

Collateralized Debt Obligations

Pursuit Partners, LLC v. UBS AG: Implications for Hedge Funds That Invested in Collateralized Debt Obligations and Other Structured Products

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On September 8, 2009, the Connecticut Superior Court entered an order requiring two UBS entities to put aside more than \$35 million to ensure that a hedge fund claiming fraud in its purchase of notes tied to UBS collateralized debt obligations (CDOs) would be adequately compensated in the event it was successful in its lawsuit against UBS.

The case, *Pursuit Partners, LLC et al. v. UBS AG, et al.*, is notable for a number of reasons. Chief among these is the rarity of lawsuits filed by purchasers of CDOs, notwithstanding the anecdotal evidence indicating that most CDOs have suffered massive declines in value. The lack of lawsuit filings by CDO purchasers has continued to puzzle industry experts who confidently predicted that the subprime mortgage crisis would result in an explosion of litigation by purchasers of securities and derivatives tied to subprime mortgages, including CDOs. These assumptions have turned out to be spectacularly wrong and the number of lawsuits filed by mortgage-backed securities purchasers has hardly amounted to a trickle while the number of lawsuits filed by purchasers of CDOs can be counted on both hands.

There is no obvious explanation for why this expected litigation explosion did not occur beyond the general distaste that non-public institutional investors seem to have for lawsuits in general and the almost universally held assumption within the hedge fund industry that nobody could have anticipated the collapse of the subprime mortgage

securities market. The *Pursuit* case however, renders that assumption highly suspect. As the limitations clock for filing suit continues to tick down for purchasers, hedge funds with significant losses in mortgage-backed securities should examine closely the *Pursuit* court's holding in evaluating any decision not to pursue litigation against sellers. In particular, hedge funds headquartered in Connecticut should take note of the unique advantages afforded to Connecticut institutional investors willing to bring securities claims in Connecticut state courts of which the *Pursuit* case is illustrative.

Background of the Action

In March 2008, Pursuit Partners LLC, a Connecticut hedge fund, sued UBS AG and UBS Securities LLC (collectively, UBS) in Connecticut Superior Court alleging various claims arising from Pursuit's purchase of four classes of notes in three different synthetic CDOs from UBS in a series of transactions between late July 2007 and October 2007. A short time later, both Moody's and S&P downgraded their ratings on the underlying CDOs with resulting adverse effect on the value of the notes held by Pursuit. Pursuit's allegation in chief is that UBS knew that Moody's and S&P were preparing to downgrade the CDOs at the time the notes were sold to Pursuit.

Pursuit's claims are sadly familiar to many purchasers of mortgage-backed securities. The question of how much

investment banks knew about the imminent collapse of the market for securities backed by subprime mortgages while they were simultaneously heavily marketing these products to institutional investors in the summer and fall of 2007 has been rich fodder for speculation since the financial crisis began. Thanks to discovery conducted in the *Pursuit* case, the trillion dollar question of “what did they know and when did they know it” can now be answered at least with respect to certain UBS employees.

The facts, as recounted in the *Pursuit* court’s decision are quite damning:

[A]s a result of certain meetings with Moody’s, the court finds probable cause to sustain the claim that UBS became privy to material non-public information regarding a pending change in Moody’s ratings methodology. This change in ratings methodology, when implemented, would cause the Notes that UBS had previously offered and sold as investment grade to no longer receive the same investment grade ratings. Due to the way the CDOs at issue were structured, such a change would effectively render the Notes, and Pursuit’s investment in them, worthless. Thus, in the summer of 2007, UBS was aware that the Notes they were currently marketing for sale in their CDOs were Notes for which the ratings agencies would soon no longer be giving investment grade ratings. At that time, UBS was holding a significant amount of unsold Notes in inventory that would lose a significant amount of value when such a ratings downgrade occurred, and therefore had an incentive to lower UBS’s inventory of these Notes and their corresponding exposure.

The *Pursuit* court found it particularly compelling that not only had UBS learned of the rating agencies’ intention to downgrade billions of dollars of CDOs inventoried on the bank’s books and wanted to find a way to unload them, but UBS employees referred to those CDOs internally as “crap” and “vomit”:

The court takes UBS employees at their word when they referenced their Notes, these purported “investment-grade” securities which they sold, as “crap” and “vomit,” for UBS alone possessed the knowledge of what their product, their inventory, was truly worth.

Legal Analysis

While the gold mine of incriminating documents Pursuit’s litigation uncovered was an extraordinary development which captured national headlines, completely ignored by the financial press was the exceptional result Pursuit achieved without going to trial by using tools that were only available to it as a Connecticut plaintiff filing suit in Connecticut. Pursuit’s decision to bring its lawsuit in Connecticut Superior Court was, to say the least, counter-intuitive. Despite the presence of so many hedge funds in Greenwich, the Connecticut state courts do not often handle litigation arising from sophisticated investment transactions. Nevertheless, the decision by Pursuit’s lawyers to venue the lawsuit in Connecticut proved to be inspired as the case began to wind its way toward trial.

It is helpful to note that merely because a case is filed in a particular state’s court, it does not necessarily follow that the case will be decided under that particular state’s laws. In the absence of a prior agreement between the litigants choosing

the law of a particular forum, lawsuits between citizens of different states require a court to conduct a choice of law inquiry in order to determine the appropriate law to apply in deciding the dispute. In the *Pursuit* case, that inquiry was seemingly unnecessary because the underlying note indentures and Offering Memoranda contained an express choice of law clause providing that the note purchases were to be governed and construed under the law of the State of New York. This express choice of New York law clause parallels similar provisions in almost all other CDO offering memoranda as well as the choice of law provisions in the 1992 and 2002 International Swaps and Derivatives (ISDA) Master Agreements that govern most derivative and credit default swap purchases. The choice of New York as the governing law is no accident. Most state securities laws (colloquially referred to as “blue sky” laws) are extremely broad statutory schemes designed to provide in-state investors with significant protection. New York’s blue sky law, General Business Law § 352 (the Martin Act), however, does not allow for a private right of action and thus provides no protection for investors in suits where the Attorney General is not a plaintiff. See *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P’Ship*, 12 N.Y.3d 236, 244 (2009) (quoting *CPC Int’l Inc. v. McKesson Corp.*, 70 N.Y.2d 268 (1987); see also *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001) (affirming dismissal of New York state law claim for breach of fiduciary duty in securities context because such a claim preempted by the Martin Act).

Pursuit argued however that the Superior Court should apply Connecticut law to its claims notwithstanding the choice of New York law provisions contained in the Offering Memoranda, contending that the choice of New York law to which it had contracted was contrary to Connecticut’s

own public policy of protecting Connecticut investors from securities fraud by providing them with a special remedy under the Connecticut Uniform Securities Act, General Statutes § 36b-29 (CUSA). The Superior Court agreed with Pursuit, holding that, at least with regard to Pursuit’s claims under the CUSA, “it would violate our state’s fundamental policy to give an effect to a provision that would prevent suit under CUSA.” In so doing, the Superior Court provided Pursuit with a powerful weapon that provides for recovery of the entire original purchase price of the security plus interest as well as costs and reasonable attorneys’ fees. Another benefit the CUSA affords to Connecticut buyers of securities is that a buyer may prevail on the claim without showing cognizable damages if it still owns the security. This contrasts with federal securities law where a buyer may be barred from rescission under § 12(a)(2) of the Securities Act of 1933 where it fails to show that “it suffered cognizable damages as a result of the material misrepresentations and omissions made.” *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 255 (S.D.N.Y. 2003); see also *In re Morgan Stanley Tech. Fund Sec. Litig., Nos. 02 Civ. 6153(BSJ), 02 Civ. 8579(BSJ)*, 2009 WL 256005, at *5 (S.D.N.Y. Feb. 2, 2009) (citing *Randall v. Loftsgaarden*, 478 U.S. 647, 655 (1986) for the proposition that Section “12(2) prescribes the remedy of rescission except where the plaintiff no longer owns the security.”). Moreover, the CUSA also provides for aider and abettor liability where material assistance is given to a primary violator, a doctrine which the U.S. Supreme Court specifically rejected in connection with private federal securities fraud claims in the seminal case of *Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008). See also *Dreiling v. Am. Online, Inc.*, 578 F.3d 995, 1003 (9th Cir. 2009) (“[t]he Supreme Court has concluded that

the civil enforcement mechanism [enforced by the SEC, see, e.g., § 78t(e)] and possible criminal penalties [see, e.g., 15 U.S.C. § 78ff] provide secondary actors a strong deterrent to engaging in fraudulent conduct such that private litigation is not necessary” (internal citations omitted). This means that Pursuit may extend its CUSA claims to any other entity it can identify that “materially assisted” UBS in the sale of the notes.

While choice of law issues are often complex questions to be resolved after lengthy briefing and argument, the question of which state’s procedural law should govern the proceeding was an easy call for the *Pursuit* court, which found that “even in the face of an express choice of law provision, the forum state will apply its own procedure.” The decision to apply Connecticut procedural law represented a resounding victory for Pursuit because it allowed the Superior Court to utilize Connecticut’s unique Prejudgment Remedy Procedure (PJR). Many states have some procedural law that allows for the attachment of property pre-judgment in order to protect a plaintiff from the possibility of a defendant dissipating its assets and rendering any prospective judgment worthless. Almost without exception, those procedures require that an applicant for a prejudgment remedy not only demonstrate a strong likelihood of success on the merits, but also that there is indicia that the defendant will attempt to frustrate the enforcement of the judgment plaintiff is seeking. New York’s pre-judgment attachment statute, CPLR § 6201, is a good example, providing as one of the grounds for attachment that, “defendant, with intent to defraud his creditors or frustrate the enforcement of a judgment that might be rendered in plaintiff’s favor, has assigned, disposed of, encumbered or secreted property, or removed it from the state or is about to do any of these acts.”

In contrast, Connecticut’s PJR as contained in General Statutes § 52-278d, seemingly dispenses with any requirement that the plaintiff show the defendant is likely to impede enforcement of any resulting judgment and instead requires only that the court find “probable cause” as to “both . . . the merits of the cause of action and as to the amount of the requested attachment.” *Cendant Corp. v. Shelton*, 473 F. Supp. 2d 307 (D.Conn. 2007); *First Equity Group, Inc. v. Culver*, No. 3:08-CV-01893 (VLB), 2009 WL 353490, at *6 (D. Conn. Feb. 11, 2009) (“[t]he probable cause standard is settled and well defined . . . [it] is a flexible common sense standard. It does not demand that a belief be correct or more likely true than false”) (internal citations omitted). In other words, so long as a plaintiff can show probable success on the merits and a reasonable basis for measuring the loss, the attachment will issue in Connecticut even if there is no attempt by the defendant to frustrate enforcement of the eventual judgment. That’s exactly the inquiry the *Pursuit* court conducted and having found “probable cause that a judgment in the amount of the prejudgment remedy sought . . . will be rendered in favor of the Plaintiffs,” ordered that “Plaintiffs may attach and/or garnish property and/or assets of the defendants UBS AG and UBS Securities LLC to the value of \$35,573,04.53.” Thus, by merely showing a likelihood of success on the merits and proof of the amount of its claim, Pursuit was able to garnish an amount equal to its entire net loss on the subject Notes. Pursuit will ultimately have to prevail at trial in order to have the \$35.5 million actually transferred to its account, but there is nothing like an opinion by the trial court indicating that it sees strong evidence that the plaintiff was defrauded combined with having to pay in excess of \$35 million into court to motivate a defendant to settle. UBS has taken

an appeal to the Connecticut Appellate Court, but if that appeal is unsuccessful, the case is unlikely to go much further without UBS settling with Pursuit.

The lessons for other hedge funds to draw from the *Pursuit* case are myriad. First, a direct purchaser of any investment grade mortgage-backed security (including, but not limited to, CDOs) in the summer and fall of 2007 has at least some reasonable grounds to suspect that the investment bank that sold the security had knowledge that the rating agencies were preparing to drop the ratings on the security. A sale of a security under those circumstances potentially sounds in fraud under both federal and state law. Second, any hedge fund attorney filing suit alleging securities fraud should closely examine the blue sky laws of the hedge fund's home state for additional causes of action that may provide significantly more protection for investors than do the federal securities laws. Further, even if the offering documents contain an express choice of law clause, a hedge fund attorney should be prepared to argue that the choice of

law provision violates the home state's public policy. Finally, any hedge fund located in Connecticut should follow the Pursuit Partners path and file an action in Connecticut state or federal court in order to assert a CUSA claim and to avail itself of Connecticut's unique PJR.

Darren Kaplan is a Partner in the Great Neck, New York office of Chitwood Harley Harnes LLP where he represents institutional investors in individual and class actions arising from claims of securities fraud and breaches of fiduciary duty. He is currently one of a team of lawyers representing the Ohio Public Employees Retirement System in a class action against Freddie Mac, Inc. alleging securities fraud arising from misrepresentations and omissions regarding Freddie Mac's exposure to subprime mortgage losses. Mr. Kaplan is a member of the Connecticut, Georgia and New York bars.