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Stamford case reveals investment bank called some securities ‘crap’

By THOMAS B. SCHEFFEY

When the financial markets melted down last fall, much of the problem was blamed on complex new financial instruments.

In addition to investors buying stock in companies or putting money in government bonds, their funds were directed to “collateralized debt obligations” that were, in essence, securities made up of bundles of debts and loans, some of them sub-prime mortgages.

When the sub-prime market collapse aided the Wall Street crash, finger pointers asked why investment houses didn’t realize that these largely unregulated securities were so risky. Now, a lawsuit filed by a Connecticut hedge fund that’s pending in Stamford Superior Court has revealed that at least some financial giants were skeptical of the products they were selling.

In fact, according to documents provided during the discovery process, employees of UBS, the Swiss-based international investment bank referred to some collateralized debt obligations as “crap” and “vomit” in memos.

The evidence is damning enough that Stamford hedge fund Pursuit Partners has won a $35.5 million pre-judgment lien against UBS Securities and UBS AG.

Stamford Superior Court Judge John F. Blawie ordered the international investment giant to post the funds in advance of litigation, stating that the hedge fund established probable cause that UBS sold the debt instruments even though it had inside information that major credit rating agencies were just about to downgrade them.

“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,” the judge wrote.

In a statement, UBS noted that Blawie’s ruling is only “preliminary” and said it had confidence it would win the case on the merits.

Some observers view the Connecticut case as an opening shot against bond rating agencies and banks over so-called toxic debt instruments. Fairfield County is a national center for hedge funds, in and around Greenwich, Darien and New Canaan. Attorney Harold B. Finn, of Stamford’s Finn, Dixon & Herling, operates a blue chip securities law boutique with many hedge fund clients. “I think the court’s finding of probable cause …is likely to prompt many purchasers of CDOs and similar instruments to commence lawsuits here in Connecticut against the sellers of such securities,” said Finn. “They haven’t been doing so heretofore.”

And why not? “Absence of a smoking gun. This may be a smoking gun,” Finn said.

Suspected Collusion

The UBS defendants are represented by Washington, D.C's Williams & Connolly. Pursuit is represented by the Englewood, Colo., firm of Burg Simpson Eldredge Hersh & Jardine. Attorney Gary S. Klein, of Stamford's Sandak Hennessey & Greco, is local counsel for the hedge fund.

After Pursuit bought over $35 million in the notes, said Klein, "within weeks of closing on the purchase, my clients were zeroed out of their investment…Essentially, the court held that UBS, when it sold us these securities, knew that the ratings agencies – Standard & Poor's and Moody's — were on the verge of changing the rating of these securities."

Neither of the ratings agencies is subject to the prejudgment remedy, only UBS. So far, Klein said, there has only been paper discovery in the case, which revealed the "crap" and "vomit" memos sent between UBS employees. Further information is being sought about the relationship between UBS and the ratings agencies, Klein said.

Local counsel for UBS is Alfred U. Pavlis of Daly & Pavlis in Southport, who was not immediately available for comment.

In an interview, Colorado attorney Michael Burg said he was contacted by the Stamford hedge fund in 2007. "We were, I believe, the first firm in the country to begin the investigation into what happened between the rating agencies, the investment banks, and banks," said Burg, who added that his firm suspected collusion between the rating agencies and the banks. "We were, I believe, the first law firm in the nation to file a lawsuit over this, in March 2008."

That was after the Bear Stearns brokerage firm failed, one of the first big investment banks to go down. "We know that the attorney generals in New York and Connecticut are investigating the ratings agencies," Burg said.

He said he expected much more litigation in this area. "We're pretty sure that this same kind of – to use UBS's term – 'crap' and 'vomit' were sold to other hedge funds and pension funds, so the state of Connecticut, as well as hedge funds in Connecticut likely have been sold the same kind of CDO's."

Complex Jargon

The incredibly complex nature of the investment instruments, and therefore this case, is evident from Judge Blawie's decision following the pre-judgment remedy hearing. Though he tries to present the information clearly, much of the financial jargon is comprehensible to only investment experts.

Blawie said that the plaintiffs – Pursuit Partners — got involved in purchasing "synthetic" collateralized debt obligation notes from UBS in April 2007. These instruments were based on bundles of actual mortgages and also on the future performance of other complex securities, according to Pursuit's complaint.

One of the conditions that Pursuit sought was that the value of the CDOs not be subject to a "trigger" – a change in ratings that would dramatically decrease the value of the securities, or even wipe it out.

Pursuit told UBS it was willing to invest in mortgage securities, but wanted them to be "investment grade" and "triggerless." The products Pursuit bought was anything but investment grade, Blawie found.

The UBS notes value would disappear if an investment downgrade cut off their ability to pay interest. "With such a heavy reliance on the ratings," Blawie found, UBS created "a kind of ratings trap, due to the catastrophic consequences of a downgrade."

Blawie also found that UBS became privy to secret insider information about a pending

Moody ratings downgrade due to a change in methodology.

The judge found that “in the summer of 2007, UBS was aware that the notes they were currently marketing” were not going to be listed as investment grade for long.

Because the value was about to plummet, UBS had an incentive to unload as many of the notes as it could, and it did. Court documents reveal brokers laughing to themselves via memos. Some were aware of the doomsday nature of their sales, and the impending end of their sales opportunity. One top UBS employee, upon heading out to lunch one day, left a note to a friend: “Hearing that Moody’s will announce a bunch of CDO downgrades in the next hour-ish. Don’t call police if I never return.”

Blawie’s finding of probable cause for the PJR did not explore whether a fast-moving economic meltdown, including the failure of Lehman Brothers and the resultant credit freeze, could have been the real cause for the loss of value in the CDO instruments.

At trial, one key issue will be whether a change in methodology was pending at the ratings agencies, and whether UBS knew about it.