

# Approaches To Asset Recovery For Pension Fund Subprime Exposure

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The recent implosion of U.S. credit markets caused by widespread losses in subprime mortgage-related investments has threatened private hedge funds and public pension funds alike.<sup>1</sup> Public pension funds may face subprime-related investment losses in at least three areas: 1) direct investment in subprime backed debt instruments, credit default swaps, etc; 2) investments in the securities of financial institutions holding or issuing subprime instruments, debt or credit related enhancements such as guarantees, liquidity puts and stand-by letters of credit; and/or 3) investment in private equity and hedge funds that are subjected to direct exposure to certain subprime related instruments. Given the overall scope of subprime-related market losses reported thus far, it is prudent for public pension funds to examine potential asset recovery strategies at a very early stage in the process.

Strategies appropriate for recovering assets will obviously differ according to the specific terms and circumstances of a given fund's subprime-related investments. Moreover, judicial rulings on individual subprime-related claims are difficult to predict given the unsettled nature of this legal area. Nonetheless, a review of

specific types of subprime-related instruments, and emerging details on how some of them generally operate, sheds some light on potential avenues for asset recovery.

## **Subprime-Related Instruments**

Public pension funds have historically had their portfolios and cash reserves invested in conservative, high-yield instruments such as government bonds and investment grade commercial paper. However, the increasing demand for higher investment returns given growing retiree numbers has resulted in more frequent investment in an expanding array of private equity and hedge funds, as well as complex mortgage-backed instruments. Indeed, since the advent of mortgage-backed securitizations in the 1970s, the diversity of investment products collateralized by mortgage loans, and the volume of overall trading in those products, has increased substantially.

While certain similarities exist, each of the subprime-related financial instruments or vehicles at the center of the current market downturn has a distinct set of characteristics as described below:

## **Asset-Backed Commercial Paper**

Commercial paper is an unsecured short-term debt instrument mainly issued by corporations on an interest bearing basis for financing short-term liabilities such as trade receivables and inventories. It matures within 270 days of issuance and is generally backed by bank lines of credit rather than collateral assets.

Asset-backed commercial paper ("ABCP") is also a form of short-term debt (no more than 270 days to maturity) that is backed by collateral assets such as trade receivables, mortgages, automobile and equipment loans, credit card receivables, mortgage-backed securities, and other commercial assets. ABCP is generally issued by a special purpose vehicle ("SPV"), which may be an independent entity that is not consolidated onto the financial statements of the sponsoring company or bank. Repayment of ABCP generally comes from the expected cash flows generated by the pool of assets held by the ABCP-issuing SPV. As receivable amounts on the underlying assets are collected, they are passed onto the SPV conduit entity, which then forwards the proceeds to holders of the ABCP.

Pension fund investments in ABCP may create subprime exposure if the pool of assets comprising the collateral for the purchased paper includes subprime mortgages. The increasing number of defaults and delinquencies on subprime mortgage payments in the past six months has led to a significant investment downgrading of certain widely held ABCP.

## **Residential Mortgage-Backed Securities**

Residential Mortgage-Backed Securities ("RMBS") are a type of mortgage-backed debt instrument in which a pool of mortgages on residential rather than commercial real estate serve as the collateral. RMBS investors receive interest and principal payments from the mortgages, home equity loans, and subprime mortgages which make up the collateral pool. The credit rating agencies downgraded their ratings for over 400 different RMBS in the Summer of 2007 as a result of high delinquencies on the underlying subprime mortgages in the collateral asset pool.

## **Collateralized Debt Obligations**

A collateralized debt obligation ("CDO") is a package of bundled supposedly investment-grade equity and debt securities that are collateralized by a pool of diversified debt instruments such as corporate bonds, bank loans, mortgage-backed securities, and real estate investment trusts ("REITs"). CDOs are comprised of different "tranches" with varying degrees of debt and credit risk. The senior tranches have the best credit quality (often rated AAA) and the lowest yield, the mezzanine tranches have slightly lower credit ratings (AA to BB) but higher yields, and the subordinate or equity tranches pay the highest yields, but have no credit ratings and are the first to suffer losses in the event of a default. Some CDOs offer a form of principal protection to allow pension funds to invest in unrated CDO equity tranches. Such protection involves investing a portion of the money received into zero coupon

government bonds which cover the principal investment if all is lost on the equity tranche investment.

CDOs also generally involve the formation of an SPV which issues equity and debt to finance the purchase of the collateral assets described above. The CDO debt often takes the form of commercial paper. A bank or other financial institution generally serves as the trustee or manager of a particular CDO's investments. The CDO manager is responsible for the initial asset portfolio selection, as well as subsequent monitoring and trading of the collateral instruments. The principal proceeds from the CDO's collateral asset pool, such as mortgage payments, are used to pay down the rated tranches of debt in order of priority. CDOs often have credit protection agreements requiring banks to purchase the CDO debt if there are no other purchasers in the market.

The recent collapse of the subprime mortgage market has made it clear that a substantial portion of CDO asset pools are made up of subprime mortgages. The widespread defaults on these subprime mortgages have resulted in significant downgradings of certain CDO debt tranches to junk status. Pension funds that have invested in CDOs with substantial subprime mortgage-backed collateral may face significant losses as the market continues to decline. Moreover, significant risks are presented by any pension fund investment in CDO equity tranches since these holders are the first to suffer loss, and any credit protection provided by the principal protection arrangements do not counteract the funds' lost opportunity to earn money during the time of the failed CDO equity investment.

## **Structured Investment Vehicles**

A structured investment vehicle ("SIV") is a limited purpose entity that funds itself through the issuance of low interest short-term commercial paper, and uses those funds to purchase longer-term securities such as asset and mortgage-backed securities ("ABS" and "MBS"), and corporate bonds. Profits from an SIV investment are generated by the difference between the higher interest payments on the purchased ABS and MBS, and the interest owed on the commercial paper issuances. SIVs are generally arranged or underwritten by banks, and also have a separate investment manager such as a partnership or hedge fund which can make investment decisions with little disclosure to SIV investors.

Like CDOs, there are typically junior and senior tiers of debt issued by SIVs, with the senior notes rated AAA, and the junior notes unrated. An SIV is generally required to obtain a liquidity facility from a bank in order to obtain a high rating for the senior SIV debt. Such liquidity is designed to protect SIV investors from market uncertainty, such as when the SIV is unable to refinance its commercial paper debt at maturity through the sale of new commercial paper.

The short-term nature of the commercial paper used by SIVs to finance longer-term ABS and MBS creates a constant need to refinance the commercial paper. SIVs have been increasingly at risk of significant losses from the tightening of liquidity in the commercial paper markets caused by the subprime crisis.

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## Strategies for Asset-Recovery

The complexity of these subprime-related instruments alone makes it difficult to identify any generalized asset recovery strategy for investors. The multitude of players involved in structuring, managing, and marketing these investments to pension funds raises questions about the appropriate parties from which to seek recovery. Moreover, any susceptibility to specific legal claims has yet to be fully tested by the courts and/or regulatory agencies. As always, much will depend on the underlying facts of each particular investment and the applicable law of the jurisdiction in which claims are brought.

Despite the obvious complexities, certain asset recovery options are emerging based upon a better understanding of the transaction structures underlying these instruments, as well as the risks present in the market over the past few years. The following is a brief summary of possible bases for obtaining a recovery of losses suffered in connection with the investments discussed herein:

### Breach of Contract

The existence of a liquidity facility or guarantee in the operative documents for subprime related vehicles provides a potentially straightforward mechanism by which investors can protect their interests.

Agreements to provide liquidity to investors in CDO or SIV issued paper when such instruments will not or cannot be refinanced, or "rolled over," in the open market has generally taken two basic forms. In the first, banks responsible for creating and/or sponsoring the CDO or SIV provide a direct guarantee or stand-by credit facility to repay amounts owed on the paper issued by the CDO or SIV.

The second type of credit enhancement takes the form of a "liquidity put," whereby a bank, or other institution agrees to buy back the paper from either holders who do not wish (or are unable) to "roll over" or refinance the debt, or the SIV itself. Similar to a stock put option, these liquidity puts create a financial contract between the investor/SIV and the bank issuing the liquidity put. The sponsoring bank, therefore, has the contractual obligation to purchase the commercial paper from the investor at a set price (generally at the original purchase price) should the investor choose to exercise the put. Investors concerned about subprime exposure should consider exercising such contractual rights to protect their investments prior to default or to use it as leverage in a work out.

A bank's failure to honor either type of liquidity guarantee for holders of CDO/SIV issued paper gives rise to a straightforward breach of contract claim. Such a claim has the advantage of not being subject to the stringent pleading requirements and stay of discovery imposed on investors seeking recovery under the federal securities laws. Much obviously depends on the specific terms of the agreement to provide liquidity, and a careful examination of the transaction documents is crucial to assessing the viability of any breach of contract claim.

An adjunct to any such breach of contract claim would be a potential claim for fraudulent and/or negligent misrepresentation against the bank or any other entity that promised to provide liquidity to CDO/SIV investors and later refused to honor that obligation.

### Breach of Fiduciary Duty

A common law claim for breach of fiduciary duty against the CDO or SIV asset managers responsible for investment in worthless subprime mortgages provides another potentially viable approach to asset recovery. The viability of any such claim will of course depend on whether an SIV/CDO asset manager owes a fiduciary duty to investors as opposed to the SIV/CDO entity itself.

As noted above, the basic structure of a CDO or SIV includes an asset manager, which is generally a bank or hedge fund, responsible for making investment decisions on behalf of that special purpose entity. Since the repayment of principal and interest on the paper issued by CDOs and/or SIVs depends on the performance of the underlying collateral assets, the asset managers arguably have a fiduciary duty to investors to ensure that sound investment decision-making processes are in place. The failure to follow internal investment guidelines and risk management procedures, and/or the use of faulty valuation models for assessing the performance of subprime loans may subject CDO/SIV asset managers to potential liability for breach of their fiduciary duty to investors. Indeed, the precipitous decline in the value of subprime loans purchased at the direction of these asset managers suggests that their valuation models and processes for making investment decisions were deeply flawed.

The failure of CDO/SIV managers to properly disclose specific investment decisions may also give rise to breach of fiduciary duty claims, as do quid pro quo types of arrangements between managers and sponsoring banks and/or banks issuing credit enhancements. For example, the failure to disclose faulty determinations about the frequency of defaults on the subprime mortgage collateral on the one hand, or purchasing high risk debt from a bank in exchange for the issuance of credit enhancements on the other, may serve as a basis for such breach of fiduciary duty or even fraud claims.

An SIV/CDO asset managers' substantial insider sales while in possession of material nonpublic information concerning imminent subprime losses may provide another ground for breach of fiduciary duty claims based on a conflict of interest with investors. In addition, evidence of "front-running," whereby asset managers place trades for internal accounts with advanced knowledge of large institutional trades that will move the market, could also potentially be a basis for breach of fiduciary duty claims.

### Shareholder Suits

Shareholder lawsuits are another potential ground for recovering investment losses. The shareholder suits filed thus far have focused on subprime mortgage lenders, and the financial institutions that have been forced to record significant losses resulting from subprime related exposure. Federal securities lawsuits were first

filed in the direct subprime lending area with suits against lenders like Countrywide Financial Corporation. These suits quickly spread to major banks like Citigroup and Merrill Lynch and are now poised to spill over to credit insurers like ACA, who are unable to satisfy the claims of credit default swap holders.

## Conclusion

The viability and success of any of these asset recovery strategies will of course depend on the underlying facts of each investment structure and the jurisdiction in which such claims are pursued. More potential options for recovery will undoubtedly emerge as the market begins to piece together the subprime puzzle. As a preemptive measure, careful risk management procedures can help minimize a pension fund's exposure to unstable subprime-related investments going forward and increase the likelihood of a satisfactory pre-litigation work out.

## Endnotes

1. See "UBS Shuts Hedge Fund After Big Subprime Losses," by Andrew Clark, *The Guardian*, May 4, 2007; "Bear Shuttters Third Hedge Fund," by Yael Bizouati, *IDD Magazine.com*, January 10, 2008; "Thomson Focus: Pension Funds Seen Posting Huge Losses From Subprime Investments," *Thomson Financial News*, November 21, 2007.
2. See Christopher L. Peterson, *Subprime Mortgage Market Turmoil: Examining the Role of Securitization*, University of Florida Law School, April 7, 2007 (describing "explosive growth" of mortgage-backed securities market in past decade).
3. See Federal Reserve Bank of Richmond, *Instruments of the Money Market* 105-07 (Timothy Q. Cook & Robert K. Laroche eds.) (1993).
4. *Id.* at 116-17.
5. See Federal Reserve Bulletin, *Asset-Backed Commercial Paper Programs*, by Gerald A. Edwards, Jr. (Feb. 1, 1992).
6. See Fitch Ratings, *Asset-Backed Criteria Report: Asset-Backed Commercial Paper Explained*, (Nov. 8, 2001).
7. *Id.*
8. See, e.g., "Subprime 'Tsunami' Hits Asset-Backed Commercial Paper Market," by Mark Pittman and Elizabeth Stanton, *Bloomberg*, August 8, 2007; "Moody's Cuts or May Cut Ratings on SIVs with \$33 Billion in Debt," by Alistair Barr, *MarketWatch*, November 7, 2007.
9. See Laurie S. Goodman & Frank J. Fabozzi, *Collateralized Debt Obligations: Structures and Analysis*, 71-72, 74 (John Wiley & Sons, Inc. 2002).
10. See "Moody's Downgrades Residential Mortgage-Backed Securities," available at <http://www.cnbc.com/id/19698687/>.
11. See Laurie S. Goodman & Frank J. Fabozzi, *Collateralized Debt Obligations: Structures and Analysis*, 1-2.
12. *Id.* at 2, 271-72, 287-88.
13. *Id.* at 258-59; see also "Collateralized Debt Obligations (CDOs)," available at <http://thismatter.com/money/bonds/types/cdo.html>.
14. See "Moody's Downgrades Bear Stearns Tranches," *The Wall Street Journal*, January 8, 2008.
15. See Standard & Poor's, *Structured Investment Vehicle Criteria*, March 13, 2002 (McGraw Hill).
16. *Id.*
17. See, e.g., "Structured Investment Vehicles' Role in Crisis," by Gillian Tett, Paul J. Davies and Norma Cohen, *Financial Times*, available at <http://www.ft.com/cms/s/0/8eebf016-48fd-11dc-b326-0000779fd2ac.html>, August 12, 2007; "Citigroup Cuts SIV Size By \$15 Billion: Report," *Reuters*, available at <http://www.reuters.com/articlePrint?articleId=USL1111435920071211>.
18. Where the credit enhancements are between the SIV and a third-party bank, the investor is in effect a third party beneficiary to the contract and has potential claims against the SIV and the bank issuing the liquidity puts.