Strafford

presents

Collateralized Debt Obligation Litigation on the Rise

Strategies for Investors, Issuers and Trustees to Pursue and Defend CDO Claims

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Zachary D. Rosenbaum, Partner, **Lowenstein Sandler**, New York
Glenn S. Arden, Partner, **Jones Day**, New York
Amelia M. Charamba, Partner, **Nixon Peabody**, Boston

Thursday, March 18, 2010

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers.
Please refer to the dial in/ log in instructions emailed to registrations.

CLICK ON EACH FILE IN THE LEFT HAND COLUMN TO SEE INDIVIDUAL PRESENTATIONS.

If no column is present: click **Bookmarks**  or **Pages**  on the left side of the window.

If no icons are present: Click **View**, select **Navigational Panels**, and chose either **Bookmarks** or **Pages**.

If you need assistance or to register for the audio portion, please call Strafford customer service at **800-926-7926 ext. 10**

For CLE purposes, please let us know how many people are listening at your location by

- closing the notification box
- and typing in the chat box your company name and the number of attendees.
- Then click the blue icon beside the box to send.

CDO LITIGATION ON THE RISE

STAFFORD CLE WEBINAR – March 18, 2010

Zachary D. Rosenbaum
Chair, Capital Markets Litigation
Lowenstein Sandler PC
zrosenbaum@lowenstein.com
212-204-8690

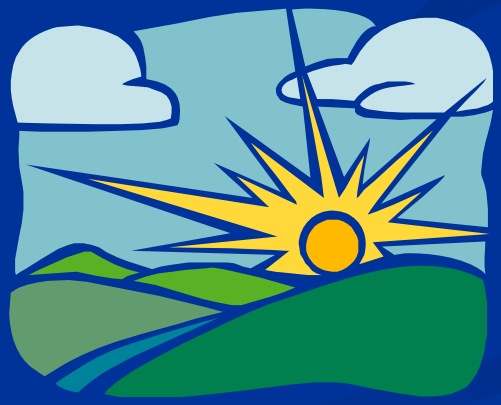
Lowenstein Sandler
ATTORNEYS AT LAW

The Power and Risk of Leverage

The Old Landscape

v.

The New Landscape



Lowenstein Sandler
ATTORNEYS AT LAW

The OLD Landscape

Borrower Defaults !!!

Residence / Home

Bank Loan

Bank

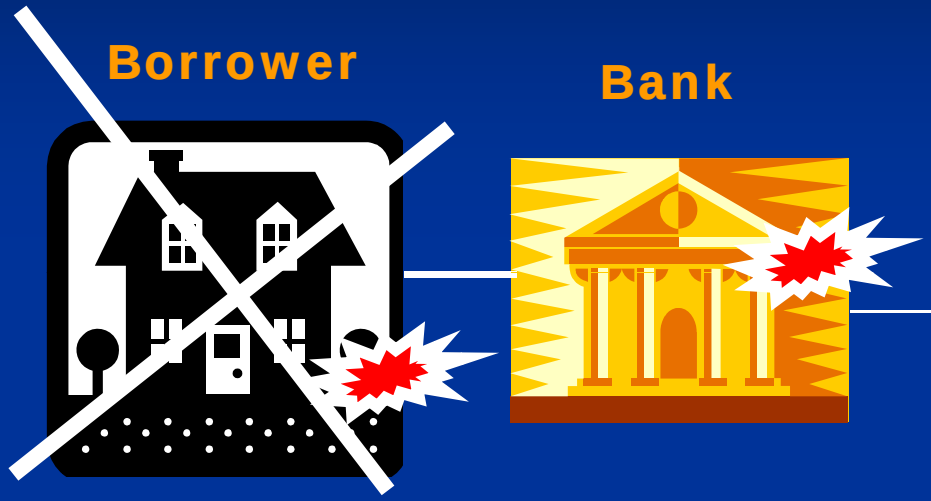
?

Borrower

Lowenstein Sandler
ATTORNEYS AT LAW

The NEW Landscape

Borrower Defaults !!!



SIV / Conduit

Credit Default Swaps, Synthetic CDS, Other Derivative Products

ABS

CDO

CDO^2

Monolines / Financial Guarantors

Institutional Investors / Funds

Investors

Lowenstein Sandler
ATTORNEYS AT LAW

The World Has Changed

Then:

"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."

- Thomas Friedman of *The New York Times*, 1996 interview with David Gergen of *U.S. News & World Report*

Lowenstein Sandler
ATTORNEYS AT LAW

Yes, The World Has Changed

Now:

December 15, 2006 Email:

"Rating agencies continue to create and (sic) even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters. :o)"

April 5, 2007 IM:

- "we rate every deal"
- "it could be structured by cows and we would rate it"
- "we should not be rating it"

Lowenstein Sandler
ATTORNEYS AT LAW

The Players = The Targets ?

- Central Transaction Parties
  - Sponsors, Issuers, Structurers
  - Placement Agents
  - Collateral Managers
  - Trustees
- Related Transaction Parties
  - Monoline/Financial Guarantors
  - Rating Agencies
- Other Afflicted Parties
  - Noteholders
  - Synthetic Position-Holders (short position-holders)

Lowenstein Sandler
ATTORNEYS AT LAW

Waves of Litigation

First, Shareholder actions
e.g. Moody's, S&P, UBS, Countrywide

Second, Trustee "interpleader" and "waterfall" actions
e.g. Deutsche Bank, Wells Fargo

Third, Monoline/CDS actions
e.g. Merrill Lynch v. XL Capital, FGIC v. IKB, MBIA v. Countrywide; MBIA v. Merrill Lynch; VCG Special Opportunities Master Fund v. Citibank

Fourth, CDO investor and collateral owner actions; Collateral management claims
e.g. HSH Nordbank v. UBS; M&T Bank v. Gemstone CDO VII, Ltd.; Carrington v. American Home; Ambac v. JPMorgan

Fifth, Rating Agency actions
e.g. Abu Dhabi Commercial Bank v. Morgan Stanley et al.

Lowenstein Sandler
ATTORNEYS AT LAW

What Did They Really Think?

The Court's September 8, 2009 decision in the *Pursuit Partners, LLC* case, pending in Connecticut, quoting emails of a prominent global investment bank:

- "sold more crap to Pursuit." (Exh. 49)." [Decision p. 24]
- "OK still have this vomit?" (Exh. 62)." [Decision pp. 24-25]

Lowenstein Sandler
ATTORNEYS AT LAW

CDO Litigation

- Legal claims include:
  - Fraud
  - Breach of Contract
  - Negligent Misrepresentation
  - Negligence
  - Breach of Fiduciary Duty
  - Civil Conspiracy
  - Violations of federal and state securities disclosure laws (e.g. 1933 Act/Section 12(2); 1934 Act/Rule 10b-5)
  - False Information Negligently Supplied for Guidance of Others

Lowenstein Sandler
ATTORNEYS AT LAW

Enforcement Initiatives

- SEC Reorganization (January 13, 2010)
  - Structured and New Products
  - Asset Management
  - Market Abuse
- SEC Initiative to Encourage Cooperation (January 13, 2010)
  - Potential "game-changer" for the Division of Enforcement (Robert Khuzami, Director, Division of Enforcement)
  - Cooperation tools replicate those available to DOJ

Lowenstein Sandler
ATTORNEYS AT LAW

Questions?

Lowenstein Sandler
ATTORNEYS AT LAW

JONES DAY | One Firm Worldwide℠

Derivatives & CDO Litigation – Developments and Recurring Themes

March 2010

New York, New York

The More Things Change… The More They Stay the Same

- Recent court decisions provide direction on key issues, but for every question answered, many more arise.
- Recent bankruptcy court decisions have resulted in some dramatic developments, but to what extent and for how long?

Floating Amount Events and Collateral Calls — The Tie That Binds

- Has a Writedown Occurred? *See VCG Special Opportunities Master Fund Ltd. v. Citibank*
  - Under the CDO Indenture, a deterioration in the CDO's collateral assets and payment shortfalls could result in a writedown of those assets.
  - However, such a writedown in the value of the CDO's assets did not, under the Indenture, result in a writedown or reduction to the principal amount of the CDO's liabilities — the notes it issued.
  - Was this the type of writedown contemplated by PAUG CDS? Is a writedown of the CDO's assets the equivalent of a writedown of the CDO's notes?

JONES DAY

Implied Writedowns and CDOs

- *VCG v. Citibank* – Background
  - VCG, a hedge fund, and Citi entered into a CDS. In exchange for periodic fixed payments from Citi, VCG agreed to pay Citi a "Floating Payment" up to $10 million if specified credit events occurred.
  - The credit events included an "Implied Writedown" with respect to the Class B Notes of a certain CDO.
  - In accordance with the CDS, VCG deposited $2 million as collateral against the risk of VCG's default on its obligation to make the Floating Payment.
  - The parties disagreed whether a Floating Amount Event in the form of an Implied Writedown occurred under the CDS.

Implied Writedowns and CDOs (cont'd)

- *VCG v. Citibank* – Background (cont'd)
  - The parties also disagreed about whether the CDS permitted Citi to demand additional collateral (variation margin) based upon a reduction in the daily mark-to-market value of the Class B Notes.
  - Nonetheless, VCG continued to make the payments out of concern that Citi would otherwise declare VCG in technical default and seize the collateral.
  - Subsequently, Citi informed VCG that a Floating Amount Event had occurred and demanded the $10M Floating Payment. VCG refused. Citi foreclosed on the collateral and demanded the remaining amount under the CDS.
  - VCG initiated the lawsuit for declaratory judgment, rescission, breach of contract, breach of the implied covenant of good faith and fair dealing, and unjust enrichment. Citibank filed a counterclaim for breach of contract.

Implied Writedowns and CDOs (cont'd)

- *VCG v. Citibank* – Issues
  - Whether Floating Amount Event in the form of an Implied Writedown had occurred.
  - Whether Citi's demand for additional collateral was improper under the terms of the CDS.

Implied Writedowns and Collateral Posting — Acting in Good Faith

- Can the Calculation Agent determine that an implied writedown has occurred, calculate its amount and then determine that the implied writedown requires additional collateral to be posted?
- Is this a violation of the implied covenant of good faith and fair dealing? Did the Calculation Agent abuse its discretion?
  - An allegation that a calculation agent "arbitrarily and irrationally" demanded credit support in excess of notional amount of the contract may be sufficient to state a claim that the agent breached the covenant of good faith. *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*

Acting in Good Faith (cont'd)

- Did the Calculation Agent abuse its discretion?
  - Under the "good faith" requirement of Section 14 of the 1992 Master Agreement, the reference market-makers' function is to provide an independent quotation. Interference with the market-makers' independent valuation through repeatedly emphasizing certain factors was not in good faith. *The High Risk Opportunities Hub Fund Ltd. v. Credit Lyonnais*.
  - A recent complaint charges that defendant, counterparty in an interest rate swap, "did not seek in good faith to obtain genuine quotations for transactions that were economically equivalent to the Terminated Transactions." *Ambac Fin. Servs., LLC v. Bay Area Toll Auth.*

The Difference Between a Writedown of Assets and a Writedown of Liabilities

- *VCG v. Citibank* – Decision
  - If the Reference Obligations under the CDS are the CDO's notes, a writedown of the CDO's assets does not equate to a writedown under the CDS.
  - Therefore, since the Indenture did not expressly provide for writedowns of Notes, the Calculation Agent was authorized by the terms of the CDS to determine that an implied-writedown credit event had occurred and to calculate the implied writedown amount.
  - The court did not address VCG's claim that Citi's calculation of the Floating Payment was "commercially unreasonable" because VCG improperly made this assertion for the first time in its moving papers, rather than the complaint.

Have You Waived Your Rights?

- *VCG v. Citibank* – Decision (cont'd)
  - Waiver supplants the issue of propriety of collateral demand: VCG had waived its right to challenge the demands for additional collateral by posting the disputed collateral and accepting Citi's regular payments under the CDS rather than invoking the dispute resolution clause in the documents.

Have You Waived Your Rights? (cont'd)

- Can a party waive the right to terminate following an EOD or waive a breach of contract claim concerning posting of additional collateral?
  - Waiver (or estoppel) may arise from a course of conduct, including:
    - Continuing to perform or to make or receive payments
    - Entering into new transactions under a Master Agreement after an Event of Default or a Termination Event
    - Continuing to post collateral or demand collateral pursuant to a Credit Support Annex
      - For example, under a CSA, each transfer of collateral is subject to the condition precedent that no Specified Condition or Early Termination Date exists. *See* CSA ¶ 4.

JONES DAY

Have You Waived Your Rights? (cont'd)

- What is the effect, if any, of the "no waiver" provision in the Master Agreement?
  - Key Cases
    - *VCG Special Opportunities Master Fund Ltd.* (protection seller waived objection (after the fact) to posting variation margin because it acceded to protection buyer's requests to post variation margin at the time)
    - *CDO Plus Master Fund*. (same)

Contract Principles and Derivatives

- Do traditional contract principles and rules of interpretation apply?
  - Answer: The trend indicates that they do.

Derivatives are Executory Contracts — Does That Mean Anticipatory Breach Principles Are Different?

► *Merrill Lynch* – Background

- Merrill Lynch, as protection buyer, was party to seven CDSs with XL Capital, the protection seller. The reference obligations underlying the CDSs were certain CDO notes owned by Merrill.
- Merrill owned the super senior tranches of the CDOs. Under the CDS Confirmations, it was an ATE if Merrill failed to exercise any of the voting rights associated with those tranches in accordance with the instructions of XL Capital.
- Subsequently Merrill entered into six additional CDSs with a third party relating to the same underlying CDOs. These six transactions also implicated Merrill's exercise of the voting rights at the direction of this third party.

JONES DAY®

Anticipatory Breach Principles (cont'd)

- *Merrill Lynch* – Background (cont'd)
  - Arguing that the implication of the voting rights in the subsequent transaction amounted to an anticipatory breach, XL Capital purported to cancel the seven CDSs. Merrill sued for declaratory judgment.
- *Merrill Lynch* – Issues
  - Whether Merrill's decision to enter into the six additional credit default swaps amounted to anticipatory breach.
  - Whether the doctrine of adequate assurance applied where XL Capital had sought assurances from Merrill that it did not intend to breach the seventh CDS with XL Capital.

Anticipatory Breach Principles (cont'd)

- *Merrill Lynch* – Decision
  - No Anticipatory Breach: Despite the dual assignment of rights to the A-1 tranche, Merrill was not prevented from complying with its obligations to XL Capital. If conflict arose in relation to XL Capital's voting rights, Merrill could either heed XL Capital's instructions or give up its coverage. There was no breach because Merrill "retained the ability to abide by XLCA's voting instructions."
  - Adequate Assurance Doctrine Inapplicable: The court rejected the application of the doctrine in the context of CDSs because CDSs "have very little in common with sale of goods." Even if the doctrine applied, Merrill's responses to XL Capital's requests for assurance were held to be sufficient. In its responses, Merrill assured XL Capital that it had not failed to exercise voting rights as directed by XL Capital and had not exercised any rights without XL Capital's consent.

Misrepresentations and Conduct

- *Société Générale v. Fin. Guar. Ins. Co.*
  - The complaint alleges that FGIC improperly and in bad faith, terminated twenty-two credit derivative contracts under a single Master Agreement (1992 Multicurrency-Cross Border) with a notional value of $2 billion, motivated by its desire to remove $2 billion worth of liabilities from its balance sheet to aid its ongoing restructuring.

Misrepresentations and Conduct

- *Société Générale* (cont'd)
  - Claims
    - FGIC should be estopped from using two missed payments by SocGen under two of the transactions, totaling $110,000, as basis of its purported termination because FGIC falsely represented that it wished to engage in good faith negotiations over the non-payment. During these negotiations FGIC allegedly accepted payments from SocGen on the other transactions. Regardless, SocGen claims to have cured the missed payments within the relevant cure period.
    - A "pattern of bad faith conduct" by FGIC constituted a repudiation of the Insurance Policies, resulting in an Insurer Default. The default, in turn, entitled SocGen to declare an ETD with respect to all transactions under the Master Agreement and to seek damages pursuant to Section 6(e) of the Master Agreement.

Misrepresentations and Conduct (cont'd)

- *MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, Index No. 2009-601324 (N.Y. Sup. Ct. N.Y. Cty. May 15, 2009) (Amended Complaint)
  - Hearing on motion to dismiss held November 17, 2009; decision expected by March 2010
  - In discovery

JONES DAY®

Misrepresentations and Conduct (cont'd)

- *MBIA* – 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 payments when credit events occurred.
  - MBIA has sued Merrill to rescind the transactions and for damages.

JONES DAY®

Misrepresentations and Conduct (cont'd)

- *MBIA* – Key Allegations (cont'd)
  - MBIA alleges that Merrill was aware 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 books, along with CDO tranches that Merrill also held on its books, all of which were backed by subprime RMBS.
  - MBIA also alleges 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.

JONES DAY

Misrepresentations and Conduct (cont'd)

- *MBIA* – Key Observations from Hearing
  - The court seemed receptive to MBIA's explanation that it could not have done due diligence – at reasonable expense – because the collateral included CDOs and CDOs of CDOs.
  - The court seemed receptive to MBIA's policy-based argument that capital market transactions would become prohibitively expensive if the court rules that sophisticated investors must distrust initial purchasers and the rating agencies and conduct their own forensic investigations.
  - The court directed parties to begin discovery.

JONES DAY

CDO Mechanics Lawsuits (cont'd)

- *Deutsche Bank Trust Co. v. LaCrosse Fin. Prods., LLC*, Case No. 08-cv-00955 (S.D.N.Y.)
  - Interpleader action in which super senior counterparty sought to ensure control of escrowed funds so that funds could be distributed to pay certain senior obligations and then to pay down the super senior counterparty's liquidity commitment
  - Summary judgment granted to super senior swap counterparty after all other claimants withdrew claims (S.D.N.Y. Oct. 27, 2009 (Order)

JONES DAY

CDO Mechanics Lawsuits (cont'd)

- *LaSalle Bank Nat'l Ass'n v. BNP Paribas, London Branch*, Case No. 08-cv-6134 (S.D.N.Y. January 21, 2010) (Bench Ruling)
  - Interpleader action in which senior noteholders in a CDO that had experienced an Event of Default (and the monoline that had entered into a swap agreement to assure payments to the senior noteholders) sought to ensure they were paid in full before payment to subordinated noteholders.
  - At issue was whether Section 11.1(a) or 13.1(d) of the Indenture controlled priority of distribution following an event of default in the ESP Funding I CDO.
  - The court granted summary judgment to the A-1 Noteholders.

JONES DAY

CDO Mechanics Lawsuits (cont'd)

- *BNP Paribas (cont'd)*
  - The court acknowledged that when contract clauses conflict, a court should attempt to reconcile the clauses.
  - But a "notwithstanding clause", as existed in Section 13.1(d), trumps all conflicting clauses and, here, favored the position advanced by the A-1 Noteholders.
  - "Payment in full" means payment of both principal and interest – payment of all outstanding debt, not just amounts due.
  - Major implication – To what extent, if any, does the ruling bind trustees in other structured transactions with similarly conflicting sections and similar language?

JONES DAY

Bankruptcy Developments

- Application of Section 365(e)(1) of the Bankruptcy Code – prohibiting *ipso facto* clauses
- Application of the Code's Safe Harbor provisions

JONES DAY

Bankruptcy Developments (cont'd)

- What is the application of the prohibition on *Ipso Facto* clauses and the Safe Harbor provisions?
  - Answer
    - A party should move promptly to exercise their rights to terminate, liquidate, or accelerate derivatives transactions upon the bankruptcy of a counterparty. A party may not wait indefinitely to see how the market moves. The exact amount of time is not clear, but a year appears to be an outer limit.
    - Whether the prohibition on *ipso facto* clauses is triggered by the bankruptcy of a party other than a counterparty (such as an affiliate of the counterparty) is a case-by-case question. But the bankruptcy of a party that is integrated financially with the counterparty appears to suffice.

Bankruptcy Developments (cont'd)

- *Metavante* (Bench Ruling, Sept. 15, 2009) – Background
  - A plain vanilla swap between LBSF and Metavante, in which LBHI was the credit support provider to LBSF.
  - Metavante failed to make three, fixed quarterly payments totaling approximately $6.6 million.
  - Lehman had fully performed its obligations at the time that LBHI, and then LBSF, filed for bankruptcy.
  - When Metavante refused to pay the matured payments, LBSF brought a motion to compel in the bankruptcy case.

Bankruptcy Developments (cont'd)

- *Metavante* – Principal Arguments
  - Metavante refused to perform its obligations under the swap (that is, to pay LBSF) on the grounds that Lehman's bankruptcy was an Event of Default under Section 5(a)(vii) of the Master Agreement that suspended its payment obligations by operation of Section 2(a)(iii) of the Master Agreement.
  - Metavante also refused to terminate because it would have owed LBSF a substantial termination payment. It claimed it had a right, but not an obligation, to terminate the swap.
  - Lehman argued that Section 5(a)(vii) is an *ipso facto* clause that is unenforceable under Section 365(e) of the Bankruptcy Code.

Bankruptcy Developments (cont'd)

- *Metavante* – Principal Arguments (cont'd)
  - Lehman acknowledged that the Bankruptcy Code provides a safe harbor to non-defaulting non-debtors. But, it observed, the safe harbor provides limited options – terminate, liquidate, or accelerate. Lehman argued that Metavante was pursuing none of these, but simply suspending performance to see which way the market went.

Bankruptcy Developments (cont'd)

- *Metavante* – Key Bankruptcy Code Provisions
  - 11 U.S.C. §365(e):

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on — (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title . . . .

Bankruptcy Developments (cont'd)

- *Metavante* – Key Bankruptcy Code Provisions (cont'd)
  - 11 U.S.C. §560:

> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title . . . .

Bankruptcy Developments (cont'd)

- *Metavante* – Decision
  - Motion granted: Metavante ordered to perform (that is pay) under the contract. The swap agreement is an executory contract. Therefore, until the debtor decides to assume or reject the contract, the counterparty must perform. (11 U.S.C. §362).
  - Safe Harbor is available, but limited in scope: The safe harbor provisions provide the non-defaulting, non-debtor counterparty with limited alternatives to performance. It may terminate, liquidate, accelerate, or offset or net.

Bankruptcy Developments (cont'd)

- *Metavante* – Decision (cont'd)
  - . . . and time: Refusing to exercise those options for a year "is simply unacceptable and contrary to the spirit of these provisions of the Bankruptcy Code." The safe harbor was enacted to promote prompt action by the counterparty to avoid market disruption. Therefore, Metavante waived its right to terminate.

JONES DAY

Bankruptcy Developments (cont'd)

- *Dante* – Parallel and "conflicting" results from . . .
  - The English action: *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd.*
  - The action in the U.S. Bankruptcy Court, Southern District of New York: *Lehman Brothers Special Financing Inc. v. BNY Corp. Trustee Services Ltd. (In re Lehman Brothers Holding Inc.).*

JONES DAY®

Bankruptcy Developments (cont'd)

- *Dante* – Background
  - LBSF was a swap counterparty in a synthetic collateralized debt obligation pursuant to a 2002 ISDA Master Agreement governed by English law.
  - LBHI was the credit support provider for LBSF. The relevant noteholder was Perpetual Trustee Co. Ltd. BNY Corporate Trustee Services Ltd. was the trustee of the structure.
  - As a result of LBHI's and LBSF's filing for bankruptcy, the issuer terminated the swap agreement and sought to redeem the notes.

Bankruptcy Developments (cont'd)

- *Dante* – Background (cont'd)
  - The structure provided LBSF priority of payment ahead of the noteholders. But a so-called flip clause subordinated LBSF's priority in the event of an Event of Default by LBSF. To similar affect was a clause that revised the calculation of the redemption amount (the amount due LBSF in a redemption) if the redemption were caused by an Event of Default on LBSF's behalf.
  - Perpetual sued BNY in the English courts for a declaration that the flip clause and calculation clause were enforceable under English law. Perpetual won, and the decision was upheld on appeal.
  - LBSF sued BNY in the Bankruptcy Court for a declaration that the flip clause and calculation clause were unenforceable under U.S. Bankruptcy Law.

Bankruptcy Developments (cont'd)

- *Dante* – Principal Arguments
  - LBSF argued that the flip clause and calculation clause were unenforceable *ipso facto* clauses under Section 365 because they modified LBSF's payment priority based solely on a bankruptcy filing.
  - BNY argued that Section 365's prohibition of *ipso facto* clauses applied only to clauses triggered by the counterparty's bankruptcy. Here, the flip clause and calculation clause were not triggered by the counterparty's bankruptcy, but its credit support provider's bankruptcy three weeks earlier.

Bankruptcy Developments (cont'd)

- *Dante* – Principal Arguments (cont'd)
  - BNY also argued that the flip clause and calculation clause took effect automatically upon LBHI's filing. Therefore, LBSF already had lost its priority and calculation rights by the time it filed for bankruptcy.

Bankruptcy Developments (cont'd)

- *Dante* – English Decision
  - Flip Clause Is Enforceable under English Law: The flip clause and calculation clause were enforceable under English law.
  - The Anti-Deprivation Rule Does Not Apply: The flip clause did not fall within the scope of the Anti-Deprivation Rule.
    - The Rule: "There cannot be a valid contract that a man's contract shall remain his until his bankruptcy, and on the happening of the event shall go over to someone else, and be taken away from his creditors."

Bankruptcy Developments (cont'd)

- *Dante* – English Decision (cont'd)
  - No Deprivation Even if the Rule Applied: LBSF suffered no deprivation. The flip clause was triggered by LBHI's bankruptcy filing on September 15, before LBSF's bankruptcy filing on October 3. LBHI's filing could not operate to effect a deprivation of an asset owned by its subsidiary LBSF, which was a separate legal entity.

Bankruptcy Developments (cont'd)

- *Dante* – U.S. Decision
  - Motion granted: The Bankruptcy Court granted summary judgment to LBSF.
  - LBSF did not lose its rights before its bankruptcy filing: The court held that – contrary to BNY's position – LBSF had not lost its priority and calculation rights before it entered bankruptcy. Rather, by operation of Section 541 of the Bankruptcy Code, those rights belonged to LBSF as of its petition date.
    - The flip clause and calculation clause did not operate automatically upon LBHI's bankruptcy filing.
    - Certain other events had to occur first, including the sale of the collateral and termination of the swap agreement.

Bankruptcy Developments (cont'd)

► *Dante* – U.S. Decision (cont'd)

- But neither had occurred before LBSF filed for bankruptcy. Therefore, "LBSF held a valuable property interest [in its priority and calculation rights] as of the LBSF Petition Date and, therefore, such interest is entitled to protection as part of the bankruptcy estate."

- Key clauses were *ipso facto* clauses: The court held that the flip clause and calculation clause were unenforceable *ipso facto* clauses, and that BNY could not escape this conclusion by arguing that Section 365's prohibition on *ipso facto* clauses applied only to the bankruptcy filing of the debtor counterparty.
  - Relying on the Code's plain language and legislative history, the court held that the prohibition on *ipso facto* clauses is triggered by the commencement of a case, not just the debtor counterparty's case.

JONES DAY

Bankruptcy Developments (cont'd)

- *Dante* – U.S. Decision (cont'd)
  - Court held that not just any case would suffice, but that a court must decided on a case-by-case basis.
  - In Lehman's case the court found that LBHI and its various corporate affiliates "comprise an 'integrated enterprise' and, as a general matter, 'the financial condition of one affiliate affects the others.'" Therefore, the bankruptcy filing of LBHI and its affiliates "is a singular event for the purposes of interpreting" Section 365(e)(1).

Bankruptcy Developments (cont'd)

- Implications of the Bankruptcy Court Decisions
  - Principally, these decisions speak more to the application of the Bankruptcy Code to derivatives transactions under the ISDA Master Agreement than they do, generally to the ISDA Master Agreement.
  - Still, at the time of contract, parties now must consider how to protect their expectations in the event of a counterparty's bankruptcy.
  - If *Metavante* and *BNY(Dante)* are affirmed, then non-defaulting, non-debtor counterparties must continue to perform or avail themselves of the safe harbor options within an as-of-yet undetermined amount of time (though less than one year). They also have the option of moving to compel the debtor to assume or assign the contract.

Collateralized Debt Obligation
Litigation on the Rise
(Thursday, March 18, 2010)

The Indenture Trustee Perspective

Amelia M. Charamba, Esq.
(acharamba@nixonpeabody.com)

NIXON PEABODY LLP
ATTORNEYS AT LAW

Litigation On The Rise:
The Indenture Trustee Perspective

I. Trustee Involvement in Disputes

II. Trustee's Use of Judicial Remedies

III. Investor Directed Litigation

IV. Select Issues Facing Trustees

I. Trustee Involvement in Disputes

- Tranche disputes: conflict among note classes.

- Controlling Class rights; extent of (or limits on) powers.

- Other Interested Parties.
  - Swap Counterparties/Insurers
  - Managers
  - Others (?)

Trustee Involvement in Disputes (cont.)

- Nature of Dispute and Trustee Role
  - Extreme scrutiny of language, battles over interpretation and ambiguities.
  - Common disputes:
    - Acceleration: subordination and priority issues.
    - Liquidation and “preservation of collateral”.
    - Coverage Tests.
- Other Considerations:
  - Trustee As Necessary Participant.
  - Trustee Performance.
  - Expense and Cost burdens imposed on structures.
  - Administering deal in light of (despite) dispute/litigation.

Trustee Involvement in Disputes (cont.)

- Indenture Protections:
  - Certificates and advice of counsel.
  - Directions from appropriate parties.
  - Rights of indemnification.
  - No obligation to risk own funds.

II. Trustee Use of Judicial Remedies

- Caught between competing interpretations and disputes over meaning, intent or application.
- Where terms are ambiguous, unclear, incomplete or contradictory.
- Parties driven by position in capital structure.
- Trustee may face threats of suit from all sides.
- Trustee not obliged to expose itself to liability: Court action may provide guidance and protection.

Trustee Use of Judicial Remedies (cont.)

- Different proceedings may be available, depending on the circumstances:
  - Interpleader.
  - Declaratory judgment.
  - Applicable state “trust instruction” statutes.
- Availability, best option, will depend on facts and circumstances.

Trustee Use of Judicial Remedy (cont.)

- A number of CDO Trustees have utilized this remedy and others are reportedly considering it in variety of circumstances.
- Likely that more will follow (in CDO and other contexts) if disputes over interpretation continue.

Trustee Use of Judicial Remedy (cont.)

- A variety of issues to be addressed:
  - Choice of proceeding.
  - Jurisdiction.
  - Venue.
  - Identification of necessary parties.

III. Investor Directed Litigation

– Landscape.
  - In contentious situations, one or more investors or insurers may seek to direct Trustee to initiate litigation.
  - May arise in variety of circumstances: servicing issues, interpretive issues.
  - In certain circumstances there may be reasons why Trustee would conclude it is inappropriate, or otherwise be unwilling to undertake litigation.
  - Where action is appropriate, there will be a variety of issues to be addressed and resolved --

Investor Directed Litigation (cont.)

- Investor Issues:

  Who is directing, and to do what?
  - Who are the directing party/parties: "Controlling" party/class? Majority?
  - Are their rights clearly stated in the documents?
  - What is the nature and basis of the action being directed?
  - Do the interests or positions being asserted conflict with other investors, other classes? Is the action clearly in interest of all investors?
  - Are there limits on Trustee duty or authority under the circumstances?
- Is it an action the directing party should instead bring directly? Or join as a party?

Investor Directed Litigation (cont.)

- Indemnification and Treatment of Expenses
  - Trustee's entitlement to indemnification against expense and liability.
  - Any cap or limitations on expense recovery under the applicable documents?
  - Depending on circumstance, recovery of expenses for the action from deal cash-flow may be questionable. Should reimbursement instead come from any recovery in the litigation?
  - Should an expense reserve be established? How funded?
  - Other investors may have conflicting views (as to the action or the treatment of costs). Obtain consent of other investors?

Investor Directed Litigation (cont.)

- Engagement of counsel:
  - Directing party often seeks to direct engagement of counsel.
  - Issues to be addressed:
    - Nature, limits of counsel's engagement in the circumstance.
    - Co-representation issues: duty of loyalty vs. waiver of conflicts.
    - Power to direct counsel, strategy.
    - Communications between client and counsel, communications with investors.

Investor Directed Litigation (cont.)

(Engagement of counsel, cont.)

- Trustee's right to consult separate counsel.
- Terms of payment: Payment from directing party? Payment from deal cash-flow? Establishment of reserve?
- Approval of pleadings.

V. Interpretive Issues Facing Trustees

- Interpretive issues and disputes continue
- A sampling of issues:
- "Discount Securities" amendments:
  - Early 2009 many CLOs wrestled with definitions and treatments of "discounted securities" and "CCC/ccc haircuts."
  - For "discounted securities" many Collateral Managers proposed amendments to add flexibility.
  - Most proposals undertaken without noteholder consent (Section 8.1).

CDO/CLO Interpretive Issues (cont.)

- Indentures permit some amendments without noteholder consent, but many require a determination of "*no material adverse effect*" on noteholders.
- Proposed amendments were supported by all required deliverables, including Collateral Manager certificate (or Opinion of Counsel supported by same) as to "*no material adverse effect*".
- However, after notice, some investors disagreed and gave notice of objection.
- Some investors went further and gave notice to Trustees of objection "in advance" to any future amendments.

CDO/CLO Interpretive Issues (cont.)

- Prompted a host of issues and debates:
  - Can the amendment proceed in face of objection? What if the objection is not in good faith or without basis?
  - What does “material and adverse” mean? How does one determine?
  - Is it an objective standard (factual) or subjective standard (Collateral Manager’s determination in good faith)?
  - How do the above impact Trustee’s ability to rely on an officer certificate or opinion of counsel, if at all?
  - Is a generic objection in advance effective? Even when the specific context of a specific transaction and terms of a specific proposed amendment are not yet even known?

CDO/CLO Interpretive Issues (cont.)

- CLO Note repurchases:

- A number of CLOs recently proposed to acquire their own notes in open market or negotiated transactions and surrender without payment.
- Sometimes proposed to use deal cash-flow for the purchase.
- Concept is simple: if CLO notes can be acquired at steep discount to par, and surrendered without payment, the liability side of the transaction "balance sheet" is improved, dollar-for-dollar.

CDO/CLO Interpretive Issues (cont.)

- Some Indentures have terms that specifically contemplate and, if so, may have specific procedure and requirements.
- But many Indentures are more or less silent on the constituent questions:
  - Is it a permissible use of cash-flow (where not otherwise qualified for purchase under eligibility criteria, trading provisions)?
  - Is it permissible to surrender and cancel without payment?
  - What is proper treatment of the note cancellation?

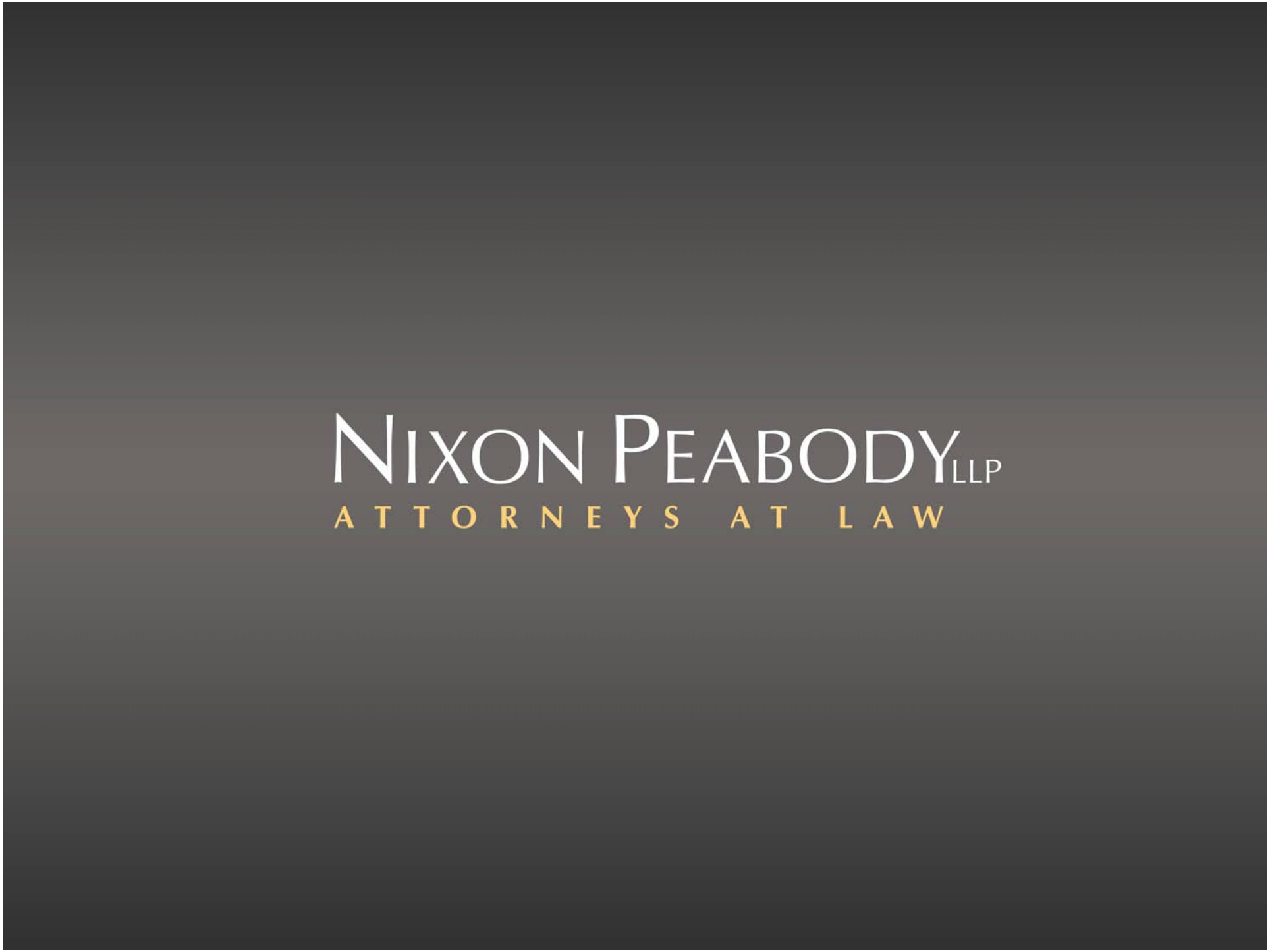
CDO/CLO Interpretive Issues (cont.)

- Position that this "obviously improves the deal" may be debatable, depending on one's perspective.
  - Who is affected if overcollateralization is improved?
  - What if failing o/c test now passes, stopping senior class amortization?
  - What if an o/c-based event of default trigger is avoided?
  - Which of these is desirable, and to whom?

CDO/CLO Interpretive Issues (cont.)

Other issues to consider -

- Does it matter whether CLO notes are acquired on the open market or in privately negotiated transactions? If the latter, does it matter from whom?
- Does it matter if acquired by manager affiliate, or unaffiliated third party?
- May be reasonable and sensible arguments on each side – but again, without adequate guidance in the documents, Trustee may be caught in middle.


NIXON PEABODY LLP
ATTORNEYS AT LAW