

## The Subprime Lending Mess and the D&O Marketplace

The collapse of the subprime mortgage lending industry has recently dominated the headlines, led to turmoil in the credit and financial markets, and is inflicting damage to the residential real estate sector. So-called “subprime woes” have also generated waves of litigation, much of which has the potential to implicate directors’ and officers’ liability coverage. This article takes a look at the subprime lending litigation wave to date, considers its potential future direction, and analyzes the possible impact on the D&O insurance marketplace.

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### The Subprime Lending Litigation Wave

The litigation arising out of the subprime lending mess has taken a variety of forms, with lawsuits pointing in just about every possible direction: borrowers have sued lenders, borrowers have sued financial institutions, regulators have sued lenders, financial institutions have sued lenders, and investors have sued financial institutions.

Aggrieved parties seeking to recoup their losses are also looking to assumedly deep pocket third parties to try to hold them responsible. As litigants look to assign blame for the subprime mess, they are targeting the gatekeepers – the professionals who allegedly could have prevented the harm. The gatekeepers targeted so far have included:

*Credit Rating Agencies:* Shareholders of both Moody’s and McGraw-Hill (the corporate parent of the Standard and Poor’s rating agency) have filed lawsuits alleging that the rating agencies failed to disclose that they were providing inflated ratings of securities backed by subprime mortgages, or that a significant portion of their revenue depended on providing investment grade ratings to mortgage backed securities.

*Auditors:* Shareholders of American Home Mortgage Investment Corp. have sued the company’s auditors, Deloitte & Touche, alleging that the auditors’ clean opinion of the company’s audit just prior to the company’s secondary offering - and only four months prior to the company’s bankruptcy - misled investors and withheld critical information in violation of the federal securities laws.

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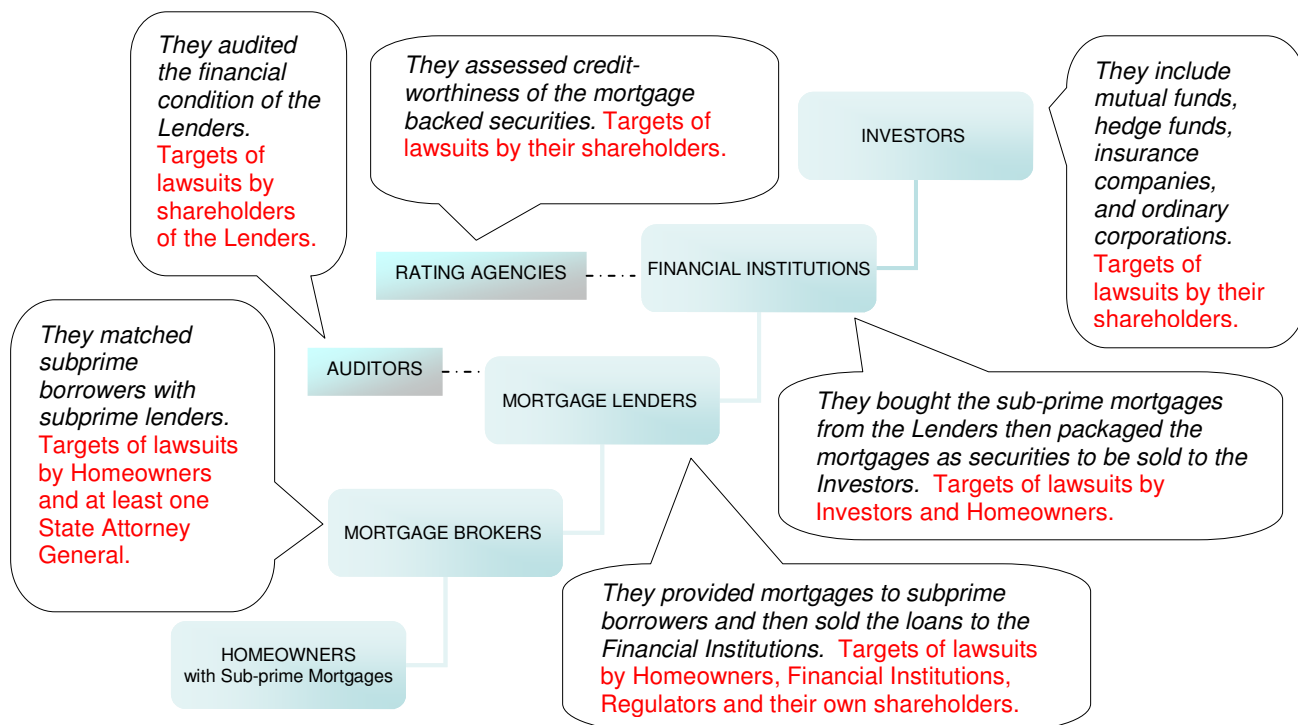
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*Mortgage Bankers and Real Estate Appraisers:* Ohio's Attorney General, Marc Dann, has sued ten mortgage brokers for allegedly improperly pressuring appraisers to inflate home values, so as to support larger mortgages.

*Directors and Officers:* The plaintiffs' lawyers have also targeted the directors and officers of publicly traded companies. As of September 24, 2007, 16 companies and their directors and officers have been named as defendants in subprime lending-related securities class action lawsuits. Four home construction companies and their directors and officers have also been named in subprime lending related class action lawsuits. In addition, two fiduciary liability suits have been filed by employees under ERISA in connection with the employees' holdings in the company's stock in the company's 401(k) plan.

As financial problems have spread beyond the subprime lending arena, companies not directly involved with subprime lending have also found themselves drawn into lawsuits as a result of turbulence in the credit marketplace. For example, Care Investment Trust and several of its directors and officers were sued in September 2007 in a securities class action lawsuit. The company, a real estate investment trust (REIT), is not involved in subprime lending, but holds health care related mortgage assets. The complaint alleges that the company's Prospectus, issued in connection with the company's June 2007 IPO, failed to disclose that some of the company's assets were materially impaired and

**A Diagram of the Pending Litigation related to the Subprime Lending Mess**



therefore overvalued on the company's financial statements, and that the company was experiencing difficulty in securing warehouse financing credit lines. As the disruption in the credit marketplace arising from the subprime meltdown spreads outward, the ensuing complications will engulf increasing numbers of companies that, like Care Investment Trust, have no direct connection with subprime lending.

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In all likelihood, the consequences will continue to spread and the litigation wave will continue to grow. According to the Office of the Comptroller of the Currency, over \$1.08 trillion in securitized subprime mortgage debt is being carried on the balance sheets of untold numbers of enterprises outside of the lending industry itself. Recent news reports have disclosed that companies as diverse as J.M. Smucker, Garmin, Microsoft, Netflix, Sun Microsystems, and numerous others, carry investments in mortgage-backed securities on their balance sheets.

These mortgage-backed securities are only as valuable as the performance of the underlying mortgages. Unfortunately, mortgage foreclosures – already at historically high levels - are likely to increase in the months ahead as adjustable rate mortgages reset at interest rates above the initial teaser rate. According to the Bank of America, over \$1.3 trillion in adjustable rate mortgages – over 70% of which are subprime – will reset before the end of 2008. As borrowers face increased mortgage payments and the inability to refinance, foreclosure rates will increase and the performance of the mortgage-backed securities will decline. As the declining asset values show up (or are exposed) on the balance sheets of publicly-held companies, further litigation inevitably will ensue.

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### **The Impact on the D&O Marketplace**

The most immediate impact so far from the subprime lending meltdown has been for companies in the financial institutions sector. Companies that are or have been involved in the subprime lending industry now face a D&O insurance marketplace that is far different than just a few months ago. Companies with subprime lending risk may find themselves in the “hard to place” category. Even other companies involved more generally in residential real estate lending, or in other aspects of the residential real estate business, may find that they are facing heightened underwriting scrutiny. At least one leading D&O insurer has created a three-page questionnaire to be used to

determine whether applicants have made home loans to the riskiest borrowers or have invested in securities backed by subprime mortgages. For companies not directly involved in the subprime mortgage arena, D&O underwriters will attempt to analyze applicants' possible balance sheet exposure to mortgage investment risk. Obvious places for underwriters to look for this risk include hedge funds and other alternative investment vehicles; mutual funds; investment banks; certain REITs; and insurance companies.

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But the underwriters' inquiries may not be limited just to companies in those sectors; given the sheer magnitude of the mortgage-backed asset investment risk dispersed in the economy, the risk may be found in some unexpected places. In addition to questions about direct investments in mortgage backed securities, underwriters' questions will also likely include inquiries as to whether the applicant holds investments in hedge funds or other investment vehicles with significant exposure to mortgage-backed investments.

At this point, it appears that underwriters are still trying to find the right underwriting response to the subprime mess. Most carriers are not requiring a written questionnaire, but they are still concerned about inquiring into applicants' vulnerability to subprime exposure. (In general, well-advised companies will - where possible - steer clear of providing written answers to any questionnaires out of concern that the carrier could later try to use the answers to rescind the policy.) Absent a written questionnaire to complete, applicants may be called on to give supplemental information in meetings or conference calls. Applicants should take the same degree of care in providing answers in a meeting or on a call that they would in providing written answers to a questionnaire. Keep in mind, if given cause, a carrier may later look carefully at its ability to deny coverage or even to rescind the policy based on oral representations.

### **Conclusion**

While carriers are still trying to get a handle on the underwriting issues, there is no doubt that subprime lending-related litigation has the potential to have significant impact on the D&O industry. The quick emergence of subprime lending-related claims and the uncertainty over the eventual extent of the problem are matters of concern to D&O insurers. Whether these concerns will be enough to reverse the downward pricing trend that has prevailed for the last several years remains to be seen. For now it appears likeliest that the impact will be uneven, with some predictable sectors constricting but most others remaining competitive. Whether the constrictive impact will become more generalized will depend on how large and how widespread the subprime litigation wave becomes.

**About the Author**

This article was prepared by Kevin M. LaCroix, Esq. of OakBridge Insurance Services. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 25 years. Prior to joining OakBridge, Kevin was President of Genesis Professional Liability Managers, a D&O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell. Kevin is based in OakBridge's Beachwood, Ohio office. Kevin was the co-Chair of the 2007 PLUS D&O Symposium. Kevin's direct dial phone number is (216) 378-7817, and his email address is [klacroix@oakbridgeins.com](mailto:klacroix@oakbridgeins.com).

A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the blog via our website at [www.oakbridgeins.com](http://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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