SOCIETY OF ACTUARIES

Article from:

Reinsurance News

November 2008 – Issue 64

THE SUBPRIME CRISIS: A BRIEFING FOR INSURANCE COMPANY CLAIM PROFESSIONALS[1]

By Jack Cuff, JD, CPCU, ARe

The wave of litigation stemming from the collapse of the U.S. subprime mortgage industry will likely reach new records of questionable distinction. They could include some of the highest levels of settlement amounts, parties sued, parties suing, and accounting complexity. By many yardsticks it will probably dwarf the lawsuits arising out of past financial crises such as the October 1987 stock market crash, the savings and loan debacle in the late 1980s[2] as well as the Enron/ WorldCom accounting improprieties earlier in this decade. Insurers are bound to be drawn deeply into it on many fronts.

At the heart of the subprime problem is the fact that millions of U.S. mortgages originated by independent mortgage brokers were passed on to finance companies that in turn resold them to Wall Street firms and ultimately investors around the world. Other than the final investors, it would seem that no one along this chain needed to be worried about the credit quality of the home owners because they simply passed that entire risk on to parties down the line.[3]

Magnitude of the Subprime Crisis

In its study, *Securities Class Action Case Filings. 2007: The Year in Review*, the Stanford Law School and Cornerstone Research found that the number of securities lawsuits filed in 2007 increased 43 percent from the year before. It attributed the increase to the subprime crisis. This dramatic increase in subprime litigation is no doubt because of the huge financial losses. For example, Deutsche Bank analyst, Stephen Taub, predicted in his article, "Subprime Losses Could Reach $400 Billion," that eventually 30- 40 percent of subprime debt will default, (CFO.com, Nov. 13, 2007). In February 2008, UBS, the giant Swiss financial group, estimated that the crisis could exceed $600 billion, including a loss of $350 billion to banks and brokers with the remainder spread out among other parties such as shareholders and the entire mortgage industry from appraisers to wholesalers. (By contrast, the U.S. savings and loan crisis of the 1980s ultimately cost taxpayers 3.2 percent of G.D.P., which would roughly translate into $450 billion today.) More estimates will surely be forthcoming as the subprime crisis unfolds.

continued on page 20

[1] This article is intended as background only and is not intended to apply precisely to any particular case. Always seek professional advice on specific facts and issues.

[2] "Looking at litigation activity from the savings-and-loan crisis of the early 1990s as a benchmark, subprime related cases filed in 2007 (federal court only) already equal one-half of the total 559 actions handled by the RTC over a multiple-year period." Subprime Mortgage and Related Litigation 2007: Looking Back at What's Ahead, Navigant Consulting Inc., Feb. 2008 publication.

[3] In a March 21, 2008 editorial, The New York Times described it as: "Translation: derivatives based on incomprehensible mortgages with unpredictable interest rates given to people who have no reasonable chance of understanding them, let alone paying them back."

The Subprime Crisis: … from page 19

Impact of the Crisis on Insurers

The insurance industry will hardly be immune to this gathering subprime litigation storm. A February 2008 study by Navigant Consulting Inc.[4] found 278 lawsuits had already been made against virtually every participant in the subprime collapse. Fortune 1000 companies were named in 56 percent of these cases. Mortgage bankers and loan correspondents represent the highest percentage of defendants (32 percent), but defendants also include mortgage brokers, lenders, appraisers, title companies, homebuilders, servicers, issuers, underwriting firms, bond insurers, money managers, public accounting firms, and company directors and officers, among others. There is little doubt that most of these purchased professional liability coverage and have already notified their insurers.[5]

Also in February 2008, Advisen Ltd., a provider of technical information and data to the commercial insurance industry issued a report, "The Crisis in the Subprime Mortgage Market and Its Impact on D&O and E&O Insurers." In it, Advisen forecast D&O losses of $3.6 billion, "most of which will be borne by a small group of financial institution D&O insurers."

In mid-March Bear Stearns, which had considerable business in mortgage finance, had to be rescued through a takeover by J.P. Morgan Chase backed up by the federal government. No doubt every one of Bear Stearns' professional liability insurers have already been notified. J.P. Morgan Chase indirectly confirmed this when it announced that its transactional costs for this deal, would total about $6 billion—which specifically included considerable reserves for the anticipated expense of litigation over the collapse of and its purchase of Bear Stearns.

As this article was being written, the bad news kept coming. On April 23, 2008 Navigant Consulting, Inc. updated its February study and reported that the number of subprime-related cases filed in federal courts during the first quarter of 2008 had proceeded apace. A total of 170 cases were filed during the first *three* months of 2008 according to the firm. By contrast, there were 181 such filings over the final *six* months of 2007.

And perhaps for the first time, some carriers will find themselves simultaneously on many sides of a single case that is in dispute. For example, shareholders may sue the insurers' directors and officers for losing billions of dollars that they invested in the subprime bonds. But, as purchasers of collapsing subprime bonds themselves, insurers may consider an action against investment banks and brokers.[6] Finally, those insurers who provide professional liability insurance to directors and officers, investment banks, auditors[7] and other players in the financial and professional communities will experience an increase of claim reports *from* their policyholders as this crisis progresses.

One could easily imagine a scenario where the shareholders of an insurance company sue its Directors and Officers for losing money in subprime investments. When the insurer then sues the banks that sold it the bonds, it may discover that it provides those very banks with bankers' Errors and Omissions insurance protecting them against the claim they themselves made.

To minimize surprises, insurers need to consider how to stay ahead of the expected subprime litigation wave. They must: simultaneously develop early and adequate reserves based on current information; prepare for any possible coverage issues; alert their reinsurers as quickly as possible; and, to the extent they can, influence the course of the litigation as it proceeds. For those insurers exposed, failure to stay on top of the oncoming subprime deluge would be very foolhardy.

John J. Cuff, JD, CPCU, ARe, manages the Navigant Consulting Inc. Reinsurance Claims Practice in Greenwich, CT. He can be reached at *jcuff@optonline.net*.

---

[4] Subprime Mortgage and Related Litigation 2007: Looking Back at What's Ahead, Published Feb. 2008.

[5] A simplified outline of the NCI report is provided in the appendix. It indicates in summary form the claim categories, parties sued, and allegations of wrongdoing. See the full report for greater detail. The insurance policies that may provide coverage have been added by the author.

[6] See, e.g. Bankers Life Ins. Co. v. Credit Suisse First Boston, et. al., No. 8:07-CV-00690 (M.D. Fl. Apr. 20, 2007)

[7] See NYTimes, April 13, 2008, A Lender Failed. Did Its Auditor?

The Case Against the Defendants

Just how successful some of these lawsuits are likely to be for the plaintiffs is unclear and will depend on what is asserted and the weight of the evidence. The allegations appear to fall into two very broad categories: first, violation of state and federal securities laws and other statutes; and, second, common law causes of action such as fraud and negligence. They will include additional causes of action unique to the facts of each case.

The following discussion is by no means comprehensive or generally applicable. It is meant only to provide a flavor of some of the issues that may very well come up.

State and Federal Security laws

In its study, *Securities Class Action Case Filings. 2007: The Year in Review*, the Stanford Law School and Cornerstone Research described the chief allegations being made in the subprime litigation under the securities laws:

> It is noteworthy that approximately 19 percent of all cases in 2007 were specifically linked to issues in the subprime lending market. These subprime cases have caused a shift in emphasis from allegations related to traditional income statement line items to allegations related to balance sheet components. … Meanwhile, the percentage of GAAP-related cases alleging the understatement of liabilities, the overstatement of accounts receivable or of other assets, or problems with estimates, all increased from 2006 to 2007.

On first blush, it would seem that many defendants will have a strong defense to the complaints asserting violations of securities statutes. For example, recent U.S. Supreme Court decisions place the burden of proof squarely on the shareholders who are seeking recovery under federal securities laws. To even survive a motion to dismiss the complaint, the Court recently held that the shareholders must have evidence that is as "cogent and at least as compelling as any opposing inference of nonfraudulent intent."

In that June 2007 decision, the U.S. Supreme Court, in *Tellabs, Inc., et al v Makor Issues & Rights, Ltd et al*. No. 06–484 Argued March 28, 2007—Decided June 21, 2007, interpreted The Private Securities Litigation Reform Act of 1995. This Act requires plaintiffs to plead improprieties that "give rise to a strong inference of fraud" in order to proceed with a case and to access corporate documents. The decision made the hurdles for plaintiffs to survive a motion to dismiss the complaint very high. The Court held that:

> An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct. To qualify as "strong" within the intendment of §21D (b) (2), we hold, an inference of scienter [fraudulent intent] must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.

The decision seems to present a no-win position for shareholders with strong suspicions, but no hard evidence of wrongdoing. To prove their case of fraudulent intent, these plaintiffs would have to conduct discovery; but before they are even allowed to conduct discovery they would first need to have evidence of wrongdoing. Defendants on the other hand would argue that this is only fair: the plaintiffs should be required to have strong evidence of wrongdoing before they can be allowed to tie up the corporation and the courts in a protracted fishing expedition.

The defendants' may also simply plead pure ignorance: they did not know anything any more than anyone else and never meant to mislead anyone. How could they foretell that the whole subprime house of cards would come crashing down? It is unprecedented. If they were wrong, the whole world was wrong.

Further, in January 2008, the U.S. Supreme Court rejected an effort to expand the scope of secondary liability in private lawsuits under the federal securities laws. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta.,* No. 06–43. Argued Oct. 9, 2007—Decided Jan. 15, 2008.

In that case, two suppliers of a cable company entered into sham contracts apparently for the sole

continued on page 22

purpose of allowing the company to falsely improve its balance sheet and mislead its auditor, Andersen. The shareholders' action against the suppliers, Motorola and Scientific Atlanta, was dismissed by the Court since they had not made any statements that the plaintiffs relied on.

> Reliance is tied to causation, leading to the inquiry whether respondents' deceptive acts were immediate or remote to the injury. Those acts, *which were not disclosed to the investing public,* are too remote to satisfy the reliance requirement. [Emphasis added]

AS A FIRST IMPRESSION, MANY OF THE ELEMENTS NECESSARY FOR A SUCCESSFUL PROSECUTION FOR FRAUD APPEAR TO BE ABSENT IN THE CASES AGAINST THE MORTGAGE BROKERS. …

Thus, in effect, the §10(b) private right of action does not extend to aiders and abettors of a stock market fraud if their statements "were not disclosed to the investing public." Some parallel could well be found as to the mortgage brokers, lenders, appraisers, title companies, etc. who may be sued under the federal securities laws. They might be successful in arguing that their misleading statements or acts, if any, were too remote to satisfy the reliance requirement because they were never disclosed to the public.

Common Law Fraud and Negligence

To prove a case of fraud under black letter law the claimant must demonstrate three elements: a material false statement made with an intent to deceive (scienter); a victim's reliance on the statement; and, damages.[8] As a first impression, many of the elements necessary for a successful prosecution for fraud appear to be absent in the cases against the mortgage brokers, lenders, appraisers, title companies, homebuilders, etc. These firms will argue that they never made a statement that they knew at the time was false and that someone would reasonably rely on. They were just doing their jobs, not making up stories, and never dreamt of the subprime crisis that was to come. In fact, their businesses, tied closely to the sale of land, are drying up because of the crisis; they would have wanted to avoid the subprime collapse as much as anyone else.[9]

At common law, a negligence recovery can be made only if the party sued had a duty of care towards the injured claimant, breached that duty, and the breach proximately caused an injury to the claimant. It remains to be seen whether the defendants in the subprime litigation had either a duty of care to warn the plaintiffs or, for that matter, breached it. They may argue that they could not predict that subprime borrowers would begin to default en masse as they ultimately did. In any case, the investors assumed this risk themselves. After all, they may assert, many were aware that behind the bonds were homeowners with checkered credit histories; they received the higher interest rates the bonds paid precisely because of this extra risk.

To overcome some of these hurdles, claimants will probably make an effort to examine each defendant's contemporaneous internal reports, analyses and all communications relating to the subprime business. They may look to see if the defendant was saying one thing internally (like it anticipated a meltdown) but quite the opposite publicly.[10] The claimants would

---

[8] Alternatively, the claimant must show that the defendant made a statement which was knowingly false and reasonably relied on by another person which proximately caused a financial loss.

[9] Most D&O and financial professionals' E&O policies exclude coverage for private profit, and for dishonest, fraudulent or criminal acts. But the language of the exclusion must be closely examined. Sometimes the exclusion requires a "final adjudication" of wrongdoing or contains the more open-ended requirement of wrongdoing "in fact." If a final adjudication is required then the insurer will need to provide a defense until the final adjudication is made. But if the latter, a closer question is presented.

[10] In the recently concluded federal criminal trial in Hartford involving finite reinsurance, consider how critical Gen Re's Robert Graham's e-mail was to his personal freedom: "How AIG books it is between them, their accountants and God," he wrote. He was convicted in February 2008 and faces 230 years in jail. Damaging e-mails and internal memos came to light in the government anti-trust prosecution of Microsoft. The same thing happened with investment banks' internal analyses in the WorldCom Litigation.

still need to show there was some duty to disclose this information to them.

The obstacles to winning a case against credit-rating agencies, or Nationally Recognized Statistical Rating Organizations (NRSRO), are particularly daunting for claimants. In past cases, the raters have invoked constitutional protections of free speech; comparing their evaluations of a company's debt to judgments made in a newspaper editorial. In *Lowe v. SEC,* 472 U.S. 181, 210 (1985), for example, the Supreme Court found there could be "no doubt" that publications containing information and commentary on market conditions and trends were protected by the First Amendment.

Damages

As indicated at the very beginning of this article, the estimates keep changing as to the size of subprime losses. It would be imprudent at this early stage to talk about provable financial losses in specific cases other than to say that the amounts sought should be sizeable. Because of the great magnitude of the subprime meltdown, claim staff should anticipate protracted and extensive litigation—both in coverage disputes and to defend the policyholder—with the attendant high costs. It should also be borne in mind that, by the terms of many contracts, defense expenses erode policy limits and should therefore be considered as a part of damages.

Conclusion

The tangled subprime mess has invaded the insurance industry in a variety of ways and some carriers will play several roles in it simultaneously. They will be plaintiffs suing their investment advisors and brokers; defendants in shareholder lawsuits; insurers of defendants who are in shareholder and other lawsuits; defendants and/or plaintiffs in coverage litigation; parties in arbitration against their reinsurers. There will be other roles they will play that cannot even be imagined now.

Coping with this will require ready access to full and accurate information, continuous analysis of coverage and exposures, and considerable internal coordination. It will be a challenge. ✹