

# Risk-Mispricing of structured products under New York law

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## Key points

- Structured financial products such as asset-backed securities collateralized debt obligations (ABS-CDOs) present highly complex issues of loss causation due to structural complexity, illiquidity and asymmetries of information.
- This article provides a framework for the evaluation of whether losses are attributable, under New York law, to market events or to seller misconduct.
- The issues involve questions of transaction documentation, including disclosures and disclaimers, as well as possible seller arbitrage, rating agency methodologies and differential access to information regarding underlying collateral.
- The article suggests, in conclusion, that New York courts are engaged in a critical reappraisal of the viability of fraud and related claims brought by sophisticated investors of structured products against arranging banks and ratings agencies.

## 1. The Problem

Structured credit instruments present special issues of modelling and valuation due to the inherent complexity of the structures, the illiquidity of the products and the asymmetries of information regarding the underlying collateral value and credit quality. These issues are compounded in re-securitizations. Further, the severity of the financial crisis has caused a convergence of performance across structured credit transactions, with buyers, sellers and traders all caught with losses. The financial crisis itself has been blamed on a wide set of factors including regulatory inaction, excess leverage in the capital markets promoted by Federal Reserve interest rate policies, rating agency incompetence, the downturn in the US housing markets, mark-to-market accounting and other factors. Loss causation may appear difficult to assess.

But injured investors and risk insurers should not overlook real differences in credit quality and fairness of pricing across equivalently rated and priced transactions which may be a key driver of loss. As Mr Alan Greenspan admitted, in his 23 October 2008 Testimony to the Committee of Government Oversight and Reform: 'It was the failure to properly price such risky assets that precipitated the crisis.' Investors now facing loss positions should pay particular attention to the possibility of systemic mispricing of credit risk by some arranging banks that may have knowingly arbitrated rating agency

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methods and industry modelling techniques to offload risks—without full and fair disclosure—at below-market prices.

Of course, on a forward-looking basis, regulators on both sides of the Atlantic have expressed an intent to work to ensure adequate transparency and risk disclosure in the structured credit markets. In the USA, for example, Securites and Exchange Commission (SEC) Chairman Mary Schapiro and Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler gave coordinated testimony on 22 June 2009, to the Senate Banking Subcommittee on Securities, Insurance and Investment, advocating an expansion of regulatory authority over all over-the-counter (OTC) derivatives, with the SEC to exercise jurisdiction over security-related OTC derivatives (such as credit default swaps written against debt securities), while the CFTC would exercise jurisdiction over all other OTC derivatives. As detailed by Chairman Gensler, the new regulatory framework should achieve ‘four key objectives’: (1) ‘Lower systemic risks’; (2) ‘Promote the transparency and efficiency of markets’; (3) ‘Promote market integrity by preventing fraud, manipulation and other market abuses, and by setting position limits’; and (4) ‘Protect the public from improper marketing practices’.

The problem for injured investors and insurers is how to assess whether losses sustained in past transactions are properly attributable to market events or instead to seller misconduct—and, if the latter, how to seek redress for those losses. This article sets a framework for that analysis under New York law for structured products in the US mortgage sector, including residential mortgage backed securities (RMBS),<sup>1</sup> collateralized debt obligations (CDOs) backed by RMBS and other debt collateral,<sup>2</sup> and credit default swaps (CDS) and financial guarantees written against tranches of RMBS and CDOs.<sup>3</sup>

## 2. An analytical approach

As a rule, the analysis of structured products issues is transaction specific and will turn upon the particular documentation, representations and collateral of each deal. Certain common issues, however, may be identified for US mortgage sector transactions in the critical period from 2005 through 2007 where losses are most highly concentrated.

From the investor side, what drove the market for US RMBS and RMBS-derivatives was the promise of apparently high-quality, highly rated structured credit with higher yields than other comparably rated debt instruments. For example, ‘super-senior’

1 RMBS trusts (or other special purpose vehicles [SPVs]) acquire pools of residential mortgage or home equity loans and repackage risks through the issuance of tranching, rated securities with differing rights to the loan pool cash flow in order to satisfy investor demand as to credit quality and maturity of the debt securities. RMBS securitizations effectively transfer borrower credit risk from loan originators to RMBS investors and insurers.

2 RMBS–CDOs purchase RMBS tranches (or, through swaps, synthetic interests in RMBS tranches) and re-securitize the RMBS through the issuance of tranching, rated Notes with sequential rights to the RMBS collateral cash flows. This re-securitization allows the creation of new securities with risk/return profiles that differ from the underlying collateral: entirely BBB-rated RMBS may support the creation of CDO Notes that are predominantly AAA, though with subordinated tranches that generally include tranches lower than BBB.

3 A CDS is a contract in which one party, the protection seller, covers the risk of loss (or other defined credit event) on referenced obligations in exchange for set premiums paid by the protection buyer during the period of the swap. The risk of loss to the protection seller depends on the risk of loss on the reference obligation but may not be co-extensive with that risk (eg the protection seller may not hold ownership rights to the reference obligation).

CDO/CDS (credit default swap) risk built on residential mortgage loans was marketed as safer and less volatile than AAA corporate debt, a claim backed up by comparisons of historical default and recovery rates. Capital moved from the other investment sectors into the RMBS sector that promised the better risk/return profile.

Yet it is now widely recognized that the quality of mortgage loan origination may have deteriorated markedly during this 2005–2007 period, with certain lenders aggressively expanding new products to riskier borrowers in an attempt to increase profits and market share. With the success of early securitizations and continued investor demand, certain RMBS arrangers increasingly aggregated loans with higher risk and higher yield in order to generate greater cash flows for repackaging in securitizations. For example, RMBS built from subprime or ALT-A loans with pay-option adjustable-rate mortgages (ARMs) might include low documentation or no documentation features (such as borrower stated income without verification), which can facilitate borrower fraud.<sup>4</sup>

At the same time, many RMBS arrangers and loan originators continued to secure strong credit ratings on the products—and investor and insurer interest—through extensive written representations and warranties regarding strict loan origination ‘underwriting guidelines’ and the specific required characteristics of the loans in the pool, as well as contractual ‘put-back’ obligations for the loan originator to repurchase any loans that did not satisfy the stated criteria. According to the International Monetary Fund, ‘[o]ptimism about how subprime mortgages would perform led to more than 90 percent of securitized subprime loans being turned into securities with the top rating of AAA.’<sup>5</sup> And as reported in the Federal Reserve Board Finance and Economics Discussion Series, ‘[i]n dollar terms, nonprime mortgages represented 32 percent of all mortgage originations in 2005, more than triple their 10 percent share only two years earlier.’<sup>6</sup> It now appears that certain leading originators may have been aware that their subprime loan products represented materially different credit risks than those disclosed to their shareholders and investors. The SEC’s recently filed complaint against Countrywide executives, for example, quotes internal emails in support of allegations of such knowledge at Countrywide as early as 2005.<sup>7</sup>

4 See, eg ‘Inside the Countrywide Lending Spree’ *The New York Times* (New York 26 August 2007); ‘Countrywide’s New Scare – ‘Option ARM’ Delinquencies Bleed Into Profitable Prime Mortgages’ *Wall Street Journal* (New York 24 October 2007); *Re Countrywide Corp. Secs. Litig.*, Index No 07-05295 (CD Cal 7 January 2009); *SEC v Mozilo et al*, Index No 09-03994 (CD Cal 4 June 2009).

5 R Dodd and P Mills, ‘Outbreak: U.S. Subprime Contagion’ (2008) 45 *Fin Dev* 15.

6 C Mayer, K Pence and S Sherlund, ‘The Rise in Mortgage Defaults’ (Working paper) (20 November 2008) <<http://www.federalreserve.gov/pubs/feds/2008/200859/200859pap.pdf>> accessed 30 November 2009, 2.

7 On 4 June 2009, the SEC filed securities fraud charges against former Countrywide Financial Chief Executive Officer Angelo Mozilo, former chief operating officer and President David Sambol, and former Chief Financial Officer Eric Sieracki. According to the SEC’s description of its complaint, the SEC alleged, among other things, that: (1) ‘Mozilo, Sambol, and Sieracki misled the market by falsely assuring investors that Countrywide was primarily a prime quality mortgage lender that had avoided the excesses of its competitors’; (2) ‘Countrywide’s credit risks were so alarming that Mozilo internally issued a series of increasingly dire assessments of various Countrywide loan products and the resulting risks to the company . . . refer[ring] to a profitable subprime product as “toxic” [and] . . . regarding the performance of its heralded Pay-Option ARM loan . . . acknowledg[ing] that the company was “flying blind”’; (3) ‘Countrywide’s annual reports for 2005, 2006, and 2007 misled investors in claiming that Countrywide “manage[d] credit risk through credit policy, underwriting, quality control and surveillance activities”’; and (4) ‘Mozilo, Sambol, and Sieracki actually knew, and acknowledged internally, that Countrywide was writing increasingly risky loans

Accordingly, the basic question for RMBS investors and insurers is whether the loan originator abandoned stated guidelines or reasonable and customary underwriting practices just when such guidelines and practices had become even more critical to ensure borrower creditworthiness. The first level of this inquiry should be based on documents within investor/insurer control, including: (1) the closing documents, including the prospectus and all contracts (eg purchase and sale agreement, servicing agreement, insurance agreement), with a focus on express representations, warranties and disclaimers; (2) the pre-closing data tape or mortgage schedule of loans, and any other pre-closing representations about origination guidelines and loan attributes; (3) the relevant underwriting guidelines or standards of the specific originator, and any available data regarding reasonable and prudent underwriting standards; and (4) the actual loan application files (including the borrower application, asset appraisal and verification documents), which typically may be demanded as of right from the RMBS arranger or loan originator. The investor or insurer should also review (5) public disclosures in financial statements and elsewhere by the loan originator and RMBS arranger, as well as (6) complaints or other filings by federal and state regulators and state Attorneys-General, and civil actions filed by private litigants.

For RMBS transactions, the loan files should be assessed against stated underwriting guidelines (eg borrower FICO scores, loan to value/combined loan to value (LTV/CLTV) and debt to income (DTI) ratios, lien priorities, asset attributes, asset-type exclusions and whether ‘exceptions’ can be justified on the basis of compensating factors). The mortgage schedule or loan tape should be tested for accuracy; documentation should be reviewed for completeness; appraisals should be tested for use of proper comparables and adjustments; the loan status should be tested for delinquency as of the date of inclusion in the securitization; loan diversification across regions should be reviewed; and so on.

An inference of loan originator and/or arranger fraud may be appropriate if reviews of mortgage loan files show, in conflict with stated disclosures, a materially aberrant incidence of permitted borrower fraud, unjustified ‘exceptions’ to underwriting criteria, unreasonable stated income, inflated asset value and/or other problems such as incomplete documentation. If there are material deviations off stated guidelines or loan eligibility criteria, it should be expected that the loan pools, at inception of the transaction, had risk profiles materially different than implied by the representations and warranties of the loan originator and/or RMBS arranger—with higher expected rates of loan defaults and delinquencies, lower expected recovery rates and fewer assets available to the RMBS trust.

The problems become both more complex and more severe with the re-securitizations of RMBS into CDOs (or, in the case of CDO<sup>2</sup>, RMBS–CDOs and/or other CDO tranches into new CDOs). CDOs, like other debt securities, are marketed on the basis of expected cash flows. The ‘credit spread’ component of yield, which can be implied from price,

and that defaults and delinquencies would rise as a result, both in loans that Countrywide serviced and loans that the company packaged and sold as mortgage-backed securities.’

reflects the market's perception of credit risk—though for highly illiquid and complex securities, where market prices are not readily available, investors and insurers are unusually dependent upon arranging banks for this information. Through late 2007, for investors and insurers of senior AAA-rated tranches and super-senior CDO tranches, the industry standard buy-side approach to due diligence typically involved, among other things: (1) due diligence into the integrity and capabilities of the arranger and (for actively managed transactions) the collateral manager, and (2) reliance upon ratings-based cash-flow modelling and related stress testing. Arranging banks generally also marketed CDO and related CDS products on the strength of credit ratings and arranger/manager expertise in selecting collateral of a defined type from within a given rating class.

But the evidence is rising that certain arranging banks were valuing and structuring CDOs and CDS internally on the basis of models that fundamentally conflict with the ratings-based cash-flow models on which the deals were sold—specifically, with the arranging banks rejecting the very ratings measures that the banks had represented as indicative of the credit quality of the transactions, without disclosing this to investors.<sup>8</sup> This potential problem of two sets of models—and two sets of books—arises from inherent limitations in the rating agency methodologies that apparently were known to and exploited by certain arranging institutions.

While there were differences in approach to the modelling of RMBS and other structured finance (SF) CDOs by S&P, Moody's and Fitch (and these differences were also exploited in the structuring of transactions), each of the major rating agencies evaluated the expected performance of SF CDOs on the basis of the prior-issued 'ratings' of the underlying collateral—without regard to credit spreads implied by then-current pricing. That, in effect, makes use of often-stale historical data rather than market data. Thus, the S&P CDO Evaluator takes as inputs collateral ratings previously issued by S&P (regardless of when the collateral ratings were originally issued) without regard to the implied ratings or credit quality from market data as of the closing of the CDO.<sup>9</sup> Similarly, in its late-2007 disclosure of modelling criteria, Fitch acknowledged that its 'CDO rating methodology uses Fitch's rating and the term of an asset as the primary inputs to determine a default probability.'<sup>10</sup> And Moody's 2005 revision of its asset-correlation assumptions for SF CDOs specifically rejects the use of inferences drawn

8 See, eg *HSH Nordbank, AG v UBS AG*, Index No 600562/08 (Sup Ct NY County 28 September 2009), Slip op at 4–5 (holding plaintiff had adequately alleged, through use of internal UBS documents produced in discovery that UBS's internal accounting and assessments of CDO transactions differed materially from representations made to plaintiff about the performance and value of those transactions); *Pursuit Partners, LLC v UBS AG*, FST-CV08-4013452 (Conn Super Ct 8 September 2009) (plaintiff presented sufficient evidence to support its fraudulent concealment claim that UBS was in possession of superior knowledge not readily available to Pursuit, relying on internal UBS emails demonstrating that UBS met privately with rating agencies, received advanced knowledge of downgrades and then redoubled its efforts to sell CDOs, with the court stating that 'The court takes UBS employees at their word when they referenced their Notes, these purported "investment-grade" securities which they sold, as "crap" and "vomit," for UBS alone possessed the knowledge of what their product, their inventory, was truly worth').

9 In 2005, S&P described its Gaussian copula model as using survival probabilities obtained from the cumulative default probabilities of each asset, characterized as credit curves, which for ABS assets were based on the 'average historical ABS transition matrix' defined by rating. See Standard and Poor's, 'CDO Evaluator Version 3.0: Technical Document' (London 19 December 2005) 6 and Appendix 1.

10 Derivative Fitch, 'Global Criteria for the Review of Structured Finance CDOs with Exposure to US Subprime RMBS' (15 November 2007) 4.

from credit spreads, predominantly on grounds of the illiquidity of structured instruments.<sup>11</sup>

In periods of volatility or rapidly evolving market conditions—such as the deterioration in the subprime sector known to loan originators and certain arranging banks well before changes in widely observed indices such as the ABX and TABX—ratings often lag market prices as reliable indicators of market quality. An arranging bank could thus game the rating agency models, and market transactions on the basis of materially stale credit ratings to investors and insurers, by choosing otherwise eligible collateral (eg BBB-rated RMBS) with unusually high credit spreads indicative of deteriorating credit quality at a level below that implied by the rating (eg an effective credit quality of single-B), knowing that market participants generally rely on ratings to assess the creditworthiness of a transaction.<sup>12</sup> This may be one reason why distress was recognized in the subprime loan sector long before it was recognized in subprime RMBS–CDOs.

A separate problem in the rating agency methods for this critical 2005–2007 period was the underestimation of correlation risk for RMBS–CDOs—a severe issue for structured products marketed in part on the basis of supposed internal diversification. As Fitch admitted in late 2007: ‘[T]he intra-sector correlation assumptions for US subprime RMBS, as well as SF CDOs with exposure to US subprime RMBS, were among the highest assumed, at 45%. However, the current extent of rating co-movement would suggest a systemic risk exposure underestimated by the current correlation assumptions.’<sup>13</sup> This problem could be compounded if an arranging institution exceeded stated thresholds for certain types of securities by misreporting concentrations of securities. For example, a stated overall limit of 30% for the ‘subprime RMBS’ bucket of a CDO could be defeated if the arranger filled a separately defined ‘ABS’ or ‘CDO’ bucket with structured securities that in turn held substantial amounts of subprime RMBS. In either case, the arranger’s pricing of the CDO tranches would be expected not to correspond to the actual risk transferred.

Because of these flaws in rating agency methodologies, it must be recognized that it was possible for certain arranging institutions to source collateral with high spreads (relative to collateral rating) and then procure CDO ratings that did not fairly reflect the actual credit quality of the CDO tranches. Thus one ‘arbitrage’ opportunity to be investigated in any particular transaction is straightforward: lower quality loans provide arrangers with a low-cost basis to source collateral with high amounts of cash flow, thus increasing profits from arranging the transaction while transferring increased risk to investors and insurers. As an additional economic incentive, the enormous capital invested in RMBS structured credit products, and the resulting supply/demand

11 Moody’s Investor Service, ‘Moody’s Revisits Its Assumptions Regarding Structured Finance Default (and Asset) Correlations for CDOs’ (27 June 2005) 2.

12 *Abu Dhabi Commercial Bank v Morgan Stanley & Co., Inc.*, No 08 Civ 7508, 2009 WL 2828018 (SDNY 2 September 2009) (‘the market at large, including sophisticated investors, have come to rely on the accuracy of credit ratings and the independence of rating agencies because of their [status as “nationally recognized statistical ratings organizations”]’) (sustaining claims of fraud).

13 Derivative Fitch (n 10) 6.

imbalance, led to a shortage of higher quality underlying loans, threatening the fee stream for arrangers of new securitizations. Further, certain transactions were structured so that the bank was not only the arranger of the transaction but also a credit default swap counterparty purchasing protection on the substantial majority of the CDO tranches (which need not be actually held by the bank)—so that the arranging bank stood to earn additional gains if the CDO failed to generate adequate cashflow to satisfy its obligations to noteholders. (This is, for example, the structure alleged in *HSH Nordbank, AG v UBS AG*.) It is also clear that, particularly as of the early 2007 period, certain arranging institutions had accumulated very large RMBS and RMBS–CDO positions on their balance sheets, and sought to reduce their risk by re-securitizing these positions into newly rated and issued CDOs. The new tranches could either be sold to investors or, in the case of senior or super-senior tranches, retained by the bank and hedged through credit default swaps (a combined strategy that Merrill Lynch, for example, is reported to have internally referred to as ‘de-risking’ and ‘mitigation’).<sup>14</sup>

The major rating agencies have stated that they maintained independence and did not deliberately compromise rating methodologies for mortgage-related structured products, notwithstanding the ‘issuer-pays’ model (in which fees are paid by the arranger of the transaction or the originator of the securitized assets, rather than by investors or other entities without a prior interest in the transaction). S&P acknowledged that ‘one way to increase revenue would be for us to weaken our criteria to ensure that we are selected as the agency to rate a transaction or to ensure that a transaction that would not have been economically viable can take place’, but asserted that such conduct ‘would violate our internal rules as well as endanger our franchise, which is why we do not engage in such behavior’.<sup>15</sup> S&P further asserted that ‘our structured finance ratings are extremely transparent.’<sup>16</sup>

The SEC tested these rating agency assertions in 2008 and came up with different conclusions. According to the July 2008 SEC Staff Summary Report investigating the practices of Fitch, Moody’s and S&P in rating RMBS and CDOs, the ratings agencies did not always disclose or document their actual methodologies or significant participants in the ratings process. In particular, the SEC Staff found that: (1) ‘certain significant aspects of the ratings process and the methodologies used to rate RMBS and CDOs were not always disclosed, or were not fully disclosed’; (2) ‘Rating agencies made “out of model adjustments” and did not document the rationale for the adjustment’; (3) ‘None of the rating agencies examined has specific written procedures for rating RMBS and CDOs’; and (4) ‘the ratings agencies had inadequate surveillance to monitor the accuracy of ratings on an ongoing basis’.<sup>17</sup> Indeed, then-nominee SEC Chairman Mary Schapiro

14 Susan Pulliam, Serena Ng and Randall Smith, ‘Merrill Upped Ante as Boom In Mortgage Bonds Fizzled’ *Wall Street Journal* (New York 16 April 2008) A1.

15 Standard and Poor’s Structured Finance: *Commentary*, RatingsDirect (23 August 2007) 5.

16 *Ibid.*

17 United States Securities and Exchange Commission, ‘Summary Report of Issues Identified in the Commission Staff’s Examination of Select Credit Ratings Agencies’ (July 2008) 13, 14, 16 and 21.

testified in January 2009 that: ‘Until we deal with the compensation model, we’re not going to deal with the conflict of interest, and people are not going to have confidence that the ratings are worth relying on, worth the paper they’re printed on.’<sup>18</sup>

A fundamental question for CDO investors and protection sellers on CDO tranches, therefore, is whether the arranging bank made material misrepresentations of the key attributes of the transaction that affect the basic risk/return profile, including marketing on the basis of information (such as ratings) that the arranging institution knew to be false. As in the RMBS context, the starting point is the documentation within the possession or control of the investor or insurer: (1) the Rule 144A Offering Circular or prospectus and any other marketing representations, including pitch books, emails, slide presentations and the like; (2) the Indenture; (3) the collateral management agreement; (4) lists of collateral; (5) marks-to-market or other marks and valuation estimates (both pre- and post-closing); (6) any contracts or side agreements; and (7) public disclosures by the CDO arranger and collateral manager. Obviously, for CDS written against CDO tranches, the International Swaps and Derivatives Association (ISDA) Master, Schedule and Confirmation must be consulted as well.<sup>19</sup>

A retrospective valuation of the transaction as of the closing date, and any dates of valuations provided by the arranging bank or counterparty, should also be considered. Ordinarily, the valuation should be conducted in accordance with standard techniques for arranging institutions: for example, constructing a loan-level valuation for the collateral in order to derive the cash flows reasonably expected for the CDO transactions. Price-benchmarking may or may not be feasible for these often-bespoke transactions, depending upon issues of complexity and illiquidity; moreover, in the event of systemic mispricing of risk by arranging institutions for given products of a certain vintage, price-benchmarking would simply confirm industry conduct rather than indicate fair valuations.

### 3. Claims and defences in a New York forum

There are certain obvious advantages for an injured investor or insurer to litigate in a New York forum, whether federal or state court, rather than in the UK. The standard is notice pleading, requiring a short and plain statement of the claim;<sup>20</sup> fraud must be pleaded with specificity, but may be alleged on information and belief.<sup>21</sup> In state court, these complex structured products cases are assigned to the Commercial Division, where

18 Stephen Labaton, ‘Obama Plans Fast Action To Tighten Financial Rules’ *New York Times* (New York 25 January 2009) A1.

19 The transaction structure should be assessed with a particular eye to conflicts of interest and related disclosures. A structure that provides for the front-loading of equity returns, for example, will disfavour debt investors, and collateral manager or arranging bank ownership of equity will not align interests.

20 See Fed R Civ Proc 8(a) (‘short and plain statement’); CPLR 3014 (‘plain and concise statements’).

21 See Fed R Civ Proc 9(b) (‘In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.’); CPLR 3016(b) (‘Where a cause of action or defense is based upon misrepresentation, fraud, mistake, willful default, breach of trust or undue influence, the circumstances constituting the wrong shall be stated in detail.’).

discovery is ordinarily available upon filing of the complaint despite the pendency of any motion to dismiss,<sup>22</sup> and includes wide-ranging documentary, deposition and third-party discovery. Punitive damages are possible if intentional wrongful conduct may be shown. There is typically no cost-shifting absent indemnity obligations; a defendant, however, may be taxed with the plaintiff's fees in the event of fraud. There is a right to jury trial for damages claims, although this is generally waived by contract for SF transactions. Unlike in England,<sup>23</sup> claims may be asserted for breaches of implied covenants of good faith and fair dealing.<sup>24</sup> Accordingly, typical claims to consider include: fraud (under state common law or the federal securities acts); negligent misrepresentation; breach of contract; breach of an implied covenant of good faith and fair dealing; and violations of fiduciary duty (if there is a relationship to support this claim). The discussion below addresses issues that may be common to claims of fraud in this sector.

The elements of fraud are: material misrepresentation, falsity, scienter, justifiable reliance and injury. For bank on bank (or insurer/fund on bank) fraud claims, arranging banks should be expected to assert certain standard defences related to: (1) the reasonableness of reliance upon any misrepresentations or omissions in light of the sophistication of the buyer; (2) loss causation in light of the financial crisis and the general decline in structured products; (3) the lengthy disclaimers in each of these transactions; and, potentially (4) duplication of fraud and contract claims.<sup>25</sup>

As an initial matter, questions of reliance (and of course causation) are inherently fact-intensive and ordinarily not subject to resolution on a motion to dismiss. Asserting that a buyer is sophisticated does not end the inquiry: even a sophisticated investor is entitled to the truth. Thus, a fraud claim may proceed (1) on the basis of allegations of concealments, half-truths and 'misleading partial disclosures', on the theory that once a party undertakes to state a relevant fact it cannot give only half the truth, or (2) on the basis of allegations of non-disclosures, where the seller 'had special knowledge or information . . . that was not attainable by plaintiff'.<sup>26</sup> The latter duty arises where '[o]ne party's superior knowledge of essential facts renders a transaction without disclosure

22 Rule 11(d) of the Commercial Division sets the default rule, which is that discovery proceeds unless a motion to stay is granted ('[t]he court will determine, upon application of counsel, whether discovery will be stayed, pursuant to CPLR 3214(b), pending the determination of any dispositive motion'). In contrast, the Private Securities Litigation Reform Act 1995 (PSLRA) creates an automatic stay pending a motion to dismiss a federal securities action. Securities Act 1933, 15 USC s 77z-1(b)(1); Securities Exchange Act 1934, 15 USC s 78u-4(b)(3)(B).

23 See *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] 1 QB 433, 439, Bingham LJ ('In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognizes and enforces an overriding principle that in making and carrying out contracts parties should act in good faith . . . It is in essence a principle of fair open dealing. . . English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness.')

24 Under New York law, every contract incorporates an implied covenant of good faith and fair dealing, which includes the expectation that 'neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.' *Dalton v Educ. Testing Serv.*, 87 NY2d 384, 389 (1995) (internal quotation marks omitted).

25 Negligent misrepresentation claims will face the added defence that a plaintiff must show the existence of a special relationship or other source of a duty to speak with care. This inquiry is a fact-intensive one that is generally inappropriate on a motion to dismiss. See *Kimmell v Schaefer*, 89 NY 2d 257, 264 (1996).

26 *Williams v Sidley Austin Brown & Wood*, 38 AD3d 219, 220 (1st Dep't 2007).

inherently unfair.<sup>27</sup> Both principles are directly applicable to marketing by arranging banks on the basis of credit ratings that the banks know do not fairly reflect the credit quality of the transaction.

Disclaimers are likely to be extensive and far-reaching, but the analysis is very content specific. As a rule under New York law, a disclaimer must specifically track the subject matter of the alleged misrepresentation in order to be effective. Disclaimers are not effective if they are ‘general not specific’ and ‘fall . . . short of tracking the particular misrepresentations alleged by the plaintiff.’<sup>28</sup> In addition, even specific disclaimers cannot insulate a seller with respect to statements that are uniquely or peculiarly within the seller’s knowledge. ‘[A] purchaser may not be precluded from claiming reliance on misrepresentations of facts peculiarly within the seller’s knowledge, notwithstanding the execution of a specific disclaimer.’<sup>29</sup>

One recent decision to consider the question of fraud claims in the context of mis-selling claims against arranging institutions is *M&T Bank Corp. v Gemstone CDO VII, Ltd. et al.*, No. 7064/08, 2009 WL 921381 (NY Sup Ct 7 April 2009). M&T had brought contract and tort claims against the arranging bank, issuing CDO, swap counterparty, trustee and collateral manager arising out of its \$82 million in losses on two tranches of Notes. Defendant moved to dismiss pursuant to CPLR 3211(a)(7) on the ground that the complaint failed to state any cause of action. The court reached several significant conclusions in upholding the core claims of fraud and breach of contract against the arranging bank, including that: (1) ratings are not mere ‘predictions or opinions’ but ‘a present analysis of current valuation’; (2) in the ‘absence of specific language addressing the representations made both orally and in writing’, the disclaimers were not adequately specific to bar the claim of fraud—including the claim of misrepresentation arising from marketing through re-publication of ratings; and (3) the related questions of sophistication and reliance are not only factually intensive on a motion to dismiss, but also substantially distinct in the case of complex CDO transactions (‘a highly complex derivative form of investment’), in contrast with traditional loan transactions.<sup>30</sup> The case is currently pending appeal.

The Court also recently upheld fraud claims against UBS in an amended complaint in *HSH Nordbank, AG v UBS AG*, Index No 600562/08 (Sup Ct NY County 28 September 2009). This case relates to a synthetic CDO called North Street 4 (‘NS-4’), which closed in 2002 and whose underlying CDS exposes it to a reference pool of securities controlled by UBS. The Court held that the disclaimers cited by defendants were not sufficiently specific to defeat the misrepresentations alleged, which were based in part on UBS documents produced in discovery. For example, the Court held, ‘while representing to

27 *Swersky v Dreyer & Traub*, 219 AD2d 321, 327 (1<sup>st</sup> Dep’t 1996).

28 *Eternity Global Master Fund Ltd. v Morgan Guar. Trust Co. of N.Y.*, No 02 Civ 1312, 2002 WL 31426310 (SDNY 29 October 2002); see also *Caiola v Citibank, N.A.*, 295 F3d 312, 330 (2d Cir 2002).

29 *Steinhardt Group Inc. v Citicorp.*, 272 AD2d 255, 256–57 (1<sup>st</sup> Dep’t 2000); see also *Solutia v FMC Corp.*, 456 F Supp 2d 429, 448 (SDNY 2006).

30 *M&T Bank Corp. v Gemstone CDO VII, Ltd. et al.*, No. 7064/08, 2009 WL 921381 (NY Sup Ct 7 April 2009) 11–12.

HSH that the reference pool would hold assets which would realize steady, long-term gain, an “internal [UBS] approval memorandum” dated January 23, 2002, shows that, rather than expecting to hold the assets long-term, UBS intended that “[t]he economic driver of the [NS-4] transaction is the below market purchase of credit default protection.” (Slip op at 4 (internal citation omitted).) The Court further held that HSH’s allegation that ‘specific internal materials show that UBS knew the NS-4 notes were not worth “par value” on the closing date . . . and intended to gain thereby, resulting in an immediate gain of \$180 million to UBS’, was ‘not the same as merely claiming that UBS did make such a profit at HSH’s expense’, but rather was an actionable misrepresentation.<sup>31</sup>

Finally, the question of whether fraudulent inducement and breach of contract claims can both be asserted based on similar misrepresentations turns on whether there were misrepresentations of present fact independent of the contract itself. The seminal New York case is *Deerfield Communications Corp. v Chesebrough-Ponds, Inc.*, 68 NY2d 954, 956 (1986), which holds that ‘a representation of present fact, not of future intent[,] collateral to, but which was the inducement for the contract, [is] . . . neither duplicative of the [contract claim] nor barred by [a] general merger clause contained in the contract.’ As developed in the First Department case of *First Bank of the Ams. v Motor Car Funding, Inc.*,<sup>32</sup>—a case of direct relevance to RMBS claimants in that it involved both claims of fraud and breaches of representations and warranties relating to loan pool characteristics—the rule is that: ‘[I]f a plaintiff alleges that it was induced to enter into a transaction because a defendant misrepresented material facts, the plaintiff has stated a claim for fraud even though the same circumstances give rise to [a] breach of contract claim. Unlike a misrepresentation of future intent to perform, a misrepresentation of present facts is collateral to the contract (though it may have induced the plaintiff to sign the contract) and therefore involves a separate breach of duty.’ This rule has been applied in the context of an investor’s claim against an arranger of a credit default swap transaction.<sup>33</sup>

Recently, this rule was also applied in the context of a monoline insurer’s claim against a loan originator and securitizer of RMBS transactions.<sup>34</sup> In that action, the plaintiff insurance company had insured the obligations of RMBS trusts to repay principal and interest to Noteholders in the event that the cashflow from the collateral pool of mortgage loans proved insufficient. Plaintiff asserted both breaches of express representations and warranties, as well as claims of fraudulent inducement based upon misrepresentations and omissions in the marketing of the transactions as to the origination process and the quality and characteristics of both the collateral pools and individual loans. The New York State Supreme Court denied defendants’ motion to dismiss plaintiff’s fraud claims

31 *HSH Nordbank, AG v UBS AG*, Index No 600562/08 (Sup Ct NY County 28 September 2009).

32 *First Bank of the Ams. v Motor Car Funding, Inc.*, 257 AD2d 287, 292 (1<sup>st</sup> Dep’t 1999).

33 See, eg *Eternity Global Master Fund*, 2002 WL 31426310.

34 See *MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, Index No 602825/08 7–10 (NY Sup Ct 8 July 2009).

as duplicative of its breach of contract claims.<sup>35</sup> The court held that, on the face of the complaint's allegations, the insurer's fraud claim related to misrepresentations made in connection with entering into the contract, in contrast with breaches of the terms of the contract, and thus was not duplicative of the contract cause of action.

Investors and insurers should also consider potential rating agency liability. Historically, the ratings agencies have avoided liability on the basis that their ratings constituted protected statements of opinion entitled to First Amendment protection, a position affirmed by both the Sixth and Tenth Circuits in other contexts. For example, *Compuware Corp. v Moody's Investors Servs., Inc.*, 499 F3d 520, 529 (6th Cir 2007) ('Moody's credit rating is a predictive opinion, dependent on a subjective and discretionary weighing of complex factors', that could not 'communicate[...] any provably false factual connotation'); *Jefferson County School Dist. No. R-1 v Moody's Investor's Servs., Inc.*, 175 F3d 848, 853 (10th Cir 1999) (dismissing claims for tortious interference, injurious falsehood and anti-trust violations because Moody's credit ratings are 'protected expressions of opinion').

Recent legal developments indicate that the courts may not tolerate such defences from liability in the context of the ratings of structured products. In *Abu Dhabi Commercial Bank v Morgan Stanley & Co., Inc.*, No 09 Civ 7508, 2009 WL 2828018 (SDNY 2 September 2009), plaintiffs brought suit over their purchase of a structured investment vehicle (SIV) arranged by Morgan Stanley, asserting claims of New York common law fraud against not only Morgan Stanley but also S&P and Moody's, which had rated the SIV's notes. The Court held that: misleadingly high ratings were actionable misrepresentations, despite agency disclaimers that the ratings represented mere opinions, because the agencies knew or should have known that the ratings were inaccurate; and plaintiffs' reliance was not unreasonable as a matter of law, despite disclaimers in the offering circular, because 'the market at large, including sophisticated investors, have come to rely on the accuracy of credit ratings and the independence of ratings agencies because of their NRSRO (Nationally Recognized Statistical Rating Organization) status and, at least in this case, the Rating Agencies' access to non-public information that even sophisticated investors cannot obtain.'<sup>36</sup> The Court further rejected the ratings agencies' First Amendment defence because the ratings were marketed to a select group of investors, rather than the public at large<sup>37</sup>—a common consideration for structured credit products marketed under Rule 144A offerings.

The trajectory of these New York cases suggests that the courts may recognize what some now regard as market fact: that even highly sophisticated parties may be defrauded in structured credit transactions where the complexity and illiquidity of the product and underlying collateral creates significant informational asymmetries and resulting opportunities for arbitrage and seller misconduct.

<sup>35</sup> *Ibid.* 10.

<sup>36</sup> *Abu Dhabi Commercial Bank v Morgan Stanley & Co., Inc.*, No 09 Civ 7508, 2009 WL 2828018 (SDNY 2 September 2009) 38, 46.

<sup>37</sup> *Ibid.* 33–35.

#### **4. Conclusion**

This is an era of critical reappraisal—by governments, regulators and market participants—of the transparency and efficiency of the markets for structured products, as well as the proper roles of arranging banks and ratings agencies in the structuring, marketing and management of these products.

The legal system increasingly will be forced to address questions of extraordinary complexity in assessing potential seller misconduct. Understanding that complexity on a granular, transaction-specific basis is essential to understanding investor and insurer claims, and to determining whether, how and why even sophisticated investors exercising reasonable due diligence may have been materially misled by certain arranging banks in exploiting market and rating agency information asymmetries. These inquiries are lengthy and fact-specific, but the market itself will benefit (not least through more effective—targeted—regulation) if the courts let these matters be fairly tried.