CDO Litigation Reaching Crucial Stage

June 10, 2009
Agenda

- Introduction
- Presentation
  - Jayant W. Tambe, Jones Day
  - James K. Goldfarb, Jones Day
  - Gene L. Deetz, Navigant Consulting
  - Jeff Nielsen, Navigant Consulting
- Questions and Answers — (anonymous)
- Slides — now available on front page of Securities Docket
  > www.securitiesdocket.com
- Wrap-up
Webcast Series

- Series of webcasts — every other week
- www.securitiesdocket.com/webcasts
- Next: Monday, June 15, 2 pm Eastern
  - A New Frontier: Best Practices in Fraud Investigations and Emerging Trends in SEC and DOJ Enforcement
Panel

Jayant W. Tambe

Gene L. Deetz

James K. Goldfarb

Jeff Nielsen
CDO Litigation Reaching Crucial Stage
A Securities Docket Webcast

Jay Tambe, Jones Day
James Goldfarb, Jones Day
Gene Deetz, Navigant Consulting
Jeff Nielsen, Navigant Consulting

June 10, 2009
2:00 p.m. EDST
Topics of Discussion

► CDOs in context – Overview of Credit Crisis-related litigation
► The nuts and bolts of CDOs
► CDO litigation themes and issues
► Types of CDO litigation – a survey of CDO-related litigation and impending decisions
► Trends and developments in CDO litigation
Overview of Credit Crisis-Related Litigation

Subprime-Related Federal Filings by Case Type, 2007 – 2008

Note: Reflects all cases filed during 2007 – 2008.

The Nuts & Bolts of CDOs

- What are CDOs
- Who are CDO participants
- Why issue or invest in CDOs
- The hybrid CDO
A Collateralized Debt Obligation (CDO) is a structured financial product in which an entity issues debt and equity and uses the proceeds of the issuance to invest in a portfolio of debt securities, the interest and principal from which is used to satisfy the CDO’s debt obligations.
### Global issuance of cash CDOs by year, in US$ millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash</th>
<th>Synthetics</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$133,000</td>
<td>$177,000</td>
</tr>
<tr>
<td>2004</td>
<td>$196,000</td>
<td>$214,000</td>
</tr>
<tr>
<td>2005</td>
<td>$320,000</td>
<td>$317,000</td>
</tr>
<tr>
<td>2006</td>
<td>$564,000</td>
<td>$563,000</td>
</tr>
<tr>
<td>2007</td>
<td>$521,000</td>
<td>$643,000</td>
</tr>
<tr>
<td>2008</td>
<td>$238,000</td>
<td>$65,000</td>
</tr>
</tbody>
</table>

### Issuance by broad collateral type, 2007

<table>
<thead>
<tr>
<th>Type</th>
<th>Issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-Yield Loans (Below investment-grade)</td>
<td>50%</td>
</tr>
<tr>
<td>High-Grade SF (High-rated ABS)</td>
<td>18%</td>
</tr>
<tr>
<td>Inv. Grade Debt (BBB and better)</td>
<td>11%</td>
</tr>
<tr>
<td>Mezzanine SF (Lower-rated ABS)</td>
<td>10%</td>
</tr>
<tr>
<td>Other (CMBS, CDO^2, junk bonds, other)</td>
<td>10%</td>
</tr>
</tbody>
</table>
## CDO Statistics

Total credit market issuance by year, in US$ billions

<table>
<thead>
<tr>
<th>Year</th>
<th>All sectors credit market Instruments</th>
<th>Commercial banking credit market Instruments</th>
<th>Cash CDOs</th>
<th>CDO issuance as a % of Commercial banking issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$3,461</td>
<td>$657</td>
<td>$320</td>
<td>49%</td>
</tr>
<tr>
<td>2006</td>
<td>$4,055</td>
<td>$762</td>
<td>$564</td>
<td>74%</td>
</tr>
<tr>
<td>2007</td>
<td>$4,541</td>
<td>$745</td>
<td>$521</td>
<td>70%</td>
</tr>
<tr>
<td>2008</td>
<td>$2,727</td>
<td>$654</td>
<td>$238</td>
<td>36%</td>
</tr>
</tbody>
</table>
CDX Spreads widened out in the second half of 2007

Exhibit 24: CDX Indices: Select Tranche Spreads *

Source: Credit Suisse. *Data are based on DJ CDX indices.
Who are CDO Participants?

- Structuring, issuing, and administering the CDOs
  - Issuers
  - Structuring agents
  - Initial purchasers/brokers
  - Collateral managers
  - Trustees

- Third party service providers
  - Ratings agencies
  - Monoline insurers
  - Law firms
  - Accounting firms

- Investing – Qualified Institutional Buyers
  - Hedge funds
  - Pension funds
  - Banks and investment banks
  - Insurance companies
  - Structured vehicles
CDO Structure – A Precursor: A Typical RMBS Securitization

ORIGINATOR

Mortgage Loans

Proceeds

TRUST

Certificates

Mortgage Payments

Proceeds

INVESTORS

Servicing

Servicing Fee

JONES DAY

Navigant Consulting
CDO Structure – A Typical Cash Flow CDO

- Portfolio of Assets
- Asset Proceeds
- Note Proceeds
- CDO
- Manager
- Fees
- Interest and Principal
- Note Proceeds
- Portfolio Management Services

- AAA Tranche
- AA Tranche
- A Tranche
- BBB–BB Tranche
- Equity Tranche
- Notes
An example CDO might have an underlying portfolio of 150 bonds with an average rating of triple-B (Moody’s Baa, S&P BBB). If the total size of the portfolio is $300 million, the CDO might issue 6 classes of securities:

<table>
<thead>
<tr>
<th>Class</th>
<th>Amount ($ millions)</th>
<th>Pct. of Deal</th>
<th>Subordination (%)</th>
<th>Ratings (Moody’s/S&amp;P)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Super Senior</td>
<td>$195.0</td>
<td>65.0</td>
<td>35.0</td>
<td>Aaa/AAA</td>
</tr>
<tr>
<td>Class A</td>
<td>45.0</td>
<td>15.0</td>
<td>20.0</td>
<td>Aaa/AAA</td>
</tr>
<tr>
<td>Class B</td>
<td>30.0</td>
<td>10.0</td>
<td>10.0</td>
<td>Aa2/AA</td>
</tr>
<tr>
<td>Class C</td>
<td>9.0</td>
<td>3.0</td>
<td>7.0</td>
<td>A2/A</td>
</tr>
<tr>
<td>Class D</td>
<td>9.0</td>
<td>3.0</td>
<td>4.0</td>
<td>Baa2/BBB</td>
</tr>
<tr>
<td>Equity</td>
<td>12.0</td>
<td>4.0</td>
<td>0.0</td>
<td>Not Rated</td>
</tr>
</tbody>
</table>
A Typical Cash Flow CDO Waterfall

Interest Proceeds

- Trustee and Admin Fees
- Portfolio Management Fees
- Class A1 Interest (Super Senior)
- Class A2 Interest (Mezz AAA)
- Class B Interest (A rated)
- Class C Interest (BBB rated)
- Equity (unrated)

Principal Proceeds

- Trustee and Admin Fees
- Portfolio Management Fees
- Class A1 Principal (Super Senior)
- Class A2 Principal (Mezz AAA)
- Class B Principal (A rated)
- Class C Principal (BBB rated)
- Equity (unrated)

OC and IC triggers

Note: Not all tranches have OC and IC triggers (credit enhancements). Failure of OC and IC triggers redirect cash flows.
A Hybrid CDO

CDS Counterparty

Premium

Credit Protection Payments

Cash Assets

Interest

Note Proceeds

GIC

(Contributed Investment Contract)

CDS

Interest and Principal

Note Proceeds

Fees

MANAGER

Unfunded

Funded

AAA Tranche

AA Tranche

A Tranche

BBB-BB Tranche

Equity

Super Senior Protection

Credit Protection Payments

Premium

MANAGER

Portfolio Management Services

GIC

(Contributed Investment Contract)
Why Issue or Invest in CDOs?

- Demand for Yield
- Regulatory Capital
- Balance Sheet Management
- Accumulate Diverse Assets
- Arbitrage Opportunity
CDO Litigation Themes & Issues

- Sophisticated plaintiff vs. Sophisticated defendant
- Effectiveness of risk factors, anti-reliance clauses, and disclaimers
- Documentation issues
- Who is a fiduciary
- Forseeability of the Credit Crisis
- Loss causation principles outside the fraud-on-the-market context
- The value of a AAA rating
- Fraud vs. contract claims
- Damages
- Interplay with governmental investigations and actions
- Conflicts for counsel & unknown litigants
Types of CDO Litigation

- Investor lawsuits
- Documentation lawsuits
  - Interpleader actions
  - Common law actions
- Collateral manager lawsuits
- Monoline lawsuits
- Shareholder and derivative lawsuits
- Governmental investigations and actions
Investor Lawsuits

- Plaintiffs: Investors
- Defendants
  - Issuers
  - Structuring Agents
  - Initial Purchasers/Brokers
  - Collateral Managers
  - Trustees
  - CDS Counterparties
Investor Lawsuits (cont’d)

Claims

• Fraud
• Negligent Misrepresentation
• Breach of Fiduciary Duty
• Breach of Contract
• Consumer Protection (e.g., N.Y. G.B.L. §§ 349 - 350)
• Unjust Enrichment
• Aiding and Abetting theories
Investor Lawsuits (cont’d)

► Key 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 the collateral underlying the CDO’s collateral was of poor or deteriorating quality.
• Defendants used the collateral pool as a dumping ground for underperforming or increasingly risky assets on their balance sheets.
Investor Lawsuits – Representative Cases

  - Appeal pending
  - In discovery

  - Decision due on motion to dismiss Amended Complaint
  - In discovery

  - Removed and remanded
Documentation Lawsuits

► Plaintiffs: Trustees

► Defendant-stakeholders: Noteholders, Super Senior Credit Providers (Monolines), Collateral Managers

► Claims: Interpleader Actions (Contract-based)

► Key issues
  • The correct interpretation of the subordination provision in the event of an Event of Default – who is entitled to what money and in what order
  • The risk-reward proposition of CDOs
  • Ensuring the court’s jurisdiction over the stakeholders
  • Documentation, Documentation, Documentation
Documentation Lawsuits – Representative Interpleader Actions

- **Deutsche Bank Trust Co. v. LaCrosse Fin. Prods., LLC**, 08-cv-00955 (LAK) (S.D.N.Y. Nov. 5, 2008) (Amended Complaint)
  - Briefing for LaCrosse’s motion for judgment on the pleadings is nearly completed, and oral argument is scheduled for June 17
  - In discovery

  - Briefing on cross-motions for summary judgment is nearly completed
  - In discovery

  - Issue is or nearly is joined
Documentation Lawsuits – Common Law Action

  - Motions to dismiss are fully submitted
Collateral Manager Lawsuits

► Plaintiffs: Structuring Agents
► Defendants: Collateral Managers
► Claims
  • Breach of Contract
  • Fraud/Fraudulent Inducement
  • Breach of Fiduciary Duty
Collateral Manager Lawsuits (cont’d)

  • Motions to dismiss are fully submitted
  • In discovery

► Key Allegations
  • BofA structured and marketed a CDO-squared transaction to raise funds for two BSAM hedge funds; BSAM was to serve as collateral manager for the CDO.
  • Unbeknown to BofA, the two hedge funds were experiencing severe financial trouble due to falling asset prices and rising redemptions.
  • The day before the transaction closed, BSAM advised BofA that one of the funds had received a significant number of redemption requests.
  • The transaction closed and almost immediately failed – BofA could not sell the super senior tranche of notes and was forced to buy them.
  • BofA’s loss was exacerbated by plunging asset prices caused by the collapse (and rapid liquidation) of the BSAM funds.
Monoline Lawsuits

► Plaintiffs: Monoline Insurers
► Defendants: CDO Arrangers
► Claims
  • Fraud
  • Negligent Misrepresentation
  • Breach of Contract & the Covenant of Good Faith and Fair Dealing
  • Breach of Fiduciary Duty
Monoline Lawsuits (cont’d)

► Background & Key Allegations

• MBIA affiliate, LaCrosse, sold credit default swap protection on the highly-rated tranches of four CDOs arranged and marketed by Merrill Lynch; LaCrosse’s obligations were insured (“wrapped”) by MBIA.
• MBIA was obligated to make good on its payment guarantees when the credit events occurred.
• MBIA has sued Merrill to rescind the transactions and for damages.
• Merrill was aware that the CDOs were doomed and, in fact, Merrill arranged the four CDOs as a means to offload deteriorating subprime RMBS that Merrill held on its book, along with CDO tranches that Merrill also held on its book, all of which were backed by subprime RMBS.
• Merrill knew that, because of the deal economics, MBIA would not perform loan-level due diligence – that is, MBIA would not evaluate the underlying collateral for the RMBS and CMBS notes that were collateral for the Merrill CDOs.
Shareholder Derivative & Securities Lawsuits

- **Plaintiffs:** Shareholders
- **Defendants:** Issuers
- **Claims**
  - Breach of Fiduciary Duty
  - Corporate Waste
  - Federal Securities Fraud (Rule 10b-5)
  - Control Person Liability (Securities Fraud Actions)
  - Unjust Enrichment
- **Representative Actions**
Conclusion & Expectations

- Old wine in new bottles
- Interpleader actions have the greatest potential for new law
- Review documentation now
- Plaintiffs’ sophistication could hamper their claims
- The economy’s effect
- Educating the bench
- Damages – loss causation theories and modeling
Trends & Developments

- Copycat actions
- Collateral management/substitution actions
- CRE CDO litigation
- Ratings agency litigation
- International litigation
- Class action litigation
- Bespoke tranche litigation
- Governmental investigations and actions
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Questions?
Thank You

Thank you for attending this webcast.