



***Litigation as an Investor Tool: Lessons from the
Financial Crisis for Distressed Opportunities in
the Next Downturn***

Donald Hawthorne

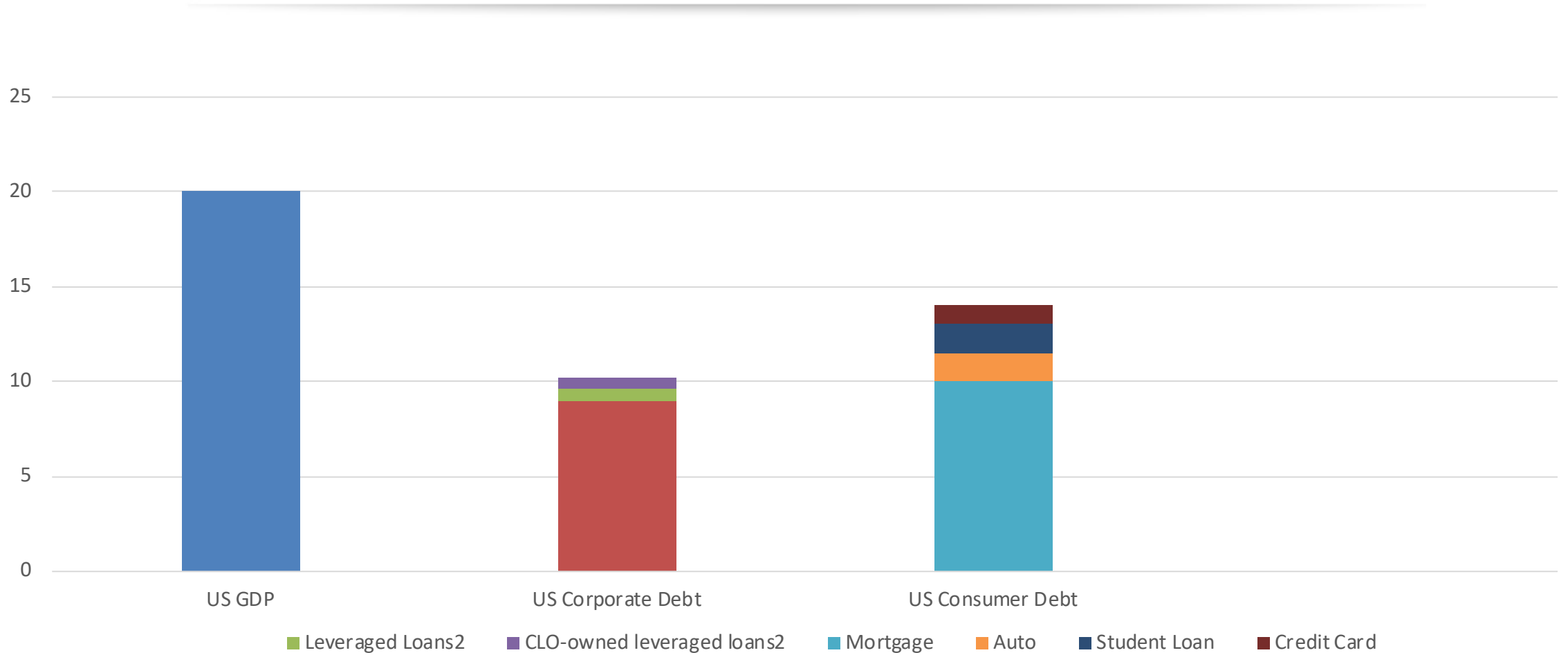
Litigation as Means of Pursuing Distressed Opportunities

- Fluctuations in asset value: the fundamental play
- Litigation pressure: upping the ante
 - Traditional: bankruptcy
 - New weapons: investor-backed litigation
 - Steroids: financial backing
- Speaking as a litigator

Subjects for Today

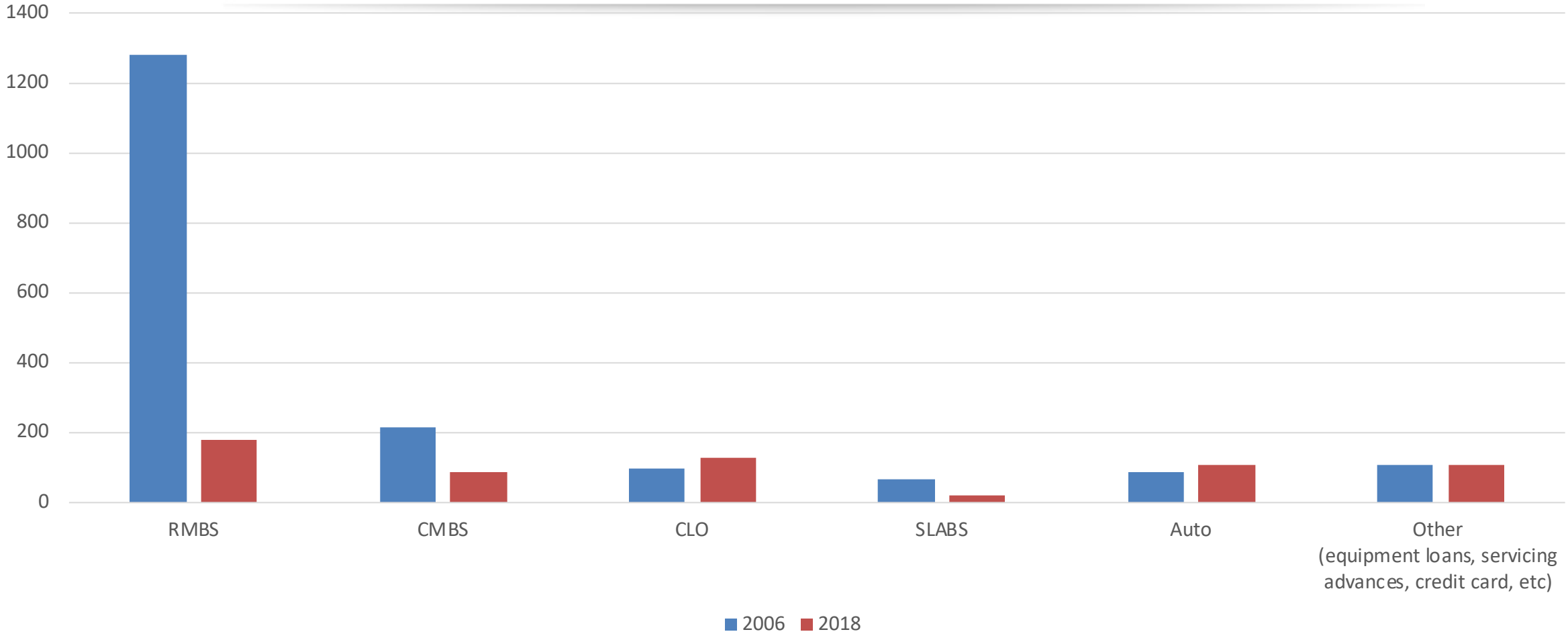
- The financial crisis: how litigation increased recoveries for RMBS investors
- Lessons for the next generation of distressed opportunities
 - CLOs
 - CMBS
 - Student loans
 - Auto loans
 - Corporate BBB
 - Libor-denominated debt

U.S. Debt Outstanding, 2018



Issuance Volume By Asset Class, 2006 and 2018

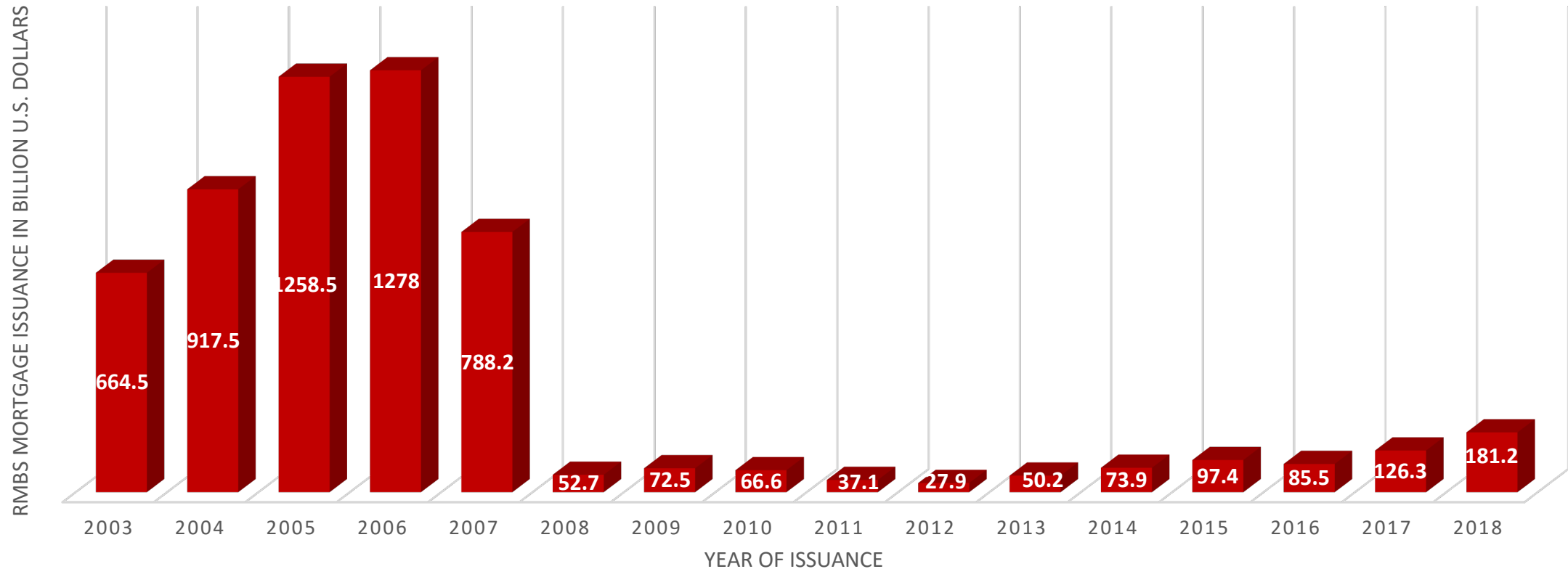
(in billions)



HOW RMBS INVESTORS RECOVERED BILLIONS AFTER THE FINANCIAL CRISIS

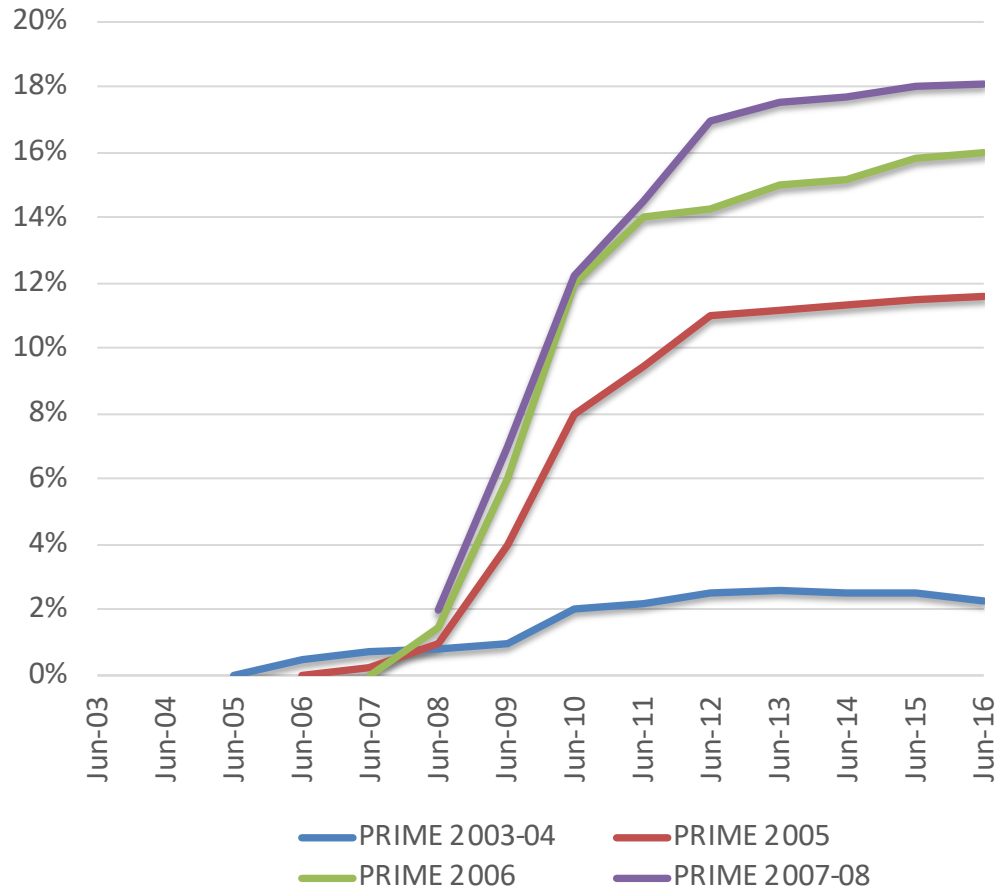
RMBS Issuance: Pre- and Post-Crisis

RMBS ISSUANCE IN THE US (2003-2018)

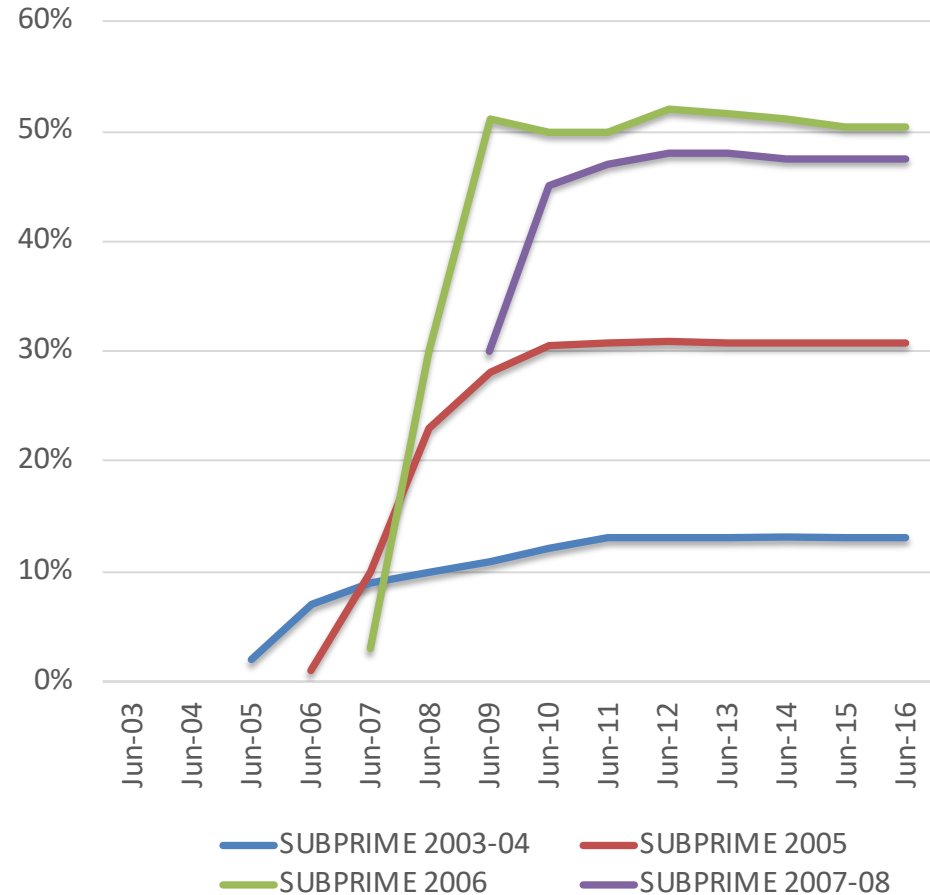


Cumulative RMBS Default Rates

Prime Cumulative Default Rates



Subprime Cumulative Default Rates



The RMBS Investment Context Pre-Crisis

- Misplaced reliance on collateral value
 - Never a nationwide decrease in home prices
 - Rapidly escalating home prices ignored
- Secondary market appetite overcoming credit concerns
 - If there was a buyer, it was credit-worthy
- Hair trigger on defaults
- The end was quick
 - Liquidity tightening
 - Fresh lending stops
 - Property values fall
 - RMBS free-fall follows

Many Profited – and Litigation Made a Difference

- Many who bought RMBS in the dip did very well
 - The bleakest picture was over-blown
 - Recoveries have continued to improve
- Litigation has made an enormous difference to investor recoveries
 - Monolines
 - Investor suits: Blackrock/Pimco group
 - Individual investors
 - Waterfall litigation

RMBS – the Litigation Difference

- Mass Trust Settlements:
 - Countrywide / BOA Settlement, 2011 – 530 trusts, payment of **\$8.5 billion** plus servicing improvements
 - ResCap Settlement, 2013 - **\$7 billion allowed claim**
 - JP Morgan Settlement, 2013 – 330 trusts, payment of **\$4.5 billion**
 - Citi Settlement, 2014 – 68 trusts, payment of **\$1.1 billion**
- Monoline Recoveries:
 - Assured v. Flagstar – post-trial judgment for **\$106 million** (100% of losses)
 - Syncora v. Countrywide – 2012 settlement for **\$375 million** plus other consideration; estimated by some analysts at up to 93% of losses
 - MBIA v. Countrywide – 2013 settlement for **\$1.7 billion** plus other consideration
- Individual Trust Litigations:
 - US Bank as trustee for CMLT 2007-AHL2 v. Citigroup – 2017 settlement for **\$38 million**
 - US Bank as trustee for Harborview 2005-10 v. Countrywide – 2016 settlement for **\$86 million**
 - US Bank as trustee for MARM 2006-OA2 v. UBS – 2018 settlement on three trusts for **\$850 million**

The Litigation Hook: Reps and Warranties

- “As of the Closing Date ... each Mortgage Loan was originated *in accordance with the Sponsor's underwriting guidelines*” (CWHEQ 2006-D)
- “Each Mortgage Loan at the time of origination was underwritten in general in accordance with guidelines not inconsistent with the guidelines set forth in the Prospectus Supplement and *generally accepted credit underwriting guidelines*” (BSABS 2006-HE1)
- “The *information set forth in the Mortgage Loan Schedule* with respect to each Mortgage Loan is *true and correct* in all material respects as of the date or dates which such information is furnished.” (RASC 2005-EMX3)
- “*No fraud or misrepresentation* has taken place in connection with the origination of any Mortgage Loan.” (RALI 2006-QS11)

The Litigation Form: “Put-Back” Suits

- **“Upon discovery or receipt of notice of ... a breach by the Sponsor of any representation, warranty or covenant under the Mortgage Loan Purchase Agreement in respect of any Mortgage Loan *that materially and adversely affects the value of such Mortgage Loan* or the interest therein of the Certificateholders, the Trustee shall promptly notify the Sponsor and the Servicer of such ... breach and request that the Sponsor ... cure such defect or breach within sixty (60) days ... and if the Sponsor does not ... *the Trustee shall enforce the obligations of the Sponsor under the Mortgage Loan Purchase Agreement to repurchase such Mortgage Loan* from REMIC I at *the Purchase Price* within ninety (90) days...” (ACE 2006-SL2)**

Waterfall Litigation

- “Waterfall” determines order in which investors are paid – or not paid, when defaults occur
- Waterfall litigation: ***trust beneficiary vs. beneficiary*** to determine priority of payments or control rights
- ***Trust instruction proceedings***: New York CPLR Article 77, Minnesota Stat. 501C
- Issues include:
 - Distribution of settlement proceeds
 - Pay first or write up first?
 - Can settlement payments create OC?
- ***Waterfall litigation as investment strategy***
 - investors may purchase in anticipation of favorable rulings on disputed or unclear PSA language, or for hold-up value
 - Showing up to protect your rights: courts and trustees often resolve these issues based on consent

Legal Challenges

- Causation: good precedent
 - “Cause” a breach
 - Increase risk of default
- Statute of limitations: less good precedent
 - Accrual at inception
 - Accrual on failure to cure
- Role of trustees: hard-earned experience
 - Investor direction
 - Trustee direction proceedings

Lessons Learned

- Act fast
- You can work through trustees and win
- Organization matters
- Niches are worth real money
 - “Hold up” value
 - Waterfall distribution
- There are opportunities for funders
- Potential for “tranche warfare”
- ***What matters is what works in court***

LESSONS FOR THE NEXT WAVE OF DISTRESSED ASSET LITIGATION

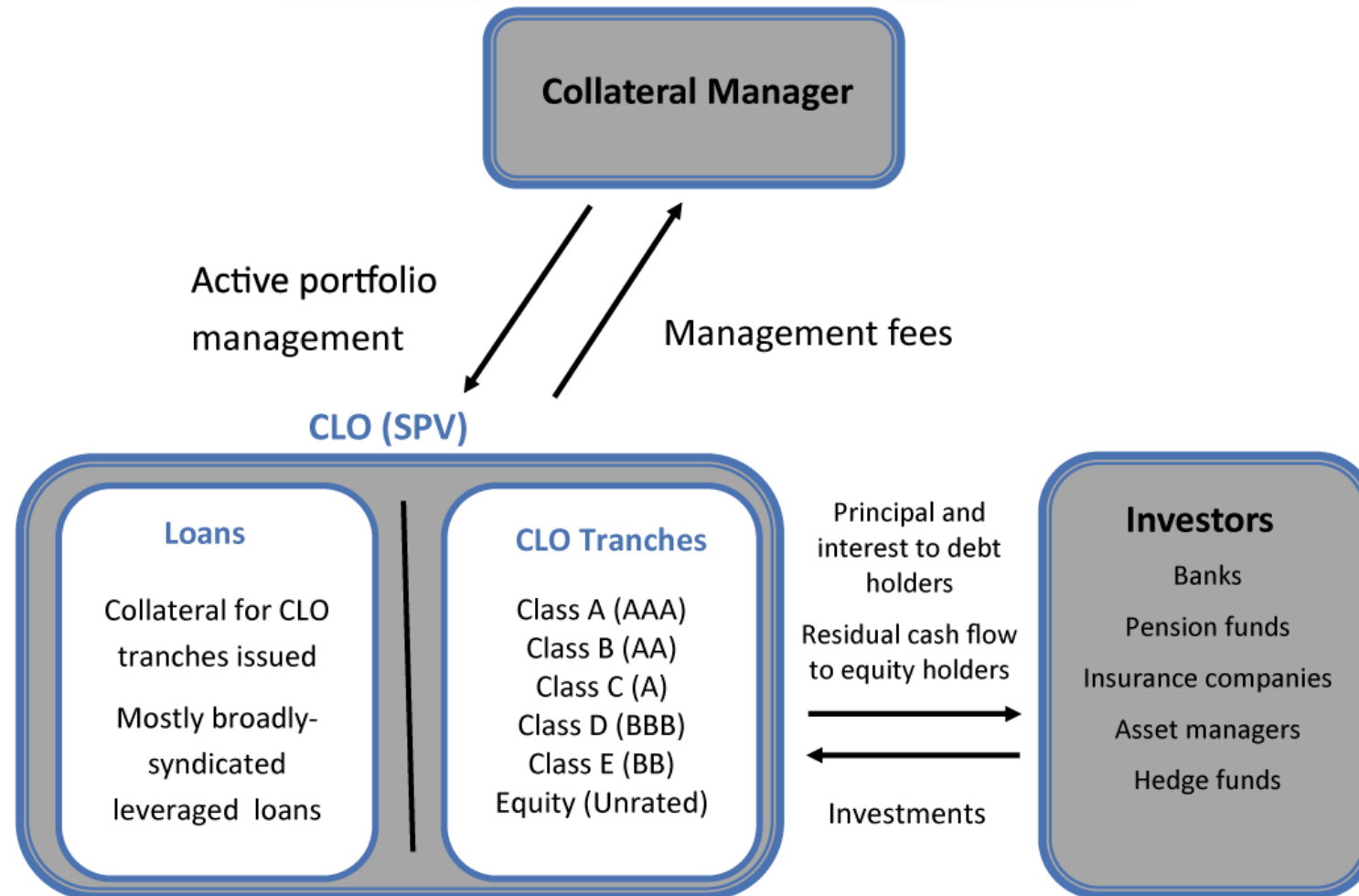
What are the vulnerable asset classes where litigation could unlock value in the next downturn?

- CLOs
- CMBS
- Student loans
- Auto loans
- Corporate BBB
- Libor-denominated debt

CLOs – What's a Collateralized Loan Obligation?

- It's a securitization:
 - Debt security funded by interest payments
 - Certificates purchased by investors
 - Tranched structure – layers of risk
 - Equity layer
- What's in it?
 - Slices of corporate debt – 100-250 loans
- Who are the players?
 - Collateral manager (selects, manages collateral)
 - Arranging bank
 - Issuer (SPV)
 - Trustee
 - Debt investors
 - Equity investor

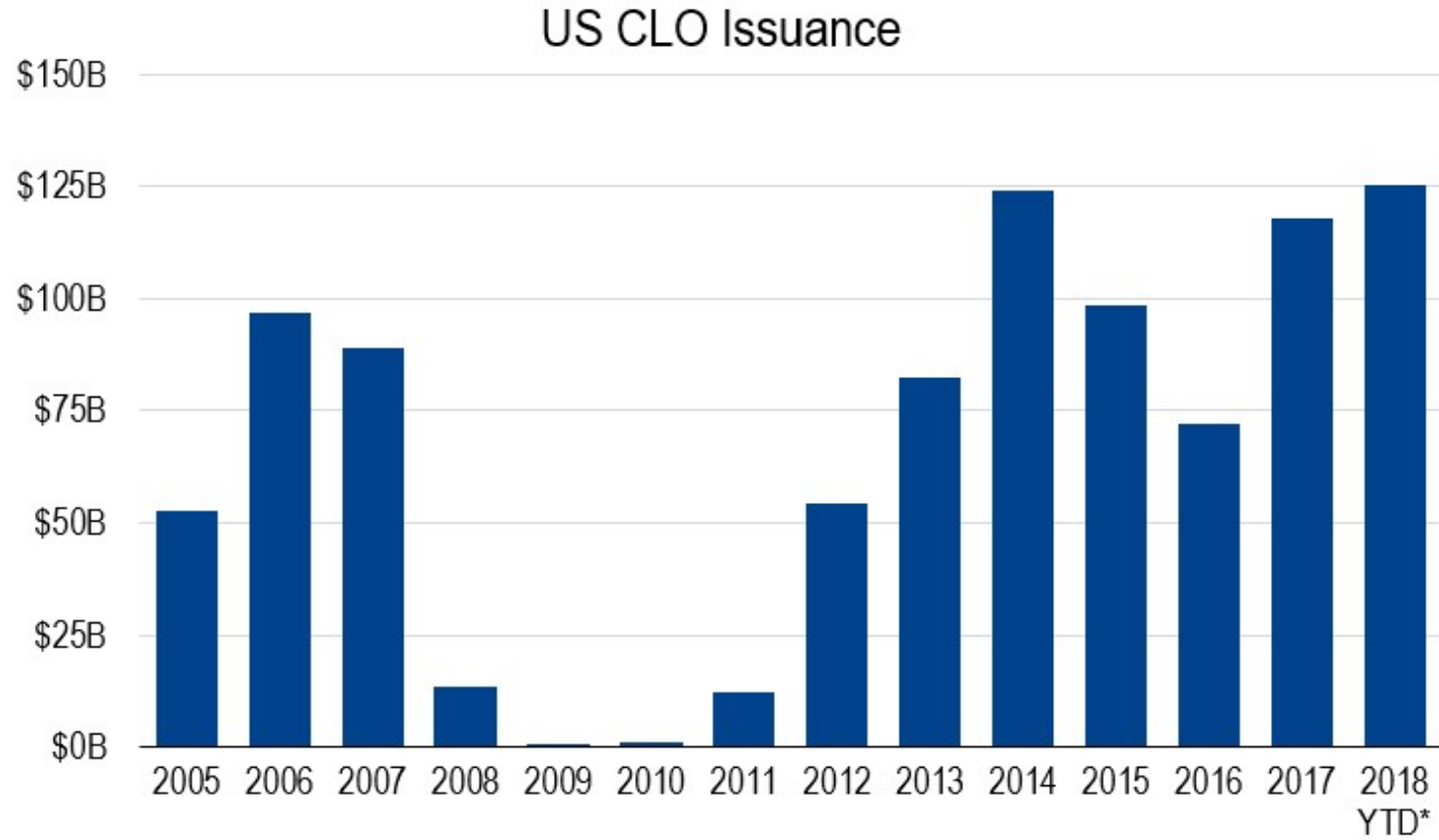
CLOs – What’s a Collateralized Loan Obligation?



CLOs – What are the “Ls” in CLO?

- Leveraged loans
 - BB+ or lower
 - LIBOR+150
 - Can't access high yield bond market
- Purposes
 - M&A related (LBOs)
 - Recapitalization
 - Debt Refinancing
 - Dividend issuance
 - General corporate purposes
- Syndicated
 - Agent bank
 - Direct lending

CLOs – A Trendy Asset

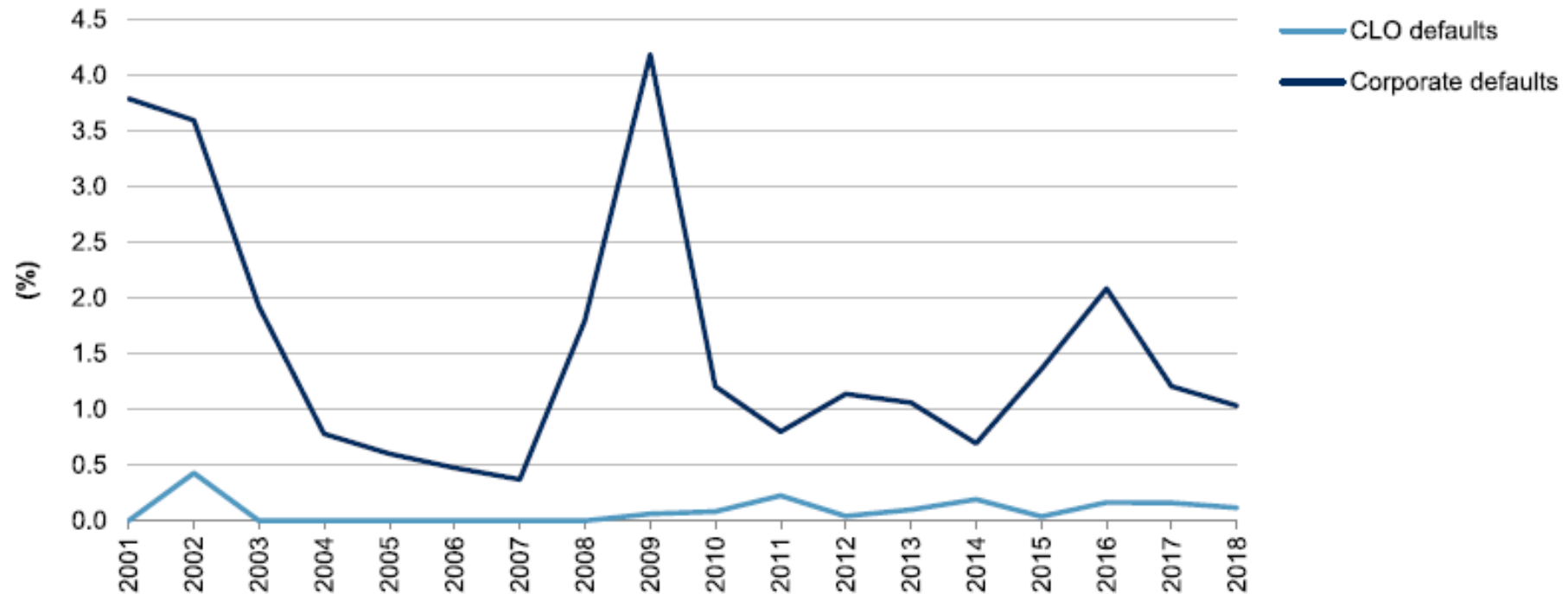


Source: LCD, an offering of S&P Global Market Intelligence

* Data thru Dec. 7

CLOs – A Hardy Asset

Annual Global Default Rates For CLOs And Corporate Issuers

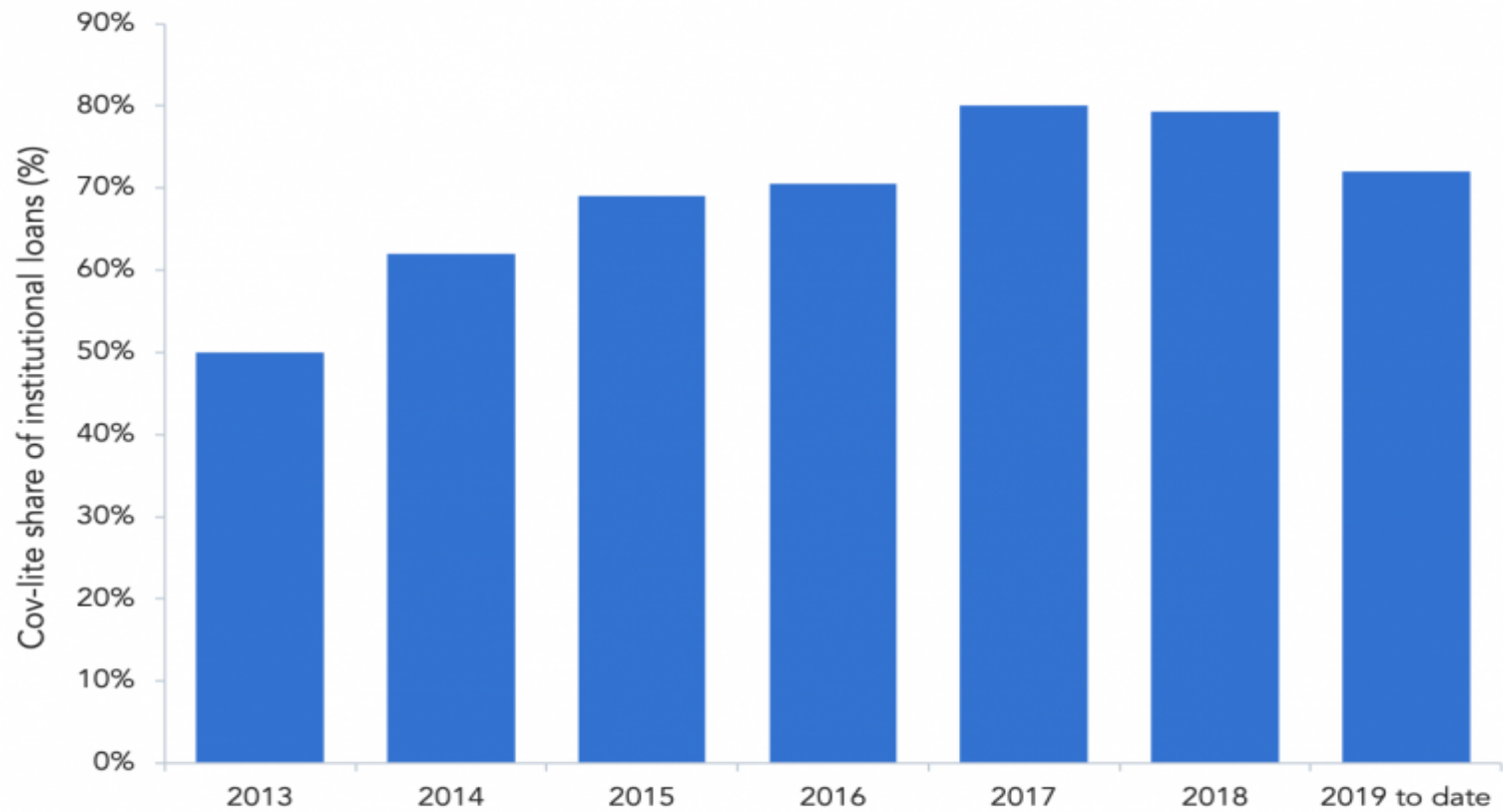


Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

CLOs – So What’s the Risk?

- Covenant lite loans: no maintenance covenants



CLOs – Increasing Appreciation of Risk

- 2018: **88% of leveraged loans in Europe are covenant light**, without maintenance covenant protection (FT)
- 2019: **80% of leveraged loan market is covenant light** (e.g., without restrictions on dividends or additional borrowing), **up from 10% in 2009**. (NYT)
- March 2019 – **FSB initiates investigation** of risks to financial stability from leveraged loans and CLOs
- February 2019 – London CLO manager: “how can we have defaults if we don’t have covenants?”

CLOs – Two tiers of potential litigation

- CLO Structure
 - Defendants: collateral manager, arranging bank, equity investor, AAA tranche investor
 - Plaintiffs: investors
- Underlying loan defaults
 - Defendants: borrower, syndication agent, syndicating banks
 - Plaintiffs: syndicating banks; CLO trustee, collateral manager, non-CLO loan purchasers

CLOs – the Litigation Hook

- This is not RMBS
 - Very few reps and warranties
 - All initial loans specifically identified
 - Limited role for “origination to securitize.”
 - Most loans purchased in secondary market
 - Limited role for repurchase litigation
 - Limited contract standardization; every CLO has different risks

CLOs – the Litigation Hook

- Collateral managers have ongoing obligations through the life of a CLO, exposing them to potential liability. The hook this time will be covenants.
 - Selection of initial investments
 - Active trading of assets within the CLO.
 - Reinvestment of principal.
 - Selecting and applying collateral quality test levels
 - Refinancing or issuance of additional notes.
 - Repaying or redeeming notes
 - Maturity extensions on underlying loans
 - Interpretation of provisions regarding collateral assets

CLOs – the Litigation Hook

- Contractual standard of care is limited for collateral managers
 - Standard of care: “The Collateral Manager shall perform its obligations hereunder and under the Indenture with ***reasonable care and in good faith***, using a degree of skill and attention no less than that which the Collateral Manager or its Affiliates exercise with respect to comparable assets that they manage for themselves and others. To the extent consistent with the foregoing, the Collateral Manager shall follow its customary standards, policies and procedures in performing its duties under the Indenture and hereunder...”
- Collateral managers may have ***fiduciary duties*** as investment advisor
- Potential ***conflicts of interest*** could increase liability
 - Where is the collateral manager invested? In equity?

CLOs – the Litigation Hook

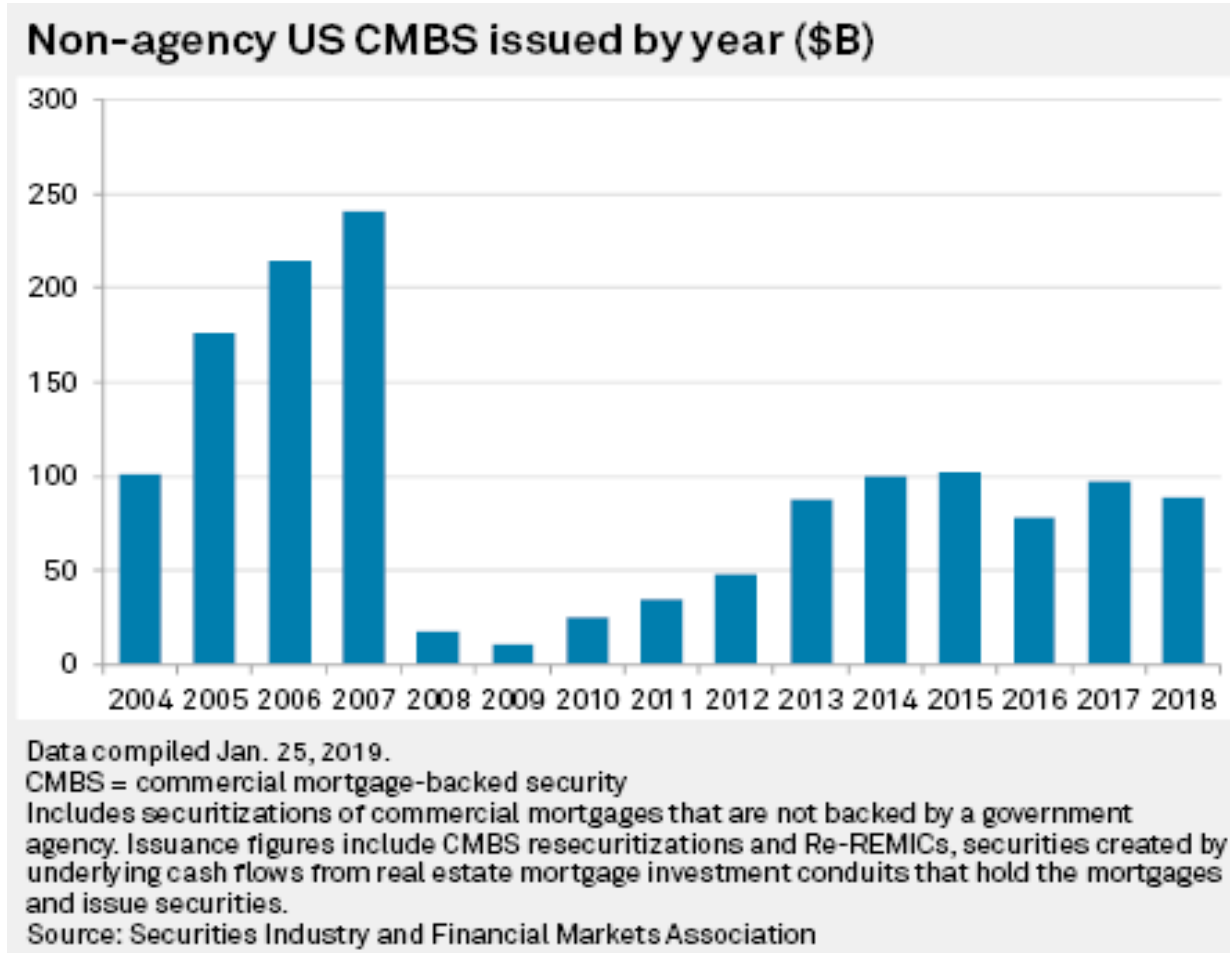
- Issuers are further weakening covenants constraining collateral manager conduct
 - Loosening standards for amending indenture terms, including those relating to asset quality tests, and trading rules, with limited noteholder consent
 - Widening the definition of permissible exchanges
 - Undermining over-collateralization tests by weakening haircuts to par value of troubled assets
- Will this get collateral managers off the hook, or spread the potential liability?

CMBS – the Securitization Landscape

Commercial mortgage-backed securities are a long-established asset class – with a limited history of litigation

- Like RMBS:
 - Securitization structure
 - Tranched
- Unlike RMBS:
 - Limited number of high-value loans
 - Limited reps and warranties
 - “Controlling Class” structure, in which first-loss investors have direct control over servicing
- Losses have been low and recovery strong compared to RMBS, in part due to less volatile collateral, in part due to controlling class structure.

CMBS – Hit, But More Robust Than RMBS



CMBS – What CMBS Litigation Has Looked Like

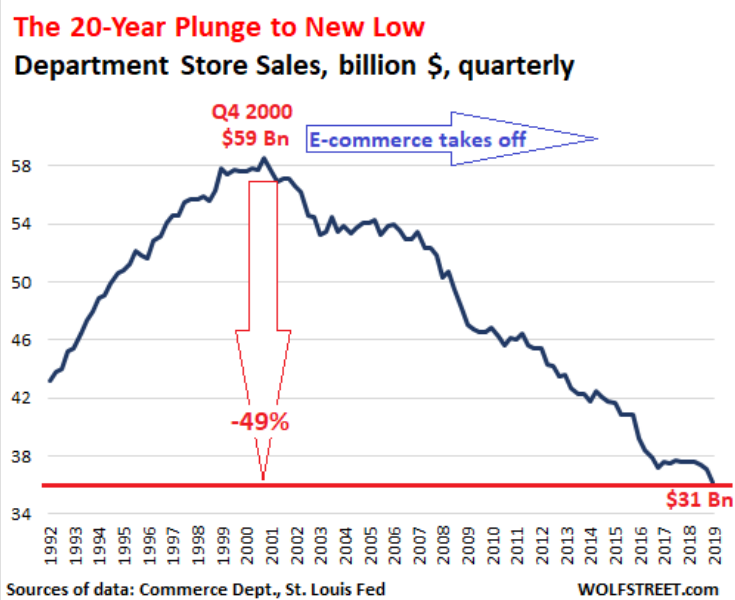
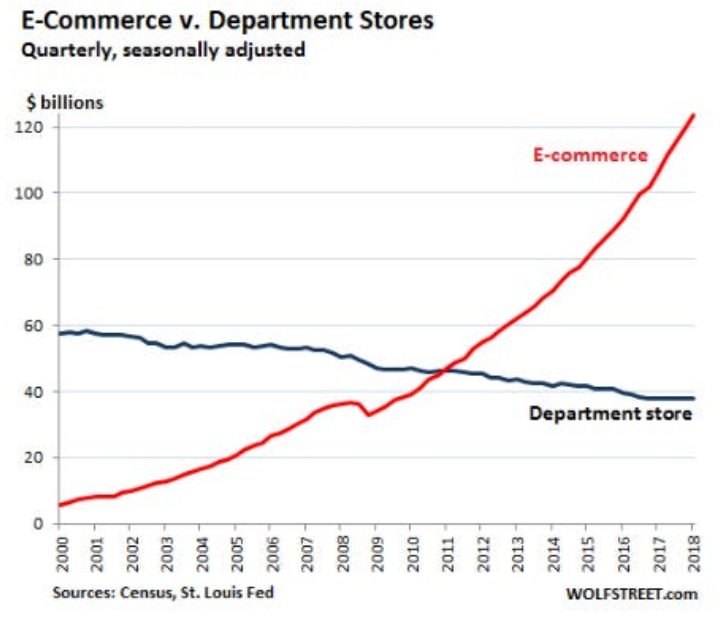
- One-off litigation – at three levels
- CMBS trustee sues borrower or guarantor on individual loans
 - Breach of loan terms
 - Breach of guarantee
- CMBS trustee sues the lender/loan seller
 - Breach of reps and warranties
 - Mortgage loan documents are enforceable
 - Appropriate appraisal was conducted
 - Origination, servicing and collection practices were legal and consistent with industry practice
 - Borrower fraud
 - Key legal issues have been similar to repurchase (causation, SOL, damages, interpretation of RWs)

CMBS – What CMBS Litigation Has Looked Like

- Conflict of interest litigation between the controlling class and other noteholders
 - The controlling class representative typically has the right to purchase loans from the trust at fair value
 - Recent litigations claim that the controlling class representative is buying loans at deflated prices or blocking sales for fair market value to deflate the price
 - Challenges by other noteholders have turned on standing – an issue not yet resolved.
 - An ongoing source of dispute

CMBS – Why The Story May Change

- CMBS collateral faces structural headwinds
 - Commercial over-building. The We-Work effect.
 - The continuing web attack on brick and mortar retail



CMBS – Why The Story May Change

Retail stores closing in 2019

| RETAILER | CLOSURES | RETAILER | CLOSURES | RETAILER | CLOSURES | RETAILER | CLOSURES |
|--------------------|----------|------------------------|----------|----------------------------|----------|---------------|----------|
| Payless ShoeSource | 2,500 | Avenue | 222 | Party City | 55 | Henri Bendel | 23 |
| Gymboree | 805 | Walgreens | 200 | A'Gaci | 54 | Lowe's | 20 |
| Dress Barn | 650 | Forever 21 | 178 | Victoria's Secret | 53 | Z Gallerie | 17 |
| Charlotte Russe | 520 | The Kitchen Collection | 160 | Office Depot and OfficeMax | 50 | Walmart | 17 |
| Fred's | 520 | Sears | 124 | CVS Health | 46 | Barneys | 15 |
| Family Dollar | 390 | Kmart | 115 | The Children's Place | 45 | Macy's | 9 |
| Shopko | 371 | Performance Bicycle | 102 | Abercrombie & Fitch | 40 | J.Crew | 7 |
| Charming Charlie | 261 | Destination Maternity | 42-67 | Christopher & Banks | 30-40 | Kohl's | 4 |
| Chico's | 250 | Bed Bath & Beyond | 60 | JCPenney | 27 | Nordstrom | 3 |
| Gap | 230 | Pier 1 Imports | 57 | Beauty Brands | 25 | Lord & Taylor | 3 |

*Source: Business Insider as of October 2019

CMBS – the Litigation Hook

- CMBS reps and warranties have been the basis for litigation
- If a downturn and structural changes increase pressure on commercial real estate values, those tested sources of liability may give rise to significantly increased litigation.
- Rep and warranty hooks to look to:
 - “The **origination, servicing and collection practices** used by the Seller with respect to such Mortgage Loan have been in all material respects legal and have **met customary industry standards.**” (CMPC 2006-MF2)
 - “The information pertaining to each Mortgage Loan set forth in the **Mortgage Loan Schedule was true and correct** in all material respects as of the Cut-Off Date...” (Wachovia 2007-C30)
 - “The **Seller has no knowledge** that the material representations and warranties made by the related Borrower in the related Mortgage Loan Documents **are not true in any material respect**” (Credit Suisse 2006-C5)
 - “There is **no breach, violation, or event of acceleration existing under the Mortgage** or the related Mortgage Note” (Merrill Lynch 1991-C1)

Student Loans - the Securitization Landscape

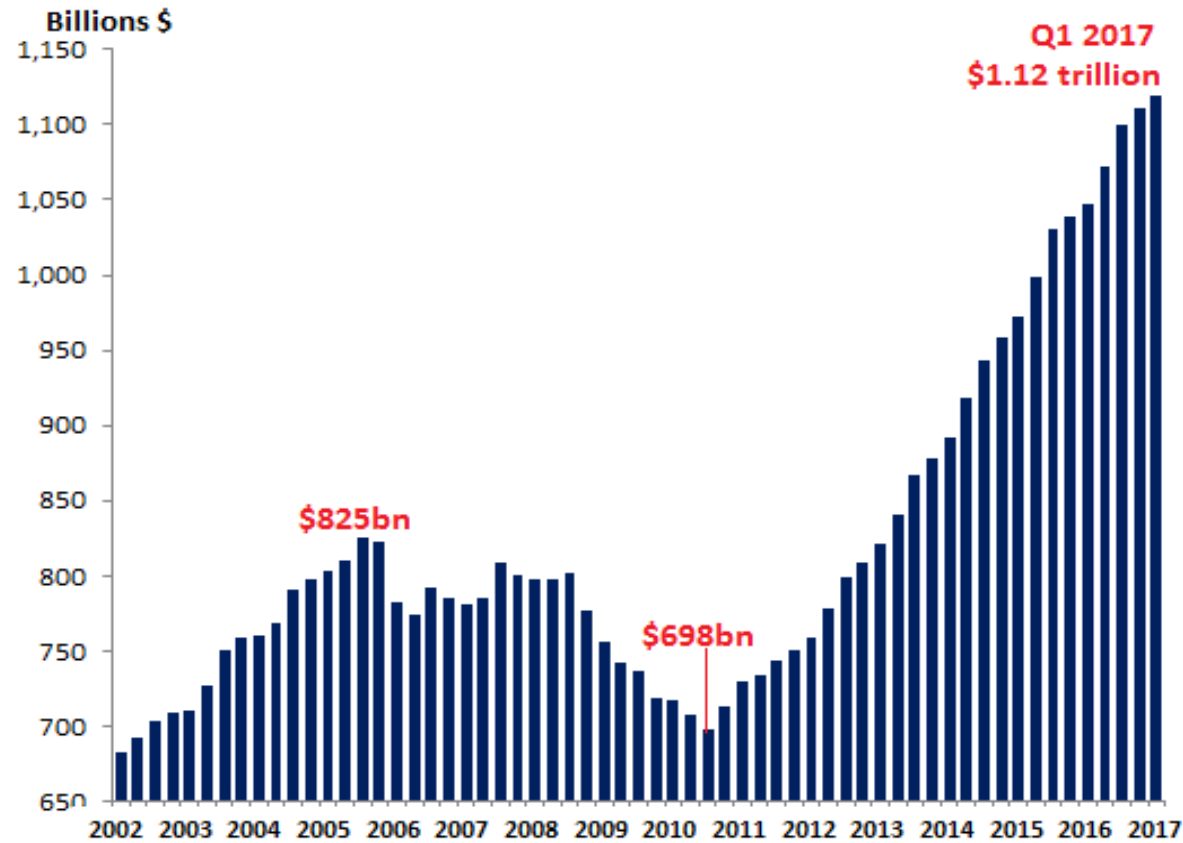
- The securitization structure resembles RMBS
- Market has changed. Federal guarantees to private lenders discontinued in 2010.
- Today, great majority of student loans are federally held. \$1T outstanding.
- Private label SLABS focus on high credit borrowers, professional schools. Default rates around 3%.
- A highly politicized asset, creating additional risk

Student Loan Litigation

- Rep and warranty
 - Student loan securitization sellers make reps and warranties similar to RMBS sellers
 - Compliance with origination guidelines; no fraud; accuracy of loan schedule
 - However, “guidelines” are weaker– no collateral, no borrower employment, little or no borrower credit history
 - Little R&W litigation over student loans to date, but that could change
- Servicing
 - Regulatory focus on abusive servicing practices, but unclear impact on investors
- “Conflict” litigation (National Collegiate Student Loan Trust litigation)
 - Struggle for control between holders of residual interests and noteholders
 - Alleges scheme by residual holder to wrest control of trust accounts

Auto loans – the Securitization Landscape

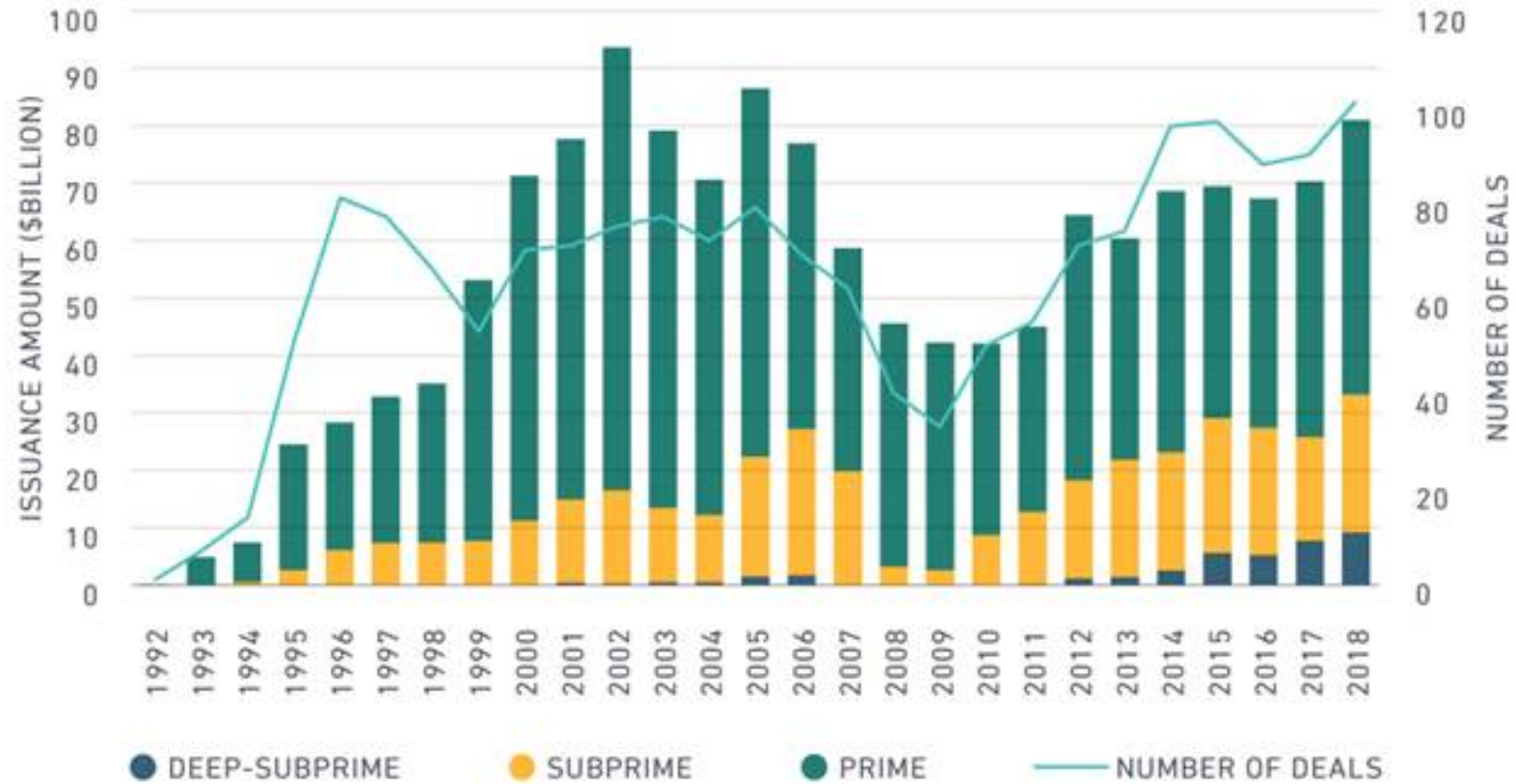
Auto Loans, Owned and Securitized



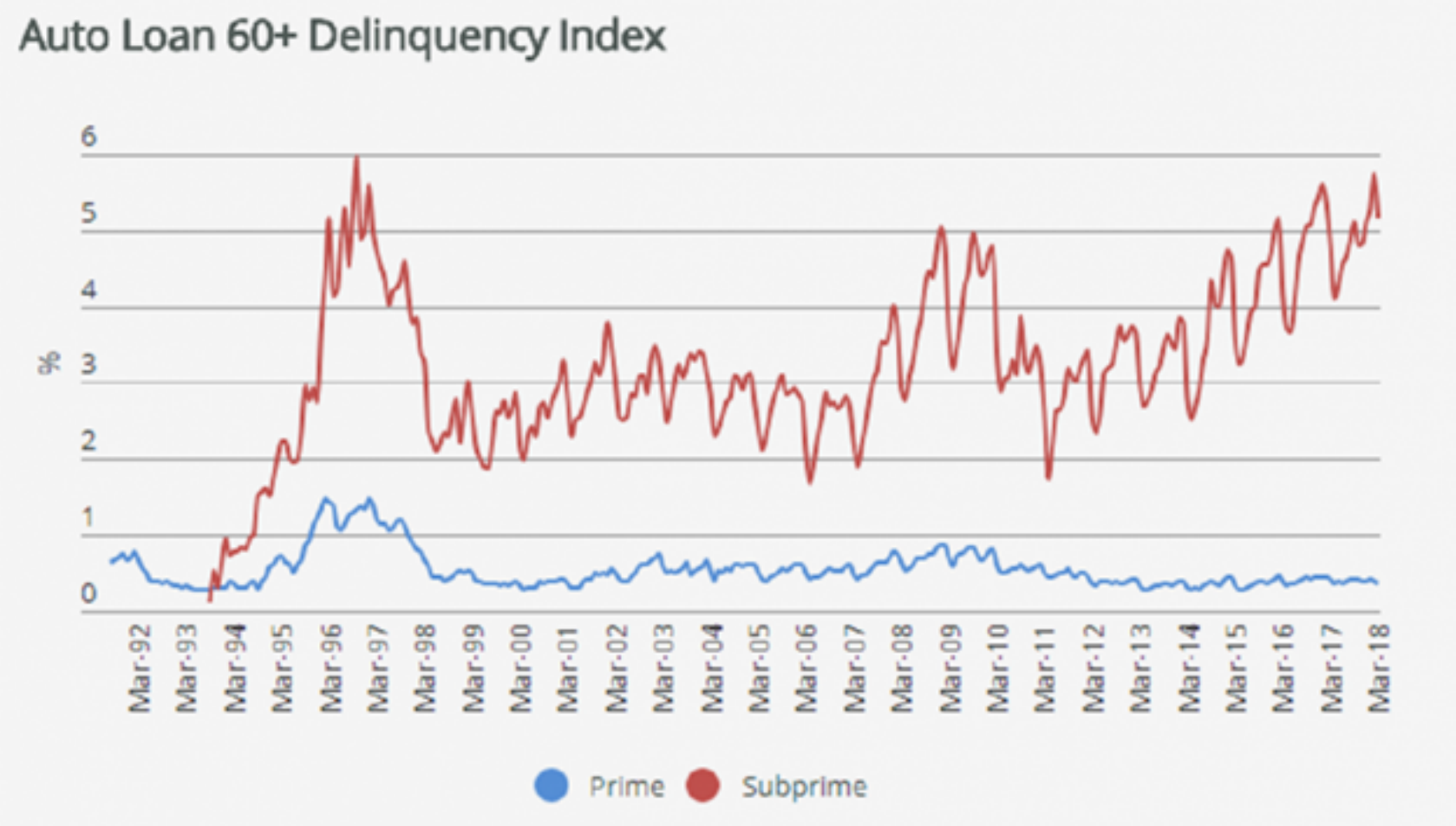
Source: Fed Board of Governors, St. Louis Fed

WOLFSTREET.com

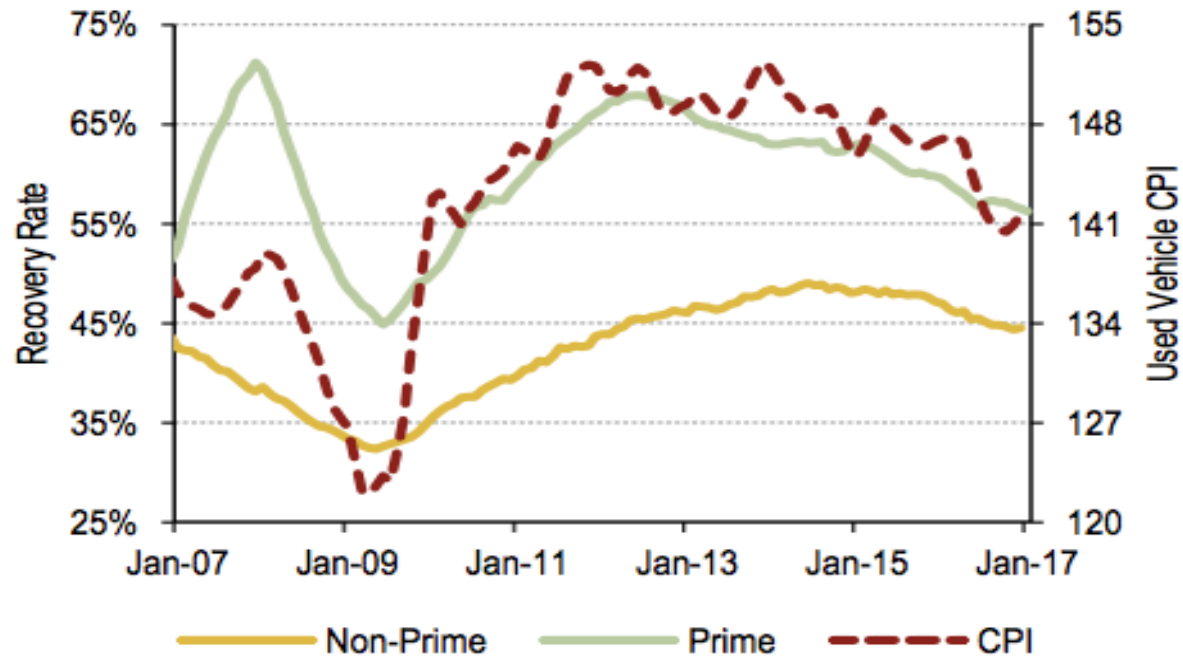
Auto loans – Sub Prime Creeps in



Auto loans – High Delinquency



Auto loans – Challenging Recovery Rates



Source: BofA Merrill Lynch Global Research, Intex, BLS

Auto loans – RMBS Redux?

- The securitization structure resembles RMBS
 - Loan originators:
 - Affiliates of car companies
 - Sub-prime specialists
 - Securitization issuers: Wells Fargo, JP Morgan, Santander

Auto loans – RMBS Redux?

- Reasons to worry about credit quality
 - Car lot financing. No standardized terms.
 - Aggressive terms
 - Extended payment – underwater forever
 - Stated income loans
 - Government litigation
 - Massachusetts and Delaware settlement with Santander, 2017:
 - \$26 million in fines and borrower relief
 - Allegations of outright fraud (income inflation, collateral inflation)
 - Santander pointed the finger at car dealers who “submit[ed] loan applications reflecting inflated borrower income, thereby inducing [Santander] to purchase loans”
 - Massachusetts and Delaware investigations of auto loan lending are ongoing; recent settlement with Exeter for \$5.5 million
 - 2018 CFPB/DOJ regulatory actions against auto lenders for discriminatory practices and TILA violations, resulting in settlements (Fifth Third Bank, Wells Fargo); ongoing NY DFS investigations into auto lending

Auto loans – RMBS Redux?

- Brakes on losses – to date
 - Collateral values historically maintained
 - Sound familiar?
- The risks on the horizon
 - Aggressive lending terms + underwater borrowers + recession
 - Technological shocks that may depress resale prices
 - Uber
 - Self-driving

Auto loans – the Litigation Hook

- Although securitization reps and warranties have become less investor-friendly since the credit crisis, litigation hooks remain:
 - “The ***records of the Servicer do not reflect any fact which would give rise to any right of rescission, offset, claim, counterclaim or defense with respect to such loan*** or the same being asserted or threatened with respect to such loan.”
 - “***The loan complied at the time it was originated or made in all material respects with all requirements of applicable federal, state and local laws, and regulations thereunder.***”
 - While borrower protections (e.g., “***ability to pay***”) are weaker than for mortgages, they exist for auto borrowers
 - Source: Santander Drive Auto Receivables Trust 2018-1.

Corporate BBB – the Landscape

- Corporate BBB Debt is the lowest rated investment grade debt
 - On a knife-edge.
 - Many investors are barred from holding less than BBB grade debt
 - Sub BBB market is much more illiquid
 - Vicious circle: demotion below BBB increases borrowing costs
- BBB debt has grown enormously as a share of the debt market in recent years
 - BBB debt outstanding. 2007: \$750B. 2019: 2.7T.
 - % of investment grade bonds outstanding. 2008: 30%. 2018: 54%
 - % of MSCI Index with a credit rating of BBB or lower. 1999: 10%. 2019: 50%.
- This growth in BBB debt has occurred in a rapidly growing over-all corporate debt market
 - Volume of corporate debt has doubled since the end of the financial crisis (OECD)
- Accompanied by weakening covenants

Corporate BBB – the Implications

- 2019 warnings from:
 - Federal Reserve
 - BIS
- From litigation perspective
 - A bankruptcy play
 - Potential for accelerating downward market trajectory

Libor – The End is Nigh

- The end of LIBOR
 - Rampant manipulation
 - July 2017: FCA announces no more required LIBOR submissions after 2021
- Replacements: SOFR, SONIA
- Fallback language for new agreements (AARC)

Libor – the Legacy Problem

- Negotiation is ongoing. But it won't resolve everything.
 - How do you negotiate publicly traded floating rate notes, securitizations, and preferred stock?
- Michael Held, General Counsel, Federal Reserve Bank of New York (Feb 2019)
 - “In a permanent cessation of LIBOR, ***the fallback solutions in existing contracts become impractical or materially change the economics. That’s a situation that invites litigation, and in the case of LIBOR that litigation would be on a massive scale.***”
 - “You can imagine the litigation risk when the reference rate for a 20-year contract disappears and there’s no clear path to replace it. Now imagine 190 trillion dollars’ worth of those contracts. ***This is a DEFCON 1 litigation event if I’ve ever seen one.***”
- FCA:
 - “There may still be a material volume of such contracts in cash markets into the 2030’s.”
- John C. Williams, President and CEO, Federal Reserve Bank of New York (Sept 2019)
 - “The date when the existence of LIBOR can no longer be guaranteed is fast approaching... while some institutions are making good progress, others are ***sticking their metaphorical heads in the sand*** ... wearing rose-tinted glasses, getting nostalgic about LIBOR and hoping for an extension to the deadline or a reincarnation of the rate. I cannot emphasize enough that the clock is ticking and everyone needs to get their firms ready for January 1, 2022.”

Libor: We Didn't See This Coming

- What do legacy fallback terms say? Many things.
 - Call three London banks and request their borrowing rate
 - Fix the interest rate at the last LIBOR rate (floating rate notes)
 - Revert to prime rate (syndicated loans)
 - Lender chooses a “comparable rate” (consumer loans)
 - No fallback
- Other negotiation challenges
 - Some contracts referenced 3, 6 or 1 year LIBOR. SOFR is an overnight rate.
 - LIBOR included bank funding risk. SOFR is based on repo transactions secured by treasuries.

Libor: Where Are the Landmines?

- Longer term contracts with limited incentive or opportunity for negotiation and the epicenter
- Less litigation risk
 - Business loans – shorter term
 - Derivatives – shorter term
 - OTC derivatives– subject to ISDA protocols
 - Exchange traded derivatives – subject to exchange rules
- Greater litigation risk
 - Consumer loans
 - Mortgages
 - Floating rate notes
 - Floating rate securitizations
 - Preferred stock

Libor: What Will Claims Look Like?

- Contract claims - damages
- Mutual mistake - reformation
- Impossibility of performance – rescission
- Trustee instruction proceedings
 - Different investor views based on place in capital structure
- Post SOFR/SONIA litigation
 - Disputes over triggering events



Donald W. Hawthorne

A Rhodes Scholar, Don Hawthorne's practice focuses on litigation involving complex financial instruments, and he has extensive experience in credit crisis litigation. He has represented insurers in fraud and contract claims relating to their investments and has also successfully resolved coverage disputes.