COMMITTEE NEWSLETTER

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The current market collapse (the COVID-19 Crisis) is different from prior market crashes because it was not caused by the collapse of a particular market segment or the failure of an ascertainable industry to embrace responsible lending and/or investment practices. The current market collapse will likely spawn litigation that is focused on both particular market segments (e.g., healthcare, oil and gas, airline, airplane manufacturing, restaurant, cruise-line, and tourism, to name a few), and particular investment products. This bulletin focuses on two investment products that likely will be the subject of many investor claims: structured notes and high-yield (junk) bonds.

Potential Investment Litigation and Arbitration Trends Arising out of the COVID-19 Financial Crisis: Two Products that will Likely be the Subject of Claims

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Litigation following a global financial crisis often focuses on particular products and/or market segments. Many claims following the 2000 "Technology Crash" focused, not surprisingly, on losses caused by investments in the tech sector. The 2008 "Mortgage Crisis" spawned much litigation over the financial services industry's failure to properly screen mortgage applicants and the related issuance, purchase, and sale of certain financial services products, primarily collateralized debt obligations (CDOs) and mortgage-backed securities (MBSs).

The current market collapse (the COVID-19 Crisis) is different from prior market crashes because it was not caused by the collapse of a particular market segment or the failure of an ascertainable industry to embrace responsible lending and/or investment practices. We can only hope this difference will help financial markets recover more rapidly from the COVID-19 Crisis than the past two.

Regardless, we believe the current market collapse will spawn litigation that is focused on both particular market segments (e.g., healthcare, oil and gas, airline, airplane manufacturing, restaurant, cruise-line, and tourism, to name a few), and particular investment products.

This bulletin focuses on two investment products we believe will be the subject of many investor claims: structured notes and high-yield (junk) bonds.

Structured Notes

A structured note is a debt security issued by financial institutions; its return is based on equity indexes, a single equity, a basket of equities, interest rates, commodities or foreign currencies. So, in addition to being a type of bond, a structured note is also a type of derivative, because its return is derived from the performance of an underlying asset, group of assets or index.

Structured notes are complex and illiquid. When the underlying asset on which a structured note's return is derived drops significantly, as many assets have in the current market, the return and the related value of that structured note is substantially diminished. For these and other reasons, structured notes are unsuitable for many investors.

Underscoring this conclusion, the SEC issued an Investor Alert regarding structured notes in 2015. Nonetheless, throughout the last three years of overall market growth, structured notes have been a tempting product for financial advisors to recommend to customers. As long as the market is strong, structured notes can offer a relatively high return.

Current market conditions will likely cause many investors to lose money unexpectedly on structured notes. Structured notes also often pay relatively high commissions, a point plaintiffs' attorneys assert demonstrates that defendants are acting in their self-interests when recommending these investments. Several plaintiffs' securities law firms have recently posted information on structured notes in an effort to obtain clients.

"High-Yield" Bond-based Investments

A high-yield (junk) bond is a bond rated below investment grade (i.e., below BBB). These bonds have a higher risk of default and, in exchange, offer higher relative yields in order to attract investors. Despite investors sustaining significant losses from junk bonds in the past, the size of the U.S. high-yield bond market is nearly double its level at the time of the 2008 financial crisis.[1] Indeed, despite many opinions that junk bonds are an unsuitable investment for customers headed toward retirement, many IRAs actually offer high-yield bond funds as one investment option.

While it remains to be seen whether the current financial crisis will cause widespread corporate defaults on high-yield bonds, the specter of that occurring has caused a massive selloff of junk bonds around the world. High-yield bonds with below-investment-grade ratings plunged at their fastest pace in history in March 2020.[2] While it will take more time to learn whether a substantial number of these high-yield bonds will go into default, such an event seems likely, particularly for bonds issued by companies in the most adversely affected market segments.

If widespread default occurs in the wake of the COVID-19 Crisis, we anticipate investors will file claims asserting they were not warned of the potential financial risks posed by high-yield bonds and that such investments were unsuitable for the investors' conservative needs and directives.

[1] [1]Jonathan Rochford, Opinion: The Next Wreck in Junk Bonds Will be Bigger, Longer and Uglier, Market Watch (June 16, 2018).

[2] Serena Ng and Zie Yu, Investors, Fearing Defaults, Rush out of Junk Bonds, Wall Street Journal (March 26, 2020).

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