DAVID DOBLE
SOLICITORS

# Institutional investors – understanding the legal and structural risks in complex structured finance transactions

*Summary of a presentation given by David Doble of David Doble Solicitors, London on 18 March 2008 in Frankfurt*

## Limitations of the credit ratings system

Market participants should always keep in mind that a credit rating has a relatively narrow focus. A rating (from Standard and Poors, for example) addresses the probability of repayment of principal and the payment of interest and **does not incorporate any analysis or opinion on post-default recovery prospects.** However, variations in contractual documentation as between different CDO transactions can have a great bearing on likely recovery levels. Such nuances are not often transparent in the marketing and legal documentation. The **rating agencies do not negotiate the legal documents on behalf of investors** nor do they perform general legal due diligence.

A rating does not cover the **quality of transaction reporting** on an ongoing basis – i.e. the content and quality of monthly reports to investors concerning the performance and management of the underlying asset portfolio. Moreover, **ratings do not address questions relating to the incentivisation of investment managers to incur risk** in the portfolio at the expense of safeguarding ultimate repayment of principal – indeed, Moody's has recently observed that there are likely to be "many cases of litigation regarding...ethics stemming from conflicted interest and short term motivations" in transactions where the interests of investors are not wholly aligned with the interests of portfolio managers.

## What disputes may emerge between the buy-side and the sell-side in 2008

Litigation involving CDO and other structured finance investments is already under way. In one case, a large institutional investor is suing the arranger of the transaction for alleged failure to manage the portfolio in the interests of Noteholders. It should be understood however that a significant number of transactions in recent years (particularly synthetic CDOs) have been structured to allow the arranging bank to buy credit protection from investors as credit protection sellers. Not only is the arranging bank the purchaser of credit protection, it is also the manager of dynamic portfolio of assets on which the protection is sold. The arranging bank must manage the portfolio in accordance with strict investment guidelines and eligibility criteria negotiated with the rating agents at the outset of the transaction. However, within these parameters, **the arranging bank/ portfolio manager is incentivised to manage the portfolio so as to create maximum value for itself and, to put it crudely, to increase the economic loss for investors.**

Complex and unclear documentation is likely to lead to disputes between investors and issuers and arranging banks and also between different classes of investors within the same CDO. In particular, **there are likely to be many disputes over the provisions within CDOs that relate to what happens upon the occurrence of an Event of Default** and whether, in the absence of a specific Event of Default waterfall, the subordination provisions that apply across all classes of Notes (and which require that, upon the occurrence of and Event of Default, the senior class is paid in full before mezzanine and junior classes) would override the priority of payments provisions. In bespoke, privately-placed transactions, if ambiguity exists in key provisions of the legal documents, then **if there is no single common-sense interpretation, a Court (in the United Kingdom) may use the *contra proferentem* rule of construction, which will give the clause the meaning contended by the investor.**

**Disputes are likely to emerge over calculations and determinations that have a material impact on the valuation of a security.** Transaction documentation that does not require the Calculation Agent/Determination Agent to act in "good faith" and in a "commercially reasonable manner" (concepts now widespread in ISDA derivatives documentation) will afford investors little protection against arbitrary determinations that are made against their interests, since there is no general duty under English contract law for one party to act in good faith as against the other parties.

Misrepresentation is also likely to be a cause of action for investors in CDOs and other structured finance transactions who believe that material information has been withheld or misstated. Under English law, the investor will have to show that the arranging bank (or other person responsible for providing information to prospective investors) made a statement of fact (either oral or written) that was untrue and on which the investor relied in deciding to make the investment. If the investor can demonstrate these facts, then the person responsible for making the statement can only avoid liability if it can show that it reasonably believed the statement to be true. However, a claim can be difficult where the investor subsequently receives the contractual documentation (which corrects the misrepresentation) but it then fails to review that documentation. **It is vital to the success of such a claim that the investor does attempt to review the documentation provided to it. So "caveat emptor"!**

6-7 Bedford Row London WC1R 4BS United Kingdom
Tel +44(0)20 7831 1516 · Fax +44(0)20 7404 7539 · www.daviddoble.com
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