ARTICLE

THE CLOSING WINDOW

WHAT ASSET MANAGERS SHOULD KNOW ABOUT MBS SECURITIES STILL IN THEIR PORTFOLIOS

Specialising in:
- Governance
- Risk Management
- Due Diligence

This is a critical time for investment and wealth-management professionals who still hold "toxic" securities associated with the 2007-09 financial crisis to take stock of their options. Many investment managers sold these assets, wrote them down, and/or wrote them off some years ago. Many, we suspect, will not act to realize the potential value in legal claims based on these investments in time to avoid the impending expiry of limitations periods – in particular, the important six-year window for fraud and misrepresentation claims under New York common law. That will leave a windfall for issuers, many of whom made fortunes constructing and marketing defective securities to their customers, betting against them for their own account, and now evading accountability.

Asset managers holding these mortgage-backed securities ("MBS") are therefore well advised to review their portfolios carefully to determine whether they may be sitting on potentially valuable legal claims with a limited shelf life. A partial recovery of value, after all, is better than a complete write-off. And the process of recouping value need not be onerous, though it will require some attention from management at certain stages.

MBS: THE TOXIC SECURITIES

The financial crisis spawned a number of different types of litigation, based on the various financial products and the roles of various players in bringing them to market. We focus here on the most common and straightforward types of MBS litigation, those involving collateralized debt obligations ("CDOs"), credit default swaps ("CDSs"), and shares in entities investing in these securities, often using leverage.

CDOs are like bonds, but instead of relying for their credit-worthiness on the financial strength of a company, they rely on the probability of cash flow from a large pool of mortgages or other periodic debt obligations such as student loans, automobile finance, or credit card debt. CDOs are generally arranged in tiers or tranches, with the highest tiers, *i.e.*, those that represent a claim on the first income received by the mortgage pool, considered the safest. These top tiers were rated prior to the financial crisis as ultra-safe investments, typically "AAA" or cash equivalent. This could make sense in principle: unless there is a 90% rate of default on mortgage payments – which is unheard of – a claim on the first 10% of income received should not default. In fact, "AAA" ratings were generally extended to levels as high as 75% that proved untenable, and ratings agencies have been justifiably criticized – and sued – for having pervasive financial conflicts of interest that led them to over-extend the ratings, including receiving certain fees only if the target rating was achieved. The yield provided by these instruments to investors was modest, as would be expected of a cash-equivalent investment. It was, however, higher than the return on U.S. treasuries, and therefore attractive to – indeed, designed for and targeted at – institutions such as pension trusts that were required to hold certain amounts of AAA-rated paper. Investors who wanted higher returns from CDOs could invest in the riskier, lower-level tiers or make heavily-leveraged investments in these products through funds set up for this purpose. When the financial crisis hit, these securities lost all or much of their value.

CDSs are instruments whereby one party pays a periodic premium and the other insures a particular security (often a CDO) against default. It was not necessary for any party to the transaction to actually *own* the CDO that was serving as the "reference" security, and hence these instruments took on the character of simple bets on the default (or change in value) of the reference security. Over time, the volume of these "synthetic" products vastly exceeded that of the underlying reference securities. In essence, there weren't enough real mortgages and other loans in the economy to satisfy the demand that was eventually attracted to these products. Many firms pumped up their profits with the income stream from CDSs – some, massively – and were caught out with huge liabilities when the reference securities ultimately devalued and/or defaulted. To compound matters, the potential liabilities from a default were not reflected on the books of many companies exposed to CDSs, and when the financial crisis hit, literally no one knew where the trillions of dollars in ultimate liability lay. Now, of course, we do: firms such as AIG and Lehman Brothers that over-invested in CDOs and/or CDSs either perished in the financial crisis or had to gorge themselves on massive transfusions of taxpayer cash to stay alive.

CLAIMS BASED ON MBS

As is the case with most securities, CDOs and CDSs were designed to deter and withstand litigation. And as is the case with all securities, they do so only imperfectly, because those who purvey investments to third parties, and do so with superior information, invite judicial scrutiny if they mislead. A critical variable affecting litigation prospects is the quality of the risk disclosures in the relevant subscription agreement, prospectus, or other legal instrument. Broad, general risk disclosures are generally not effective, whereas specific disclosures that identify and fairly characterize the risks that actually emerged and caused the loss do tend to be effective. But even with such disclosures, ARTICLE

evidence of other communications, including informal ones, may strengthen the claim because courts understand that investors pay greater heed to real communications from the promoter of the investment than to "boilerplate" legal language in a lengthy prospectus. Similarly, broad or boilerplate non-reliance clauses tend to be ineffective, but non-reliance clauses that reflect actual negotiation between the parties as to the representations that the parties have agreed were not relied upon in making the investment have a stronger chance of blocking a misrepresentation claim. "Special knowledge" on the other hand, of risks disclosed to investors as merely possible when in fact they were known to be actual, may also overcome disclaimer and non-reliance language and lead to a finding of actionable misrepresentation. All of these factors, and others, are considered together, as the court assesses the alleged misrepresentations relative to the "total mix" of information disclosed and otherwise reasonably available to the investor.

These principles are useful, along with other variables, in predicting the outcome of claims in court, and their settlement value. In U.S. litigation, a critical threshold for a legal claim is the motion to dismiss, which is analogous to a strike-out application in the U.K. and similar legal systems. A defendant that does not succeed in having the claim dismissed faces the very considerable expense and distraction of U.S. discovery, and denial of the motion to dismiss may change the handicapping for the other major pre-trial motion, the motion for summary judgment, which is usually filed at the close of discovery. It is therefore not unusual for a claim to settle after surviving a motion to dismiss. The parties at that point have tested the claim for legal sufficiency, it is headed for trial absent summary judgment, and significant expense and risk lie ahead for the defendant. Some other factors affecting settlement value include the solvency of the defendant(s), the availability and extent of insurance cover, and adverse enforcement actions and related publicity – for example, where the defendant was investigated by the Department of Justice, the Securities and Exchange Commission, or Congress – often with incriminating emails and documents laid bare.

A key legal issue that may result in permanent dismissal of claims is the expiry of the applicable limitations periods. Some limitations periods applicable to many MBS claims have expired already – although they may be subject to tolling – and others may expire soon. For example, among the longest and most-often applicable limitations periods are the six-year periods that apply to fraud and misrepresentation claims under New York common law, which will soon expire on claims arising from typical investments made in the years preceding the 2007-2009 financial crisis. The expiry of a limitations period may be a complete bar to bringing a claim, and hence it is extremely important to pay attention to this time-sensitive issue and to seek timely advice. A limitations analysis should not be undertaken by non-experts, as there are complicated rules for when a cause of action accrues, what factors may "toll" or stop the clock, which among different potentially-applicable statutes actually apply, whether "borrowing" statutes or other special provisions may change the applicable period, and other issues that may determine whether a claim is time-barred. An error can be costly: a time bar may nullify the claim, and, even where there are arguable bases for extending the limitations period, the risk of dismissal is increased, and the settlement value of a claim is accordingly diminished.

The experience to date with claims based on toxic securities is fairly typical of securities claims: according to one informal survey, nearly half survive a motion to dismiss. Available data suggests that settlement values are also fairly typical, albeit within a very broad range. Each case, of course, turns on its own facts, and a general overview is not a substitute for a thorough examination of the circumstances of the actual investment in light of applicable legal standards. We have learned that some securities were constructed precisely because of their poor quality, as an instrument to bet against; others were deliberately mispriced; and still others were intentionally misdescribed to potential investors. What is important for a wealth manager holding CDOs, CDSs, and/or shares in corporate vehicles that invested in these securities (or who may hold valuable claims even after sale of such securities at a loss) is to seek advice, without delay, to determine whether valuable claims may exist and what limitations periods apply. There is little risk in obtaining an evaluation of potential claims, a significant potential upside, and the possibility of a closed window if too much time is allowed to pass.

H. Bradford Glassman, Esq. is a partner and Melissa M. Price, Esq. is an associate with Lewis Baach PLLC in Washington, D.C.

For queries, email brad.glassman@lewisbaach.com or call (202) 659-7210. Lewis Baach's website is www.lewisbaach.com.