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Second Circuit Finds CDO Investor To Be Third-Party Beneficiary Despite Contrary Language In Portfolio Management Agreement

On August 6, 2012, in *Bayerische Landesbank v. Aladdin Capital Management LLC*, 2012 WL 3156441, the Second Circuit held, on a motion to dismiss, that (i) provisions in a portfolio management agreement ("PMA") in a CDO transaction allowed the investor to bring a breach of contract claim against the portfolio manager as an intended third-party beneficiary of the PMA notwithstanding a "no beneficiaries" clause, and (ii) alleged misrepresentations by the portfolio manager during the marketing of the transaction as to how it would manage portfolio were sufficient for the investor to bring an independent gross negligence cause of action.

Background

Bayerische Landesbank (the "Noteholder") purchased $60 million of notes issued by Aladdin Synthetic CDO II (the "Aladdin CDO"). The Aladdin CDO entered into a credit default swap as the protection seller, providing its investors with credit exposure to a pool of assets ("reference assets"). The Aladdin CDO used premiums received from the protection buyer under the credit default swap to make periodic payments on the Aladdin CDO notes.

The performance of the notes depended on whether "credit events" such as a bankruptcy, restructuring, or a failure to make payments on its debt, occurred with respect to the reference assets. If credit events occurred, assets of the Aladdin CDO would be used to make payments to the credit protection buyer, resulting in losses to the investors. The transaction allowed Aladdin, as portfolio manager, to modify the reference assets. The Noteholder alleged that prior to its investment in the Aladdin CDO, Aladdin presented marketing materials and made statements that Aladdin's interests were aligned with those of the investors and that it would manage the portfolio in a conservative and defensive manner to avoid losses.

Aladdin entered into a PMA with the Aladdin CDO, and did not enter into any contract with the Noteholder. The PMA contained a "No Beneficiaries" section, stating that "[t]his Agreement is made solely for the benefit of the Issuers and the Portfolio Manager, their successors and assigns, and no other person shall have any right, benefit or interest under or because of this Agreement, *except as otherwise specifically provided herein*. The Swap Counterparty shall be an intended third-party beneficiary of this Agreement."

The Aladdin CDO closed in December 2006 and experienced a number of credit events, causing the Noteholder to lose its $60 million investment. The Noteholder brought suit against Aladdin and the District Court dismissed its claims of breach of contract and gross negligence. On appeal, the Second Circuit reversed the District Court.

Second Circuit Opinion

The Second Circuit's analysis of Aladdin's motion to dismiss was necessarily limited to determining whether, based solely on the allegations made in the Noteholder's complaint and inferences drawn in the Noteholder's favor, the complaint stated a plausible theory of recovery. Accordingly, the court did not determine whether, in the end, the Noteholder's claims are valid, but merely that it has made allegations that are at least sufficient to proceed to discovery.

Breach of Contract Claim

For the breach of contract claim, the Court examined the No Beneficiaries clause and found that the phrase "except as otherwise specifically provided herein" likely referred to the PMA as a whole, rather than just the clause itself as the District Court had found. Thus the court examined the rest of the PMA to determine whether it could fairly be read to confer benefits upon the Noteholder.

The Court cited two provisions as particularly persuasive. First, the agreement stated that "the Portfolio Manager shall use all reasonable efforts to ensure that [it takes no action that would] . . . adversely affect the interest of holders of the Notes in any material respect (other than as permitted by the Transaction Documents)." Second, a section entitled "Benefit of this Agreement; Limit on Liability" stated "[t]he Portfolio Manager agrees that [its obligations under the agreement] shall be enforceable at the insistence of each Issuer, the Trustee on behalf of holders of the relevant Notes, or the requisite percentage of holders of the relevant Notes on behalf of themselves . . . ." The Court concluded that it was plausible to read the PMA as expressing an intent for the Noteholder to be a third-party beneficiary able to bring a breach of contract claim directly against Aladdin.

Gross Negligence Claim

The Court's analysis of the Noteholder's gross negligence cause of action turned on the Noteholder's allegations that it detrimentally relied on Aladdin's representations in marketing materials and during meetings with the Noteholder of how it would select and manage the reference portfolio. In particular, the Court found that Aladdin's alleged solicitation of the investment of the Noteholder, and its representations that it would manage the CDO in the Noteholder's favor, were sufficient to show an understanding by Aladdin that the Noteholder would rely on Aladdin's performance and to establish the existence of a legal duty independent of Aladdin's contractual duties. As a result, the Court denied Aladdin's motion to dismiss the Noteholder's gross negligence claim.

Implications

This decision raises several important issues for parties to securities transactions:

- Precision in drafting continues to be important to avoid opportunities for meanings to be ascribed to agreements beyond what the parties intended or anticipated. Especially for key issues such as to whom transaction parties owe duties, provisions in agreements that contradict each other, even if unrelated, can lead to ambiguities and unexpected results. The use of generalized language such as "except as otherwise provided herein", "other provisions notwithstanding" or similar clauses that can create such conflicts or ambiguities should be avoided in favor of specific cross-references.

- Although investors will typically represent that they have read and relied <u>only</u> on the final offering document, and not on other statements made outside that document, this case is another example that is exceedingly difficult to avoid costly discovery by obtaining dismissal on the pleadings in investor lawsuits based on alleged misrepresentations when marketing a deal. Accordingly:

  - underwriters and managers should consider requiring written representations from investors as to their reliance only on the final offering document;

  - managers and other transaction parties should consider the role they play in marketing and the distribution of marketing materials, and how they describe their obligations to investors in meetings; and

  - care must be taken with statements made outside the offering document, and in particular in materials provided at investor meetings. Appropriate risk factors and disclaimers, and careful descriptions of the role of the various parties in the transaction and their obligations deserve particular attention.

- These issues should be considered broadly applicable to other securities issuances beyond structured finance and CDOs. It is now common that where investors - even highly sophisticated ones - lose money on their investment, all parties to the transaction are potential defendants in subsequent litigation for statements and representations made at all stages of the marketing of a transaction.

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Capital Markets" or "Structured Finance" under the "Practices - Areas of Law" section of our website at http://www.cgsh.com.

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