

The Subprime and Credit Crisis-Related Litigation Wave: A Status Update

It has now been over three years since the first subprime-related securities class action lawsuit was filed in February 2007, yet many of the cases filed in the ensuing litigation wave are still only in their earliest stages. While the vast majority of these cases are still unfolding, there have been some important recent developments, suggesting that the evolving litigation wave has passed some significant milestones. With that possibility in mind, it seems appropriate to check in for a status report on the subprime and credit crisis-related litigation wave.

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Filing levels

There have now been a total of 208 subprime and credit crisis-related securities class action lawsuits. While the subprime and credit crisis securities suits continue to be filed, the pace has definitely slowed in recent months. Of the 2009 filings, the bulk of the cases were filed in the first quarter. There have only been three new subprime and credit crisis-related securities cases filed in 2010. Although the pace of filing activity could pick up again, it seems that subprime and credit crisis litigation may have reached a saturation point, at least in terms of new filings.

Another circumstance suggesting that the litigation wave may have ebbed is the changing mix of companies that are the targets of the latest securities class action lawsuits. In the first half of the 2009, approximately two thirds of the new securities lawsuits involved companies in the financial sector. But since that time only about a third of new securities class action lawsuits have involved companies in the financial sector. In other words, the proportion of lawsuits against financial companies versus nonfinancial companies seems to have completely reversed.

Of course, another possibility to explain the recent filing patterns is that the litigation has changed as the world economy has changed. What started several years ago with the subprime meltdown has evolved into a global financial crisis, affecting all companies across the entire economy. As a result of these developments, it has become increasingly difficult to define precisely what constitutes a subprime and credit crisis-related lawsuit. It may not be so much that the subprime and credit crisis litigation wave has crested, but rather, that the wave has become a subset of a larger tidal movement and is no longer its own separately identifiable phenomenon.

The Sights

Inside:

Dismissal Motion Rulings **Page 2**

Gatekeeper Liability **Page 5**

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Dismissal Motion Rulings

Even after three years, there have still only been a relatively small number of dismissal motion rulings in the subprime and credit crisis related lawsuits. Further, the rulings have not ordained a clear path of predictability. Just the same, and even though there are still dismissal motion rulings going in the plaintiffs' favor, on balance, the rulings seem to be favoring the defendants.

As of February 25, 2010:

- There have been 52 dismissal motion rulings in the subprime and credit crisis-related securities class action lawsuits.
- Of those 52 rulings, 34 have resulted in dismissals.
- One of the dismissals (the NovaStar Financial subprime securities suit) has already been affirmed on appeal.
- Out of the 34 dismissals, 17 have been with prejudice, while the remaining 17 have been *without* prejudice (meaning that the plaintiffs have the opportunity to amend their complaint in order to try to overcome the pleading concerns).

There have been 18 dismissal motion rulings in which the motion to dismiss was denied in whole or in part. Some of the cases in which the dismissal motions have been denied include some of the more prominent subprime and credit crisis-related securities class action lawsuits, such as cases involving Countrywide, New Century Financial, and Ambac Financial.

In addition to the cases in which the initial motions to dismiss were denied, there have been a number of cases in which the initial motions were granted but the plaintiffs were able to amend their complaints to sufficiently address the courts' concerns to survive the defendants' renewed motions to dismiss. These cases include some rather high profile suits such as the cases involving Washington Mutual, Credit Suisse and PMI Group. These cases' survival on the renewed dismissal motions underscores the significance of the fact that many of the initial dismissal motions were without prejudice. These cases serve as an example that the plaintiffs may yet be able to overcome the initial pleading hurdles, notwithstanding an initial dismissal.

There have also been a series of recent rulings in which the courts have granted motions to dismiss in recognition that the defendant company's difficulties were the result of economic

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downturn, not fraud. For example, in both the lawsuit that Luminent Mortgage Corporation filed against Merrill Lynch and in the First Marblehead subprime-related securities class action lawsuit, the courts quoted with approval language from a prior RICO case in which the Second Circuit said "when the plaintiff's loss coincides with a market wide phenomenon causing comparable losses to other investors, the prospect that plaintiffs' loss was caused by fraud decreases."

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But while some courts have been willing to recognize that many companies have been adversely affected by the economic downturn, other courts have also observed that merely because the entire economy has declined does not answer the question of whether or not there was fraud at any particular company. Courts have even asserted that the conduct and disclosures of some companies may even have helped trigger the economic crisis. For example, in the Ambac Financial subprime related securities suit, the defendants had tried to argue that the company's difficulties were merely a result of the financial crisis, and not the result of fraud. In her February 22, 2010 opinion denying the defendants' motions to dismiss, Judge Naomi Reice Buchwald noted that "the conduct that plaintiffs' allege, if true, would make Ambac an active participant in the collapse of their own business, and of the financial markets in general, rather than merely a passive victim." In other words, it may not be enough for the defendants to rely on the existence of the financial crisis in order to prevail on their motions to dismiss.

At this point, about two-thirds of the motions to dismiss in the subprime and credit crisis-related securities suits have gone in the defendants' favor. This dismissal rate (which includes dismissals without prejudice) compares with the historical dismissal patterns in which about 33% to 40% of securities class action lawsuits are dismissed. This data tends to suggest that the plaintiffs are not faring particularly well in the subprime cases. But before reaching any definitive conclusions, there are a number of critical points to be kept in mind.

First, only about 25% of all of the subprime and credit crisis-related securities class action lawsuits have reached the dismissal motion phase. As such, it is premature to support definitive conclusions about the outcomes.

Second, it is entirely possible that the weakest cases have been disposed of first, and that the more substantive cases have yet to be addressed. In other words, we may not have witnessed a true representation of the subprime and credit crisis-related cases. In any event, we will not be able to draw any conclusions for some time to come.

Settlements

If there are only a few dismissal motion rulings in these cases so far, there are even fewer settlements, and thus, it is even more difficult to generalize. Unquestionably, the most attention-grabbing settlements are the series of subprime lawsuits involving Merrill Lynch. To date, the three Merrill Lynch settlements represent the three largest subprime-related lawsuit settlements:

1. \$475 million Merrill Lynch securities class action lawsuit settlement;
2. \$150 million Merrill Lynch bond action settlement; and
3. \$75 million Merrill Lynch ERISA action settlement

It is not just the sheer size that may set these Merrill Lynch settlements apart, but the fact that these enormous settlements were entered before the motions to dismiss were heard in each of these cases. Further, these settlements were reached shortly after Bank of America acquired Merrill Lynch. This may suggest that Bank of America moved quickly to clear the Merrill Lynch litigation that predated the merger - even if substantial sums proved to be required to accomplish that goal. Because of the possibility that these settlements may represent the outcome of their own unique settlement dynamic, they may be of little guidance with regard to possible future settlement ranges.

There have been other significant settlements in other cases. The largest settlement, other than the Merrill Lynch settlements, is the recent \$80 million MoneyGram subprime-related securities lawsuit settlement. The MoneyGram settlement is only one of several settlements involving cases in which the plaintiffs had survived motions to dismiss. Other examples included the \$32 million RAIT Financial subprime-related securities lawsuit settlement and the \$22 million Accredited Home Lenders settlement. These settlements clearly suggest that while it may be difficult for cases to survive dismissal motions, when the cases do survive, they can be quite costly to resolve.

Two other noteworthy recent settlements include the \$37.25 million settlement in the American Home subprime-related lawsuit and the \$30.5 million settlement in the Beazer Homes subprime related lawsuit. These settlements are notable because in both instances the cases settled *before* the motions to dismiss had been ruled upon. While each of these cases had their own particular features, and each was resolved for reasons particular to each case, they do suggest that resolving more serious cases can once again prove costly

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to settle. These cases also suggest that when the claims are sufficiently serious, the plaintiffs may be able to avoid the initial pleading hurdle altogether.

Gatekeeper Liability

One of the characteristics of many of these subprime and credit crisis related lawsuits is the extent to which the plaintiffs are seeking to impose liability on the gatekeepers of the target companies. The gatekeepers named as defendants include not only the directors and officers of the target companies, but also the companies' auditors and offering underwriters, as well as the rating agencies that provided rating on the companies' securities offerings.

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The plaintiffs have shown particular willingness to pursue claims against the auditors. Thus, for example, the trustee for New Century Financial has initiated a claim against KPMG, the company's former auditor. KPMG is also named as a defendant in the New Century Financial subprime securities lawsuit (the district court in that case specifically denied KPMG's motion to dismiss). In addition, in the Countrywide subprime-related securities lawsuit, the district court denied KPMG's renewed motion to dismiss the claims against it in the plaintiffs' amended complaint.

The possibility that these gatekeeper claims could prove valuable for claimants was highlighted in the recent \$37.25 million American Home settlement. The total settlement fund in that case included contributions of \$8.5 million from the seven offering underwriter defendants and \$4.75 million from the company's auditor, Deloitte & Touche. While it is always dangerous to try to generalize from a single settlement, the American Home settlement does at least suggest the possibility that resolving gatekeeper liability could be an important and costly part of the subprime and credit crisis litigation wave's overall consequences.

Another significant development in terms of gatekeeper liability is Judge Schira Scheindlin's September 2, 2009 ruling in the Cheyne Financial case that denies the rating agency defendants' motions to dismiss. Although there could be limitations on the overall impact of Judge Scheindlin's ruling, the ruling could influence the many other cases in which plaintiffs are seeking to impose gatekeeper liability on the rating agencies.

One final note about the gatekeeper liability development is that at least the claimants seem to have shown little inclination to try to pursue claims against the attorneys involved in the underlying circumstances. There is precedent for plaintiffs to pursue these kinds of claims against the attorneys; in a case involving a commercial mortgage backed securities transaction that

took place in the 1990s, certain claimants are now pursuing claims against the Cadwalader law firm (which had created the underlying transaction documents). Significantly, the claimants did not initiate that claim until many years after the fact, and only after extensive litigation involving other parties. This suggests that the claims against the attorneys, even if not yet filed, could materialize in the future.

Defense Expense

In addition to the potential costs of settlement, many of these cases are proving to be enormously expensive to defend. The most substantial illustration of this proposition is State Street Bank's August 10, 2009 announcement that the approximately \$625 million subprime-related litigation expense reserve established in January 2008 had been depleted to \$193 million by June 30, 2009. Further, State Street announced that there could be no assurances that the remaining amount would be adequate for the company's continuing litigation.

The potential cost of serious corporate litigation was also highlighted in the recent Broadcom options backdating derivative lawsuit settlement. Among other things, the settlement papers reflected recitals that the company's litigation expense to date in connection with company's various options backdating related legal proceedings was in excess of \$130 million. Even though the Broadcom case related to options backdating and not to subprime litigation, the defense expenses accumulated in that case underscore how expensive serious corporate litigation can become.

Many of the subprime and credit crisis related cases are equally as complicated and serious. And while the \$130 million in litigation expense in the Broadcom case may be an extreme case, it is not unusual for costs of litigation in complex corporate and securities cases to run into the tens of millions of dollars. The costs of litigation alone have become staggering and should be a consideration in the purchase of D&O limits.

Conclusion

The massive wave of subprime and credit crisis-related lawsuits has accumulated over the course of more than three years. At this point, it seems likely that these cases will be working their way through the system for years to come.

Though there are early indications that defendants are prevailing at the motions to dismiss stage in many of these lawsuits, there may simply not be enough data at this point to make any generalizations. In any event, it appears that the cost of trying to settle these cases could be significant, particularly where the cases have survived the motion to dismiss.



In Sights

In addition to the costs associated with settling these cases, the overall cost of these lawsuits also will include massive amounts of defense expense. These enormous defense expenses will add to the overall aggregate burdens for the D&O insurance industry, as well as for the companies themselves. Though there are a wide range of estimates of the overall cost to the D&O insurance industry from the subprime and credit crisis litigation wave, by any measure, the aggregate cost including defense and settlement amounts will be enormous. These costs are likely to weigh on D&O insurers' results for years to come.

A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the weblog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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