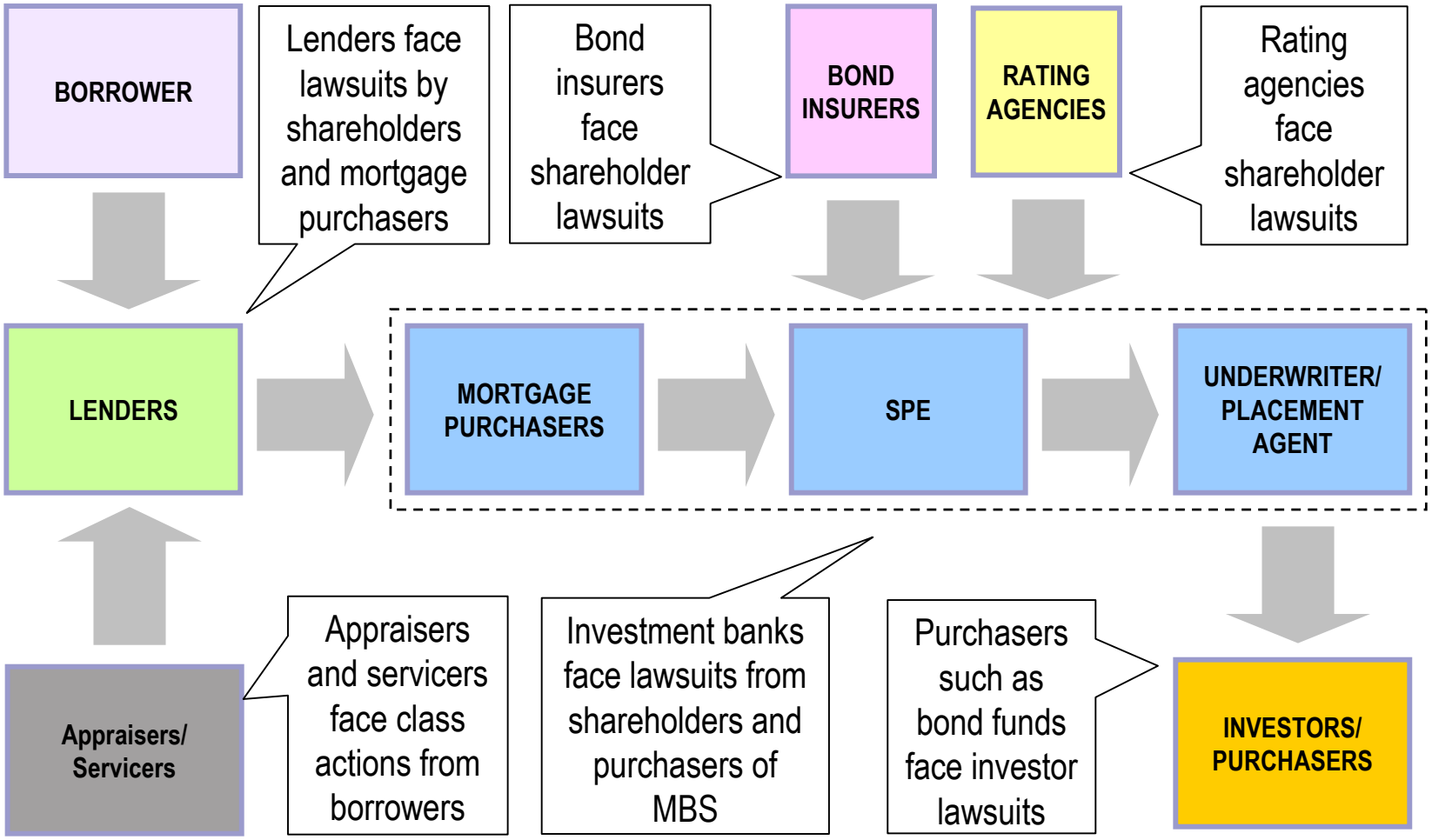
The Subprime Crisis: Emerging Litigation Trends and Insurance Issues

John N. Ellison
Reed Smith LLP
1650 Market Street, Ste 2500
Philadelphia, PA 19103
215-241-1210
jellison@reedsmith.com

David H. Topol
Wiley Rein LLP
1776 K Street NW
Washington, DC 20006
202-719-7214
dtopol@wileyrein.com

Robert M. Stern
O'Melveny & Myers LLP
1625 Eye Street NW
Washington, DC 20006
202-383-5328
rstern@omm.com

Litigation Present at all Stages of Risk Transfer



Fundamental Litigation Questions

- Widespread delinquencies and defaults raising questions about:
  - Assessment – were the risks understood?
  - Allocation – who bears the risks?
  - Disclosure – were the risks disclosed?
- In addition, shareholders of lenders, investment banks and bond insurers also took on risks created by loans and lending practices

Litigation Targets

- Targets of subprime-related securities litigation include:
  - Lenders
  - Appraisers
  - Servicers
  - Entities holding CDOs
  - Sellers of CDOs
  - Rating agencies
  - Bond insurers

Potential Coverage Issues

- Timeliness of Notice
- Existence/Absence of “Professional Services”
- No “Loss”
- Rescission/Prior Knowledge Exclusions
- Intentional Acts and Personal Profit Exclusions
- Allocation
- Subrogation

Notice – When And How

- Under Which Policies Should Notice Be Provided?
  - Claims Made v. Occurrence
  - What constitutes a “claim” or “notice of circumstances”?
- Policy Renewal Considerations

Types Of Costs Which May Be Covered

- Defense Costs v. Settlement/Indemnity Dollars
  - Timing of Payment-Advancement v. Reimbursement
- Costs of Responding to SEC or Other Gov't. Investigations
- Costs of Special Litigation Committees or Other Internal Investigations
- Impact of Settlements on Coverage Issues

Securities Fraud Litigation

Securities Fraud Suits Against Lenders
Shareholders v. Lenders

- Shareholders have filed securities fraud class actions against lenders alleging:
  - Failure to maintain adequate reserves
  - Failure to take timely impairment charges
  - Undisclosed non-compliance with lending practices
  - Failure to disclose inadequate internal controls
  - Unreasonable financial projections due to deteriorating loan underwriting market conditions

Securities Fraud Suits Against Lenders
MBS Purchasers v. Lenders

- Purchasers of MB issued by lenders have filed securities fraud class actions against lenders
  - Example: *Luther v. Countrywide Home Loans Servicing LP*, BC380698 (L.A. Super. Ct.)
    - Plaintiff asserts Securities Act claims based on allegedly false and misleading registration statements and prospectus supplements for certificates backed by mortgages
    - Registration statements and prospectus allegedly contained misleading statements or omissions about the lender's mortgage underwriting practices and standards

Securities Fraud Suits Against Lenders
Possible Defenses to Securities Fraud Claims

- Defenses to investors' securities fraud claims:
  - *Failure to establish scienter*
  - *No loss causation*
  - *PSLRA's Safe Harbor protections*
  - *Insufficiently particularized fraud allegations*

- Securities Act § 11 claims present unique challenges
  - Few defenses available at the motion to dismiss phase and "strict liability" for section 11 claims

Securities Fraud Suits Against Lenders
Related "ERISA" and Derivative Litigation

- "ERISA" and derivative lawsuits may follow on the heels of securities fraud claims

- Often based on same nucleus of factual allegations as related securities fraud lawsuits

Litigation Brought By Mortgage Purchasers

Mortgage Purchasers' Claims Against Lenders

- Purchasers allege:
  - Sellers breached reps and warranties concerning mortgages they originated
  - Lenders have refused to repurchase defaulting loans
- Purchasers have relied on the following theories:
  - Breach of contract
  - Indemnification
  - Unjust enrichment
- Examples:
  - *CitiMortgage, Inc. v. Loan Link Fin. Serv., Inc.*, No. 4:07-cv-1989-SNL (E.D. Mo.)
  - *Morgan Stanley Mortgage Capital Holdings LLC v. Fieldstone Mortgage Co.*, No. 1:07-cv-02403-AMD (D. Md.)

Mortgage Purchasers' Claims Against Lenders *Critical Issues*

- Critical issues include:
  - What information was disclosed concerning the mortgages?
  - Did the seller's reps and warranties concerning its lending practices conform with practice?
  - Were conditions for triggering repurchase obligations satisfied?
    - For example, where repurchase obligations are tied to "material" breaches, were alleged breaches of sufficient magnitude?

Mortgage Purchasers' Claims Against Lenders *Potential Defenses*

- Lenders' potential defenses include:
  - *Plaintiffs lack standing to sue*
    - If plaintiffs do not own the mortgages at issue, they may lack standing
  - *Adequacy of allegations concerning contract breaches*
    - Complaints fail to identify allegedly underperforming mortgages in sufficient detail
  - *Adequacy of disclosures concerning risks*
    - Lenders selling mortgages may succeed in demonstrating that risks were fully disclosed to purchasers

CDO-Related Litigation

CDO-Related Litigation

- CDO-related litigation has emerged as values of mortgage-backed securities have fallen
- Litigation includes:
  - Shareholder suits against banks and asset managers
  - CDO purchaser lawsuits
  - Suits again bond insurers

CDO-Related Litigation
Shareholders v. Banks & Asset Managers

- Banks' and asset managers' shareholders have filed securities fraud suits following disclosures regarding CDO exposure
- Claims include:
  - Failing to disclose that asset portfolios contained impaired and risky CDOs
  - Failing to properly account for risky and impaired CDOs
- Examples: Citi, Merrill Lynch, UBS, Morgan Keegan Bond Fund, ACA Capital

CDO-Related Litigation
Shareholders v. Banks & Asset Managers
Critical Issues

- Critical issues include:
  - When, if ever, did defendants know that the mortgage-backed securities required revaluation?
  - Did the defendants know that their valuation methodology was improper?
  - Did insiders trade on non-public information?

CDO-Related Litigation
Shareholders v. Banks & Asset Managers

- Possible defenses to CDO-related claims include:
  - *Failure to establish scienter*
  - *No loss causation*
  - *Insufficiently particularized allegations*

CDO-Related Litigation
Claims by CDO Purchasers

- Purchasers of mortgage-backed securities are asserting claims against sellers after the securities' values dropped

CDO-Related Litigation
Claims by CDO Purchasers (cont'd)

- Example: *In re Merrill Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2008-0001
  - Merrill Lynch sold CDOs to Springfield which diminished in value
  - One CDO allegedly lost 95% of its value
  - State of Massachusetts claims these investments were unsuitable for the city. Claims include:
    - Failing to disclose riskiness of CDOs
    - Failing to disclose that the CDOs were issued by Merrill Lynch

CDO-Related Litigation
Claims by CDO Purchasers (cont'd)

- State law claims
  - Example: *Bankers Life Ins. Co. v. Credit Suisse First Boston Corp.*, No. 8:07-cv-00690-FAK-MSS (M.D. Fla.)
    - Bankers Life claims CSFB made misrepresentations in connection with the sale of mortgage-backed securities:
    - Claims include:
      - CSFB should have disclosed the underlying mortgages' poor quality
      - CSFB failed to take actions that would have reduced Bankers Life's losses after the mortgages' performance deteriorated

CDO-Related Litigation
Claims by CDO Purchasers (cont'd)

- Investment managers have been sued by clients after investing in mortgage-backed securities
  - Example: *Nashua Corp. Composite Pension Trust v. State Street Bank & Trust Co.,* No. 1:07-cv-12021-RWZ (D. Mass.)
    - Investors in State Street Bank bond funds asserted "ERISA" claims alleging that the funds improperly invested in risky and volatile mortgage-backed securities without advising the investors
  - Example: *Israel Discount Bank v. Metro. Life Ins. Co.,* No. 08600242 (N.Y. Sup. Ct.)
    - Israel Discount Bank asserted breach of fiduciary duty and breach of contract claims against MetLife and BlackRock
    - Claim is based on losses suffered by the fund as a result of subprime-related investments

CDO-Related Litigation
Claims by CDO Purchasers – Critical Issues

- Critical issues include:
  - Were risks associated with the underlying mortgages adequately disclosed to purchasers?
  - What did the sellers know about the value of the CDOs and risks?
  - Nature of relationship between seller and purchaser

CDO-Related Litigation - Possible Defenses to *Claims by CDO Purchasers*

- Possible defenses include:
  - *Adequacy of disclosures*
  - *Absence of duty owed by seller to purchaser*
  - *Lack of particularized fraud allegations*
  - *Generalized allegations concerning underlying mortgages are insufficient*

CDO-Related Litigation
Claims Against Rating Agencies

- Rating agencies may be subject to lawsuits by several groups of plaintiffs:
  - Their own shareholders
  - Purchasers of mortgage-backed securities rated by the agencies
  - Issuers of securities rated by the agencies

CDO-Related Litigation
Claims Against Rating Agencies (cont'd)

- Rating agencies' shareholders have asserted securities fraud claims arising from their involvement in rating mortgage-backed securities
  - Example: *Teamsters Local 282 Pension Trust Fund v. Moody's Corp.*, 07 Civ. 8375 (S.D.N.Y.)
    - Shareholders allege Moody's maintained "excessively high rating" on bonds backed by subprime mortgage-backed debt
    - Disclosure of Moody's role in rating loan securities allegedly caused stock price drop
  - Example: *Reese v. Bahash*, No. 1:07-cv-01530 (D.D.C.)
    - McGraw-Hill shareholder alleges that CFO breached his fiduciary duties and committed securities fraud by causing the company to issue false and misleading statements regarding the rating activities

CDO-Related Litigation
Claims Against Rating Agencies (cont'd)

- Purchasers of securities generally cannot assert claims against rating agencies
  - Activities are protected by First Amendment
  - Rating agencies owe no duties to investors under the securities laws
  - Example:
    - *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 511 F. Supp.2d 742 (S.D. Tex. 2005)
- But outcome may differ where securities issuer and rating agency had contractual relationship and the rating agency received inside information

CDO-Related Litigation
Claims Against Rating Agencies (cont'd)

- Securities issuers generally cannot assert claims against rating agencies
  - Companies have unsuccessfully sued rating agencies for defamation, negligent misrepresentation, tortious inference with business relations and breach of contract
  - Rating agencies' activities receive First Amendment protection

CDO-Related Litigation
Claims Against Bond Insurers

- Bond insurers' shareholders filed suit after the value of insured CDOs fell
- Claims include:
  - Failing to disclose risk to the bond insurer's credit rating as a result of exposure to mortgage-backed securities
  - Inflating financial results by failing to properly account for mortgage-backed securities losses
  - Improperly downplaying the effect of deteriorating market conditions
- Examples: Ambac, MBIA

Consumer Class Action Litigation

Consumer Class Action Claims Against Lenders

- Purchasers allege:
  - Lenders used predatory lending practices in origination of loans; companies securitizing loans were aware of the practices.
- Purchasers have relied on the following theories:
  - Fraudulent concealment, breach of contract, negligent misrepresentation, unjust enrichment
  - Violations of Truth In Lending Act & Home Ownership Equity Protection Act
- Defenses:
  - Accurate information on loans presented to borrowers in accordance with law
  - Transactions between lender and securitization provider done at arm's length
- Example:
  - *In Re First Alliance Mortgage Company,* No. SA CV 01-971 (C.D. Cal.)

Consumer Class Action Claims Against Servicers

- Purchasers allege:
  - Servicers did not comply with federal law or terms of mortgage in servicing loans and forced borrowers into foreclosure.
- Purchasers have relied on the following theories:
  - Common law fraud, breach of contract, negligence, and unjust enrichment
  - Violations of Fair Debt Collection Practices Act and the Real Estate Settlement Procedures Act
- Defenses:
  - Servicing conducted in accordance with terms of note and relevant laws
- Example:
  - *In re Ocwen Federal Bank FSB Mortgage Servicing Litigation*, MDL No. 1604 (N.D. Ill.)