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FINANCIAL TIMES

Capital markets

ADCB action cuts to the heart of the credit boom

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Published: September 8 2008 18:08 | Last updated: September 8 2008 18:08

Abu Dhabi Commercial Bank's class action lawsuit for fraud, negligent misrepresentation and unjust enrichment over its investment in a complex fund is a fascinating collection of details and allegations that cut to the heart of the credit boom and messy aftermath.

The filing of the suit last month marked a grim anniversary for ADCB, coming almost exactly a year to the day after Cheyne Finance – one of a string of busted structured investment vehicles (SIVs) – revealed it had breached covenants that set it on the path to receivership.

The Middle-East bank had bought middle ranking, or mezzanine, capital notes in the vehicle, which had been given a single A rating by two agencies and paid a return of 1.5 per cent over Libor, the risk-free rate, it claims. These notes, it says, are worthless after the vehicle's collapse. In spite of the near total decimation of the once $400bn SIV industry, ADCB's is only the second suit filed over the collapse of one of these vehicles – the other was filed by Oddo Asset Management over two SIV-lites, named Mainsail and Golden Key.

The industry was laid low by the shut-down of the short-term commercial paper markets that funded most of their senior debt and the precipitous decline in the value of their holdings of financial bonds and asset-backed securities as markets panicked over the fall-out from the US subprime mortgage meltdown.

Some investors in the top-rated short-term debt have been paid back by banks who sold it to them. For example, Merrill Lynch agreed in the same week the ADCB suit was filed that it would buy back $20m worth of commercial paper issued by Mainsail from the state of Maine.

But these SIV suits are unlikely to be the last. Richard East, partner at Quinn Emanuel a London based firm not involved in either of these suits, expects an increase in litigation related to SIVs and other complex products. His firm is already engaged on more than 50 structured debt product cases in the US.

“Investors …have chosen to file suits in the US courts because it is easier to claim fraud than in the UK. In addition a claimant does not have to pay the defendants’ costs, while it has the ability to claim punitive damages,” he says.

One thing the two SIV lawsuits share – and which sets them apart from the wave of lawsuits related to collateralised debt obligations – is their pursuit of rating agencies alongside the more typical investment bank defendants.

The agencies have come under pressure to reform and to submit to greater regulation in the wake of the credit turmoil and the ADCB suit makes many references to comments and findings of regulators such as the US Securities and Exchange Commission.

Additionally, ADCB in its suit says that were it not for the rating agencies’ violations of the law, the capital notes, which ADCB bought, would never have been issued. A US court earlier this year reaffirmed a 1994 ruling that business partners, lawyers and bankers cannot be held liable for assisting or participating in corporate fraud unless investors can prove they specifically relied on those third parties when making investment decisions.

ADCB’s suit accuses Morgan Stanley, Bank of New York Mellon, Moody’s Investors Service and Standard & Poor’s of misleading investors about the quality of assets the Cheyne vehicle bought and held from its inception in 2005 to its collapse just two years later.

The complaint makes strong claims about how the rating agency fees involved provided a powerful incentive to work with the investment bank in turning the dross of risky mortgages into the gold of investment grade securities.

The suit claims that Moody’s and S&P were paid three times the fees they would get from typical corporate bond ratings; that they were paid only if they provided an investment grade rating and the deal closed with that rating; and that they earned success fees when the vehicle was launched and the fees increased in tandem with the growth of the SIV. It claims the agencies would have been paid $6m at the launch of the SIV.

“They provided unreasonably high ratings because they faced serious conflicts of interest,” the suit alleges.

The Oddo suit similarly names S&P’s parent company McGraw Hill alongside Barclays Capital, the UK bank, and Solent Capital, a London-based investment manager. It makes claims about how the “ratings agencies collaborated with their investment banking clients”.

“The rating agencies sought to please their banking clients because the banks were important repeat customers, and providing ratings for complicated

structured finance transactions generated significant fees for the rating agencies. In addition, the investment banks only paid the rating agencies if they delivered the desired ratings," the Oddo suit says. The ADCB suit is critical of the models the agencies used to determine their ratings, claiming they "depended on irrelevant historical information preceding 2000" when the SIV was buying mortgage-related investments from much later years.

The data was irrelevant because in the boom years the percentage of subprime mortgages to total mortgages tripled, while the loan to value went from a relatively conservative 70 per cent to 90 per cent, the suit claims. Mortgages based on limited documentation quadrupled, second-lien mortgages doubled and so called "liar loans", where borrowers certified their own financial credentials, soared, the suit claims.

"[B]y the time the rating agencies provided "investment grade" certifications to the Capital Notes in August 2005, they knew that their historical data no longer reflected market realities and that mortgage credit quality was rapidly deteriorating," the suit claims.

The investment banks do not look any better, based on the ADCB suit's portrayal of Morgan Stanley, the arranger and placement agent for the Cheyne SIV. Stanley received fees based on the market value of the assets in the SIV every quarter, the suit claims. In addition, Morgan helped select assets that went into the ill-fated Cheyne SIV and the suit claims these included loans from Saxon Capital, a sub-prime lender that Morgan Stanley owned.

The SIV also contained mortgages from another sub-prime mortgage lender, New Century, which filed for bankruptcy protection in April, 2007, the suit claims. These remained in the SIV even though Morgan Stanley knew that many New Century loans had been kicked out of pools of mortgages to be securitised precisely because of flaws in the origination process, defective appraisals and missing documentation, the suit alleges.

The Oddo suitclaims that Barclays in conjunction with the managers of the Mainsail and Golden Key SIV-lites used the vehicles to buy impaired securities from the bank at inflated prices. "In short, having set up both SIV-lites and promoted them as desirable investments to investors, Barclays proceeded to use them as a dumping ground for toxic assets that Barclays needed to quickly jettison."

Morgan Stanley would not comment on the ADCB suit, while Barclays Capital says the Oddo suit was "completely without merit and we will fight it vigorously".

Moody's says of the ADCB suit: "Based on our initial review of this complaint, we believe that the claims made against Moody's are meritless and misrepresent both the relevant facts and the applicable law."

S&P says: “This complaint is without factual or legal merit, and we will defend against it vigorously.” A spokeswoman for Solent Capital declined to comment.

Additional reporting by Brooke Masters

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INSURANCE JOURNAL

National News

Credit Rating Agencies Fending Off Lawsuits from Subprime Meltdown

By Martha Graybow
July 14, 2008

Battered by critics who blame them for helping to foment the U.S. subprime mortgage meltdown, credit raters are now trying to fend off lawsuits -- including fraud claims brought by their own shareholders.

Many financial companies, including banks and lenders, have been sued following the housing market bust; but the cases against ratings agencies may be among the most closely watched.

That's because the three biggest agencies -- Moody's Corp , McGraw-Hill Cos Inc's Standard & Poor's division and Fitch Ratings, part of Fimalac SA -- have drawn fire from some politicians and investors for awarding top marks to subprime-linked securities that later disintegrated. They've also been criticized as being too close to issuers who foot the bill for their ratings.

Based on how prior cases have played out, the plaintiffs could face an uphill battle in court -- and ratings firms say they will vigorously defend themselves against the lawsuits. Plaintiffs lawyers, though, say that their claims are strong and that a government report unveiled this week finding "serious shortcomings" at the raters could bolster their cases.

"No one has really crossed the threshold to try to hold the rating agencies accountable for their faulty ratings," said Christopher Keller, a lawyer at law firm Labaton Sucharow LLP, who represents some of the plaintiffs in a shareholder case against Moody's.

"Without their complicity in this process (of rating mortgage-backed debt pools), most of these securities would never have come to market," he said.

The agencies have agreed to institute some reforms. Last month the three top agencies struck a pact with New York's attorney general to change how they charge fees for reviewing mortgage-backed securities. A separate probe by Connecticut's attorney general is ongoing.

Rating agencies have found themselves in court before. When they were sued by Enron investors for allegedly being too slow to downgrade the energy trader's debt, a federal judge dismissed the claims, saying the ratings analysts deserved the same kinds of First Amendment protections that shield journalists because their work was in essence opinion and not a guarantee.

Under a barrage of criticism in Washington, the raters also argued that they, too, were victims of the Enron fraud, saying they weren't told the truth about the company's finances.

In another case, Orange County, California sued S&P for $2 billion after poor investments triggered its 1994 bankruptcy.

S&P settled the case for $140,000 but admitted no wrongdoing. The $140,000 represented a partial refund of the ratings fees paid by the county.

Each of the three leading raters is a defendant in at least one new lawsuit brought by investors seeking to hold them liable for the ratings on mortgage-related securities. That suit was brought by a union fund on behalf of investors in several mortgage loan trusts that issued bonds that fell sharply.

Also, Moody's, S&P and Fitch all face purported class-action cases in U.S. District Court in Manhattan that contend they deceived their own shareholders and applied lax ratings criteria to keep lucrative fee revenue going,

The claims revolve around "representations made directly by the senior insiders of these companies to the market," said Darren Robbins, a lawyer at law firm Coughlin Stoia Geller Rudman & Robbins LLP, which has sued S&P and Fitch.

Fitch's parent has called a shareholder lawsuit filed by the Indiana Laborers Pension Fund "totally without merit" and said it would "fully and vigorously defend against it."

McGraw-Hill said the various suits against S&P "are completely without merit" and it "will be moving to dismiss each of them."

A Moody's representative did not immediately respond to a phone message seeking comment.

The lawsuits are still in the early stages. Court trials -- which are highly unusual in class-actions, because most are ultimately dismissed or settled -- could be years away.

Meanwhile, the plaintiffs want to get their hands on documents cited in a U.S. Securities and Exchange Commission report this week that uncovered poor disclosure and conflicts-of-interest practices.

The report cited e-mails suggesting that the raters knew that collateralized debt obligations (CDOs)-- pools of debt linked to subprime mortgages -- were headed for problems.

The SEC report did not identify the specific agencies or individuals who wrote the documents. It would likely be up to the courts overseeing the lawsuits to determine whether plaintiffs should get access to more details.

One e-mail from an agency analyst said that her firm's ratings model did not capture "half" of one deal's risk, but that "it could be structured by cows and we would rate it." In another e-mail, a ratings agency manager called the CDO market a "monster" and said: "Let's hope we are all wealthy and retired by the time this house of cards falters."

Plaintiffs' lawyer Keller said he and his colleagues "would certainly love to know the origin of that e-mail" as they press their claims. He said the SEC report "really gives a window into what was going on."

(Reporting by Martha Graybow, editing by Gerald E. McCormick, Leslie Gevirtz)

Find this article at:
http://www.insurancejournal.com/news/national/2008/07/14/91841.htm

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