, Inc.*, No. SACV 07-0970, 2009 WL 648983, at \*4 (C.D. Cal. Mar. 9, 2009) (dismissing a federal securities fraud complaint brought against an originator of Alt-A mortgages: “Plaintiff argues that this case is about a staggering race-to-the-bottom of loan quality and underwriting standards as part of an effort to originate more loans for sale through secondary market transactions. The Court disagrees. This case is about a company involved in a volatile industry at the onset of a long, destructive economic downturn.”) (internal quotation marks and citation omitted).

9. See, e.g., *In re Bristol-Myers Squibb Sec. Litig.*, 312 F. Supp. 2d 549, 561 (S.D.N.Y. 2004) (dismissing a federal securities fraud claim: “[T]he Individual Defendants, in almost every instance, increased their . . . holdings [in the security at issue] during the Class Period—a fact wholly inconsistent with fraudulent intent.”) (emphasis in original).

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