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A credit crunch with CDOs on the side

The current sub-prime problem that has shaken the US and Australian economies demonstrates the wisdom in the sixteenth century proverb that 'you can't make a silk purse out of a sow's ear'.

Whilst Australia may be less litigious than the US, due to the enormous losses that have been suffered and are likely to be suffered relating to the sub-prime problems, it is inevitable that expensive and protracted sub-prime related litigation will be a feature of the business landscape in Australia for the next five to 10 years. The claims are likely to be many and varied.

'Sub-prime' is a reference to low quality mortgages in the US where mortgages are often divided into three classes – prime, near prime and sub-prime. Sub-prime borrowers typically have poor credit history, do not qualify for traditional loans, often have little to no equity in their homes and are approved on a 'low doc' or 'no doc' basis.

Two particular features of sub-prime mortgages have probably resulted in most of the problems. The first, and most significant, is that the originator of the mortgage often has little or no interest in the default of the borrower. The originator often has an incentive to write large volumes of loans with the quality (or lack thereof) being someone else's problem.

The second problem with sub-prime mortgages is that they often involve artificially low interest rates for the first two or three years and then switch over to much higher rates. Any loans that were marginal at the start become unsustainable when the high interest rates kick in.

A 'collateralised debt obligation' (CDO) is a security, backed by a diversified pool of one of more classes of debt. One of the simplest and most common forms of structured product in Australia is a mortgage-backed security (MBS). A special purpose vehicle, usually a trustee, purchases mortgages from an originator (mortgage broker) and then issues a MBS. This is called a 'pass through' structure as the mortgages are the only asset of the trust and are held on trust for the bond holders (this summary is from the ASX – website commentary on CDOs). This form of securitisation of mortgages has been around since the 1970s. The majority of funds lent to sub-prime borrowers in the US were not by banks in the traditional way, that is, from deposits by savers, but rather via CDOs such as MBSs.

Whilst a MBS is a relatively straightforward CDO, a 'synthetic' CDO is not. In a synthetic CDO, no legal or economic transfer of ownership of loans takes place. Instead, a bank that wishes to mitigate its balance sheet risk will purchase a credit default swap from a CDO issuer – typically a special purpose vehicle without substantial assets. Essentially, the bank is buying credit insurance from the investors. The credit default swap will identify which bank customers are covered and the events of default that will trigger payment. A number of the Australian synthetic CDOs have exposure to entities that are involved in the US sub-prime market including Bear Sterns, Ambac Assurance and MBIA .

The terms of synthetic CDOs vary, however, typically a synthetic CDO concentrates the risk for the investor in that the investor may lose all of its principal, notwithstanding that the vast majority of the bank customers identified in credit default swap do not default.

In brief:

- Sub-prime related litigation will become a feature of the Australian business landscape
- Banks & financial planners who have recommended CDOs are likely to be targets of litigation
- Insurance premiums will rise to compensate insurers for additional costs and liability due to sub-prime problems
- Investors who have suffered losses will be examining whether the market was properly kept informed by the companies in which they held shares

Current proceedings

In NSW, Wingecarribee Shire Council has already commenced proceedings against Lehman Brothers Australia in relation to its $2.55 million loss from a $3 million investment in a CDO called Federation. The Council is alleging that Lehman engaged in misleading conduct in relation to the CDO. The Council risked (and lost) most of its principal for the chance of an increased return of probably 1% to 3% (compared to depositing the money in a bank). It is not hard to imagine that there will be other cases in which investors claim that the risks of CDOs were not adequately explained to them.

Possible targets of litigation

The banks have played an important role in arranging CDOs and thus are likely to be a target. So will financial planners who have recommended CDOs to their clients. In the early 1980s the ability to obtain low interest rate loans in foreign currencies in Australia spawned a whole series of cases against banks primarily related to the advice that was given or not given regarding currency risk. The decisions in these cases often came down to an evaluation of key the factual witnesses' recollection of one or two meetings. Understanding foreign currency loans is child's play compared to understanding the risks and the likelihood of their eventuality with CDOs (synthetic or otherwise). The FX loan cases provide an insight into the types of claims that may be advanced against the promoters of CDOs. The claims will include negligence, breach of contract and the statutory provisions prohibiting misleading conduct. A critical focus will be what risks were present that the promoters were aware of or should have been aware of and how were these explained to the investors.

The conduct of the rating agencies who provided the credit rating for the CDOs will be closely examined. These agencies sometime played an additional role in that they provided advice to the banks as to how best to structure the CDOs to obtain the highest rating.

In addition to the investors in CDOs who have lost out, many other investors (such as the shareholders in RAMS, Allco, MFS) have suffered significant losses due the to credit crunch caused by the sub-prime problems. No doubt these investors will be examining whether the market was properly kept informed by the companies in which they held shares as to the companies' exposure to the sub-prime problem or the credit crunch.

Insurers will also be dragged in through directors and officers insurance policies and errors and omissions policies. Premiums will have to rise to compensate the insurers for the additional costs and liability that will or may be incurred due to the sub-prime problems.

The US Securities and Exchange Commission is currently conducting a large number of investigations into those heavily involved in the sub-prime market including mortgage originators, investment banks and credit agencies. Whilst there is likely to be more litigation in the US relating to the sub-prime problems, companies in Australia will not be immune.
As with the FX loan litigation, in sub-prime litigation a critical focus will be who knew or should have known of the risks and the problems and how were they disclosed to investors, the market etc. Such questions often come down to a judge's subjective evaluation of witnesses.

The sub-prime and credit crunch related problems are likely to become an industry in themselves. Only time will tell whether some of CDOs were really a pig's ear in disguise or the current criticism is unfair and occurring with the benefit of 20/20 hindsight.

Robert McGregor Partner
e: rmcgregor@ebsworth.com.au

To discuss your company's exposure to potential litigation as a result of the sub-prime problem, please contact Robert McGregor, Partner at Ebsworth & Ebsworth Lawyers.

Robert McGregor Partner
e: rmcgregor@ebsworth.com.au
t: 61 2 9234 2274