



PF2 SECURITIES EVALUATIONS, INC.

CDO Litigation: Ratings & Analysis



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CDO Litigation Themes

“Was it possible that ... bankers had bought insurance after they knew the extent of the coming damage? If so, how was that different from the fraud committed by a man who buys life insurance after the doctor tells him he has only months to live? There was a question of culpability, [then New York State Insurance Superintendent] Dinallo explains. If banks saw the crisis coming and constructed and insured securities to offload the damage, then that would be insurance fraud.”

- excerpt from *Confidence Game*, by Christine Richard

CDO Litigation Themes

Summary Issues

- ▶ Did structuring banks know that underlying assets were of low quality? If so, was this disclosed?
- ▶ Was ratings methodology correctly applied? If not, was it disclosed to clients that they were not to rely on CRAs' then-current publicly available methodology?
- ▶ Did structuring banks take too long to mark down their own positions?
- ▶ Did managers perform sufficient due diligence in selecting assets?

CDO Litigation Themes

Popular Allegations

- ▶ Plaintiffs were unsophisticated relative to the defendants.
- ▶ Plaintiffs relied on the defendants' expertise, and were incapable of ascertaining the true – and concealed – risks of the transaction.
- ▶ Defendants knew or were reckless in not knowing that collateral underlying the CDO was of poor quality.
- ▶ Defendants used collateral pool as a dumping ground for their underperforming or risky assets.
- ▶ Corruption of the ratings process “could not have been discovered by any degree of due diligence or analysis performed by the most sophisticated of investors.”

CDO Litigation Themes

Initial Checks – Some of the Basics

- ▶ Did the CDO's portfolio investments conform to the investment guidelines represented in the marketing materials and set forth in the transaction documents?
- ▶ Did the manager timely and adequately disclose and describe changes in the portfolio assets as required? (Material differences betw. offering circular and final indenture?)
- ▶ Did CDO sponsor or manager knowingly (artificially) manipulate the CDO's performance? Examples may include artificially inflating the value of the assets, thereby deflecting or delaying a trigger failure or a default, etc.?

CDO Litigation Themes

The Not-so Basics

- ▶ Undisclosed involvement of “short” parties in asset selection: Any evidence (e.g., internal memoranda, e-mails) that sponsor, manager, or particular client held negative opinion of the CDO portfolio assets than was disclosed to purchasers?
 - Under Goldman ABACUS deal, SEC argued that Paulson, the sponsor’s client, was short the securities that collateralize the CDO notes
- ▶ In re: [Space Coast Credit Union vs. Barclays Capital et al](#) the plaintiff alleged that the sponsor, itself, was short a material portion of the underlying deal:

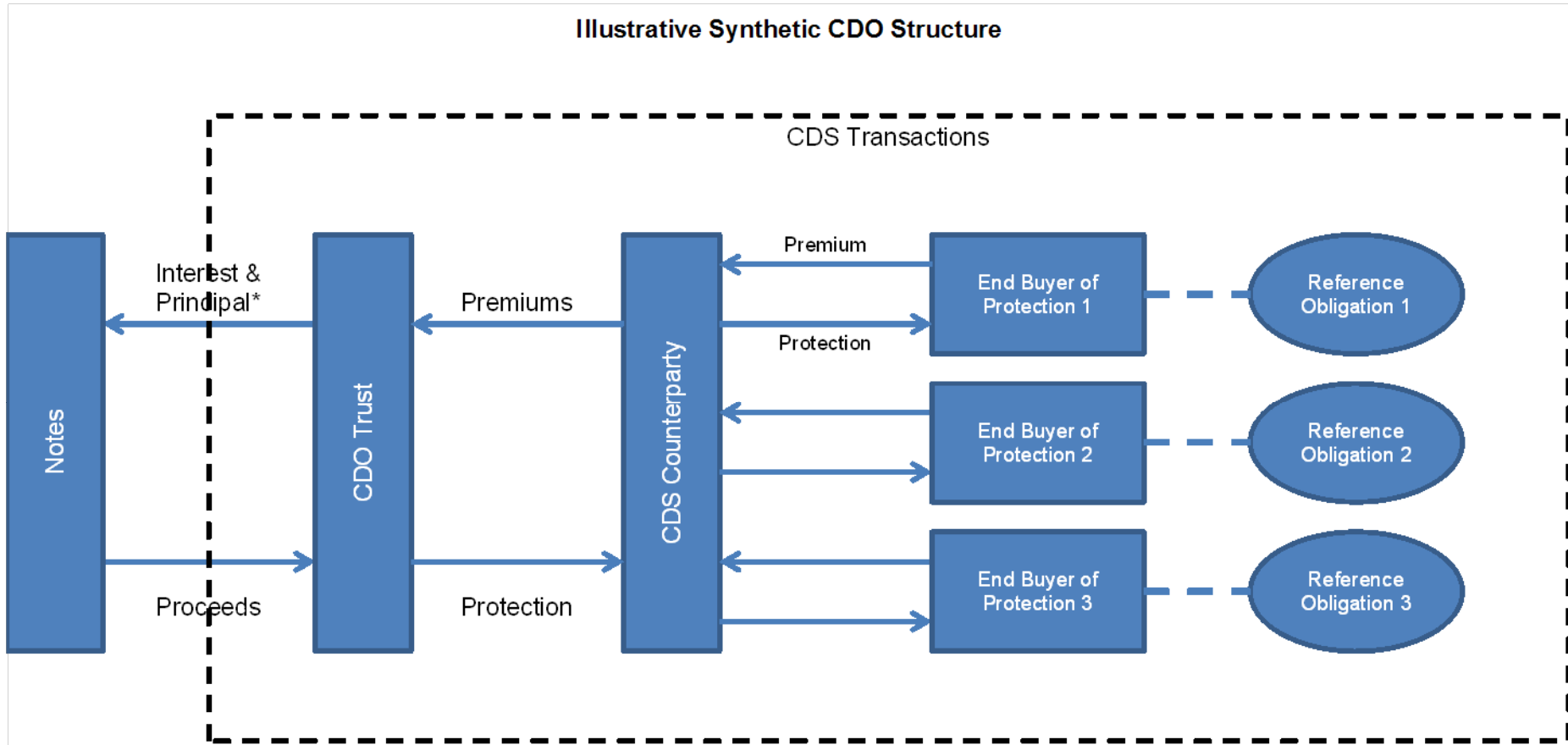
“[the] facts here leave no doubt there was clear intent to create a very large short bet through Markov against Mezzanine CDO risk”

and that:

the “Defendants were extraordinarily determined to stuff Markov [CDO] with Mezzanine CDO risk.” Plaintiff argues that: “most stunning of all, [the Defendant] was so intent on Mezzanine CDO failure that it custom-built \$300 million of built-to-fail Mezzanine CDOs ... that [the Defendant], through Markov, could then bet against.”

CDO Litigation Themes

Illustrative Synthetic CDO Structure



* The mechanic by which the notes are amortized depends of whether the notes are funded or unfunded.

For more on this topic visit [Built to Fail CDOs 101: How Well Do You Know Your CDS Counterparty?](http://expectedloss.blogspot.com/2011/07/built-to-fail-cdos-101-how-well-do-you.html)

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Ratings Themes

Ratings Background

- ▶ Credit Rating Agencies (CRAs) typically rated portfolios' underlying securities and the notes issued against them
- ▶ Ratings were critical to pricing and marketing of notes
- ▶ CRAs were engaged by CDOs' structuring sponsors (the underwriting banks) and were compensated from proceeds of the sale of the notes – this became an increasing, and increasingly concentrated, source of the overall revenues

Ratings Themes

Ratings Background

- ▶ Credit rating agencies have generally enjoyed immunity from civil liability under §11 of the Securities Act of 1935 by reason of Securities Act Rule 436(g). In addition, they have claimed even broader protection under the First Amendment as publishers of opinions.
- ▶ Problem if CRAs are knowingly diverging (materially) from their then-current opinions, or their publicly disclosed methodology without telling investors.
 - Were some parties allowed favorable ratings treatment: Was it ordinary procedure to allow Lehman and MBIA extra time to raise money to maintain their ratings?
 - Did / does U.S. retain its AAA based on the publicly disclosed methodology?
 - Were CRAs implementing an artificial smoothing process rather than downgrading to the actual ratings level?

Ratings Themes

<HELP> for explanation. Mtge **RCHG**
 25<G0>Setup Rating Change Alert
RATING CHANGES
 STAK 2006-1A P

CUSIP: 85233YAE5 0% 10/06/2043
 ABS: EXCHANGEABLE Issued: 7/27/2006

Include historical ratings

Agencies
 Standard & Poors Moody's
 Fitch DBRS
 Other

Agency	Rating Type	Rating	Effective Date ↑
Moody's	Long Term	WR	6/11/2010
Standard & Poor's	Long Term	D	5/18/2010
Standard & Poor's	Long Term	CC	8/10/2009
Standard & Poor's	Long Term	B-*-	8/21/2008
Standard & Poor's	Long Term	B-	7/24/2008
Standard & Poor's	Long Term	BBB-*-	6/17/2008
Standard & Poor's	Long Term	BBB-	2/22/2008
Standard & Poor's	Long Term	AAA*-	1/30/2008
Standard & Poor's	Long Term	AAA	4/27/2007
Moody's	Long Term	Aaa	8/31/2006

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Resources

- ▶ [CDO Lawsuits 2011](#)

<http://www.pf2se.com/Content.aspx?Type=LitigationCases>

- ▶ [Research](#)

<http://www.pf2se.com/Content.aspx?Type=Research>