



Mixed fortunes: Fulbright & Jaworski has set up a sub-prime specialist group of 100 lawyers, while Cadwalader Wickersham & Taft faces a \$70 million lawsuit over its work on mortgage securitisations (London offices pictured)

What does the sub-prime mortgage crisis mean for lawyers?

Litigators anticipating a wave of disputes triggered by the sub-prime crisis may be disappointed, while finance lawyers could face difficult questions from clients. **RAVINDER CASLEY GERA** and **DAVID ROBINSON** report the glum news facing the profession.

“What’s been going on so far has been a lot of what I call hand-holding. Very little that’s blown into a full dispute is related directly to the sub-prime crisis.”

Matthew Newick, partner, Clifford Chance

The sub-prime mortgage crisis has been, for the most part, bad news for lawyers – along with everyone else. Clifford Chance and Cadwalader, Wickersham & Taft are two of the firms that have made structured finance associates redundant in recent months as the market for mortgage-backed securities and collateralised debt obligations has collapsed. And the ensuing credit crunch has all but frozen financing and M&A work, leaving non-contentious departments scouring the world’s emerging markets for work.

Litigators, however, have been looking forward to a wave of major, complex bank-on-bank litigation as the catalogue of bad offering and investment decisions that led to the sub-prime crisis falls out. Norton Rose, CMS Cameron McKenna, Eversheds and Herbert Smith have all restructured their dispute resolution departments in recent months to focus on financial institutions. The US firm Quinn Emmanuel, which specialises in suing banks, is planning a London launch in the next few months, and another US firm, Fulbright & Jaworski, has snared away partner Melanie Ryan – currently specialising in sub-prime litigation – from Barlow Lyde & Gilbert to join a dedicated sub-prime practice with more than 100 lawyers worldwide. “A lot of highly structured sub-prime backed transactions are being looked at extremely closely right now,” says Ryan. In January, *The Times* reported that the litigation wave stemming from the crisis could be bigger than that which followed the Enron crisis. It predicted that the major investment and retail banks at the centre of the crisis would take each other on in mammoth disputes.

And yet, almost a year after the sub-prime mortgage crisis broke, the expected wave of major litigation has yet to appear. The banks have held their fire, and commercial litigators on both sides of the Atlantic are still waiting for the gold rush. “What’s been going on so far has been

a lot of what I call hand-holding,” says Matthew Newick, a specialist in financial institutions disputes at Clifford Chance. “Helping clients develop strategies for managing risks; advising them on what the documents mean; and there’s some pre-dispute rattling of cages, so we’re helping people through that. But very little that’s blown into a full dispute is related directly to the sub-prime crisis.”

Let he without sin...

Why the caution? The problem is that most financial institutions are involved in the crisis in more than one role, making litigation risky. “The major banks are afraid that any claims they might launch might come back and bite them,” explains one finance partner. “On one CDO, bank A will be the arranger or trustee, bank B an investor; but on the next issue it could be the other way round. And banks may even invest in their own CDOs, through a desk. So if you establish a point of principle that hurts one side, you could pay for it later on.”

For this reason, bank-on-bank sub-prime disputes so far have been initiated by those smaller financial institutions that participated in the mortgage-backed instruments market solely as investors. “Some smaller banks may have made enormous losses on sub-prime instruments, and for some of them the stakes may be too high not to act,” says Matthew Newick. For example, HSH Nordbank, the German investment bank, has hired Quinn Emmanuel and sued UBS over losses it sustained from investments in CDOs backed by sub-prime US mortgages.

Hedge funds, despite soaking up considerable losses on mortgage-backed instruments, are so far resisting suing. “It will be hard for hedge fund managers to argue that they were hoodwinked, as they’re supposed to be professional investors,” points out Matthew Newick. “And they depend on the banks for the leverage that’s



Matthew Newick, Clifford Chance

www.partnersandteams.com

LPA Partners and Teams has been established for over 8 years, specialising in the recruitment of partners and teams of lawyers into UK/US and international law firms globally. We adopt a consultative and strategic approach as we understand the process can be time consuming and complex.

Business planning advice is a key part of our service and for more information please visit our website at the address above.

For a confidential discussion please call any member of our dedicated team, using the contact details provided below.



Anil Shah - Managing Director

DD: +44 (0)20 7269 6804 Mob: +44 (0)7789 691221
E: anil.shah@partnersandteams.com

James O'Brien - Director

DD: +44 (0)20 7269 6807 Mob: +44 (0)7789 782605
E: james.o'brien@partnersandteams.com

Steven Horvath - Senior Consultant

DD: +44 (0)20 7269 6808 Mob: +44 (0)7789 692127
E: steven.horvath@partnersandteams.com

LPA Partners and Teams, 7 Gray's Inn Square, London WC1R 5AZ

“The major banks are afraid that any claims they might launch might come back and bite them. If you establish a point of principle that hurts one side, you could pay for it later on.”

City finance partner

vital to their investments, so they'll try to sort things out amicably if at all possible.” Richard Leedham, head of disputes at Addleshaw Goddard, believes “the jury is still out” on whether the hedge funds will sue over their sub-prime investments.

The situation is a marked contrast to previous crises, such as the collapses of Enron, WorldCom and Parmalat. “In previous crises a company has gone under, often taking others with it, as with Enron and Arthur Andersen,” points out Richard Leedham. “But here the biggest victims so far – Northern Rock and Bear Stearns – have been shored up. You haven't yet seen the kind of complete collapse that can trigger widespread litigation.”

Securities disputes: only in America?

If commercial litigators have yet to benefit from the crisis, securities lawyers – particularly in the USA – are smiling. The biggest bank-to-bank dispute to emerge so far – between Barclays and UBS – is at root a securities fraud case, concerning UBS' alleged cover-up of losses at one of its hedge funds in which UBS is an investor. And in the USA, a swath of class actions has begun, reversing the long-term decline in securities

suits. Thirty-eight sub-prime-related class actions were filed in 2007, with defendants including Merrill Lynch, UBS and Citi.

It's unclear, however, whether such suits will spread in large numbers to the UK. There remains no route available in the UK for mass litigation on the US scale. Group Litigation Orders allow for litigation on behalf of a class of people with a common grievance, and litigation firm Edwin Coe is investigating making a group claim on behalf of the shareholders of Northern Rock. But group litigation in the UK has a major limitation: all group members must opt into the suit. This makes mass litigation far harder than in the USA, where those defined as part of a class are automatically included in the suit unless they opt out. Similar restrictions apply across most of Europe. US class-action specialist Cohen, Milstein & Toll made headlines when it opened in London in May 2007, and many expected the firm to lead investor actions arising out of the crisis. But, according to associate Scott Campbell, it is competition, not securities law, that's likely to provide the main opportunities for group litigation for the foreseeable future. “Competition law is very much the driving force behind developments in group litigation in the UK at the moment,” he explains. “The OFT

Meridian Law - the choice for efficient, forward thinking Chambers.

Supplying over 90% of all UK Barristers.

We are the ONLY legal software supplier who can service all your needs:

- Diary & Case Management
- Marketing
- HR & Payroll
- Experienced Technical & Support Services
- Hosted & On demand solutions
- Business Reporting & Analysis

Web: www.iris.co.uk/legal Tel: 01614 431600 Email: legal@iris.co.uk





New York: Setting the Bar

Our consultants have just returned from New York with a call for talented lawyers with a minimum of two years of post call corporate experience.

With its non-stop action, New York is the most active legal market in the world and key experience to round out your international legal career. Our consultants know the New York law firm culture and lifestyle. We will help you navigate the maze of firms to determine the best firm and work for you.

We are the international legal recruiter of choice. Contact Renai Williams at +1 416 368 2051 ext. 238 or rwilliams@zsa.com to discuss your options in New York.

zsa.com



“We simply can’t act against big banks, who are clients. There’s a niche in the market for someone who’s prepared to sue banks.”

Ed Sparrow, partner, Ashurst

and EU publish detailed decisions which you can use as a starting point for collective redress by way of follow-on litigation. With securities cases you don’t always have that base to start from, but collective redress can still be achieved.” In addition, many of the US class actions relate to the underlying sub-prime mortgage loans, not the financial instruments they backed. As sub-prime lending has never taken off in more regulated European markets, this element of the litigation is also unlikely to spread.

Credit crunch advice

So are litigators’ hopes of gaining new work in vain? Perhaps not. While the sub-prime crisis itself has failed to generate large quantities of litigation, the ensuing credit crunch has provided plenty of opportunities for advice. “The general shortage of credit is causing banks to be cautious about lending,” explains Ed Sparrow, litigation partner at Ashurst. “In some cases, therefore, issues are arising about the meaning of commitment letters and the extent to which banks are legally obliged to make or continue loans.” Financial institutions across the City are looking for routes out of lending commitments made at the height of the easy-credit boom.

For Matthew Newick, such disputes helped keep 2007 busy. “Throughout the summer and into the winter we saw a number of examples of financing deals, particularly leveraged finance for private equity houses, where there was a commitment to provide funding for a transaction, but questions were raised about the legally binding nature of the commitment to finance. Banks and private equity houses were at loggerheads.” Even these disputes, though, “have mostly been resolved peacefully.” Modern dispute resolution departments, restructured to take account of ADR, are well suited to handle such pre-dispute advisory work.

If major litigation between financial institutions over the sub-prime crisis isn’t forthcoming,

it could at least save the largest firms a headache. As the largest commercial firms have deepened their relationships with the major investment banks in recent years, they have boxed themselves into something of a corner when it comes to litigation. “Bank-on-bank litigation is a big conflict challenge for us, and for all big city law firms,” admits Ed Sparrow. “We simply can’t act against big banks who are clients. There’s a niche in the market for someone who’s prepared to sue banks.” Indeed, in February a four-partner litigation team left the London office of US firm Dorsey & Whitney for LG in order to do just that. “The London market has to start taking sides eventually,” says Melanie Ryan.

Law firms targeted

A true sub-prime litigation boom, therefore, seems unlikely. But disputes lawyers may be kept busy picking through their own firms’ liabilities. For law firms could be facing difficult questions from clients – and perhaps a wave of lawsuits – as a result of their role in the sub-prime crisis. The complex financial instruments – mortgage-backed securities (MBS) and collateralised debt obligations (CDO) – that made the crisis possible were complex legal documents, but were frequently generated at high speed and sometimes with limited care. Those documents could lie at the heart of multimillion-dollar lawsuits, and they – and the lawyers responsible for them – face close scrutiny. “Everyone is being blamed,” warns one London finance lawyer. “Trustees of deals, arrangers, collateral managers of the deals. Somewhere in that search for a deep pocket, lawyers will get caught.”

Of course, blame for the web of questionable disclosures and optimistic assumptions that caused the crisis can hardly be put at the foot of lawyers. “We aim to be business advisers, but, ultimately, we’re involved in a legal capacity,” argues one finance partner. “There is no way for a lawyer

searsdaviesdesigners

sponsors of the 2007 Chambers Bar Awards

Case Study

Falcon Chambers and Sears Davies - building creative relationships!

Working together for over a decade, Sears Davies has created and developed a distinctive identity which has helped to transform, progress and develop the image and brand of Falcon Chambers. They understand our needs, more importantly our style and culture - we are delighted with the results!

Edith Robertson Chambers Director
Falcon Chambers

With 20 years experience, we believe it's our unique combination of strategic thinking, great design and recognised results that sets Sears Davies apart.

searsdavies

2008
years creative
direction
& design

for the bigger picture contact Julian Davies
julian@searsdavies.com +44 (0)20 7633 0939

www.searsdavies.com

“Deals have been closed in time frames that we all knew were insane.”

City finance lawyer

to assess whether a CDO is worth more than its underlying assets. We're not trained to understand that risk.” But while business risks are not in lawyers' purview, legal risks certainly are. If banks receive adverse judgments or are forced into expensive settlements arising out of the crisis, their legal advisers' work will be closely scrutinised.

Standardisation

Of course, with some of the professions' best brains documenting these highly complex instruments, you might expect the likelihood of mistakes to be low. Unfortunately not. Legal work on such instruments, once high-end, has become commoditised – and more and more rushed. “Lawyers were central to the development of securitisation and CDOs, and the first

such transactions were carefully structured by the leading lawyers in the profession,” explains one finance partner. “But as the practice has developed, things have been put together more and more quickly.” In the fast-moving world of finance with its famously demanding clients, lawyers have been called upon to produce documents more and more quickly. “Deals have been closed in time frames that we all knew were insane,” admits one city finance lawyer. While a CDO or MBS may take as much as three months to document, the basic structure of the documents can be thrown together literally overnight. “Once the term sheet is agreed, the bank often wants a first draft overnight or over a weekend.”

To respond to the need for quick document turnaround, the documentation surrounding

such instruments – particularly CDOs – has become more and more standardised. “Errors become compounded in documents, if you are using a bad precedent,” explains a securitisation specialist at another London law firm. “The client needs a deal in one week that should take eight, and they say, why don't you use this form and adapt it? And we tell clients it's deficient, but they say: ‘It's been signed off on, it's adequate, use it.’” Nor is time the only constraint. “It's also question of budgets – so-called innovations like fixed billing have made it harder and harder to justify doing things right,” argues another harassed city finance partner.

The effect of standardisation is to allow errors to spread throughout the system and become common, just as sub-prime exposures spread

Default confusion

One area where law firms are particularly likely to face difficult questions is in documentation concerning ‘events of default’. Like all bonds, CDO agreements contain a range of triggers that classify the CDO as being in default – for example, if a payment to bondholders is missed, or if the ratio of value of the underlying mortgage pool to the outstanding payments drops below a certain level. When this happens, bondholders must decide whether to hang on and hope for recovery, or to cut their losses, ‘enforce’ the bond and demand full payment, usually meaning a quick sale of the underlying assets.

The problem is that the complex ‘waterfall’ system of CDOs – which spreads return, and risk, across different ‘tranches’ – often puts different bondholders at odds. Senior bondholders, will be the first to be paid if the bond is wrapped up. But those holding riskier junior debt have little to gain. “Let's say you're the most senior bondholder of a \$900 million CDO, and you hold \$600 million and there's another \$300 million in the tranches below you,” explains James Waddington, a partner at Orrick, Herrington & Sutcliffe. “As long as the fire-sale of the assets recovers \$600 million, you're covered. But the guys below you? They get nothing.”

With such differing interests, it's vital that CDOs contain clear guidance on how the decision to enforce should be made – and how the proceeds should be distributed. Unfortunately, when the market is booming and timetables are short, planning for what could go wrong is usually the first corner to be cut. “Default used to be something that happened once in a blue moon,” explains one finance lawyer. Eventually, “people began to believe assets could only go up. And they stopped paying attention to the plans for after an event of default.”

The result? Confusion. At least \$64 billion of CDOs have experienced event of default since mid-October, and many are believed to have guidance for after default which is incomplete, unclear, or contradictory. “When you look at CDO documents, you find that some of the post-enforcement waterfalls simply don't work, or that it's not always clear how some of the waterfall provisions interact with other substantive provisions in the legal documents,” explains Sanjev Warnar-Kula-Suriya at Slaughter and May. In several cases, senior bondholders believed the documentation to give them complete control over the decision to enforce, only to find on closer inspection that it wasn't clear.

Without proper instructions in the documentation, trustees face a nightmare. “The pressure on them is enormous – one side urging them to act quickly, the other to do nothing,” explains one finance lawyer. “They're middle-ranking administrative staff, not highly paid, and suddenly they've got pension funds yelling at them, demanding they get the assets valued for sale, and hedge funds yelling at them, demanding they don't.” Already, Deutsche Bank has had to go to court to seek guidance on post-event of default action for several CDOs for which it is trustee. Should a trustee be successfully sued as a result of confusion or a misstep after an event of default, having found the documentation to offer insufficient guidance, it's highly likely they would look to their law firm for redress.

“Trustees taking bonds to court for clarification is not new,” points out one finance partner. “But it's the first time it's happened in these kind of transactions. The documentation is subject to stresses that weren't really contemplated when they were drafted. A whole new light is being shined on it. When there are problems I can see how, under specific circumstances, they could potentially amount to negligence.”

Buenos Aires

12-17 October
International Bar Association Conference 2008

Buenos Aires, often considered the cultural capital of South America, is also one of the most important and dynamic business centres of the region. As Argentina's largest and capital city, it provides a perfect location for both business and pleasure, while its cosmopolitan population and culture perfectly reflect the ethos of the International Bar Association.

What will Buenos Aires 2008 offer?

- The largest gathering of the international legal community in the world
- A meeting place for over 3,000 lawyers and legal professionals from around the world
- Over 150 working sessions covering all areas of practice relevant to international legal practitioners
- The opportunity to generate new business with many of the leading firms in the world's key cities
- Registration fee which entitles you to attend as many working sessions throughout the week as you wish
- Continuing legal education and continuing professional development
- A variety of social functions providing ample opportunity to network and see the city's key sights
- Integrated guests' programme
- Excursion and tours programme



Image source: Tourism Portal, Sub-Secretary of Tourism of Buenos Aires City Government - www.bue.gov.ar and Shutterstock www.shutterstock.com

To pre-register and receive further information, please contact:

International Bar Association

10th Floor, 1 Stephen Street
London W1T 1AT

Tel: +44 (0)20 7691 6868

Fax: +44 (0)20 7691 6544

confs@int-bar.org

www.ibanet.org



the global voice of
the legal profession

“The fact that the industry may or may not have particular standards does not immunise any law firm from negligence.”

Amianna Stovall, Dreier LLP

through the financial markets. The result is that, in one finance partner's words, “the securitisation market is riddled with documents with errors in them.” Clients confirm the problem. Arturo Cifuentes, managing director of broker-dealer RW Pressprich & Co., despairs of the quality of drafting of many CDOs he reviewed during the boom. “All the time, I would find things weren't clear. Commas all over the place. Complete confusion.”

Some finance lawyers argue that even the agreed industry standard documentation is deficient. “The standard document templates have been drafted by consensus between a number of different market players,” explains David Scheerer of Allen & Overy. “The resulting documents do contain a number of compromises between the positions of the different players. For the most part, the documents are pretty good, but they can contain ambiguity and a lack of clarity in some areas.”

Of course, when the going is good, it's straight onto the next deal. Now, though, sharp-beaked litigators are circling the bloodied corpse of the mortgage securities market, their beady eyes carefully inspecting for food – and law firms may prove the entrée. Already, one securitisation powerhouse – New York's Cadwalader, Wickersham & Taft – is defending a \$70 million lawsuit by investment bank Nomura over the documentation for a mortgages securitisation. Although the transaction took place in 1997 and was based on commercial mortgages, it illustrates the risks law firms face as more recent, sub-prime residential deals come under scrutiny. Nomura was sued by mortgage trust-holder LaSalle Bank over a warranty in the documentation which stated all the underlying mortgages were backed by properties worth at least 80% of the value of the loan. This was, assert Cadwalader, a standard industry warranty similar to that found in ratings agency manuals. But in fact, one

of the largest mortgages was only 60% backed by property. Following a \$67.5 adverse federal court decision, Nomura settled. And Cadwalader's reliance on industry standard documentation has seen it sued by its former client. “The fact that the industry may or may not have particular standards does not immunise any law firm from negligence,” argues Nomura's lawyer, Amianna Stovall of Dreier. “It's not the obligation of the rating agencies to draft contractual provisions properly in a legal context. That's what you hire lawyers to do.”

A nervous prelude

Ultimately, whether we see a wave of suits against law firms depends on the levels of litigation that arise out of the crisis. If trustees, with the help of the courts, are able to settle post-default disagreements quickly; if a major flood of bank-on-bank litigation isn't forthcoming; or if any suits hinge, not on standard documentation but on transaction-specific information provided by the client, then law firms should be safe.

But with many hastily drafted CDOs now in default, it's likely law firms will be caught in the crossfire. “I wouldn't be surprised to see law firms in the firing line,” admits one finance partner. ■