

## Has the Credit Crisis Litigation Wave Reached an Inflection Point?

Among the many side effects of the subprime meltdown has been the growing wave of subprime-related litigation. Over the last two years, as the subprime crisis has evolved into a more generalized credit crisis, the litigation wave has changed too, as new and different litigants have become involved. Now, as a result of the dramatic recent headline events in the financial marketplace, the economic crisis has entered a dark new phase. Just as the prior stages of the crisis generated a surge of litigation, this new phase has already produced its own distinctive round of lawsuits. Like the ominous economic circumstances, the new litigation phase also seems darker and more threatening.

*This article examines the waves of litigation surrounding recent dramatic events in the financial marketplace and concludes with an assessment of what these developments may signify going forward.*

This article briefly reviews the subprime litigation wave as it developed over the past two years and then notes the dramatic events that occurred in the financial marketplace beginning in September 2008. The article then examines the recent wave of litigation surrounding these events and concludes with an assessment of what these developments may signify going forward.

### Background

The first of the subprime related securities class action lawsuits were filed in February 2007, just as the problems in the subprime marketplace began to surface. Since then, as the subprime-related problems developed into a more generalized credit crisis, the associated litigation has also grown. As of October 1, 2008, there have been 120 subprime and credit crisis-related securities class action lawsuits filed, in addition to 23 derivative lawsuits and 15 ERISA lawsuits.

The events producing this litigation took a dramatic turn in September 2008, due to a series of extraordinary events in financial markets. Within the span of just a few short weeks, the government assumed control of Fannie Mae and Freddie Mac; but refused to intervene in the case of Lehman Brothers which subsequently filed for bankruptcy – resulting in the largest bankruptcy in history; Bank of America agreed to acquire Merrill Lynch; the government

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engineered a massive bailout of American International Group (AIG); government regulators took control of Washington Mutual in the largest bank failure ever; and Citigroup sought to acquire Wachovia in an FDIC-brokered deal, only to have its bid topped by Wells Fargo. On top of these events came the massive \$700 billion governmental bailout and disastrous stock market decline and continued volatility.

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Any one of these events alone would have been significant. Taken collectively, these developments represent a massive reordering of the entire financial market with enormous implications for the entire economy. This sequence of events unfolded very rapidly, but it may be months or even years before all of the consequences have become apparent.

### **Direct Litigation Effects of Recent Events**

As might have been predicted, shareholder lawsuits have already been filed against the directors and officers of some of the most prominent companies caught up in the events of Black September 2008.

For example, on September 15, 2008, Merrill Lynch shareholders filed a complaint in New York state court against the company, as nominal defendant, and certain of its directors and officers. The complaint alleges that the company's planned merger with Bank of America is the result of a "flawed process and unconscionable agreement" and that the defendants had breached their fiduciary duty.

*There have also been additional developments and resulting litigation, and it is this further litigation that suggest that the credit crisis litigation wave may now have entered a new, more complex, and perhaps more dangerous, phase.*

Similarly, on September 18, 2008, AIG shareholders filed a Delaware Chancery Court lawsuit against certain current and former directors and officers of AIG. The lawsuit blames the defendants for the company's "exposure to and grossly imprudent risk taking in the subprime lending market and derivative instruments." The lawsuit seeks the return to AIG of all compensation paid to AIG's CEO and to its directors, among other things.

In addition, on September 24, 2008, plaintiffs' lawyers initiated a securities class action lawsuit in the Southern District of New York against certain directors and officers of Lehman Brothers, on behalf of persons who purchased shares in the

company's February 5, 2008 offering of preferred securities. The complaint also names the offering underwriters as defendants. The complaint alleges, among other things, that the offering documents did not accurately reflect the company's true financial condition, because the defendants had failed to appropriately write-down both the company's subprime mortgage portfolio and its portfolio of commercial and residential real estate assets.

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These lawsuits are perhaps the inevitable product of the headline events during September. But along with these more predictable litigation consequences, there have also been additional developments and resulting litigation, and it is this further litigation that suggest that the credit crisis litigation wave may now have entered a new, more complex, and perhaps more dangerous, phase.

### **The "Second Derivative" of the Credit Crisis Litigation Wave**

As widely reported at the time, the Primary Fund money market fund of the Reserve Family of Funds "broke the buck" when its net asset value fell below one dollar per share. On September 18, 2008, plaintiffs' counsel commenced a securities class action lawsuit in the Southern District of New York on behalf of persons who purchased shares of the Primary Fund between September 28, 2007 and September 16, 2008, against the Fund's underwriters, investment advisor and officers and directors.

The complaint alleges that the Fund's offering documents failed to disclose, among other things, "the lack of diversification of the Fund's assets and exposure to, at a minimum, now largely worthless debt securities valued at \$785 million of the now defunct Lehman Brothers Holdings, Inc."

The circumstances of this lawsuit represent something of a second derivative of the subprime and credit-related crisis. That is, the subprime meltdown led to problems with certain real estate assets and investments at Lehman Brothers, which ultimately led to Lehman's collapse, which in turn caused Lehman's debt securities to lose substantially all their value, which undermined the net asset value of the Primary Fund and harmed its investors.

The Reserve Fund case is not the only example of the "second derivative" lawsuit. For instance, on September 22, 2008, plaintiffs' lawyers filed a securities class action lawsuit in the Southern District of New York against Constellation Energy Group (an

electric utility holding company) and certain of its directors and officers. The complaint alleges that on September 15, 2008, after it was already reeling from accounting-related issues and the possibility of a rating downgrade, the company announced its exposure to Lehman Brothers' bankruptcy, which affected the company's ability to engage in energy-related trades. Among other things, the complaint alleges that the company's "exposure to credit problems of trading partners was much greater than represented" and that "in fact, one of Constellation's key trading partners, Lehman, was having severe financial problems."

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The Constellation Energy lawsuit raises a number of different allegations against the defendants and the allegations relating to Lehman's collapse represent only a part of the issues involved. Nevertheless, the lawsuit demonstrates that the reverberations from recent events are spreading far beyond the high profile financial services companies whose names have been prominently featured in the press.

The reverberations from this latest phase of the credit crisis are rippling through the entire economy, encompassing a broad array of participants, many of whom themselves have little or no direct exposure to subprime-related assets or investments. However, these companies have exposures to other companies that had exposures to mortgage-related assets and investments.

*The consequences from the events that began in September 2008 are enormous and will continue to ripple through the financial markets and the general economy for months to come.*

The organizations involved in the aforementioned litigation are far from the only ones that have been harmed by an exposure to losses during the latest phase. During the last several days, a number of other companies have announced the impact from the recent round of bailouts and bankruptcies on their financial condition. Among companies that have announced losses due to events at Lehman, AIG and Washington Mutual, as well as at Fannie Mae and Freddie Mac, are Consec and Progressive Corporation. Similarly Fitch Ratings issued a ratings warning regarding Hartford Financial Services Group because of the company's asset exposures to securities and other instruments issued by AIG, Lehman and Washington Mutual. (Hartford subsequently completed a \$2.5 billion financing through Allianz to shore up its balance sheet.)

The losses on these and related investments are widespread and will affect a wide variety of companies. A multitude of other companies have announced or will announce similar losses – it is only a matter of time. Naturally, not all of these companies will become involved in litigation as a result - but some of them will.

One of the questions that has long been raised about the subprime and credit crisis-related litigation wave was whether it would eventually spread beyond the financial sector. It remains to be seen whether that will happen in any comprehensive way. But the allegations against Constellation, and the fact that a company like this has been sued, does suggest that the litigation wave could well spread outside the financial sector.

### **Conclusion**

Some time ago, it became apparent that the evolving litigation wave had ceased to be just about the subprime meltdown, but instead related to a larger credit crisis. The credit crisis itself entered a dark new phase in September, and with this evolution of the crisis, a new kind of lawsuit has also emerged. This new wave involves companies lacking any direct exposure to subprime-related assets or investments - but that nevertheless experience losses because of their exposure to companies that are suffering credit crisis reversals. Whether this new wave will grow or spread outside the financial sector in a dramatic fashion remains to be seen.

In any event, the consequences from the events that began in September 2008 are enormous and will continue to ripple through the financial markets and the general economy for months to come. Many companies are likely to be affected and some will be sued. The subprime and credit crisis-related litigation wave, which is already well into its second year, clearly has much further to run.

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### About the Author

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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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