

2009 CAS Seminar in Reinsurance

CS-16: The Credit Crisis and Associated Liabilities



Wall Street to Main Street and Back: A Crisis Swelling

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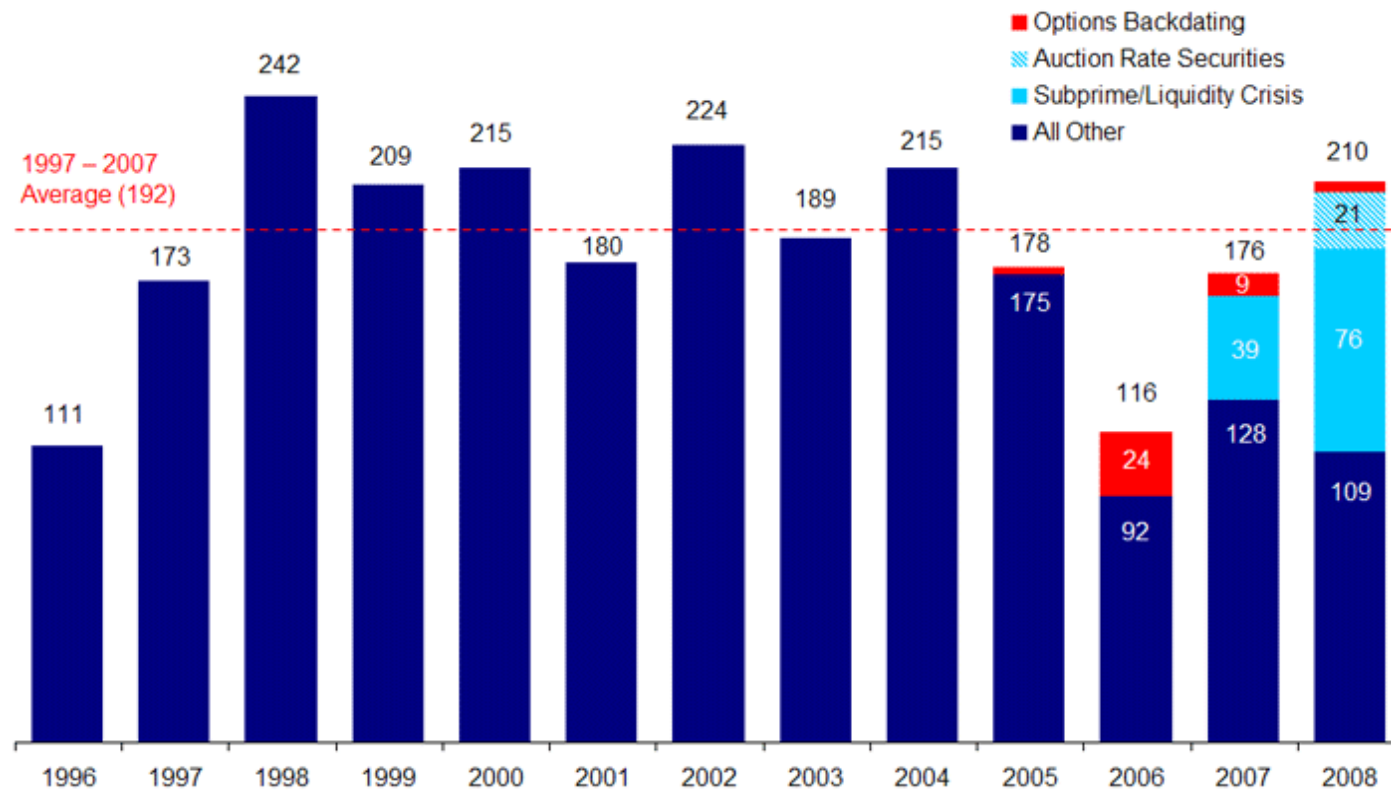
The “Ripple” Effect – How Subprime Spread

- Triggered by bad mortgages and rising defaults; housing bubble bursts
- Securities backed with subprime mortgages plummet in value
- Mortgage cash flow declines and banks' capital levels decrease
- Decrease in capital causes liquidity crunch felt by businesses
- Businesses & Banks suffer and fail
- Economy suffers; jobs are lost
- Bailouts begin



Number of Securities Class Actions Filed

CAF Index™ – Annual Number of Class Action Filings
1996 – 2008



*As of May 7, 2009, 75 Securities Class Actions have been filed. It is expected that 2009 will exceed 2008.

Growing Tide of Lawsuits

- 190 subprime/credit crisis related SCA filed as of May 14th
- 27 subprime/credit crisis related derivative suits
- 24 subprime/credit crisis related ERISA/401(k) suits
- In 07 and 08, Financial Institutions, comprising 2/3 of the Financial Sectors Market Cap, were subject of a SCA
- Over 100 Federal and State Regulatory Investigations

Policy Types Implicated

D&O Policies - Traditional A, B & C Coverage

- Directors and officers sued for malfeasance, reimbursed by company
- Securities class action

D&O - Side A Only Policies

- Directors and officers sued for malfeasance, personally, NOT reimbursed by company

E&O Policies

- Claims that companies failed to perform their services properly for others (brokerages, ratings agencies, etc.)

Fiduciary Policies

- Claims against companies for failing to manage pensions, retirement benefits etc.

EPL Policies

- Impact Unlikely – employment law claims only

D&O and E&O Liability

Directors & Officers Liability provides financial protection for the directors and officers for claims regarding the performance of their management duties as they relate to the company

Errors & Omissions Liability provides coverage for performance failures and negligence with respect to a company's products and services

D&O and E&O Liability Claims – Financial Institutions

Defendants

- Mortgage Originators
- Mortgage Securities Issuers/Underwriters
- Traded Mortgage Backed Securities
- Valued Mortgage Backed Securities
- Funds/Bonds invested with Mortgage Backed Securities

Allegations of Liability Theories

- Pressured/Faulty Appraisal Practices
- Purchase/Funding of Mortgages for Investment, Securitization, and Trading
- Maintenance on Balance Sheets
- Intentionally Concealed/Improperly Valued

D&O and E&O Liability Claims – Rating Agencies

Defendants

- Raters of Mortgage Backed Securities
- Rating was “in fact” Structuring of Securities
- Raters of Holders of “Toxic Assets”
- Evaluators of Mortgage Backed Securities

Allegations of Liability Theories

- Intentionally Delaying of Downgrading Based on Conflict of Interest
- Role was more than Rating, but Structuring
- Knowingly/Recklessly Disregarded their own Valuation Models
- Knew of Lacking or Improper Appraisal Practices

D&O and E&O Liability Claims – Home Builders

Defendants

- Construction and Marketing of Mortgages

Allegations of Liability Theories

- Misrepresented their own Financial Prospects and Level/Sale of Inventory
- Knowingly Originated/Marketed Mortgages with High Risk of Default
- Concealed “Soft” Demand for Homes

Current Litigation

- **A number of subprime SCA MTDs have been granted**
 - PSLRA – half of SCAs are dismissed during the pleadings stage
 - Stoneridge, Tellabs & Dura – additional hurdles for plaintiffs
- **Many MTDs have denied or denied in part**
 - Countrywide
 - New Century
- **Increasing Defense Costs**
 - Multiple motions be filed; lengthening duration of litigation
 - Trend to opting out of federal SCAs and pursuing individual state actions
- **Attempting to include additional parties to lawsuits:**
 - Accountants
 - Law Firms
 - Investment Advisors

Fiduciary Liability

Provides protection for fiduciaries of employee benefit plans against legal liability arising out of their role as fiduciaries, including the cost of defending those claims that seek to establish such liability

- High number of ERISA 401(k) class actions filed as a result of the deterioration of subprime investments
- Compared to D&O policies, FL policies have lower retentions and charge less premium
- Subprime ERISA suits have not been dismissed as readily as their D&O counterparts

Employment Practices Liability

EPLI provides coverage for employers for claims arising from employment-related allegations including: discrimination, wrongful termination, sexual harassment, etc.

- Claims are increasing in frequency and severity as a result of the U.S. economic downturn
- Many companies are being required to conduct Reductions-in-Force (“RIFs”) in order save on expenses
- Changes in the government due to the elections in November may result in more pro-employee legislation and more activity in the EEOC and DOL
- Cases can be expensive to prosecute and defend

Bankruptcy, Bailouts & Mergers

Bank Failures

- 25 bank failures in 2008; 21 occurring in the last half of the year
- 33 bank failures in 2009 as of May 8th

Bankruptcies

- "major" filings reached 231 in 2008 (Lehman, AIG, Indymac)
- 90 "major filing in Q1 2009 (BearingPoint, Nortel Networks, Sun-Times)

Bailouts

- \$700 billion bailout known as TARP, used to prop up banks and car companies
- Through April 30, the government's commitments total about \$12.2 trillion

Mergers & Acquisitions

- Shareholder claims regarding major mergers

Ponzi Schemes – New Wave

- Schemes which worked when the economy was healthy crash down in the economic downturn
- Two biggest schemes of late are Madoff and Stanford
 - Madoff is estimated to have defrauded investors of \$50B; Largest Ponzi scheme on record
 - Stanford's scheme was worth \$9B
- Various claims made against hedge funds, investment advisors, non profits, etc.
- More scandals are expected to be revealed as the economy continues to worsen



Charles Ponzi

Credit Crisis Future

- Continued bankruptcies and bailouts
- Spreading to Retail Industry
- Recession continuing
- More government interaction and legislation

- More claims...

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