Coalition for Mortgage Industry Solutions

CMIS Executive Leadership Summit

Assessing the Mortgage, Credit, and Capital Markets Crisis and Exploring Industry-Based Solutions

June 17, 2008

Dickstein Shapiro LLP
Potomac Conference Center

Coalition for Mortgage Industry Solutions

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Executive Leadership Summit
Agenda

June 17, 2008
8:30AM – 5:30PM

Dickstein Shapiro
Potomac Conference Center
1825 Eye Street NW
Washington, 20006

8:30 – 9:30AM
Registration & Continental Breakfast

9:30 – 10:00AM
Welcome
Michael E. Nannes, Chairman, Dickstein Shapiro LLP

Opening Remarks
Richard I. Rydstrom, Esq., Chairman, CMIS

Overview of the Crisis and State of the Marketplace
Andrew J. Sherman, General Counsel, CMIS

10:00 – 10:30AM
Morning Keynote
Wilbur L. Ross Jr., Chairman & CEO, WL Ross & Co. LLC

10:30 – 11:45AM
Panel One: Impact on Capital Markets, Financial Institutions, Consumers, and Communities

Moderator: David M. Dworkin, CEO and Founder, Affiniti Network Strategies, LLC

Douglas G. Duncan, Vice President and Chief Economist, Fannie Mae

Richard H. Neiman, Superintendent of Banks, New York State Banking Department

Rick Sharga, Vice President, RealtyTrac, Inc.

11:45 – 12:00PM
Break

12:00 – 1:15PM
Luncheon with Keynote Speaker

Marc H. Morial, President and CEO, National Urban League, Former Mayor, City of New Orleans, Former President of the U.S. Conference of Mayors

1:15 – 1:30PM
Break

1:30 – 2:45PM
Panel Two: Effective Loss Mitigation – Workouts that Work (and Those That Don't)

Moderator: Richard Rydstrom, Esq., CMIS

Bruce Dorpalen, Co-Founder, Director of Housing Counseling, ACORN Housing Corporation

Arnold Gulkowitz, Partner, Bankruptcy Practice, Dickstein Shapiro LLP

Patricia A. Hasson, President, Consumer Credit Counseling Service of Delaware Valley, Inc.

Steven Horne, President, Wingspan Portfolio Advisors, LLC

Andrew Jakabovics, Associate Director for the Economic Mobility Program, Center for American Progress

Laurie Maggiano, Deputy Director, Office of Single Family Asset Management, U.S. Department of Housing and Urban Development

2:45 – 3:00PM
Break

3:00 – 4:15PM
Panel Three: Charting a Future Course – The Case for Self-Regulation

Moderator: William LeRoy, AFN

R. K. Arnold, President and CEO, MERSCORP, Inc.

Francis P. Creighton, Vice President of Legislative Affairs, Mortgage Bankers Association

Henry E. “Hank” Hildebrand, Chapter 13 Trustee

Robert Klein, Chief Executive Officer, Safeguard Properties

Hon. Raymond T. Lyons, U.S. Bankruptcy Court, District of New Jersey

Debra L. Miller, Chapter 13 Trustee

George W. Stevenson, Chapter 13 and 7 Trustee

Carolyn A. Taylor, Partner, Hughes, Watters & Askanase LLP

4:15 – 4:30PM
Closing Keynote
Congressman Thaddeus McCotter (MI-11)

4:30 – 4:45PM
Closing Remarks

4:45 – 5:30PM
Cocktail Reception

Coalition for Mortgage Industry Solutions

Summit Organizing Committee

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Richard Ivar Rydstrom, Esq.

David M. Dworkin

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Dickstein Shapiro LLP
CMIS General Counsel

Dickstein Shapiro LLP, founded in 1953, is a multiservice law firm with more than 400 attorneys in Washington, DC, New York, and Los Angeles, representing clients in diverse industries with a wide variety of requirements. While Dickstein Shapiro's work generally originates from a client's need for legal representation, the Firm is mindful that legal service is but one ingredient in achieving a client's strategic business goals. The Firm prides itself on learning and understanding client objectives and partnering with clients to generate genuine business value and has a long history of providing clients with creative and sophisticated strategies to resolve complex, multifaceted disputes.

Dickstein Shapiro is proud that the diversity of its clients coincides with the diversity of its practice. The Firm's clients include more than 100 of the *Fortune* 500 companies, as well as start-up ventures and entrepreneurs, multinational corporations, leading financial institutions, major motion picture studios, charitable organizations, and government officials. Dickstein Shapiro's core practice groups—Antitrust & Dispute Resolution, Business & Securities Law, Corporate & Finance, Energy, Government Law & Strategy, Insurance Coverage, and Intellectual Property—involve the Firm in virtually every major form of counseling, litigation, and advocacy. Detailed descriptions of each practice, and biographies of individual attorneys, are available at dicksteinshapiro.com or upon request.

Richard Ivar Rydstrom, Esq.
CMIS Co-Founder and Chairman

Richard Ivar Rydstrom is the Co-Founder and Chairman of the Coalition for Mortgage Industry Solutions. The Coalition for Mortgage Industry Solutions (or CMIS) seeks to supply a neutral forum and framework to foster dialogue necessary to convert diverse self-interests into comprehensive solutions or priorities for all industry participants, as well as borrowers and consumers. All related trade associations, industry and consumer leaders are invited to join and participate. The Coalition will act as a policy institute or think tank, a repository and reconciliation clearinghouse, as well as a facilitator of self-regulating solutions in the mortgage, housing and capital markets.

Over 27 years ago Mr. Rydstrom began his career working for banks (such as Westside Federal Savings & Loan and Nationwide) in New York City as an accountant and auditor with respect to mortgage originations, loan pools, fraud detection and as an FBI interface. Richard has earned a J.D. in Law, a Bachelor of Science in Professional Accountancy, an International Law Certificate from Cambridge Law School in England, and an LL.M. in Taxation. Richard is a member of the Association of American Trial Lawyers (ATLA) and practices law in California. His practice includes litigation and transactional matters concerning consumers and business, banking, mortgages, finance, real estate, foreclosures, loan buy backs, trusts, contracts, legal risks and asset protection planning, and select special engagements regarding international business, SOX, bankruptcy, taxation and insurance matters.

In January 2007, Mr. Rydstrom was published by the 110th Congress, House Ways & Means Committee in hearings held by Chairman Charles Rangel on the State of the Economy and Challenges Facing the Middle Class, Homeownership & Retirement (republished in Pepperdine's Journal of Business Entrepreneurship and the Law). Richard created TID™ (Truly Intelligent Disclosures™), SHILO™ (Safe Harbor Intelligent Loan Options™),OptinSafeHarbors™,OptinCramDowns™, SharedBuiltInEquityMortgages™, Foreclosure Mortgage Investment Insurance Funds™ (FMII™), and HotNeutral™ to reconcile and equalize the bargaining power between the lenders and homeowners in mortgage loan workouts and modifications.

He has authored numerous industry articles including the Public Educational Outreach Booklet entitled *13 Homeowner Solutions to Default & Foreclosure, "Zone of Insolvency" Meets the "Zone of Coverage" in the Mortgage Meltdown" – Liability Lessons from the Official Take-Under of Bear Stearns, The National Mortgage Meltdown and the Collapse of the Shadow Banking System, Helping Homeowners Keep Their Homes, and Lenders Keep Their Loans, The New Liability Circle, From Enron to*

Martha! and 12 New Rules to Keep You & Your Client Out of Corporate Jail! [2003 Update re SOX – Sarbanes-Oxley; FASB, GAAP].

Richard has been recognized as a Spotlight personality in B*rokers News* (October Research Company), *MortgageOrb's* Person of the Week, among others.

Great Elm Solutions
Summit Organizing Committee Member

Great Elm Solutions is a management consulting firm pioneering a new model for a vital U.S. workforce. Our mission is to provide companies with dual advantages:

- Experts in your industry, when you need them, at a reasonable cost
- A well-trained workforce that gives you an alternative to the offshoring of jobs.

We specialize in helping clients resolve the complex business challenges they face today while positioning them to optimize their growth opportunities for tomorrow. We implement practical solutions that deliver immediate results as we develop sustainable and competitive long-term strategies.

We offer expertise and seasoned insight acquired through years of leadership in a wide range of industries from financial services and telecommunications to law and government. Our clients span from emerging companies coping with challenges of growth and competition to Fortune 100 firms looking to lead their competition by streamlining processes, reducing cost structures, introducing premier products and services, or developing new technical advantages.

Great Elm Solutions is a new-breed consulting company that provides real-world business expertise, results-oriented solutions, strategic guidance, and global market-competitive fee structures to our clients while continuously investing in our local talent and resources.

Coalition for Mortgage Industry Solutions

The American Legal and Financial Network
Summit Organizing Committee Member

The mission of the American Legal & Financial Network® (AFN®) is to serve the Legal and Residential Mortgage Banking Professional through leadership, education and professional development. The AFN is a national network of legal and residential mortgage banking professionals and leads the industry as a provider of strategic and timely education. The largest national organization of its kind; the AFN offers members of the residential mortgage banking community high quality, robust educational and training resources. AFN's educational and training programs are designed to help its members meet the ever present challenges our industry presents. AFN's Onsite, WedED, WedEDPlus and our twice monthly national litigation webinar programs focus on working hand-in-hand with our members and industry partners to build comprehensive learning environments. AFN's membership rosters include professionals from the following segments of the residential mortgage banking community: Legal, Residential Mortgage Bankers and Investors, Risk Evaluation, Investment Research, Consulting, Land and Title, Technology and Asset Protection.

A Brief History of the American Legal & Financial Network (AFN)

The AFN had its beginnings in October of 2001 as an effort to bring residential mortgage industry professionals together. Today the AFN is the largest national organization of its kind and has become a sweeping industry phenomenon. We believe that as members of the residential mortgage community, we are privileged to live and work in an industry that is constantly growing and changing. Our industry is teeming with talented and highly energetic professionals who are overflowing with new ideas and approaches. Attorneys, residential mortgage bankers, and service providers alike are part of this dynamic, and by working together we can become a force for strategic information, quality education, positive innovation and change. We seek members who will join with us to provide the members of the residential mortgage banking industry the education necessary to thrive in a business environment of increasing interdependency and change. We seek to foster a dynamic educational environment where the ever present changes in

our industry offer our members an opportunity to learn and grow. We see the AFN as a leader in education, connection, innovation, and industry wide coordination.

Those of us who are working in the residential mortgage banking industry today will witness significant changes. The AFN will remain focused upon providing the best in education and working with our members to make this industry of ours a better place for all of its stakeholders. "*Change your thoughts and you change your world*," Norman Vincent Peale (1898 - 1993).

RealtyTrac
Summit Organizing Committee Member

Founded in 1996, RealtyTrac publishes the largest and most comprehensive national database of foreclosure and bank-owned homes, with nearly 1.7 million properties from over 2,200 counties across the country. Over 3.5 million homebuyers and investors visit the company's website, www.realtytrac.com, every month. The company publishes the *RealtyTrac Monthly U.S. Foreclosure Report*, which provides a count of the total number of households that have received at least one foreclosure filing – a notice of default, notice of trustee or sheriff sale, or bank repossession – during the prior month. RealtyTrac data is the most widely quoted foreclosure information, and is used by government organizations such as the Federal Reserve, the FBI, OFHEO and the Senate Economic and Banking Committees, and by numerous state and local governments. With corporate offices in Irvine, CA, the company also publishes a blog at www.foreclosurepulse.com, and a monthly subscription-based newsletter, *The Foreclosure News Report*™.

Coalition for Mortgage Industry Solutions

June, 2008

Welcome:

As you know, the mortgage, finance, and credit industries are struggling to deal with one of the greatest challenges of our time. Many assumptions once held as foundational, like the nation-wide stability of home values, and the attendance of market liquidity, has been shattered. Great institutions have been harmed, and millions of consumers have seen their American Dream turned into a nightmare. The fallout of the mortgage meltdown has been felt worldwide.

Industry leaders, state and federal regulators and enforcement agencies, politicians and interest groups are struggling to develop solutions to this crisis. But appropriate self interests are not always aligned and at a time when discussion, debate and compromise is most needed, it is often most difficult.

This is why we have formed the Coalition for Mortgage Industry Solutions. Our aim is to provide a neutral forum and framework to foster dialogue necessary to convert diverse self-interests into comprehensive solutions or priorities for all industry participants, including borrowers and consumers. All related trade associations, industry and consumer leaders are invited to join and participate.

The Coalition will act as a policy repository and reconciliation clearinghouse, as well as a facilitator of self-regulating solutions in the mortgage, housing and capital markets. The Coalition will bring together the brightest and the best minds to explore comprehensive solutions in the mortgage, housing and capital markets.

There are many organizations that are working to address individual aspects of the current mortgage crisis. The Coalition for Mortgage Industry Solutions will bring all parties working on these issues together to create a framework for additional creative thinking and solutions, and to promote greater coordination and reconciliation of current activities and issues.

Richard Ivar Rydstrom, Esq.

Chairman, Coalition for Mortgage Industry Solutions™

www.mortgagecoalition.org

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R.K. Arnold
President & CEO

R.K. Arnold serves as President & CEO of MERSCORP, Inc. and its subsidiary, Mortgage Electronic Registration Systems, Inc. He joined MERS at its inception in 1996, and served as Senior Vice President & General Counsel until his promotion to President in 1998. He is a member of the MERS Board of Directors. His team has built MERS into the central electronic registry for the mortgage finance industry.

MERS achieved profitability in 2001 and now registers more than half the mortgage loans originated in the United States. The company's goal is a 100% market share nationwide. MERS enables its members to eliminate the need to record assignments by acting as a placeholder for all its members in the local land records. This reduces unnecessary paperwork and makes buying a home more efficient and less expensive. MERS registers loans in every county in every state and serves both the residential and commercial markets. Most recently, the company launched the MERS® eRegistry, which tracks electronic promissory notes and represents the future of mortgage lending.

As General Counsel, R.K. managed the successful effort to gain regulatory approval for MERS to serve as original mortgagee of record on uniform security instruments. He orchestrated approval of the Rules Governing Membership in MERS and played a major role in defining the business requirements for development of the MERS® System. Before joining MERS, he served as Vice President & Corporate Counsel at AT&T Universal Card, practiced law with Holloway, Dobson, Hudson & Bachman, and held management positions with USAA and Johnson & Johnson.

R.K. is a former U.S. Army Ranger. He and his wife, Lynne, are both from Oklahoma. He holds a B.B.A. in Finance from the University of Oklahoma, an M.B.A. from the University of Dallas and a J.D. from Oklahoma City University.

Francis Creighton
Vice President of Legislative Affairs
Mortgage Bankers Association

Francis Creighton is Vice President of Legislative Affairs at the Mortgage Bankers Association (MBA), where he lobbies Capitol Hill on behalf of affordable housing and other issues important to the real estate finance industry. Before coming to MBA, Francis worked in several capacities on Capitol Hill, most recently as Legislative Director for Congressman Steve Israel.

From 1999-2001, Francis served as a presidential appointee at the US Department of Labor, where he focused on employee benefits in the private sector workplace. He left government at the start of 2001 to be Senior Counsel for Public Affairs at GCI Group, an international public relations consultancy.

Prior to 1999, Francis was Legislative Assistant for Congressman Sam Gejdenson, focusing especially on pension and campaign financing reforms. He also worked in the office of Senator Daniel Patrick Moynihan.

Francis received a Masters Degree in public policy from Georgetown University and a Bachelor of Arts magna cum laude in political science and history from the University at Albany, State University of New York. He is currently an adjunct faculty member of public policy at Georgetown University.

Bruce Dorpalen
Director of Housing Counseling
ACORN Housing Corporation

Bruce Dorpalen is the Director of Housing Counseling for ACORN Housing Corporation (AHC). He developed the AHC housing counseling program originally in Philadelphia in 1986 and in 1991 moved fulltime to directing the AHC housing counseling programs around the country.

Mr. Dorpalen has helped negotiate community reinvestment partnerships with over forty banks and mortgage companies, has developed models for low income mortgage underwriting which are being used extensively by the industry, and has created a number of community-based outreach and education programs to bring in minority, lower income, single parent, immigrant and other underserved populations. The program has provided mortgages to over 100,000 families in 40 cities across the country.

The program has branched out to increase low income people's access to homeowner's insurance, mortgage refinancing, and home equity loans. New programs are being developed to increase the availability of mortgage loans in minority and lower income communities.

He is currently working on increasing the number and quality of affordable mortgage loan workouts for delinquent homeowners. ACORN Housing has a network of 40 mortgage servicers, prime and subprime, where AHC housing counselors can work with senior managers to stop foreclosures and develop sustainable resolutions for the homeowner. He is also working on recovery programs for New Orleans homeowners displaced by Hurricane Katrina.

Mr. Dorpalen has participated in various HUD working groups, and has worked to increase the availability and effectiveness of housing counseling in a variety of forums, including the Office of the Comptroller of the Currency, the Federal Reserve, the U.S. Senate, the Department of Housing and Urban Development, Hope Now, various city and state housing agencies, and the mortgage lending industry. Mr. Dorpalen helped found AHC in 1985.

Before his career with ACORN Housing Corporation, Mr. Dorpalen was a community organizer for the community organization PACE in Providence, RI, a tenant organizer for Brockton Tenants Union, Brockton, MA, and a researcher and lobbyist for Connecticut Citizen Action Group, Hartford, Connecticut. From 1975 to 1985, Mr. Dorpalen was a community organizer for Carolina Action, Georgia Action, and ACORN in Durham, Raleigh, Greensboro, NC, Atlanta, GA, and Philadelphia, PA. He graduated with honors from Brown University in 1974 with a BA in Urban Studies.

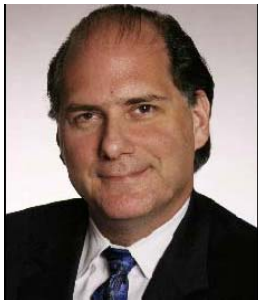
Doug Duncan
Vice President and Chief Economist
Fannie Mae

Douglas G. Duncan is Fannie Mae's vice president and chief economist. He is responsible for managing Fannie Mae's Economics & Mortgage Market Analysis Group. In this leadership role, Duncan provides all economic, housing, and mortgage market forecasts and analyses and serves as the company's thought leader internally and with external constituent groups. Reporting directly to the senior vice president of Business Strategy, Duncan is an important source of information and commentary on the external business and economic environment, and is a leading voice on the economy, housing, and mortgage markets.

Prior to joining Fannie Mae, Duncan served as senior vice president and chief economist of the Mortgage Bankers Association (MBA) since 2000. Duncan served as the primary spokesperson on economic and mortgage market developments and performance for the MBA, a trade group representing 3,000 companies that make the majority of all residential, multifamily, and commercial real estate loans in the U.S.

Prior to joining the MBA in 1992, Duncan worked on Capitol Hill as a LEGIS Fellow and staff member on the Committee on Banking, Finance, and Urban Affairs, and at the U.S Department of Agriculture's Economic Research Service. He has been elected to the Board of Directors for the National Association of Business Economists, is a member of the American Economics Association and the American Real Estate and Urban Economics Association, and is past president of the Housing Statistics Users Group. Duncan is a frequent speaker on national and state economic outlooks and housing and mortgage market conditions, and has been listed in the "Top 100 Most Influential People in Real Estate" by Inman News.

Duncan received his Ph. D. in Agricultural Economics from Texas A&M University and his B.S. and M.S. in Agricultural Economics from North Dakota State University.



David M. Dworkin
CEO and Founder, Affiniti Network Strategies, LLC

Mr. Dworkin is an authority on underwriting and marketing affordable housing mortgages, urban redevelopment and recovery, and catastrophic loss mitigation. He founded Affiniti Network Strategies, LLC after 20 years of experience in government and business, including positions in the House of Representatives, the U.S. Department of State, and a twelve year career at Fannie Mae. There he led the Detroit Partnership Office; the Regional Public Affairs team; and the Community Partners team, which developed and launched the highly successful MyCommunityMortgage affordable home loan and led the Katrina Housing Program following the 2005 hurricane season.

Mr. Dworkin led outreach to 200,000 grass roots supporters in the real estate and mortgage finance industry and managed and executed political strategies with a team of 3,000 affinity contacts (individuals with personal relationships with Members of Congress as well as a business relationship with Fannie Mae). He also managed the production of over 5,000 public events with elected officials in every state in the nation over a four-year period. **The Washington Post** called his team "among the most sophisticated and extensive politicalinfluence machines in corporate America."

Mr. Dworkin came to Fannie Mae from the political communications and consulting firm, Fitzwater & Tutwiler, Inc. His service in the administration of President George H.W. Bush included appointments as the State Department's acting deputy assistant secretary for legislative affairs and senior legislative advisor for Latin America policy. He also worked on Capitol Hill for four years. Prior to his government service, Mr. Dworkin was a freelance correspondent for *The Detroit News*, where he reported on and photographed the war in Afghanistan in the region known as Tora Bora.

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Arnold Gulkowitz
Partner
Dickstein Shapiro LLP

Arnold Gulkowitz joined Dickstein Shapiro LLP's New York office in 2007 as a partner in the Bankruptcy and Creditor's Rights Practice. Mr. Gulkowitz focuses his practice on bankruptcy and debt restructuring, as well as corporate work.

Areas of Concentration

Creditor's Rights

Mr. Gulkowitz specializes in representing creditors' committees, hedge funds, and financial institutions in both domestic and overseas bankruptcy proceedings. Recently, he has been extensively involved in representing hedge funds in maximizing value in various investments in subprime mortgage. He has represented both ad hoc and official creditor committees as well as unsecured creditors in numerous bankruptcy cases. Recently, in one of the largest bankruptcy cases filed in U.S. history—litigation involving Reliance Group Holdings, Inc—his successful representation resulted in an increase in value of more than 2,500 percent to bondholders. In a case involving Cybercash, a computer software company, Mr. Gulkowitz was successful in returning 100 percent of the creditors' claims plus post-petition interest in his capacity as counsel to the official creditors' committee. In addition, he has represented creditors in Comdisco, Geneva Steel, Amerco, Golden Ocean, Hadson, JTS, Koger Properties, and others, in numerous major bankruptcies and restructurings. Mr. Gulkowitz also has represented bondholders in Ometraco, an Indonesian company, in liquidation proceedings, and Mayora, the largest Indonesian agricultural company, in debt restructuring. Recently, Mr. Gulkowitz has been very successful in assisting a private equity firm in maximizing value from subprime derivative products.

Corporate

Mr. Gulkowitz has substantial corporate experience, including mergers and acquisitions, structured finance (credit card receivables, mortgage-backed securities, real estate lease receivables), project finance, and securities. Recently, he represented the purchasers in the acquisition of Chinese manufacturing companies.

Patricia A. Hasson
President
Consumer Credit Service of Delaware Valley, Inc

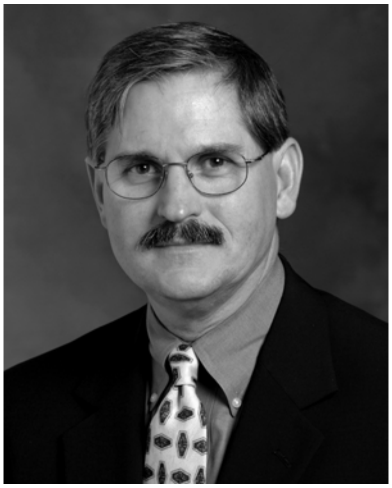
Patricia A. Hasson has served as President and Executive Director of Consumer Credit Counseling Service of Delaware Valley, Inc. (CCCSDV) since 1998. Reporting to the Board of Directors, Ms. Hasson oversees the operation of the agency and its professional and administrative staff. She provides overall vision and direction for the development and administration of agency initiatives, programs and services, policy formulation, and public relations and communication efforts. During her tenure to date, Ms. Hasson has channeled much of her energies and resources into initiating and participating in financial literacy initiatives, benefiting low-moderate income households throughout the Delaware Valley.

In 2007 Ms. Hasson was appointed the Federal Reserve Board Consumer Advisory Council (CAC) for a three-year term. Founded in 1976, the CAC meets with the Board of Governors three times a year to advise the Fed on issues including fair lending, community development and consumer protection. She was recently appointed Vice Chair of the Community Affairs & Housing Committee for the CAC.

She is currently a member of the Board of Directors and the Executive Committee for the Greater Philadelphia Chamber of Commerce and Vice Chair of the Small Business Board for the Chamber. The Philadelphia Business Journal and NAWBO honored her with the 2006 Women of Distinction Award. In 2005 she was awarded the Center City Proprietors Association in Philadelphia Lifetime Achievement Award for her agencies commitment to stabilizing neighborhoods and improving the quality of life for individuals and families in the Greater Philadelphia area. She serves on the steering committee for the Governor's Institute on Personal Finance and Entrepreneurship Education. She and her agency are the lead agency managing the Philadelphia Saves Campaign.

Prior to joining CCCSDV of Delaware Valley, Ms. Hasson spent over twelve years as a banking executive with a diverse consumer and commercial lending background which includes expertise in small business, credit card, education finance, merchant processing and auto finance.

Patricia has an MBA from Villanova University and BS in Finance from the University of Dayton.



Henry E. Hildebrand, III
Office of the Chapter 13 Trustee

Henry E. Hildebrand, III has served as Standing Trustee for Chapter 13 matters in the Middle District of Tennessee since 1982 and as Standing Chapter 12 Trustee for that district since 1986. He also is of counsel to the
Nashville law firm of Lassiter, Tidwell, Davis, Keller & Hogan, PLLC.

Mr. Hildebrand graduated from Vanderbilt University and received his J.D. from the National Law Center of George Washington University. He is a fellow of the American College of Bankruptcy and serves on its Education Committee. He is Board Certified in consumer bankruptcy law by the American Board of Certification. He is Chairman of the Legislative and Legal Affairs Committee for the National Association of Chapter 13 Trustees (NACTT). In addition, he is on the Board of Directors for the NACTT Academy for Consumer Bankruptcy Education, Inc.

Mr. Hildebrand has served as case notes author for *The Quarterly*, a newsletter dealing with consumer bankruptcy issues and Chapter 13 practice in particular, since 1991. He is a regular contributor to the American Bankruptcy Institute *Journal*. He is an adjunct faculty member for the Nashville School of Law and St. Johns University School of Law.

Steven R. Horne
President, Wingspan Portfolio Advisors

Steve is the founder and President of Wingspan Portfolio Advisors, a performance catalyst focusing on innovative solutions for highly delinquent loans. Working with investors, stakeholders, and servicers, Wingspan creates opportunities for extraordinary portfolio returns from exceptional assets.

Previously, Steve was Director of Servicing Risk Strategy with Fannie Mae where he restructured the National Servicing Organization and redesigned servicer performance reporting and legal services management.

Prior to Fannie, he spent nine years as a partner with Sherman Financial Group and Executive Vice President of Sherman's servicing affiliate Resurgent Capital Services. During his 9 years at Sherman he built three of Sherman's most successful business lines:

- HLTV Second Mortgages - purchasing and resolving portfolios of delinquent second mortgages,
- Unsecured Bankruptcy - purchasing and servicing portfolios of credit cards in Chapter 13, and
- Mexican Consumer Lending - the origination and servicing of unsecured peso-denominated loans to Mexican consumers.

Prior to Sherman, Steve founded and was President of MSV, was Director of Default Servicing for Ocwen Financial, RTC supervising attorney for numerous asset management contractors, and an attorney with the Washington, DC law firm of Frank, Bernstein, Conaway & Goldman.

He has a JD from George Washington University and bachelor degrees from Emory University. He is admitted to the bar in Virginia, Maryland, and the District of Columbia.

Andrew Jakabovics
Associate Director for the Economic Mobility Program

Andrew Jakabovics is the Associate Director for the Economic Mobility Program. He works on housing, household debt, and higher education, as well as other issues related to sustaining and growing the middle class. Jakabovics has appeared on television and radio and in print, most recently for his research on the effects of the current mortgage crisis and potential policy solutions. Prior to joining American Progress, Jakabovics served as the research chief of staff for the MIT Center for Real Estate's Housing Affordability Initiative.

In 2004, he founded a grassroots organization, Kiruv for Kerry, which conducted outreach to the Orthodox Jewish community, drafted position papers, and connected policy issues with Jewish principles. He has also lectured on the relationship of Jewish law to the modern, democratic state. Andrew holds a B.A. in Urban Studies from Columbia University and an M.C.P. from the Massachusetts Institute of Technology, where he is currently pursuing his doctorate.

Robert Klein
Founder and Chief Executive Officer
Safeguard Properties, LLC

Robert Klein is the founder and Chief Executive Officer of Safeguard Properties, LLC. Under Robert's leadership, Safeguard has grown from a handful of employees in 1990 to over 400 today with an extensive network of contractors throughout the United States, Puerto Rico, and the Virgin Islands. Robert has developed Safeguard around the doctrine of "Customer Service = Resolution" with the mission of creating a company focused on client satisfaction and strong business relationships. Since Safeguard's inception, Robert has developed and maintained a reputation as an innovator and is recognized as a leader and an advocate for the Industry. Robert continually focuses his attention on initiatives affecting our clients, providing current and relevant industry information and offering creative solutions to meet their needs.

Robert represents not only Safeguard, but the industry as a whole in national associations including MBA, USFN, CMBA and REOMAC. He has been a session leader and panelist at their yearly conferences, in addition to being the primary sponsor of the National Property Preservation Conference in Washington D.C. Robert's Industry leadership was never more evident than during the aftermath of Hurricanes Katrina, Rita and Wilma. Robert proactively initiated a series of eight industry Hurricane Disaster Conference Calls that included more than 300 participants. These conference calls were crucial to the creation of industry consensus in handling issues created in wake of the disasters.

William M. LeRoy
CEO
American Legal and Financial Network

Mr. LeRoy is a seasoned professional with over two decades of management experience in the fields of Law Firm Operations, Technology Solutions and Mortgage Loan Servicing. In the mortgage loan servicing arena, his experience encompassed the administration of residential default servicing functions; including collections, foreclosures, bankruptcies, loss mitigation, claims, real estate owned, investor reporting, securitization and investor accounting.

He is the CEO of the American Legal and Financial Network. In his current position he oversees all corporate initiatives for the corporation, and has aligned the organization to be the largest of its kind in the mortgage banking industry. A well known writer, Mr. LeRoy is nationally recognized for his “out of the box” thinking and innovative approach to problem solving. His articles deal with the resolution of systemic issues affecting the financial services industry.

In his prior legal career, Mr. LeRoy enjoyed senior management positions with the national law firms of Katten, Muchin, Zavis and Lewis, Brisbois, Bisgaard and Smith. In the early 90’s he was Vice President of ARM Financials Post Foreclosure Operations, a division of the LOG’s Financial Group. He was a Director of Strategic Product Development with the London England Based, Global Technology Company, The London Bridge Group and assisted with the conceptual development of a new suite of web based REO and Valuation Product Process Management Systems that are now deployed in-house by Wells Fargo and Countrywide Home Loans, amongst others. Mr. LeRoy also owned and operated a national consulting firm specializing in the due diligence activities associated with defaulting loan portfolio transfers between loan servicing companies. Mr. LeRoy currently holds memberships in the Mortgage Banking Association, REOMAC, CMBA, NHEMA, NALTEA, The National Housing Association, and MISMO.

Honorable Raymond T. Lyons
U.S. Bankruptcy Court
District of New Jersey

Raymond T. Lyons was appointed as a Bankruptcy Judge for the District of New Jersey on April 13, 1999. Prior to taking the bench Judge Lyons was a partner in Connell, Foley & Geiser, LLP of Roseland, New Jersey. Judge Lyons received his Bachelor of Arts degree with a major in mathematics from Lehigh University in 1970 and his Juris Doctor from Seton Hall University School of Law in 1973. In 1981 he was awarded an LLM in taxation from New York University School of Law.

Laurie Anne Maggiano
Deputy Director
Office of Single Family Asset Management
US Department of Housing and Urban Development.

Laurie Anne Maggiano is Deputy Director of the Office of Single Family Asset Management at the US Department of Housing and Urban Development. The Office is responsible for development and oversight of servicing policy for FHA insured loans and the disposition of foreclosed real estate acquired by HUD. A major focus her work involves programs related to foreclosure prevention. Ms. Maggiano was a primary architect of FHA's highly successful loss mitigation program and regularly advises other agencies and organizations seeking to strengthen their foreclosure prevention programs.

Prior to joining the government 9 years ago, Ms. Maggiano had a 25 year career in the private sector including 9 years as Sr. Vice President of Great American Bank, Director of Real Estate Operations for Freddie Mac and 4 years as an independent consultant working with nonprofit housing organizations including Neighborworks.

Congressman Thaddeus McCotter (M1-11)

A life-long resident of southeast Michigan, U.S. Representative Thaddeus McCotter was first elected to Congress in 2002 to represent the citizens of Western Oakland and Western Wayne Counties.

Congressman McCotter has focused his efforts on preserving and promoting manufacturing and small businesses, because he knows they form the back bone of our community's economy. He has steadfastly supported winning the War for Freedom and increasing our homeland security; tirelessly fought to reduce taxes and the size and scope of government; and, most importantly, Congressman McCotter has dedicated every effort to listen to and serve his constituents.

Congressman McCotter was elected by his colleagues in Nov. 2006 to serve as Chairman of the Republican House Policy Committee, a leadership position once held by former Vice President Dick Cheney. Congressman McCotter is also a member of the House Financial Services Committee, where he serves on the Capital Markets, Insurance, and Government Sponsored Enterprises and the Housing and Community Opportunity subcommittees.

Congressman McCotter is a graduate of Catholic Central High School; the University of Detroit; and the University of Detroit Law School. He is a bar admitted attorney by profession. Thaddeus and Rita McCotter, a registered nurse, have three young children, George, Timothy, and Emilia. The McCotter family lives in his home town of Livonia. Congressman McCotter travels to and from our nation's capital every week to serve our community.

Debra Miller
Chapter 13 Bankruptcy Trustee
Northern District of Indiana, Fort Wayne and South Bend Divisions

Debra Miller is the appointed Standing Chapter 13 Bankruptcy Trustee for the northern district of Indiana, Fort Wayne and South Bend Divisions. She is active in the National Association of Chapter Thirteen Trustees and serves as Treasurer of the NACTT executive board and Chair of the NACTT Mortgage Liaison Committee.

Prior to her appointment in 2000, she served as the staff attorney for Gary D. Boyn, Chapter 7 panel Trustee at Warrick and Boyn LLP in Elkhart and as a Law Clerk for the Honorable Sanford Brook.

She is married with two children and in a prior life; Debra served as a Special Agent for the United States Secret Service in the Cleveland Field Office where she specialized in Credit Card and White Collar Fraud.

Marc H. Morial
National Urban League
President and Chief Executive Officer

According to a major publication, "**Marc H. Morial**, a lawyer by profession, is leading the National Urban League into a new era with street smarts and boardroom savvy." Selected in May of 2003 as the 8th President and CEO of the nation's largest and oldest civil rights and direct services organization empowering African Americans and other ethnic communities, Morial has helped thrust the League into the forefront of major public policy issues, research and effective community-based solutions.

From Hurricane Katrina and the extension of the Voting Rights Act to creating jobs and housing through effective economic strategies, he is considered one of the nation's foremost experts on a wide range of issues related to cities and their residents. He has also been recognized by the *Non-Profit Times* as one of America's top 50 non-profit executives and has been named by *Ebony Magazine* as one of the 100 "Most Influential Blacks in America."

Upon his appointment to the League, **Morial** established an ambitious five-point empowerment agenda encompassing Education & Youth, Economic Empowerment, Health & Quality of Life, Civic Engagement and Civil Rights & Racial Justice that informs the League's programs, research and advocacy efforts. He created the new quantitative "Equality Index" to effectively measure the disparities in urban communities across these five areas. The index is now a permanent part of the League's annual and much-heralded *The State of Black America* report.

In 2004, **Mr. Morial** launched the League's first Annual Legislative Policy Conference (LPC) in Washington, D.C. Armed with a common agenda of jobs, education and civil rights, the Urban League leadership (staff, board and volunteers) from across the country served as frontline advocates in discussions with congressional lawmakers. A Black Male Commission was formed to explore and formulate concrete recommendations, solutions and programs to address the alarming inequities, disparities and social trends disproportionately affecting black males. Morial also established the Urban Entrepreneur Partnership (UEP), combining public and private sector resources to support business development growth among minority entrepreneurs. Under Morial's economic agenda, five economic empowerment centers have been established; and $127.5 million has been secured in new market tax credits for business financing.
Prior to joining National Urban League, **Morial** served two distinguished four-year terms (1994-

2002) as Mayor of New Orleans, maintaining a 70% approval rating. During his tenure, crime fell by 60%; a corrupt police department was reformed; and $400 million was appropriated for city infrastructure improvements, including the construction of 15,000 new homes, 200 miles of streets, a new sports arena and the expansion of the convention center. He also brought the NBA's Hornets basketball team to New Orleans and was president of the U. S. Conference of Mayors.

Before becoming mayor, **Morial** served as a Louisiana State Senator for two years. He holds a bachelor's degree from the University of Pennsylvania, a law degree from the Georgetown University Law Center and honorary doctorate degrees from Xavier University and the University of South Carolina Upstate.

DICKSTEINSHAPIRO LLP

Michael E. Nannes
Chairman
Dickstein Shapiro LLP

Michael Nannes was elected Chairman of Dickstein Shapiro in 2006 after serving as Firmwide Managing Partner of Dickstein Shapiro since 2004, and as Deputy Managing Partner for 10 years. Mr. Nannes provides leadership and strategic direction for the legal and business areas within the Firm. He oversees every aspect of the Firm's operations, working closely with five department officers—Finance, Operations, Marketing, Human Resources, and Information Systems. Under his leadership, the Firm has established its first California office (in Los Angeles), has substantially grown its New York office, and has received recognition for its diversity and quality-of-life programs in numerous high-profile business and trade publications.

Areas of Concentration

Firm Administration

Mr. Nannes works closely with the Firm's Associates' Committee and Diversity Committee, and often is invited to speak at programs focused on matters of particular interest to law firms such as growth, mergers, and hiring.

Committed to the Firm's core values of excellence, loyalty, respect, initiative, and integrity, Mr. Nannes was instrumental in the development of the Firm's Quality of Life programs, which include paternity leave, nanny care, "managed time" arrangements, and "Dickstein Shapiro University," which offers a variety of classes in specific areas of professional growth and personal development. As a result of these progressive programs, Dickstein Shapiro was the first large law firm to receive The Bar Association of the District of Columbia's Constance L. Belfiore Quality of Life Award in 1999. The recognitions have continued, including rankings in the November 2003 "Great Places to Work – 6 Best Law Firms" issue of *Washingtonian Magazine* and the June 2005 "50 Best Places to Work in Greater

Washington" issue of *Washington Business Journal.* Furthermore, the Firm's diversity efforts have been recognized recently in *Multicultural Law* magazine's "2005 Top 100 Law Firms for Diversity," and in Vault's *Guide to the Top 100 Law Firms*, 2005 and 2006 Editions, which ranked Dickstein Shapiro in the overall "Best 20 Law Firms for Diversity," as well as in the "Top 20 for Diversity" categories specifically related to Minorities, Gays and Lesbians, and Women. In August 2002, the Firm also was awarded the American Bar Association's National Association of Women Lawyers President's Award for a "strong record of support for the advancement of women in the law." In September 2006, Mr. Nannes was named a Women's Bar Association "Star of the Bar," an award that recognizes members of the Washington, DC legal community who have "made a difference in the professional lives of women attorneys by encouraging their advancement and retention."

Legal Practice

Prior to becoming Managing Partner, Mr. Nannes focused his legal practice on matters related to energy and construction, project finance, privatization, and commercial arbitrations. He participated in the development of numerous infrastructure projects, including electric power plants, both domestic and international. He also developed and evaluated RFPs, negotiated contracts, and integrated contracts into complete financings.

NEW YORK STATE
BANKING DEPARTMENT

Richard H. Neiman
Superintendent of Banks

Richard H. Neiman was appointed on March 5, 2007 by Governor Eliot Spitzer to serve as the Banking Department's 43rd Superintendent. Prior to his appointment, Mr. Neiman accumulated extensive experience in the financial industry from a range of perspectives in executive, regulatory, and legal roles. Immediately prior to joining the Banking Department, Mr. Neiman served as President and Chief Executive Officer of TD Bank USA, N.A., a wholly-owned subsidiary of The Toronto-Dominion Bank.

Mr. Neiman began his career with the Office of the Comptroller of the Currency in Washington, D.C. where he served as Special Assistant to the Chief Counsel. After the Comptroller's Office, he spent 10 years at Citicorp, where he held a variety of legal and regulatory positions, including General Counsel of its Global Equities Group. Mr. Neiman then returned to Washington, D.C. to serve as Director of Regulatory Advisory Services for Price Waterhouse.

In 1994, Mr. Neiman joined TD Waterhouse Group, Inc., a bank holding company and leading global online financial services firm, as Executive Vice President and General Counsel. He remained with TD Waterhouse until its acquisition by Ameritrade in 2006.

Mr. Neiman holds a B.A. degree in political science from American University, School of Government and a J.D. degree from Emory University School of Law.

Mr. Neiman is on the Board of Directors and is a Vice President of the Henry Street Settlement, one of New York's oldest social services organizations. He also serves on the Board of the Harlem Educational Activities Fund, a mentoring and college preparatory organization serving students in Harlem and Washington Heights.

Wilbur Ross
CEO
WL Ross & Co. LLC

Wilbur Ross, CEO of WL Ross & Co. LLC, may be one of the best known private equity investors in the U.S. His private equity funds bought Bethlehem Steel and several other bankrupt producers and revitalized them into the largest U.S. producer before merging them into Mittal Steel for $4.5 billion. Mr. Ross remains a Director of what is now ArcelorMittal, the world's largest steel company. He also created and chairs International Coal Group; International Textile Group, the most global American company in that industry; and International Auto Components Group, a $4.5 billion producer of instrument panels and other interior components, operating in 17 countries; and Compagnie Europeenne de Wagons Sarl, the largest rail car leasing company in Europe.

Mr. Ross was Executive Managing Director of Rothschild Inc. for 24 years before acquiring that firm's private equity partnerships in 2000. He is a Board Member of the Whitney Museum of American Art, Yale University School of Management, Japan Society, Partnership for New York City, Palm Beach Civic Association, Business Roundtable, Harvard Business School Club of New York, the Committee on Capital Markets Regulation, the Harvard University Committee on University Resources and the Chairman's Council of the U.S./India Business Council. President Kim Dae Jung awarded him a medal for his assistance in Korea's financial crisis, President Clinton appointed him to the Board of the U.S.-Russia Investment Fund and he served as Privatization Advisor to New York Mayor Rudy Giuliani. China Institute has presented him with its Blue Cloud Award. Mr. Ross formerly served as Chairman of the Smithsonian Institution National Board.

Mr. Ross is a graduate of Yale University and of Harvard Business School (with distinction).

Richard Ivar Rydstrom, California Attorney At Law,
J.D. Law, Bachelor of Science in Public Accounting, LL.M. Taxation

Richard Ivar Rydstrom is the Co-Founder and Chairman of the Coalition for Mortgage Industry Solutions. The Coalition for Mortgage Industry Solutions (or CMIS) seeks to supply a neutral forum and framework to foster dialogue necessary to convert diverse self-interests into comprehensive solutions or priorities for all industry participants, as well as borrowers and consumers. All related trade associations, industry and consumer leaders are invited to join and participate. The Coalition will act as a policy institute or think tank, a repository and reconciliation clearinghouse, as well as a facilitator of self-regulating solutions in the mortgage, housing and capital markets.

Over 27 years ago Mr. Rydstrom began his career working for banks (such as Westside Federal Savings & Loan and Nationwide) in New York City as an accountant and auditor with respect to mortgage originations, loan pools, fraud detection and as an FBI interface. Richard has earned a J.D. in Law, a Bachelor of Science in Professional Accountancy, an International Law Certificate from Cambridge Law School in England, and an LL.M. in Taxation. Richard is a member of the Association of American Trial Lawyers (ATLA) and practices law in California. His practice includes litigation and transactional matters concerning consumers and business, banking, mortgages, finance, real estate, foreclosures, loan buy backs, trusts, contracts, legal risks and asset protection planning, and select special engagements regarding international business, SOX, bankruptcy, taxation and insurance matters.

In January 2007, Mr. Rydstrom was published by the 110th Congress, House Ways & Means Committee in hearings held by Chairman Charles Rangel on the State of the Economy and Challenges Facing the Middle Class, Homeownership & Retirement (republished in Pepperdine's Journal of Business Entrepreneurship and the Law). Richard created TID™ (Truly Intelligent Disclosures™), SHILO™ (Safe Harbor Intelligent Loan Options™), OptinSafeHarbors™, OptinCramDowns™, SharedBuiltInEquityMortgages™, Foreclosure Mortgage Investment Insurance Funds™ (FMII™), and HotNeutral™ to reconcile and equalize the bargaining power between the lenders and homeowners in mortgage loan workouts and modifications.

He has authored numerous industry articles including the Public Educational Outreach Booklet entitled 13 *Homeowner Solutions to Default & Foreclosure, "Zone of Insolvency" Meets the "Zone of Coverage" in the Mortgage Meltdown" – Liability Lessons from the Official Take-Under of Bear Stearns, The National Mortgage Meltdown and the Collapse of the Shadow Banking System, Helping Homeowners Keep Their Homes, and Lenders Keep Their Loans, The New Liability Circle, From Enron to Martha! and 12 New Rules to Keep You & Your Client Out of Corporate Jail! [2003 Update re SOX – Sarbanes-Oxley; FASB, GAAP]*. Richard has been recognized as a Spotlight personality in Brokers News (October ResearchCompany), MortgageOrb's Person of the Week, among others.

Rick Sharga
Senior Vice President, RealtyTrac Inc.

Rick is responsible for building and maintaining the RealtyTrac brand, corporate positioning and messaging, public and investor relations, and business development activities. As a spokesman for the company, Rick has been quoted extensively in the press on foreclosure, mortgage and real estate trends, and appeared on NBC Nightly News, CNN, CBS, ABC World News, CNBC, MSNBC and NPR.

Prior to joining the company, Rick spent more than 20 years developing corporate and product branding strategies for technology start-up companies and international corporations such as DuPont, Fujitsu, Hitachi and Toshiba. Rick created and executed successful sales and marketing programs in B2B, technology, consumer electronics and retail for companies like JD Edwards, Cox Communications and Honeywell.

The 2006 Stevie® Award Winner for Best Marketing Executive, Rick began his career with Foote, Cone & Belding, and also held executive positions with Ketchum Communications and McGraw-Hill. He founded his own consulting firm, CJ Patrick Company, in 2002 to help companies develop business and brand strategies that clearly communicate a unique value proposition, create a position of competitive advantage, and leverage the strength of their brands in the marketplace.

Rick is a member of the National Association of Real Estate Editors and the Public Relations Society of America. He is Vice President of the Technology Council of Southern California and on the Advisory Board of *Default Servicing News*.

A nationally-recognized speaker on Branding, Rick spends his spare time working toward a black belt in Tae Kwon Do with his 12-year-old son, and trying to keep up with his increasingly-mobile 6-year-old daughter. He also continues in his lifelong quest to find the perfect wine to compliment his BBQ'd baby back ribs.

DICKSTEINSHAPIRO LLP

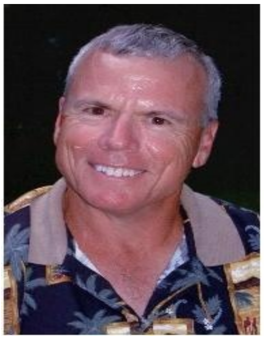
Andrew J. Sherman
Partner
Dickstein Shapiro LLP

Andrew Sherman joined Dickstein Shapiro as a partner in the Corporate & Finance Practice in February 2005. Mr. Sherman focuses his practice on issues affecting business growth for companies at all stages, including developing strategies to leverage intellectual property and technology assets, as well as international corporate transactional and franchising matters. He has served as a legal and strategic advisor to dozens of *Fortune* 500 companies and hundreds of emerging growth companies. Mr. Sherman has represented both U.S. and international clients anywhere from early stage, rapidly growing start-ups, to closely held franchisors and middle market companies, to multibillion-dollar international conglomerates. He also provides counseling on such issues as franchising, licensing, joint ventures, strategic alliances, capital formation, distribution channels, technology development, and mergers and acquisitions.

Areas of Concentration

Mr. Sherman's practice involves general corporate law, franchising, emerging business, mergers and acquisitions, intellectual property transactions, and capital formation. He has served as securities counsel on a wide variety of private and public offerings, and as transactional counsel to both buyers and sellers in mergers, acquisitions, spin-offs, leveraged buy-outs, acquisitions of and reorganizations for Chapter 11 companies, and management buy-outs. He prepares, negotiates, and reviews loan proposals and general corporate and business agreements such as shareholders agreements, extensive employment contracts, distribution and sales agency agreements, joint venture agreements, technology transfer agreements, and related corporate documentation.

Mr. Sherman has served as counsel in a diverse range of business industries such as high technology, specialty retailing, consumer electronics manufacturers, restaurants, automotive aftermarket services, Internet service providers, database management companies, financial services and venture capital, communications, manufacturing, healthcare services, recreation and entertainment, transportation, and computer services. He also has served as counsel on international corporate matters in more than 30 countries.



George Stevenson
Chapter 13 Trustees for the Bankruptcy Court
Western District of Tennessee

George Stevenson has served as one of the Standing Chapter 13 Trustees for the Bankruptcy Court for the Western District of Tennessee for the last twenty-six years. He has served as a Chapter 7 Trustee for twenty years. During his tenure, he has administered more than 300,000 bankruptcy cases and has been involved in the collection and disbursement of more than $2.6 billion.

Mr. Stevenson is a past president of the National Association of Chapter 13 Trustees, and he is the current president and acting CEO of the National Data Center. Mr. Stevenson holds degrees from the University of Texas at Austin, the University of Memphis and Middle Tennessee State University. He is a proud veteran of the United States Air Force and is a practicing attorney

Carolyn A. Taylor

Carolyn A. Taylor is a partner in the Houston law firm of HughesWattersAskanase L.L.P. where her practice is concentrated in the areas of mortgage banking, credit union law, and creditor's rights. A magna cum laude graduate of the University of Denver, Ms. Taylor earned her J.D. degree from Emory University (Order of the Barristers). She is certified by the Texas Board of Legal Specialization in Consumer Bankruptcy Law (1985) and Business Bankruptcy Law (1989)

Ms. Taylor manages the firm's default servicing group and was instrumental in implementing the internal policies and procedures that enable her team to provide exemplary service. The selection to participate in the Freddie Mac Designated Counsel Program (Texas) and receipt of the Service Excellence Award (2005-2007) and the Summit Award (2006-2008) given annually by Fidelity National Default Solutions pinnacle that collective teamwork.

Ms. Taylor is a member of the State Bars of Texas and Georgia, the American Bar Association, the national and Texas Mortgage Bankers Associations, the American Legal & Financial Network (Texas), the Default Attorney Group (Texas), the Houston Chapter of Credit Unions, and Credit Unions for Kids, among other professional, industry and community associations. Ms. Taylor regularly trains, speaks and publishes on mortgage servicing and consumer finance legal issues.

COALITION FOR MORTGAGE INDUSTRY SOLUTIONS

ANTITRUST COMPLIANCE POLICY

It is the Coalition's policy to comply with all federal and state antitrust laws, in such manner as to avoid even the appearance of improper activity. Compliance with the antitrust laws is the responsibility of all Coalition members, directors, employees and consultants.

The antitrust laws broadly prohibit competitors from restraining competition among themselves with reference to the price, quality or distribution of any products or services. These laws also forbid competitors from acting in concert to restrict the competitive capabilities or opportunities of their competitors, suppliers, or customers.

Certain practices are, under these laws, conclusively presumed to be unreasonable and thus illegal. Such practices include entering into or facilitating any anticompetitive or exclusionary agreement among competitors –

- on prices or fees;
- on the terms or conditions of purchases or sales;
- on distribution, or sales practices, or territories; or
- refusing to use or purchase a particular product, or refusing to patronize a particular service provider.

Such prohibited agreements need not be formal or in writing. They can be oral and informal, where the course of discussions among competitors or their conduct forms the basis for antitrust enforcement agencies to allege a collective decision.

Many forms of collective action by a trade group are permissible, such as lobbying, standards setting and data collection and dissemination. It is important, however, that such actions be undertaken with the guidance of counsel, in compliance with the Coalition's antitrust policy and do not serve as a vehicle for any anticompetitive agreement.

Because the penalties for violating the antitrust laws are most severe, the Coalition's policy is to avoid any activities that may create even an appearance of improper conduct by the Coalition or its members. The Coalition appreciates your support for its compliance efforts in this area. Should you have any questions, or should any issues or concerns arise during any Coalition meeting, program or activity, please consult with the Coalition's counsel.

COALITION FOR MORTGAGE INDUSTRY SOLUTIONS

CHECKLIST OF DOS AND DON'TS TO FOLLOW TO ADHERE TO CMIS'S ANTITRUST COMPLIANCE POLICY

- ✓ **Do** avoid any activity that could be interpreted as an agreement not to deal with a particular industry member or to deal with other industry members only on certain terms.
- ✓ **Do** consult counsel before the initiation of any new survey, data collection or statistical program or development of industry standards.
- ✓ **Do** prepare and adhere to advance written meeting agendas.
- ✓ **Do** ensure that the minutes of all meetings fully and accurately describe all the matters that transpire.
- ✓ **Do** protest against any discussions or meeting activities that appear to violate the antitrust compliance statement or guidelines.
- ✓ **Do** promptly excuse yourself from any group or meeting that discusses inappropriate topics, insist that the minutes reflect your departure, and communicate your protest to CMIS counsel.
- ✓ **Do** follow the antitrust guidelines at social events and informal gatherings that occur in connection with meeting activities.
- ✓ **Do** have CMIS counsel present at all CMIS-sponsored meetings.
- ✓ **Do** consult with CMIS counsel concerning appropriate methods for influencing governmental activities or policies.
- ✓ **Do** consult with CMIS counsel on all antitrust questions related to CMIS activities, and educate yourself on the antitrust requirements related to your participation in CMIS.
- ✗ **Don't** reach an agreement, express or implied, to fix, stabilize or otherwise tamper with the price of goods and services (or any price-related aspect of competition).
- ✗ **Don't** discuss or exchange of any information by or among competitors concerning prices, profits, profit margins or cost data.
- ✗ **Don't** discuss or exchange any information by or among competitors concerning sales territories or markets or the allocation of customers or territories.
- ✗ **Don't** discuss or exchange any information by or among competitors concerning sales or market shares, unless it is part of a survey approved by CMIS counsel.

- ✘ **Don’t** discuss or exchange information regarding plans of individual companies concerning the design, production, distribution or marketing of particular products or services, including proposed territories or customers.

- ✘ **Don’t** discuss or exchange of any information by or among competitors concerning any restrictions on the development or use of technologies.

- ✘ **Don’t** discuss or exchange information regarding elimination, restriction, or limitation of the quantity or quality of any product to be sold or service to be offered.

- ✘ **Don’t** take any joint action that would disadvantage another participant in the industry.

A positive solution to negative equity in America

By Wilbur Ross

Published: May 21 2008 03:00 | Last updated: May 21 2008 03:00

The US federal government has tried to stabilise residential real estate, but nationwide prices have dropped by 13 per cent in the past 12 months. Analysts have forecast that by June 30, 10.6m families will have either no equity in their homes or a negative equity.

This problem seems likely to become more severe. The solutions proposed so far have been directed mainly towards helping delinquent borrowers avoid foreclosure, but the incentives have been weak. Remedies are needed to reduce delinquent mortgages to present property values, provide lenders with possible future recovery of the amounts by which they discounted their loans, restore mortgage lender liquidity and make mortgages available for future home buyers.

Many lenders would reduce the principal amount of troubled loans to the present value of the house if they could liquefy part of the loan and share in the eventual upturn in property values. To provide some liquidity, the Federal Housing Administration, the government insurer for low-income housing, should be authorised to guarantee $1 of existing troubled mortgages on primary residences for each $1 forgiven by the lender. The lender would be able to resell the guaranteed portion of its principal amount.

The FHA would receive an insurance premium, as it already does on other mortgages, and on the first resale of the home would receive the lesser of 25 per cent of the gain or the amount it guaranteed. The total of the premiums and appreciation on some sales would more than offset losses on foreclosed homes. The FHA would require that government-approved appraisers confirm the house's market value. Also, if there were a shortfall on foreclosure and resale, the FHA would not pay a lump sum but instead make the payments when originally due. Therefore, at worst the FHA's payments would be spread over many years and the FHA's risk would decline whenever the borrower made payments.

Lenders would be able to sell the guaranteed portion of the loan, thereby restoring their liquidity. Lenders also would receive on the first resale of the home the lesser of 25 per cent of the gain or the amount forgiven. This would enable them to recapture some of the principal amount they forgave, thereby providing them with an incentive to restructure the mortgage rather than foreclose. Appreciation sharing would not carry over to the next owner, but qualified home purchasers would be able to assume these favourable mortgages. Thus the resale market for these properties would be largely self-financing for several years and this would stabilise or improve property values. Meanwhile the original borrower would retain 50 per cent or more of the appreciation on a property that otherwise would have been foreclosed. It would be unreasonable for home-owners to expect a totally free ride on concessions granted by lenders, but retaining half of the upside would motivate the homeowner to make monthly payments even though there initially would be no equity value.

If a mortgage had been $180,000 against an original home value of $200,000 and the loan were now reduced to $160,000, the lender would have lost $20,000. If the home later were sold at its original $200,000 value, the lender would have recovered $10,000, or half of the concession. The FHA would have gained $10,000 and the homeowner would have made $20,000, thereby restoring his original equity position.

This co-operation between public and private sectors would provide both lenders and borrowers with a rational, incentivised alternative to foreclosure.

The government's present voluntary plan of restructuring brings neither added incentives to the lender nor liquidity to the mortgage market. This FHA-based plan would do both. Lenders and borrowers would negotiate interest and repayment terms without government intervention and existing servicers would continue to service the loan. All parties would benefit from stabilisation of housing markets.

Most important, the process would be voluntary and therefore would not chill the willingness of lenders to make loans in the future. In contrast, the proposed remedies incentivise all parties to negotiate but do not create moral hazard by bailing out reckless lenders or borrowers. The lenders will write down their loans and borrowers initially will lose their original equity. Both will have a chance to recoup and substantial liquidity will be brought back to the mortgage market.

The writer has created the US's second largest servicer of subprime mortgages by acquiring American Home Mortgage and Option One

ACORN HOUSING

Foreclosure Prevention

ACORN Housing is working with the following mortgage servicers to prevent foreclosure and provide longterm, affordable resolutions:

ABN Amro/LaSalle Bank
American Home Mortgage
Americas Servicing Company (ASC)
Ameriquest
Avelo Mortgage
Bank of America
Beneficial Finance
Carrington Mortgage Services
Centex
Chase
CitiFinancial
CitiMortgage
Countrywide
Dovenmuehle Mortgage
EMC Mortgage
Everhome Mortgage
First Franklin (HLS)
First Horizon
GMAC
HomEq
Homecomings Financial
Household Finance
HSBC
IndyMac
Litton Loan Servicing
Long Beach Mortgage
M & T Bank
Midland Mortgage
National City
NationStar
New Century
Ocwen Servicing
Option One
PHH (Cendant)
Popular Mortgage
Saxon Mortgage
Select Portfolio Services
Standard Mortgage
21st Mortgage
US Bank
Wachovia
Washington Mutual
Wells Fargo
Wilshire Financial
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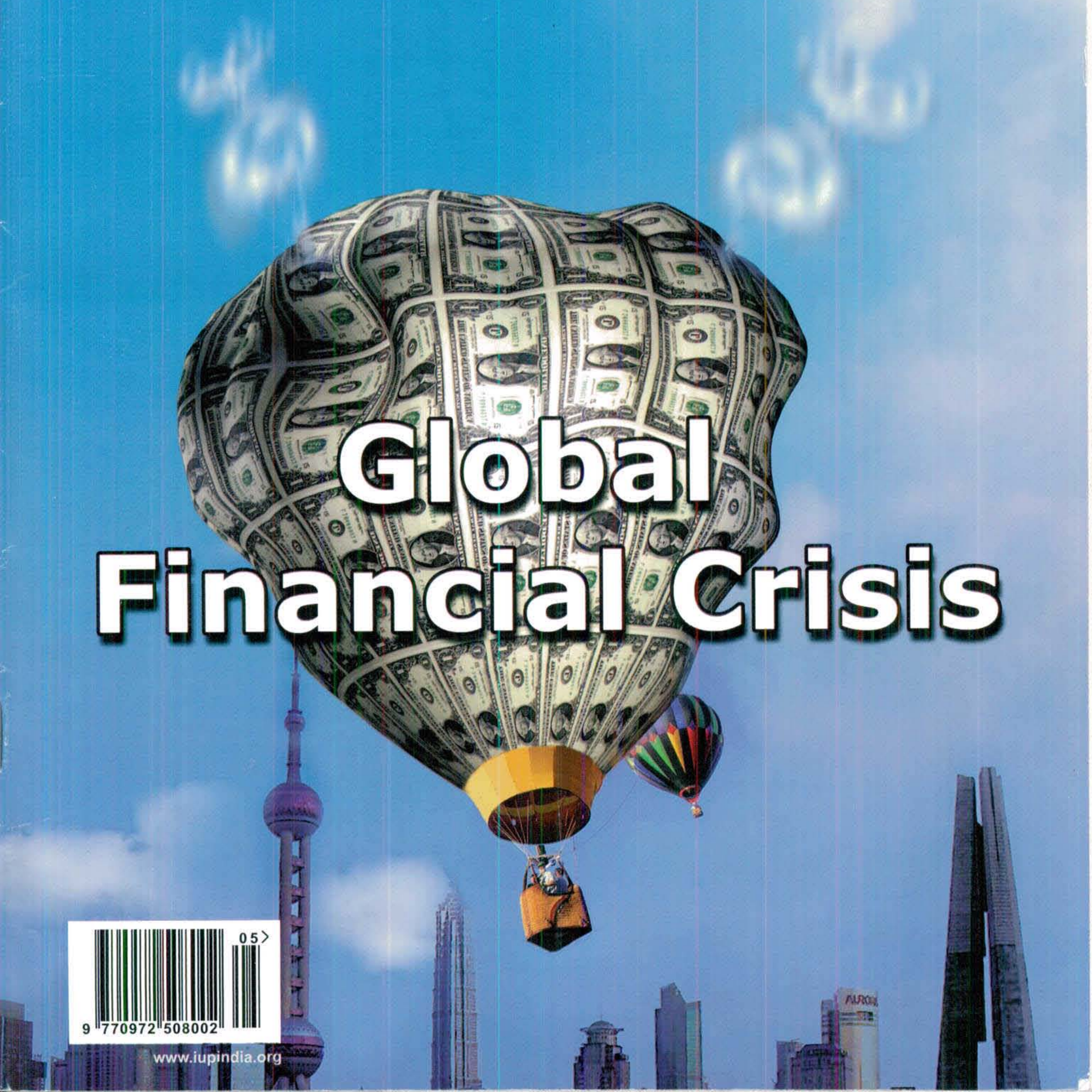
May 2008 The Icfai University Press Rs. 60

- Agrarian Crisis
- Commodities Market
- Software-as-a-Service Model



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INTERVIEW

"I doubt there is any long-term solution to the present crisis—other than suffering what it takes to liquidate all these unsound financial instruments."

How do you view the current global financial crisis? What is the root of the problem?

Andrew J Sherman: The current global financial crisis has reached a critical point which needs to be resolved over the next six months or we will all be paying the price for the next decade. At its root is the pinnacle of a cycle where "caution was thrown to the wind" and everyone seemed to enjoy the party until it came to a rapid and uncomfortable end. The global economy seems to go through these cycles more regularly now than in the past, with the two most recent cycles before this one being the 'dot com' crash of the late 1990s and the governance crisis of early 2000.

Andrew J Sherman
Partner, Dickstein Shapiro
Washington

Oskari Juurikkala: We may be witnessing one of the most serious financial crises in several decades, if not in the whole history. It has been caused by several factors:

Complex financial derivatives: I mean especially the so called Over-The-Counter (OTC) credit derivatives. They created a massive liquidity bubble, which began to burst around August 2007. Since the collapse started, it seems to be impossible to stop.

These instruments apparently originated in the US in early 2000, but then they turned into a global gamble. Hence, the resulting crisis is global too.

Derivatives as such are not the problem. The problem is their abuse. And that has been widespread, often combined with fraudulent practices. OTC derivatives are practically unregulated, and the accounting rules relating to these instruments are woefully inadequate. These factors encouraged a gamble with unsound valuation models and fraudulent trades.

Expansionary monetary policies: Here the US took the lead again. Derivatives would not have been such a problem had they not been combined with expansionary monetary policies of central banks. These encouraged the creation of a global liquidity boom that is unsustainable in the long-term.

Central banks were partly able to do this, because traditional inflation accounting has been modified. In order to make CPI figures seem more rosy than reality, public bodies responsible for inflation accounting began to create new models, so that one can say "CPI is not what it used to be." The US government had an additional reason to do so, because their growing social security budget could be reduced by diminishing the effect of inflation indexing.

Greed and herd-mentality: None of the above alone would have created a problem of this magnitude. They were coupled by a moral environment infested with greed and self-

There are pockets of vulnerabilities that are causing panic in the global financial system. However, the global spillovers could test the resilience through three main channels, as suggested by Caruana. These include the general re-pricing of credit risk that would increase the cost of external financing and reduced availability of funding to emerging markets. Following this, the cross-border interbank funding could recede, owing to pressures on banks in mature markets; and, if growth slows in emerging markets, investment flows could be retrenched, promoting corrections in equity valuations and increased potential for currency volatility. It all depends on the emerging and developing economies' improved policies, stronger balance sheets, as well as better macroeconomic conditions.

Paying attention to asset prices

Global policy makers and the world's central banks have taken several positive steps since August 2007 to restore investor confidence. Despite this, banks in the US, Britain and Germany could not escape multibillion dollar banking casualties. Besides, the recent proposals of Henry Paulson, US Treasury Secretary, for broad market reforms include doing away with the SEC and increasing the powers of the Federal Reserve. But, there is a mixed reaction about granting new regulatory powers to the Federal Reserve.

The IMF has urged that monetary policy be the first line of defense in industrialized countries. And the major central banks have been providing liquidity and easing monetary policies while keeping inflationary expectations under check. Banks follow a business model, where they borrow short and lend long. Martin Wolff, a leading economist, says, "Provided the Federal Reserve sets the cost of short-term money below the return on long-term loans, as it has for much of the past two ish incentive packages. The herd-mentality of present-day financial markets also supported the gamble with their unsound financial instruments.

How serious are the real consequences of the financial market crisis? Do you think that almost all countries will be affected by this crisis?

Andrew J Sherman: The consequences of the current crisis are quite serious yet relatively limited in terms of direct impact on the US and parts of Europe. As a matter of fact, even the Canadian economy, which typically closely tracks the US economy, is navigating through this crisis due to Canada's rich natural resources in a much stronger fashion. Many of the developing economies such as India and China will only indirectly feel the effects of this crisis as business and consumer spending slows down considerably in the US.

Oskari Juurikkala: The real consequences will certainly be serious. The main problem is the rapid loss of liquidity (credit). This will put companies in a difficult situation even when their main business a basically fine. Households will also suffer.

Oskari Juurikkala
Research Fellow and Consultant,
Institute of Economic Affairs, UK

The scariest part is that these OTC credit derivatives have been tied to various classes of credits: including household consumer credit, credit card debt, and business loans. So far, we have been talking about mortgage-related derivatives and their meltdown, but as someone famously said: "You ain't seen nothin' yet."

The consequences will vary from country to country. In some countries, we are yet to witness a large-scale housing market collapse and a consequent credit derivative crisis. England, Ireland and Spain are among clear targets in Europe.

Other countries may be safer, especially if they are less dependent on foreign credit, investments and trade.

How far will the fiscal stimulus package and Fed rate cuts contain the global financial crisis? Is there any global answer for the present financial crisis?

Andrew J Sherman: The current stimulus package and Federal Reserve rate cuts will have a positive but only an incremental effect on the financial weakness in the US and is not likely to have much of an impact on the global economy. My current view is that the current crisis is relatively confined to the US and therefore the search for a global answer is not currently as relevant as the need for a domestic solution.

Oskari Juurikkala: It seems to me that 'containment' is a bluff. I doubt there is any long-term solution to the present crisis—other than suffering what it takes to liquidate all these unsound financial instruments. They will, however, try to save major banks by printing money out of thin air.

I think countries would do wisely to steer towards greater financial and economic independence, and to avoid the covert rule of IMF and similar instruments of the global financial elite. Unsound monetary systems have created enough suffering already.

What lessons can we draw about the state of risk management from the crisis on Wall Street? Do you subscribe to the notion that financial innovation has increased the opaqueness of the financial market?

Andrew J Sherman: In the ongoing battle between fear and greed, greed has lost out in the last six months, and improved controls and risk mitigation policies need to be put in place on Wall Street. The only question that remains is who will be accountable and responsible for developing a better set of solutions—it will either be federal and state regulators or the industry must take the initiative. I have been involved in the recent founding of the Coalition for Mortgage Industry Solu-

decades, banks can hardly fail to make money." Meanwhile, the shrinking bank capital could lead to less lending and further fall in asset prices. Thus, central banks must continue to pay more attention to asset prices in future.

The emerging economies should support policies to strengthen their domestic demand, including greater exchange rate flexibility to play a more dynamic role in global growth. Asian economies have a huge backlog to make up in basic infrastructure, which can be a powerful instrument of stimulating demand in Asia. Ramgopal Agarwala, Senior Consultant, Research and Information System (RIS) for Developing Countries, suggests, "Like any other economy with a large current account deficit, the US must depreciate its currency, perhaps by 30-40% to promote exports and restrain imports. A quick and drastic devaluation will reduce the risk of further depreciation in the dollar and restore confidence in the dollar." In fact, a concerted and steady appreciation of Asian currencies in relation to the US dollar is desirable. The US and the Asian governments could promote such an exchange rate policy in Asia.

Worst yet to come?

The debate on US economic recession is over. Today, the focus is on how deep and long that recession will be. If the recovery could take longer, it will affect the global financial markets adversely. Pessimists have started to say that this is, perhaps, 'The Big One', by which they mean the onset of a New Great Depression; similar sentiments were expressed by the economists at HSBC that there has been a 'catastrophic breakdown' of trust. But when that had happened in the past—in the US in the 1930s and in Japan in the 1990s—chucking extra money at the banks in the hope that they will start lending again proves ineffective. Joseph Stiglitz, former Chief Economist, World tions (CMIS), which will be a cross-industry forum to explore self-regulatory and innovative solutions to the current mortgage lending and related financial crisis.

Oskari Juurikkala: 'Innovation' can mean a number of things. If it is sound, it is good. The problem in recent years (or perhaps recent decades) is that major banks have sought to avoid regulatory rules by creating new instruments, which enable them to hide risks. The lack of regulation of these new derivative instruments has been appalling, partly because the banks themselves have captured the regulatory bodies and stifled attempts to bring in sound rules.

There are many lessons that can be learnt, but perhaps these are the main ones:

Regulate activities that are genuinely risky for the economic system. OTC derivatives have been dangerously underregulated for years, and all industry insiders know this. Many books and articles have been written about it much before the current crisis. The crisis was no surprise; it was fully foreseen by those in the know.

At the same time, cut the regulatory red-tape that only serves the interests of the biggest banks and lawyers. Banks encouraged this overregulation because it creates barriers to entry.

Stop central bank manipulation of money. Return to sound monetary principles. Abolish fractional-reserve banking, which is legally unsound and economically unstable.

Do you think that current global financial markets crisis will last longer than has been anticipated so far? How do you see this evolving in 2008?

Andrew J Sherman: In my view, if 2008 is a year focused on solutions then we should start enjoying the benefits of a recovery in early 2009, but the recovery is not likely to be rapid given the size of the problem. It may very well be a slower recovery that extends into 2010; however, the pace of the recovery is likely to correlate to the strength and effectiveness of the solutions. In other words, if we are too quick to put a band aid on a cancer then the long-term problem is not likely to be solved.

Oskari Juurikkala: I do not see any improvements in the short-term. We are still in the first stage of a vicious circle, which is slowly unfolding before our eyes.

Actually, it is unfolding faster than I or many others expected. It is, therefore, most difficult to make predictions about timing. I see the credit crisis spreading globally all through 2008 and into 2009. The dollar will continue to weaken. Inflation will rise. Gold will shoot higher.

Bank, believes, "The current financial crisis is worse than the Great Depression of 1929 and that the consequences of the subprime mortgages are just beginning to be felt."

The US-led financial crisis will end once house prices stop falling and banks stop racking up huge losses on their loans. Experts say the crisis will only end when the US government intervenes directly in the real estate market to end the wave of foreclosures. According to them, it is ideologically ill-equipped to take that step and, as a result, property prices will fall and the financial meltdown will go on and on.

Need for a global answer

As the financial crisis in US grows, policy makers are proposing a variety of solutions. However, IMF Chief Dominique Strauss-Kahn warns, "The financial crisis which started in the US is more serious and more global than it was a few weeks ago. The risks and dangers are very high. The economic environment is still worsening." He opines that the current crisis will require a global answer. Therefore, the entire global system requires a thorough review and overhaul of financial oversight and regulatory mechanisms. George Soros opines, "There is something rotten in the state of the global financial system, and the very foundation of that system is the problem." The modern financial system, which has its origins in the 1980s, requires a paradigm shift and a new emphasis on regulation and government responsibility and is the root of today's market chaos as proposed by Soros.

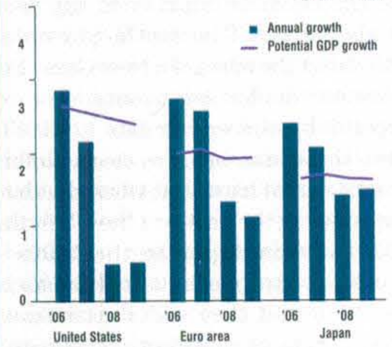
Consequently, the global financial system needs an 'integrated and global' approach instead of a segmented, partial and national one. Besides, greater disclosure, more oversight and improved risk management by the world's banks and financial institutions are the need of the hour to cure the global financial contagion.

– **N Janardhan Rao** with Inputs from **V Ratna**

Reference # 01M-2008-05-06-01

Slowing Economies

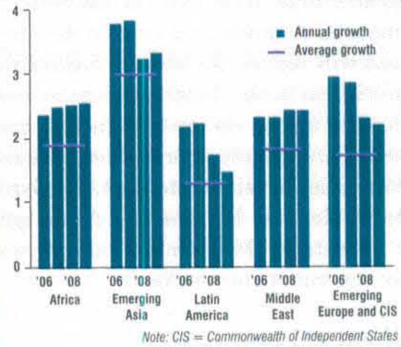
Growth in advanced economies is being most affected by financial turbulence



Sources: IMF, World Economic Outlook Database

Resilient Economies

Growth in emerging and developing economies is slowing, but it is still above trend



Note: CIS = Commonwealth of Independent States

Sources: IMF, World Economic Outlook Database

PERSON OF THE WEEK: Richard Rydstrom And A New Coalition Of The Willing

Phil Hall, Tuesday 13 May 2008 - 00:59:56

In the face of mounting challenges and growing concerns facing the nation's economy, a new coalition of mortgage, finance and credit industry professionals has come together to address pending and potential regulatory and litigation activities. Their goal is to help bring about a new slate of governmental and private-sector solutions.

This new group is called the Coalition for Mortgage Industry Solutions. Richard Rydstrom, an attorney based in Newport Beach, Calif., is a founding principal in this coalition, and he recently spoke with MortgageOrb on the coalition's genesis and goals.

Q: What was the reason for creating the Coalition for Mortgage Industry Solutions?

Rydstrom: The mortgage, finance and credit industries are becoming increasingly fragmented with disparate interests - from regulators and enforcement agencies to politicians and interest groups - trying to shape their future.

The Coalition for Mortgage Industry Solutions provides a unique forum in which leaders from across these industries can work together and take a leading role in defining meaningful and viable solutions for the welfare and benefit of their industries, the economy and the consumer. The coalition converts all related industry and consumer diverse and conflicting self-interests into comprehensive workable solutions, legislative and regulatory initiatives. The coalition also acts as an arbiter for conflicting self-interests.

Q: How does this coalition differ from other coalitions or trade associations related to the mortgage industry?

Rydstrom: The coalition is the first to step up and offer a centralized forum for all related and conflicting self-interest trade associations or interests arising from industry, consumer, regulatory and legislative initiatives. The coalition will invite all related associations, industry and consumer leaders to join and participate. The coalition will bring together the brightest and the best minds to explore solutions and refinements.

The Coalition for Mortgage Industry Solutions operates as a reconciliation clearing house for the mortgage, finance and credit industries, its consumers and related governmental, regulatory and legislative interests or priorities. Its goal is to convert conflicting self-interests into comprehensive solutions for all participants, and act as a depot and arbiter of critical issues, solutions, information, education and coordination.

There is no other organization that offers this comprehensive function to the mortgage, finance, and credit industries. The Coalition for Mortgage Industry Solutions is the first to offer these solutions to a diverse set of interests.

The coalition also provides a unique opportunity for these diverse interests to work collaboratively within a neutral setting, permitting an unparalleled opportunity to work constructively and proactively.

At a time when consumers, investors and regulators are seeking answers from industry leaders, coalition members will be considered "part of the solution" to the serious challenges we are confronting.

Q: What will be the coalition's short-term goals and long-term goals?

Rydstrom: In the short term, for example, the coalition will deal with the related conflicting authority precluding effective and efficient loss mitigation and loan modifications, including related investor, servicer, REMIC, capital, credit and related secondary market issues as well as reconciliation of bankruptcy, foreclosure and alternatives. This will assist the heart of the industry, as well as its consumer, the homeowner. The coalition will also explore new solutions or refinements for the affordability- and liquidity-related issues.

Additionally, the coalition will explore new safe harbor solutions that may allow industry and consumers to opt in to solutions that resolve conflicting interests, and serve both the economic and liability uncertainty issues facing all related parties, including but not limited to the servicer, investor, trusts, lender, borrower, etc.

The coalition will hold a summit on June 17 in Washington, D.C., for related industry, congressional, regulatory and consumer group leaders to vet and participate in defining the immediate and short-term issues facing the mortgage, credit and capital market concerns. The coalition will provide the forum and framework to immediately begin the coordination of working groups in fashioning solutions to these diverse sets of interests.

For the intermediate and longer term, but starting in first order, the coalition will provide the forum and framework to allow related industry, congressional, regulatory and consumer group leaders to vet and participate in defining intermediate and longer-term concerns, including but not limited to reconciliation of international and domestic "fair value" accounting conflicts, sustainability of homeownership, safeguards in structured finance, the banking system and credit rating systems, new and innovative products for loan origination, refinance and credit enhancements, fraud detection, etc.

Q: What will be your specific duties in the coalition?

Rydstrom: As founding principal, I will be the chairman of the advisory and reconciliation boards. We will soon begin our search for an executive director.

Q: As things stand today, where do you see the industry heading?

Rydstrom: Without making predictions, let me say where the industry needs to go. The industry needs to reconcile its conflicting self-interests in a comprehensive manner for the betterment of not only the industry, but its consumers as well. To grow the industry, we need to grow homeownership and the economy at the same time.

We need more creative products, not less. We don’t need more disclosures or regulations for disclosure or regulations' sake, but we do need intelligent disclosures (for borrowers and investors), refined and coordinated regulations that update the regulatory system to the 21st century, more self-regulation and structural safeguards and refinements in the mortgage, credit and capital markets.

DICKSTEINSHAPIRO LLP

Insurance Coverage for Losses Arising from the Subprime Lending Crisis

By James R. Murray, Kirk A. Pasich, Avner E. Mizrahi
2008

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I. INTRODUCTION

The subprime lending crisis officially is a worldwide catastrophe. Morgan Stanley, the second largest U.S. investment bank, recently suffered its first-ever loss because of poor investments in the subprime debt market. After taking a $9.4 billion write-down, Morgan Stanley sold approximately a 10 percent interest in itself to a division of the Chinese government for a cash infusion of $5 billion.[1] Citigroup, UBS, and other large U.S. banks have suffered similar fates.[2] This disaster's impact, though, is not limited to the United States. France's largest bank, BNP Paribas, froze more than $2.2 billion in investments backed by subprime loans.[3] The Federal Reserve has estimated that investors will lose between $50 and $100 billion as a result of this crisis.[4] As a consequence, this meltdown has resulted in a wave of lawsuits involving borrowers, state governments, subprime lenders, brokers, loan issuers, banks that repackage loans into mortgage-backed securities (MBS), ratings agencies, real-estate appraisers, investment funds, and others. It is very important for companies to be aware of the potential insurance coverage available to all parties involved.

Subprime lending institutions, and their officers and directors, are being sued by a variety of plaintiffs and in a variety of contexts. Borrowers are asserting that their lenders, among other things, defrauded them, lied to them, and negligently misrepresented information about their loan interest rates.[5] Investors are alleging claims for breach of contract and negligent misrepresentation, and claiming that a lender's mortgage insurance should be available for those losses.[6] Shareholders are suing for various securities violations, including allegations that the

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[1] Landon Thomas, Jr., *$9.4 Billion Write-Down at Morgan Stanley*, N.Y. Times, Dec. 20, 2007, *available at* http://www.nytimes.com/2007/12/20/business/20wall.html.

[2] *Id.*

[3] Norm Alster, *Signs of Weakness in a Sector Known for Its Strength*, N.Y. Times, Aug. 12, 2007, *available at* http://www.nytimes.com/2007/08/12/business/yourmoney/12fina.html.

[4] Brooke Masters & Saskia Scholtes, *Payback Time: As Subprime Bites, US Investigators Look for Culprits*, Fin. Times, Aug. 9, 2007, at 5, *available at* http://www.ft.com/cms/s/0/1f7200ca-4611-11dc-b359-0000779fd2ac.html; *Bernanke: Subprime Hit Could Top $100B*, CNNMoney.com, July 19, 2007, http://money.cnn.com/2007/07/19/news/economy/bernanke/index.htm.

[5] *See, e.g.*, *Morris v. First Franklin Fin. Corp.*, No. 07-00614 (N.D. Ga. filed Mar. 16, 2007); Jason Szep, *As Subprime Crisis Deepens, Some Fight Back*, Mar. 16, 2007, Reuters, http://www.reuters.com/article/ousiv/idUSN1516483920070316; Gretchen Morgenson & Julie Creswell, *Borrowing Trouble*, N.Y. Times, Apr. 1, 2007, http://www.nytimes.com/2007/04/01/business/yourmoney/01nova.html.

[6] *See, e.g.*, *Bankers Life Ins. Co. v. Credit Suisse First Boston Corp.*, No. 07-690 (M.D. Fla. filed Apr. 23, 2007).

directors and officers gained illegal profits.[7] To top it all off, some State Attorneys General have jumped into the fray and sued or investigated subprime lenders for allegedly violating state laws, including allegations that lenders failed to fund mortgages after closings.[8] Indeed, two major American cities—Cleveland and Baltimore—have sued subprime lenders on public nuisance and racial discrimination grounds, respectively.[9]

But subprime lenders are not the only ones being sued or investigated. Ratings agencies have been sued by their shareholders and pension funds for allegedly over-valuing bonds backed by subprime mortgages.[10] At least one real-estate appraiser has been sued by a State Attorney General for allegedly colluding with a savings and loan company to inflate the value of homes, which supposedly contributed to the subprime fallout.[11] One of the world's largest securities firms was sued for alleged improper investment of $134 million of a client's cash reserves in subprime loans.[12] The filing of suits related to the subprime crisis does not appear to be slowing down any time soon.

Corporate defendants may very well have insurance protection for these liabilities under their directors and officers (D&O) or errors and omissions (E&O) policies. With the newest wave of lawsuits alleging public nuisance and racial discrimination, corporate defendants may be able to recover insurance proceeds for any resulting losses under their commercial general liability (CGL) and employment practices liability (EPL) policies. Given the very nature of the subprime crisis, companies that purchased credit risk insurance—sometimes called "accounts receivable insurance"—may have an additional and fruitful source of protection for their losses. Standard credit risk policies cover credit losses due to insolvency of a covered buyer or "protracted default" resulting from a covered buyer's slow payment. Even investment funds and other MBS owners may be able to collect on their credit risk insurance policies when lenders fail to "buy back" loans. Private Mortgage Insurance (PMI), a type of credit risk insurance, also may supply

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[7] *See, e.g.*, *Grand Lodge of Pa. v. Coast Fin. Holdings*, No. 07-479-T26 (M.D. Fla. filed Mar. 20, 2007).

[8] Press Release, Marc Dann, Ohio State Attorney General, Attorney General Dann moves to shut down New Century Financial in Ohio (Mar. 14, 2007), *available at* http://www.ag.state.oh.us/press/07/03/pr070314.asp.

[9] Thomas J. Sheeran, *Cleveland Sues Banks Over Foreclosures*, Associated Press, Jan. 11, 2008, http://ap.google.com/article/ALeqM5hEk5TzJabMToLW09kiR9fkDEgqSAD8U3SGJG2 (alleging public nuisance); Ben Nuckols, *Baltimore Sues Wells Fargo for Subprimes*, Associated Press, Jan. 8, 2008, http://ap.google.com/article/ALeqM5ibTdmbrD_q5crguVP719R03LUugD8U20IB80 (alleging racial discrimination).

[10] Yvette Essen, *Shareholders Act Against Ratings Agencies*, Telegraph.co.uk, http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/11/26/cnrate126.xml (last updated Nov, 28, 2007).

[11] *New York Widens Inquiry on Mortgages*, N.Y. Times, Nov. 8, 2007, *available at* http://www.nytimes.com/2007/11/08/business/08mortgage.html; Vikas Bajaj, *New York Says Appraiser Inflated Value of Homes*, N.Y. Times, Nov. 2, 2007, *available at* http://www.nytimes.com/2007/11/02/business/02appraise.html.

[12] Anthony Aarons, *Merrill Lynch Is Sued by MetroPCS for Fraud, Misrepresentation*, Oct. 19, 2007, Bloomberg.com, http://www.bloomberg.com/apps/news?sid=a8nJ93nljzCI&pid=20601103.

subprime investors with reimbursement for losses. Depending on the facts of a particular case, an EPL policy also may be implicated where an employee alleges breach of an employment contract related to subprime lending. Real-estate investors may find solace in a Residual Value (RV) insurance policy, if their properties have dropped in value because appraisers inflated the values as part of a subprime scheme. In sum, one or more insurance policies that your company has purchased may cover your potential losses resulting from the subprime lending fallout.

II. YOU SHOULD PROMPTLY NOTIFY YOUR INSURANCE COMPANY OF A CLAIM OR POTENTIAL CLAIM

The language and provisions contained in D&O, E&O, and credit risk insurance policies tend to vary more than with many other types of insurance coverage. Thus, it is very important that policyholders have potentially relevant policies reviewed as soon as possible. In any event, given the nature of the insurance at issue, you should give timely notice as soon as possible to your insurance company for claims or losses relating to subprime lending activity.

Most D&O and E&O policies are claims-made policies,[13] meaning that they typically cover only claims that are made against the policyholder, during the policy period. Some policies, however, provide coverage for claims that are made against the policyholder shortly after the policy period; insurance companies may contend that such a claim should be based on a wrongful act allegedly committed during the policy period. The policies frequently include specific provisions concerning timely notice of claims, giving the policyholder a discrete window of time from when it knows about a claim to notify its insurance company.

Insurance companies may argue that some D&O and E&O policies provide that both (a) the claim against the policyholder, and (b) notice to the insurance company of the claim, must occur during the policy period. Other policies may provide that the policyholder should give notice to the insurance company within a reasonable time after the claim is made against the policyholder, even if notice is given to the insurance company after the policy period. If a policyholder has purchased continuous coverage from the same insurance company, a claim made against the policyholder toward the end of the first policy period and reported to the insurance company during the second policy period should not preclude coverage. At least one court has held this to

[13] Some older D&O and E&O policies are occurrence-based policies, which cover losses from injuries that occurred during the policy period, regardless of when the claim is made against the policyholder. For example, if a group of borrowers sues a subprime lender during the current policy period for alleged misrepresentations made to the borrowers during the previous policy period, the earlier policy will apply if it is an occurrence policy because the occurrence—the alleged misrepresentations—transpired during the occurrence-based policy's policy period. (The current policy also will apply if it is a claims-made policy because the policyholder was sued, that is, a claim was made against the policyholder, during the current policy's policy period.) Recent policies typically are claims-made, but some may be occurrence-based, and a company's older policies may be relevant to a current claim if they are occurrence-based.

be the rule even when the earlier policy provided that the claim should be made against the policyholder and notice should be given to the insurance company during the policy period. *See Brown-Spaulding & Assocs., Inc. v. Int'l Surplus Lines Ins. Co.*, 254 Cal. Rptr. 192, 196 (1998) (refusing to enforce a "claims made and reported" provision against a policyholder that failed to notify its insurance company of a claim against it until after the policy expired, and holding that the policy's "reporting provision" was void as against public policy because "the result of the notice provisions in the policy issued by [the insurance company] is to deprive [the policyholder] of retroactive coverage for claims made against it near the end of the policy period. Such narrow coverage provisions are so oppressive and unfair as to be violative of public policy").

Courts generally enforce notice, or reporting, provisions as a condition of coverage. However, depending on the applicable state law, a policyholder's failure to give timely notice to its insurance company may not bar coverage if the insurance company is not prejudiced by the late notice. *See, e.g., Transportes Ferreos de Venezuela II CA v. NKK Corp.*, 239 F.3d 555, 561 (3d Cir. 2001) (applying New Jersey law); S*herwood Brands, Inc. v. Hartford Accident & Indem. Co.*, 698 A.2d 1078, 1082 (Md. 1997); *Struna v. Concord Ins. Servs., Inc.*, 11 S.W.3d 355, 359-60 (Tex. App. 2000). In California, for instance, a delay in notice typically will not be a bar to coverage unless the insurance company proves that it actually and substantially is prejudiced by the delay. *See, e.g*., *Shell Oil Co. v. Winterthur Swiss Ins. Co.*, 12 Cal. App. 4th 715, 760-61, 15 Cal. Rptr. 2d 815 (1993) ("California law is settled that a defense based on an insured's failure to give timely notice requires the insurer to prove that it suffered substantial prejudice. Prejudice is not presumed from delayed notice alone. The insurer must show actual prejudice, not the mere possibility of prejudice.") (citations omitted).

It may be even more important for companies to notify their insurance companies of circumstances that may later give rise to a claim. Most D&O and E&O policies contain clauses that provide coverage for claims occurring after the policy period where related facts took place during the policy period, so long as the policyholder gave notice of those facts during the policy period. For example, if during the policy period an investment company sends a letter requesting information about certain loans to a subprime lender from which it purchased MBS, the letter may not constitute a claim if it does not demand anything. After the policy period, when the investment company sues the lender based on those same loans, losses resulting from the suit (which certainly is a claim) may not be covered if the lender did not notify its insurance company when it received the request letter. But if the lender had given notice, it would have coverage for a claim first made against it after the policy period. These provisions generally have strict reporting conditions. Thus, it is imperative that companies also notify their insurance carriers of potential claims—of facts or circumstances that potentially may give rise to a claim.

III. A CLAIM IS A DEMAND FOR RELIEF

D&O and E&O policies typically define a claim as "a written demand for monetary or non-monetary relief; or a criminal proceeding commenced by the return of an indictment . . . against the insured for a wrongful act." When a subprime lender, or its directors and officers, are sued (or indicted), it is clear that a claim exists under a D&O or E&O policy. Regardless of whether the policy defines claim, a court may still find that a demand letter, a notice of a regulatory investigation, a demand for regulatory compliance, an initiation of arbitration proceedings, a grand jury investigation, a subpoena for documents, and even questioning by a prosecutor all constitute a claim. *See, e.g.*, *Polychron v. Crum & Forster Ins. Cos.*, 916 F.2d 461, 463 (8th Cir. 1990) (holding that a subpoena for documents, a grand jury investigation, and questioning by an assistant U. S. attorney each in its own right, and all together, constituted a claim under Arkansas law) (claim not defined); *Minuteman Int'l, Inc. v. Great Am. Ins. Co.*, No. 03 C 6067, 2004 WL 603482, at *2 (N.D. Ill. Mar. 22, 2004) (holding that a subpoena for documents and testimony constitute a claim where policy defined claim as "demand for . . . non-monetary relief"); *Nat'l Stock Exch. v. Fed. Ins. Co.*, No. 06 C 1603, 2007 WL 1030293, at 1, *3 (N.D. Ill. Mar. 30, 2007) (same where policy defined claim as "formal investigative order or similar document").

If the policy does not define, or provides only a brief definition for, "claim," courts frequently will deem communications to be claims when they actually demand something, assert a legal right, or threaten formal consequences for failure to comply. *See, e.g.*, *Richardson Elecs., Ltd. v. Fed. Ins. Co.*, 120 F. Supp. 2d 698, 701 (N.D. Ill. 2000) ("A claim is a demand for *something* due. A demand for money is not required for [it to be] a claim," and finding that a demand requiring the policyholder to comply constitutes a claim); *Phoenix Ins. Co. v. Sukut Constr. Co.*, 136 Cal. App. 3d 673, 677, 186 Cal. Rptr. 513 (1982) (A claim is a "demand for something as a right, or as due. A formal lawsuit is not required before a claim is made."). Generally, if a reasonable person would assume that the communication was making a claim, then a court likely will find that the communication indeed constitutes a claim. *See, e.g.*, *Bendis v. Fed. Ins. Co.*, 958 F.2d 960, 962 (10th Cir. 1991) (applying Kansas law).

Credit risk policies frequently contain very short deadlines both for filing a claim for loss against insolvent or troubled buyers (sometimes as quickly as 10 days from learning of a buyer insolvency) and for filing a proof of a "covered loss" with the insurance company. Many credit risk forms also include detailed claim-filing conditions, akin to proof-of-loss conditions in property polices.

IV. D&O AND E&O POLICIES COVER ACTUAL AND ALLEGED WRONGFUL ACTS

D&O policies cover liability arising out of actual or alleged wrongful acts committed by directors and officers in carrying out their corporate responsibilities. These policies often provide Side A, Side B, and Side C coverage. Side A coverage pays the directors and officers directly for losses that they suffer. Side B coverage pays the company when it indemnifies its directors and officers for their losses. Side C, also called entity, coverage protects the corporate policyholder when it suffers losses resulting from claims made directly against it. It is a somewhat common misconception that Side C coverage is available only for losses related to securities claims. This is not always, or even often, the case; hence, the corporate policyholder may have coverage for all types of subprime losses it suffers, whether or not they flow from securities claims.

E&O policies cover liability arising out of alleged wrongful acts committed in rendering or failing to render professional services. E&O policies sometimes are tailored to the professional services specific to a policyholder's line of business. Hence, the definition of professional services in a rating agency's policy may contain language related to developing bond ratings, while in an investment company's policy the definition may relate to giving investment advice for a fee. If the type of professional service covered is not specified, courts typically define a professional act as "'one arising out of a vocation, calling, occupation, or employment involving specialized knowledge, labor, or skill [which is] predominantly mental or intellectual, rather than physical or manual.'" *PMI Mortg. Ins. Co. v. Am. Int'l. Specialty Lines Ins. Co.*, 394 F.3d 761, 766 (9th Cir. 2005) (quoting *Bank of Cal., N. A. v. Opie*, 663 F.2d 977, 981 (9th Cir. 1981) (applying Washington law)) (applying California law).

Typically, losses that an insurance company contends are not covered by one policy will be covered by the other. Accordingly, just because an insurance company may argue that a D&O policy's professional services exclusion bars coverage for losses from claims made against a real-estate appraiser by a customer for over-valuing property, the appraiser's E&O policy should step in to cover those very losses.

V. LOSS IS CONSTRUED BROADLY

For a "loss" to be covered under a D&O or E&O policy, it must be an amount of money that the subprime lender or its officers and directors "becomes legally obligated to pay, . . . including but not limited to damages, judgments, settlements, pre-judgment and post-judgment interest, and defense costs." Sometimes "loss" will be defined to include "punitive or exemplary damages, where insurable by law," as some states allow punitive damages to be insured. *See, e.g.*, *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026, 1029-30 (5th Cir. 1978) (insurance covering liability for punitive damages does not violate public policy) (applying Texas law); *Meijer, Inc. v. Gen. Star Indem. Co.*, 826 F. Supp. 241, 247 (W.D. Mich. 1993) (same) (applying Michigan law), *aff'd*, 61 F.3d 903 (6th Cir. 1995).

The definition of "loss" in some policies does not include costs incurred to comply with an order for "injunctive or other non-monetary relief." This should not preclude coverage for monetary payments that at first blush appear to be injunctions. For instance, an investor suing a subprime lender for not buying back defaulted loans may request specific performance, just as a State Attorney General may try to enjoin subprime lenders to fund mortgage loans after closings. While an insurance company may assert that these are requests for injunctions and thus do not fall under the definition of "loss," the requested specific performance is for the lender to pay money; it is monetary relief. Accordingly, these losses should not fall under the injunction/non-monetary relief exception to the definition of "loss."

VI. D&O AND E&O POLICIES SHOULD PAY FOR DEFENSE COSTS, A FRUITFUL SOURCE OF SECURITY

In many situations, a subprime actor's only losses may be legal fees. D&O and E&O policies thus provide a fruitful source of protection for those players in the subprime world who ultimately may never be held liable for claims asserted against them. A good example is a State Attorney General's investigation that ends with no finding of liability. A subprime lender may very well spend millions of dollars in responding to such an investigation. One of the most beneficial aspects of a D&O or E&O policy, therefore, is the insurance company's promise to pay the policyholder for defense costs that it incurs in responding to a claim. This is a contemporaneous obligation; the insurance company must pay the defense costs as they are incurred by the policyholder. *Gon v. First State Ins. Co.*, 871 F.2d 863, 868 (9th Cir.1989) (applying California law).[14]

Moreover, if a particular claim contains covered and uncovered matters, the insurance company often must pay defense costs for the entire claim, either because state law requires it to[15] or because the policy contains a provision explicitly providing 100 percent of defense costs for claims that include covered and uncovered issues. What this means is that if a subprime lender, for instance, is sued by a group of borrowers for allegedly committing fraud and negligence, the insurance company likely will be required to pay for the entire defense, even though it may argue

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[14] *See also Little v. MGIC Indem. Corp.*, 836 F.2d 789, 793-94 (3d Cir. 1987) (applying Pennsylvania law); *Okada v. MGIC Indem. Corp.*, 823 F.2d 276, 280 (9th Cir. 1986) (applying Hawaii law); *Fight Against Coercive Tactics Network, Inc. v. Coregis Ins. Co.*, 926 F. Supp. 1426, 1432-34 (D. Colo. 1996); *FDIC v. Booth*, 824 F. Supp. 76, 80-81 (M.D. La. 1993); *Nat'l Union Fire Ins. v. Brown*, 787 F. Supp. 1424, 1430 (S.D. Fla. 1991) *aff'd*, 963 F.2d 385 (11th Cir. 1992); *FSLIC v. Burdette*, 718 F. Supp. 649, 661 (E.D. Tenn. 1989); *Am. Cas. Co. v. Bank of Mont. Sys.*, 675 F. Supp. 538, 543-44 (D. Minn. 1987).

[15] *See, e.g.*, *Seaboard Sur. Co. v. Gillette Co.*, 64 N.Y.2d 304, 311 (1984).

that the fraud allegations are not covered. This also is the case where a claim is made against covered and uncovered parties. If, for example, a credit agency purchased a D&O policy that covers losses from claims asserted only against its directors and officers,[16] but someone sues both the directors and the credit agency, the insurance company likely will have to pay 100 percent of the defense costs incurred by both the credit agency and the directors, even though the insurance company may maintain that judgments against, or settlements entered into by, the credit agency alone are not covered by the policy. Several insurance companies, however, have begun to add express allocation language regarding both indemnity and defense costs, trying, for example, to exclude coverage for costs spent in defending uncovered issues or parties. The extent to which a policyholder is entitled to coverage for defense costs, therefore, may depend upon express policy language.

Ultimately, the legal fees associated with the subprime lending crisis are expected to be astronomical, and insurance coverage should protect those losses.

A. Government Investigations

Since the subprime crisis exploded, State Attorneys General and other government agencies with enforcement powers have been investigating subprime actors for their alleged wrongdoing. Such an investigation can be one of the most harrowing experiences a company and its officers and directors ever will encounter. It involves responding to demands for documents and other information, testifying before grand juries, being pressured to sign admissions of wrongdoing, and other unpleasant experiences. Thus, it is the precise situation for which a policyholder expects coverage under its D&O and/or E&O policies. Insurance companies, however, often contend that these investigations are not claims, but rather potential claims, circumstances that could give rise to a claim if, for instance, the Attorney General decides to sue the policyholder. This contention is incorrect; policyholders need not forfeit the huge sums of money they expend in defending such investigations.

Insurance companies often will maintain that subpoenas, served as part of an investigation, requiring testimony and the production of documents, do not constitute claims because they are not demands for relief. Courts throughout the country have disagreed with that position, holding that under a claims-made D&O policy, a subpoena is a claim because it commands compliance and threatens formal consequences for failure to comply. *See Minuteman*, 2004 WL 603482, at *5-*7; *Nat'l Stock Exch.*, 2007 WL 1030293, at *3. Other courts have arrived at the same conclusion in noting the seriousness of an investigation accompanied by subpoenas. *See, e.g., Cal. Union Ins. Co. v. Am. Diversified Sav. Bank*, 914 F.2d 1271, 1276 (9th Cir. 1990) (applying

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[16] This would be a policy with Side A, and perhaps Side B, coverage, but not Side C coverage.

California law); *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035, 1047-48 (C.D. Ill. 2003) ("*Foster*"); *Abifadel v. Cigna Ins. Co.*, 8 Cal. App. 4th 145, 167 (Cal. App. 1992).

VII. INSURANCE COMPANY POSITIONS ON D&O AND E&O POLICIES AND COURTS' RECOGNITION OF COVERAGE

Insurance companies likely will assert a variety of positions to avoid paying out claims under their D&O and E&O policies. These arguments often will be based on policy exclusions. Courts, however, construe exclusions narrowly and place the burden on the insurance company to prove that a particular exclusion applies. *See, e.g.*, *HS Servs., Inc. v. Nationwide Mut. Ins. Co.*, 109 F.3d 642, 645 (9th Cir. 1997) (applying California law); *Universal Cas. Co. v. Lopez*, 876 N.E.2d 273, 278 (Ill. App. Ct. 2007); *Allmerica Fin. Corp. v. Certain Underwriters at Lloyd's, London*, 871 N.E.2d 418, 425 (Mass. 2007); *SMI Realty Mgmt. Corp. v. Underwriters at Lloyd's, London*, 179 S.W.3d 619, 624 (Tex. App. 2005). What is more, courts have interpreted many of the exclusions that may arise in the subprime lending context in ways that are beneficial for policyholders. Below are the exclusions an insurance company is most likely to assert and courts' recognition that these exclusions must be construed very narrowly to allow coverage when possible.

A. Fraud/Dishonesty (D&O and E&O)

The fraud/dishonesty exclusion addresses losses resulting from a director's or officer's intentionally dishonest or fraudulent acts. For instance, the exclusion may provide that the insurance company may not pay for losses "based upon, arising from, or in consequence of . . . any deliberately fraudulent or dishonest act or omission or any willful violation of any statute or regulation by any insured." Not all policies will provide that the fraud or dishonesty be deliberate. While some policies may reference both fraud and dishonesty, others may refer to only one or the other. Courts typically treat all of these permutations similarly. Indeed, one court interpreted a provision purportedly excluding losses "brought about or contributed to by the dishonesty of the directors or officers" to exclude only knowing acts of dishonesty. *Faulkner v. Am. Cas. Co.*, 584 A.2d 734, 751 (Md. Ct. Spec. App. 1991). Reckless acts that defraud the plaintiff in the underlying matter are not excluded. *Id.* (emphasizing that "[a] reckless, careless, negligent error, misstatement, misleading statement, act, or omission is within the definition of a 'wrongful act,' for which the policy provides coverage," and the fraud/dishonesty exclusion does not remove that coverage).

Some policies, moreover, provide that for the fraud/dishonesty exclusion even potentially to be applicable there must be a "final adjudication" of fraud/dishonesty on the merits, that is, a final verdict in the underlying case that the directors or officers committed actual fraud. A settlement of the underlying case where the directors and officers do not concede liability, therefore, would not constitute a final adjudication. Most courts have held that the words "final adjudication" in a fraud/dishonesty exclusion preclude the insurance company from litigating in the coverage action whether the director or officer actually committed fraud; the insurance company is stuck with the judgment entered in the underlying case. *See, e.g.*, *Atl. Permanent Fed. Sav. & Loan Ass'n v. Am. Cas. Co.*, 839 F.2d 212, 216-17 (4th Cir. 1988) (per curiam) (applying Virginia law); *Nat'l Union Fire Ins. Co. v. Cont'l Ill. Corp.*, 666 F. Supp. 1180, 1197-98 (N.D. Ill. 1987); *Graham v. Preferred Abstainers Ins. Co.*, 689 So. 2d 188, 190 (Ala. Civ. App. 1997). Other policies, however, exclude fraud "in-fact" or a "final determination" or "establishment" of fraud. Insurance companies may assert—incorrectly we believe—that this language permits them to litigate in the coverage action whether the directors and officers actually committed fraud, even if the underlying case never reached a final adjudication on that issue.

B. Illegal Profit (D&O and E&O)

A typical illegal profit exclusion states that a policyholder may not receive insurance proceeds for losses based upon or arising from the policyholder's "having gained in fact any profit, remuneration, or other advantage to which [he/she] was not legally entitled." If the profit results from an illegal act but is not in fact an illegal profit, or the directors and officers are sued for certain wrongful conduct from which they gained an advantage but the profit is not the basis of the claims, then this exclusion should not bar coverage. *See Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 398-401 (D. Del. 2002).

For instance, if a subprime lender's directors and officers made illegal securities misrepresentations, and as a by-product received a private gain, this exclusion would not apply because the actual gain was not illegal. *See id.* at 400. In contrast, insurance companies may contend that this exclusion would apply if the directors and officers committed insider trading, because insider trading is a form of theft, a profit that is against the law. *See id.* In essence, this exclusion does not bar coverage for "improper" profits; it may, at most, preclude coverage for "illegal" profits. *See id.* (the illegal profit exclusion "requires a profit or gain that is illegal; not an illegal act that produces a profit or gain to the insured as a by-product").

Moreover, as with the fraud/dishonesty exclusion, policies vary on whether a "final adjudication" or "final determination" that the directors and officers gained an illegal profit is necessary for this exclusion potentially to apply. *See, e.g.*, *PMI Mortgage Ins. Co. v. Am. Int'l Specialty Lines Ins. Co.*, No. C 02-1774 PJH, 2006 WL 825266, at *4 (N.D. Cal. Mar. 29, 2006) (profit exclusion did not apply because "adjudication is necessary to determine whether there was, in fact, any illegal profit or gain"); *see also Foster*, 268 F. Supp. 2d at 1045 (construing the "in fact" language in a profit exclusion to require a final adjudication of an illegal profit).

C. Insured v. Insured (D&O and E&O)

The insured v. insured exclusion provides that the insurance company is not liable for a claim "brought or maintained by or on behalf of any insured in any capacity"; that is, for a claim made by one insured against another. Insurance companies may assert that the exclusion is implicated in the case of derivative lawsuits, but most courts have held that the exclusion's purpose is to prevent collusion between the named insureds, which is not an issue in derivative suits. *See, e.g.*, *Twp. of Ctr., Butler County, Pa. v. First Mercury Syndicate, Inc.*, 117 F.3d 115, 119 (3d Cir. 1997) ("[t]he primary focus of the exclusion is to prevent collusive suits") (applying Pennsylvania law); *Fid. & Deposit Co. v. Zandstra*, 756 F. Supp. 429, 431 (N.D. Cal. 1990) ("[t]he obvious intent behind the 'insured v. insured' exclusion is to protect [the insurance company] against collusive suits"). Likewise, if a subprime lender refuses to indemnify its directors and officers for a claim covered under the policy, the insured v. insured exclusion should not bar coverage for a suit brought by the directors and officers against the lender for indemnification. Indeed, many newer policies carve out exceptions for both of these situations, so these issues often will not arise.

This exclusion, however, may become relevant in bankruptcy proceedings and receiverships. The receiver of a bankrupt subprime lending bank that sues the bank's directors and officers may face a coverage denial from the bank's insurance company on the ground that the receiver has stepped into the shoes of the bank, making the suit in essence one between two policyholders. Courts, however, have disagreed with the insurance companies, finding that the insured v. insured exclusion does not bar coverage in this context because the exclusion does not clearly exclude suits brought by receivers such as the Federal Deposit Insurance Corporation (FDIC).[17] *St. Paul Fire & Marine Ins. Co. v. FDIC*, 765 F. Supp. 538, 548 (D. Minn. 1991), *aff'd*, 968 F.2d 695 (8th Cir. 1992). Similarly, a bankruptcy trustee that has taken over a company that is not a bank but has gone bankrupt because of the subprime crisis (for example, an investment company or brokerage group) may face these same coverage denials if it sues the company's directors and officers. Because the trustee is acting "for the benefit of the [bank's] creditors," not the benefit of the bank, courts also have ruled that the exclusion does not apply to suits brought by bankruptcy trustees. *Pintlar Corp. v. Fid. & Cas. Co. (In re Pintlar Corp.)*, 205 B.R. 945, 948 (Bankr. D. Idaho 1997).

D. Securities Violations (D&O)

Some older D&O policies specifically identified certain securities violations for which they would not pay, such as a claim "related to, based upon, or arising from any violation of the

[17] Some D&O policies provide that they may not reimburse losses resulting from claims that are based upon actions brought by regulatory agencies, frequently including the FDIC. Those are not the sort of receivership actions that might be implicated by the insured v. insured exclusion. The regulatory exclusion, moreover, is narrowly construed.

Securities Act of 1934.” Newer policies, however, generally have removed these exclusions because securities violations are the precise sort of wrongful acts for which corporations seek coverage when purchasing a D&O policy. Some policies also contain exclusions for losses arising directly or indirectly from securities trades, but those typically concern losses related to market forces.

E. Breach of Contract (D&O)

Almost all banks have converted their subprime loans into MBS, which they have sold to hedge funds and other investors. Those sales typically take place through a purchase agreement, which may include provisions requiring the bank to provide financial information to the investors about the borrowers and to buy back the loans if the borrowers default within a certain time period (often three months). Investors have sued subprime lenders for allegedly breaching these buy-back provisions and for negligently providing false or inaccurate information about the borrowers. A subprime lender requesting coverage for losses resulting from such a suit may encounter a denial from its insurance company based on the breach of contract exclusion in its D&O policy.

A standard breach of contract exclusion provides that the insurance company may not be liable for losses “based upon, arising from, or in consequence of any actual or alleged breach of a written or oral contract where the claim is brought by or on behalf of a party to such contract.” Insurance companies may contend that breach of contract claims against a subprime lender are excluded and that negligence claims also are not covered because they arise out of the alleged breach of contract. However, if the alleged conduct would have been negligent regardless of whether the parties had entered into a contract or if the contract simply provided the context for the alleged conduct to take place but did not cause the conduct, the exclusion should not apply. *See, e.g.*, *Admiral Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 463 (N.D. Tex. 2003). This exclusion will not bar coverage when “the gist” of the allegations rises in tort and not in contract, or when the type of relief the plaintiff requests is not contractual in nature. *See Cont’l Cas. Co. v. County of Chester*, 244 F. Supp. 2d 403, 410 (E.D. Pa. 2003).

What is more, in some policies this exclusion is present only in Side C, the entity coverage part, meaning that it does not apply when directors and officers are the defendants. If both the corporation and the directors and officers are defendants, at the very least, the insurance company will be responsible for all losses sustained by the directors and officers and the defense costs incurred by the corporation; depending on policy language, the insurance company may be required to pay out all defense costs and losses.

VIII. CGL AND EPL INSURANCE MAY BE APPLICABLE TO SOME LIABILITIES IN THE SUBPRIME CONTEXT

Subprime lenders facing suits by cities (and others) for discrimination or public nuisance because of their alleged wrongful business practices should have insurance coverage under their CGL and EPL policies for attorneys' fees and any resulting losses. Although CGL policies typically cover claims alleging "bodily injury" or "property damage," they also often cover claims involving "personal and advertising injury." "Personal and advertising injury" is defined to mean injuries arising out of specified "offenses," including false arrest, detention or imprisonment, malicious prosecution, wrongful eviction or wrongful entry, invasion of the right of private occupancy, and oral or written publication of "material that slanders or libels a person or organization or disparages a person's or organization's goods, products or services" or violates a person's "right of privacy." Indeed, some "personal injury" clauses explicitly provide coverage for "racial or religious discrimination."

Courts across the country have interpreted "personal and advertising injury" clauses to provide extremely broad insurance coverage for claims alleging business wrongs, including those asserting race discrimination and nuisance. The court in *Gardner v. Romano*, for example, required a liability insurance company to pay a policyholder's defense costs when it was sued for racial discrimination. 688 F. Supp. 489, 492-93 (E.D. Wis. 1988). The court held that "interpreting the 'personal injury' definition to include claims for race discrimination . . . comports with the reasonable expectations of the insureds." *Id.* at 493. The United States District Court for the Central District of California, in *State Farm Fire & Casualty Co. v. Westchester Inv. Co.*, adopted the holding in *Gardner* and ruled that claims alleging racial discrimination are covered by the "personal injury" provision of a liability insurance policy. 721 F. Supp. 1165, 1167-68 (C.D. Cal. 1989); *see also Clinton v. Aetna Life & Sur. Co.*, 594 A.2d 1046, 1048-49 (Conn. Super. Ct. 1991) (applying Florida law) (interpreting "personal injury" clause as requiring a liability insurance company to pay the policyholder's defense costs in a race discrimination suit).

Courts also have held that the "personal injury" clause provides coverage for nuisance claims. *See Martin Marietta Corp. v. Ins. Co. of N. Am.*, 40 Cal. App. 4th 1113, 1123-36, 47 Cal. Rptr. 2d 670 (1995). In *Hirschberg v. Lumbermens Mutual Casualty*, for example, the United States District Court for the Northern District of California held that a "personal injury" provision provided coverage for claims alleging nuisance, which the court defined as an interference with the interest in the private use and enjoyment of land. 798 F. Supp. 600, 604 (N.D. Cal. 1992).

EPL policies similarly should cover defense costs and losses arising from discrimination claims. EPL policies generally provide coverage for an employee's discriminatory acts. Claims against a subprime lender for allegedly committing discrimination in its lending practices necessarily implicate those employees who committed the discrimination. EPL policies thus should cover the defense costs and losses resulting from those claims.

IX. CREDIT RISK INSURANCE IS ANOTHER VALUABLE SOURCE OF PROTECTION

Credit risk insurance policies offer companies an effective solution for minimizing risk by providing coverage for accounts receivable. The insurance is triggered by the indebtedness of a policyholder's clients, those in protracted default on their payments, or those that have become insolvent. Historically, industries that rely on consumer credit or loans benefit most from credit insurance. Consumer lending companies have always had a certain percentage of customers that will default on their obligations regardless of how strictly the company sets its credit requirements.

An investment group or a hedge fund might have credit insurance on its MBS to cover a lender's failure to buy back the loans, if required by a repurchase agreement. Many insolvent subprime lenders have failed to buy back these loans, and credit risk insurance may step in to make these expected payments. For example, PMI is one specific type of credit risk insurance that is relevant to the original subprime lender. Most lenders already have PMI policies because they require their subprime borrowers to purchase mortgage insurance to protect them in the event that the borrowers default on their mortgage payments.

Many mortgage insurance policies were procured specifically to protect investors in MBS, so that in the event that borrowers default, the investor receives the insurance proceeds. These policies, therefore, will be very relevant as subprime litigation progresses. In one case, for instance, an MBS investor sued, among others, the lender's mortgage insurance company, alleging that it breached its contract by not indemnifying the investor for securities' losses resulting from defaulted loans. *See Bankers Life Ins. Co. v. Credit Suisse First Boston Mortgage Sec. Corp.*, No. 8:07-cv-00690 (M.D. Fla. filed Apr. 23, 2007). The master mortgage policy at issue in this case had limits in excess of $312 million, covering 3,416 loans.

Insurance companies may raise a fraud or negligence exclusion to avoid fulfilling their agreements under a PMI policy. The exclusion typically addresses losses resulting from negligence that is "material to the acceptance of the risk by the insurance company, materially contributed to the [borrower's] default resulting in such claim, or increased the amount of the claim." To deny a claim based on this exclusion, an insurance company will have to prove fraud or negligence as to each loan at issue; proving a pervasive fraud, for instance, is not sufficient to exclude coverage for all of the loans at issue. *See, e.g., Citizens Sav. Bank, F.S.B. v. Verex Assurance, Inc.*, 883 F.2d 299, 303 (4th Cir. 1989) (applying South Carolina law).

Perhaps even more than in the case of other policies, the total level of coverage within each of the policies is greatly affected by the specific contractual provisions. Some policies feature waiting-period insolvency that can affect payouts, and others either specifically include or exclude coverage for particular instances of insolvency. For instance, many credit risk policies contain provisions—which effectively operate as exclusions—that condition payment of insurance proceeds upon the buyer's actually being in debt to the policyholder. In short, if a subprime lender disputes that it is obligated to repurchase loans it sold to an investor, the credit insurer may argue that the insurance does not kick in to reimburse the investor for that loss. So long as the subprime lender admits that it owes and cannot pay the debt to the investment company, however, the policy will cover the loss.

X. CONCLUSION

The current crisis presents numerous fact patterns for a putative defendant, all of which have different nuances that could affect the scope and type of insurance coverage potentially available to a policyholder. To maximize their insurances assets, companies that have suffered, or may suffer, losses resulting from the subprime lending crisis should perform at least two tasks. First, they should carefully review the relevant underlying issues and all of their corporate insurance policies. Second, corporate policyholders should promptly notify their insurance companies of any claims or potential claims asserted against them. By doing so, they will be taking advantage of the substantial financial benefit their policies provide.

ABOUT DICKSTEIN SHAPIRO LLP

Firm Profile

Dickstein Shapiro LLP, founded in 1953, is a multiservice law firm with more than 400 attorneys in Washington, DC, New York, and Los Angeles, representing clients in diverse industries with a wide variety of requirements. While Dickstein Shapiro's work generally originates from a client's need for legal representation, the Firm is mindful that legal service is but one ingredient in achieving a client's strategic business goals. The Firm prides itself on learning and understanding client objectives and partnering with clients to generate genuine business value.

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Insurance Coverage Practice

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Representative Insurance Coverage Attorney Biographies

Jerold Oshinsky joined Dickstein Shapiro in 1996 and is founder of the Firm's Insurance Coverage Practice. Referred to by his peers as "the dean of the policyholder bar," Jerry Oshinsky is "energetic and creative" with the "uncanny ability to size up the strengths and weaknesses of a dispute." Mr. Oshinsky focuses his practice on insurance coverage litigation on behalf of policyholders in federal and state courts throughout the country and on counseling clients nationwide on insurance coverage and related matters. In October 2007, Mr. Oshinsky was named as "The Leading Lawyer in Insurance" for Washington, DC by the *Legal Times*. He was chosen from among 10 finalists based on independent research and nominations from peers, clients, and other members of the legal industry. Mr. Oshinsky also is ranked in *Chambers USA: America's Leading Lawyers for Business* annual guide as a leading individual in the area of Insurance: Policy Holder (National and the District of Columbia). He also has been named in *The Best Lawyers in America*, *Washington DC Super Lawyers*, *Marguis Who's Who in America*, *The International Who's Who of Insurance and Reinsurance Lawyers*, and *The Lawdragon 500 Leading Lawyers.* Mr. Oshinsky is a principal author and editor of *Practitioner's Guide to Litigating Insurance Coverage Actions* (Aspen Law & Business, Second Edition 2002), a multivolume set, updated yearly, that includes legal commentary, practical advice, and forms for attorneys and legal staffs involved in insurance coverage litigation. He has also published numerous articles in various publications. He may be reached at oshinskyj@dicksteinshapiro.com

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James R. Murray joined Dickstein Shapiro LLP in 2007 as a partner in the Insurance Coverage Practice. According to *Chambers USA: America's Leading Lawyer's for Business*, the "astute" Mr. Murray is well known in the insurance sector and ". . . he understands the issues and where the bottom line is and he makes the winning argument based on reason." Mr. Murray's trial experience has ranged from environmental contribution cases to breach of contract, bank fraud, trademark infringement, and professional liability. He has more than 20 years of experience in the litigation and settlement of insurance coverage matters on behalf of policyholders, including disputes involving casualty insurance, first-party property policies, aviation coverages, broker liability, kidnap and ransom coverage, clergy abuse claims, directors and officers lines, and all manner of London-market issues. Mr. Murray also tries and arbitrates an array of other commercial matters. He may be reached at murrayj@dicksteinshapiro.com.

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In This Issue...

Featured Article

Public Nuisance: Will it Finally Swallow Traditional Notions of Product Liability Law?

Article contributed by:
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Owing in part to the high-profile settlement of lawsuits by State Attorneys General against the tobacco industry for $368 billion, there is a growing trend of cases being filed under the "public nuisance" theory by state and local governments. Public nuisance has been the basis of recent litigation filed against a variety of industries, including asbestos manufacturers, firearm manufacturers, tobacco companies, paint manufacturers, poultry and cranberry farmers, oil companies, electric utility companies and, most recently, auto manufacturers. Many of these cases have been filed by contingency-fee lawyers on behalf of government plaintiffs.

These lawsuits are a far cry from the traditional application of the public nuisance doctrine to abate waterway and highway obstructions and prevent gambling, public drunkenness and prostitution, and are filed both to circumvent the more rigorous requirements of traditional products liability law and to legislate through litigation. Such suits strip away traditional tort defenses and misapply traditional public nuisance jurisprudence by ignoring the requirements of harm to the general public, unreasonableness, proximate cause, and product identification and control, and seek to remove lawmaking functions from legislatures. Nonetheless, liability theories that once were far-fetched are gaining a foothold in American jurisprudence, and litigation is being used more and more as an instrument of public policy. Although defendants in the new public nuisance litigations generally have been successful in defeating such claims, recent decisions in lead paint litigation threaten to turn tort law generally, and public nuisance theory particularly, on their heads.

Traditional Public Nuisance Doctrine

Public nuisance jurisprudence has developed over centuries of English and American common law, and, unlike traditional torts, focuses on the rights of the general public rather than those of the individual. The tort of public nuisance is poorly understood.[1] Historically, public nuisance suits involved obstruction of public highways or waterways, or offenses of public morals or welfare that were classified as "common nuisances," including lotteries, gambling and prostitution. The traditional purpose of public nuisance law is to abate or terminate the harmful effects of the conduct, not to collect damages or to forge legislative or regulatory policies. Although individuals who have sustained a particular injury can seek compensatory damages, government entities may seek only abatement of the conduct constituting the public nuisance.

Traditionally, to sustain a claim for public nuisance, a plaintiff must prove that the offending conduct causes an injury to a right common to the general public. Such rights are "collective in nature and not like the individual right that everyone has not to be assaulted, or defamed or defrauded or negligently injured."[2] To determine whether conduct causes injury to a right common to the general public, it must be determined whether a person exercising a common right would be harmed if he or she came in contact with the conduct (*e.g.*, blocking a public road or waterway interferes with the public's right to traverse that road or waterway).

The interference with the public right also must be unreasonable. An unreasonable interference with a public right may be shown by any one of the following with respect to a defendant's conduct: 1) it significantly interferes with public health, safety or peace; 2) it continues and has produced a lasting effect, and the defendant knows that it has such effect; or 3) it violates a statute or regulation.[3] Finally, the defendant's conduct must have been the proximate cause of the nuisance, and the defendant must have had control over the instrumentality of the nuisance.[4]

Evolution of Public Nuisance Doctrine

Asbestos-contaminated buildings, tobacco-related illnesses, the marketing of firearms to criminals, lead levels in children, pollution and global warming all are legitimate societal concerns. Issues such as these, however, are properly addressed by the legislative branches of government. The failure of legislatures to resolve these issues does not make them either justiciable or a public nuisance.

Asbestos

The use of public nuisance suits against product manufacturers to resolve these societal concerns began in the 1980s with lawsuits by municipalities and school districts against asbestos manufacturers. Although these suits generally were unsuccessful,[5] they provided a blueprint for the public nuisance suits to come.

Tobacco

Beginning in the mid-1990s, public nuisance was used against the tobacco industry to avoid both the need to prove specific causation for smoking-related illnesses and defenses based upon smokers' own conduct.[6] The only court to consider a public nuisance claim in the tobacco lawsuits rejected the attempted expansion of public nuisance law.[7] Nevertheless, in 1998, 46 states and Brown & Williamson, Lorillard, Phillip Morris, and R.J. Reynolds entered into an unprecedented $368 billion settlement, allowing contingency-fee lawyers to collect up to $13 billion in fees.

Firearms

The next expansive use of the public nuisance doctrine was in municipal lawsuits against firearms manufacturers, filed and financed primarily by contingency-fee lawyers. In these suits, the allegations were not that the manufacture of firearms itself constituted a public nuisance, but that the manufacturers' marketing and distribution practices permitted criminals to acquire guns, and therefore created an unreasonable threat to public safety.

In firearms litigation, plaintiffs attempted to distort traditional public nuisance jurisprudence by equating the potential harm to large numbers of people caused by illegal firearm usage with injury to the general public. However, most courts held that harm to individuals, regardless of the number, is different from the harm to the public as a whole required to maintain a valid public nuisance claim.[8]

Plaintiffs also argued that the potential harm caused by firearms unreasonably interfered with the public's right to be free from gun violence. Firearm manufacturers, however, were held not to create "unreasonable" interferences with a public right simply by selling a product that was lawful and extensively regulated as to the timing and circumstances under which it was sold.[9]

Moreover, once the firearms were sold lawfully by their manufacturers and released into the stream of commerce, the manufacturers no longer had the requisite control over them to sustain a public nuisance claim. Courts have held that providing a lawful product to a consumer does not equate to having control over that product.[10]

Finally, although the end (mis)use of a firearm by its eventual consumer breaks the chain of causation, plaintiffs argued that manufacturers should be deemed to have proximately caused the harm because the resultant (mis)use should have been foreseeable.[11] The courts did not agree with this novel theory of proximate cause.[12] Although the firearms cases met with only limited success in the courts, with the success of the tobacco litigation, they were seen as a "vehicle for settlement,"[13] to justify huge damage demands, and as a way to achieve industry-wide regulation in the perceived absence of legislative oversight.

Lead Paint

Although success eluded the plaintiffs' bar in previous public nuisance suits, it was not deterred, and successes have been achieved, at least preliminarily, in the lead paint litigation. Spurred on by the big payouts in the state tobacco litigation, contingency-fee lawyers have shopped to state and local governments lawsuits against former manufacturers of lead paint. In October 1999, the lawyers primarily responsible for the state tobacco litigation convinced the Rhode Island Attorney General to sue the former manufacturers and their trade association, alleging that they created a public nuisance by marketing and selling lead paint with knowledge of its toxicity.[14] Moreover, because the paint is, in many instances, still there, albeit buried under layers of newer paint, Rhode Island contended that the "nuisance" is ongoing, thereby avoiding statute of limitations defenses that might otherwise apply, even though the lead paint at issue had been applied as long as a century ago, had not been sold since 1977, and was legal when it was sold and applied.

In 2006, in its second trial against the former manufacturers,[15] the State obtained a verdict against three of the original defendants, finding that the "cumulative presence" of lead paint in Rhode Island buildings – not the presence in individual homes or buildings – constituted a public nuisance and possibly required them to decontaminate more than 300,000 homes and buildings. The presiding judge essentially applied market share liability by ruling that the companies could be jointly and severally liable without proof that they ever manufactured lead paint used in the state, without proof that any former manufacturer's paint was used in any specific Rhode Island building and without proof as to which buildings contained deteriorated – in contrast to intact – paint.[16] While the court has indicated it will not award punitive damages, compensatory damages, which are yet to be determined, could be enormous – with the state seeking hundreds of millions of dollars, if not more, in cleanup costs.[17]

The Rhode Island court stripped away all traditional defenses, including product identification, proximate cause and statute of limitations, and permitted liability – despite defendants' lack of control over how the nuisance was created or over the premises in which the nuisance exists. Seven years and untold tens of millions of dollars in defense costs later, the defendants will begin the decontamination/damages phase of the trial before an appealable final judgment will be entered.

In a separate lead paint case brought by the same contingency-fee counsel used in Rhode Island,[18] the Wisconsin Supreme Court explicitly adopted a "risk-contribution theory" that eliminated traditional tort law causation requirements, going beyond the implicit application of market share liability by the Rhode Island court. The Wisconsin Supreme Court held the former lead paint manufacturers liable based merely on their past participation in the lead paint industry. As the dissent aptly noted, "[t]he end result of the majority opinion is that the defendants . . . can be held liable for a product they may or may not have produced, which may or may not have caused the plaintiff's injuries, based on conduct that may have occurred over 100 years ago when some of the defendants were not even part of the relevant market."[19]

The plaintiffs' bar also has aggressively shopped lead paint cases to cities and counties who have filed their own public nuisance suits.[20] In response to both filed and announced lead paint lawsuits by several Ohio municipalities, in September 2006, Sherwin-Williams sued the Ohio cities of Columbus, East Cleveland, and Toledo, alleging that these jurisdictions have retained or will shortly retain contingency-fee counsel to represent them in similar lead paint cases, and that such cases violate its free speech and due process rights.[21] Lead paint suits now have been filed against Sherwin-Williams and other former manufacturers by the cities of Akron, Canton, Cincinnati, Columbus, East Cleveland, Lancaster and Toledo, all using the same contingency-fee counsel as was used by Rhode Island.[22] Further, on April 2, 2007, Ohio Attorney General Marc Dann filed a lead paint lawsuit against a number of former manufacturers, alleging the creation of a public nuisance and seeking detection and abatement of lead in all buildings in the state, both public and private, accessible to children.[23]

Partly in response to such lawsuits, on December 27, 2006, the Ohio legislature sent to the Governor Senate Bill 117, which would restrict claims for the costs of cleaning up lead-based paint in buildings and cap non-economic damages in consumer protection lawsuits at $5,000. The bill provides that a manufacturer may <u>not</u> be held liable in a product liability action based on market share, enterprise or industry-wide liability. Ohio law gives the Governor's office ten days to sign or veto a bill. If he does neither, the bill automatically becomes law. On January 5, 2007, outgoing Ohio Governor Bob Taft said he would allow the bill to become law without his signature. However, on January 9, his first day in office, incoming Governor Ted Strickland vetoed the bill, calling the limit of $5,000 in non-economic damages for consumers "woefully inadequate." It is disputed under Ohio law whether the ten day period had expired by January 9. On February 2, 2007, the Ohio General Assembly, the President of the Ohio Senate and the Speaker of the Ohio House of Representatives filed an original mandamus action in the Ohio Supreme Court to compel the Ohio Secretary of State to enforce Senate Bill 117.[24] The Ohio Supreme Court heard oral arguments on May 2, 2007.

Other Prominent Public Nuisance Suits

The distortion of the public nuisance doctrine in the lead paint lawsuits has emboldened its proponents, including plaintiffs' attorneys operating on a contingent fee basis, to find judges who will continue to use public nuisance theory in ways it never was intended. Last September, California sued the "Big Six" automakers – General Motors, Toyota, Ford, Honda, Chrysler and Nissan – alleging that they are responsible for global warming in California and seeking millions of dollars of past and untold future damages on behalf of the state and its residents, even though California's regulations on auto emissions are more stringent than those of any other state.[25] Much like the firearms cases, attempting to hold automakers liable under the public nuisance doctrine ignores traditional public nuisance principles. Automakers sell a highly-regulated, lawful product, have no control over the cars once they are sold, and auto emissions are but one of the numerous causes of greenhouse gas emissions. Moreover, this suit seeks only monetary damages, a remedy not available to government plaintiffs under traditional public nuisance law. Most recently, the automakers have argued that the U.S. Supreme Court's recent decision requiring the United States Environmental Protection Agency (U.S. EPA) to regulate carbon dioxide emissions nullifies California's suit.[26]

A similar public nuisance suit also was filed by a number of states against electric utility companies, even though power plant emissions are regulated by the U.S. EPA and by state regulatory agencies.[27] Although that suit was dismissed on the grounds that such issues are more appropriate for the legislature, not the courts, the plaintiffs are appealing that dismissal.[28]

There also have been a number of environmental cases brought by states that seek damages based on public nuisance, rather than the traditional remedies afforded under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) or state environmental laws.[29] For example, in 2004, the Wisconsin Attorney General filed a suit against a cranberry grower on the grounds that his marshes were causing a nuisance by discharging phosphorous into a nearby bay.[30] The plaintiffs alleged no violation of any statute or regulation, but sought to enjoin the grower from use of the bay for his farming operation. The court dismissed the suit in April 2006, finding that there was no public nuisance caused by the grower's actions as there was no ecological damage to the bay, no threat to human health and no interference with recreational use.

In addition, in 2005, citing the protection of Oklahoma lakes and streams, drinking water and public health, Oklahoma Attorney General Drew Edmondson filed a lawsuit on public nuisance grounds against several out-of-state poultry companies, including Tyson Foods, Inc., for polluting the waters of the state.[31] The lawsuit alleged that runoff from improper dumping and storage of poultry waste caused and continues to cause the pollution of Oklahoma streams and lakes. Oklahoma has claimed that the defendants' actions have violated the federal CERCLA, state and federal nuisance laws, trespass and the Oklahoma Environmental Quality and Agriculture Codes. The suit is pending.

Although most of the recent wave of public nuisance cases, including many of the lead paint cases, have not approached a final resolution, successes by plaintiffs thus far likely will lead to the filing of hundreds of additional lawsuits against scores of additional industries. This misapplication of public nuisance theory blurs the boundary between the well-developed body of product liability law and traditional public nuisance law and threatens to create a new tort theory against which it is nearly impossible to defend. If plaintiffs cannot prevail against product manufacturers under traditional tort theories of liability, they should not be permitted to transform their claims into the realm of public nuisance, a tort theory that never was intended to be used in the proposed manner. Such public nuisance lawsuits are blatant attempts to force large settlements and to regulate through litigation, and deny defendants their traditional legal and constitutional protections.

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[1] W. Page Keeton *et al.*, *Prosser & Keeton*, LAW OF TORTS (5th ed. 1984) §86, at 616 ("There is a general agreement that [the tort of public nuisance] is incapable of any exact or comprehensive definition.").

[2] RESTATEMENT (SECOND) OF TORTS §821B cmt. g (1979).

[3] RESTATEMENT (SECOND) OF TORTS §821B(2) (1979).

[4] *See, e.g., Chicago v. Beretta U.S.A. Corp.*, 821 N.E.2d 1099, 1127–33 (Ill. 2005).

[5] *See, e.g., Detroit Bd. of Educ. v. Celotex Corp.*, 493 N.W.2d 513, 521 (Mich. Ct. App. 1992) ("manufacturers, sellers, or installers of defective products may not be held liable on a nuisance theory by injuries caused by the defect").

[6] Donald G. Gifford, *Public Nuisance As A Mass Products Liability Tort*, 71 U. CIN. L. REV. 741 (2003).

[7] *Tex. v. Am. Tobacco Co.*, 14 F. Supp. 2d 956, 973 (E.D. Tex. 1997) ("The overly broad definition of the elements of public nuisance urged by the State is simply not found in Texas case law and the court is unwilling to accept the State's invitation to expand a claim for public nuisance.").

[8] *Chicago*, 821 N.E.2d at 1115-16.

[9] *See, e.g., Chicago*, 821 N.E.2d at 1121 ("We are reluctant to interfere in the lawmaking process when the product at issue is already so heavily regulated by both the state and federal governments.").

[10] *See, e.g., City of Philadelphia v. Beretta U.S.A. Corp.*, 126 F. Supp. 2d 882, 911 (E.D. Pa. 2000).

[11] Victor Schwartz and Phil Goldberg, *The Law of Public Nuisance: Maintaining Rational Boundaries on a Rational Tort*, 45 WASHBURN L.J. 541, 577 (2006).

[12] *See Chicago*, 821 N.E.2d at 1136 (*citing People ex rel. Spitzer v. Sturm, Ruger & Co.*, 761 N.Y.S.2d 192, 201 (App. Div. 2003)).

[13] David Kairys, *The Origin and Development of the Governmental Handgun Cases*, 32 CONN. L. REV. 1163, 1172 (2000).

[14] The authors of this paper represent E.I. DuPont de Nemours & Co., one of the original defendants in Rhode Island's suit and a defendant in other lead paint lawsuits. The views expressed herein are solely those of the authors.

[15] The State's first trial ended in a hung jury.

[16] Intact lead paint does not cause elevated lead levels in blood. Despite this, the court inappropriately refused to permit discovery with respect to the maintenance practices of owners and landlords

of buildings that contained lead paint or the condition of the buildings.

[17] *See* Julie Creswell, *The Nuisance That May Cost Billions*, N.Y. TIMES, Apr. 2, 2006, at A1.

[18] *Thomas ex rel. Gramling v. Mallett*, 701 N.W.2d 523 (Wis. 2005).

[19] *Id.* at 567.

[20] *See, e.g., City of Chicago v. Am. Cyanamid Co.*, No. 02 CH 16212 (Ill. Cir. Ct. 2003); *City of Milwaukee v. NL Indus. Inc. & Mautz Paint*, 691 N.W.2d 888 (Wis. Ct. App. 2004); *City of St. Louis v. Lead Indus. Assoc.*, N. 22002-00245-01 (Mo. Cir. Ct. 2001); *see also County of Santa Clara v. Atl. Richfield Co.*, 40 Cal. Rptr. 3d 313 (Ct. App. 2006). On June 21, 2006, the California Supreme Court refused to review an appellate court decision validating the use of public nuisance law against former lead paint manufacturers. *County of Santa Clara v. Atl. Richfield Co.*, S142578 (Cal. 2006). On April 4, 2007, the trial court judge granted the defendants' motion precluding the use of outside counsel on a contingency-fee basis. *County of Santa Clara v. Atl. Richfield Co.*, Case No. 1-00-CV-788657 (Sup. Ct. Cal. filed Apr. 4, 2007); *In re Lead Paint Litig.*, No. A-1946-02T3 (N.J. Super. Ct. App. Div. Aug. 17, 2005). The New Jersey Supreme Court agreed to hear the defendants' appeal on the legitimacy of the use of public nuisance law against former lead paint manufacturers. *In re Lead Paint Litig.*, 185 N.J. 391 (2005).

[21] *Sherwin-Williams Co. v. City of Columbus*, No. 2:06 CV 829, (S.D. Ohio filed Sept. 29, 2006).

[22] *Akron v. Sherwin Williams*, No. 2006-10-639 (Ct. Com. Pl. Summit County filed Oct. 4, 2006); *Canton v. Sherwin Williams*, No. 2006-CV-05048 (Ct. Com. Pl. Stark County filed January 2, 2007); *Cincinnati v. Sherwin Williams,* No. A0611226 (Ct. Com. Pl. Hamilton County filed December 27, 2006); *Columbus v. Sherwin Williams*, No. 06-CVH-1216480 (Ct. Com. Pl. Franklin County filed December 15, 2006); *East Cleveland v. Sherwin Williams*, No. CV-06-602785 (Ct. Com. Pl. Cuyahoga County filed Sept. 29, 2006); *Lancaster v. Sherwin Williams*, No. 06-CV-1055 (Ct. Com. Pl. Fairfield County filed Oct. 17, 2006); *Toledo v. Sherwin Williams*, No. CV-06-96040 (Ct. Com. Pl. Lucas County filed Sept. 29, 2006).

[23] *People ex rel. Dann v. Sherwin Williams*, No. 07-CVC-044587 (Ct. Com. Pl. Franklin County filed Apr. 2, 2007).

[24] *State ex rel. Ohio General Assembly v. Brunner*, No. 07-0209, (Ohio Sup. Ct. filed Feb. 2, 2007).

[25] *People ex rel. Lockyer v. Gen. Motors Corp.*, No. C06-05755 (N.D. Cal. filed Sept. 20, 2006). California also has sued Coca-Cola for the public nuisance of including lead in glass bottles. *State of Cal. ex rel Lockyer v. The Coca-Cola Co*, No. BC352402 (Super. Ct. Los Angeles County 2006).

[26] *Massachusetts v. E.P.A.*, 127 S. Ct. 1438 (2007).

[27] *Conn. v. Am. Elec. Power Co.*, 406 F. Supp. 2d 265 (S.D.N.Y. 2005).

[28] Such appeal is pending in the U.S. Court of Appeals for the 2nd Circuit.

[29] *See, e.g., N.M. v. GE*, 467 F.3d 1223 (10th Cir. 2006) (affirming grant of summary judgment to defendants; using contingency-fee counsel in state nuisance case); *N.H. v. Amerada Hess Corp. (In re Methyl Tertiary Butyl Ether ("MTBE") Prods. Liab. Litig.)*, 361 F. Supp. 2d 137, 139 (S.D.N.Y. 2004) (contingency-fee counsel used by certain plaintiffs).

[30] *State of Wisconsin v. Zawistowski,* No. 04-CV-75 (Wis. Cir. Ct. Apr. 5, 2006).

[31] *State of Okla. ex rel. Edmondson v. Tyson Foods*, 05-CV-00329 (N.D. Okla. 2005) (using contingency-fee counsel).

Corporate Governance

Federal Regulation

U.S. Senators Request Sarbanes-Oxley Extension for Small Public Companies

Two U.S. Senators have requested that the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) provide more time for small public companies to comply with the upcoming final rules regarding internal controls under Section 404 of the Sarbanes-Oxley Act of 2002 (Act), which are expected to be released this summer.

In a May 8, 2007 letter to SEC Chairman Christopher Cox and PCAOB Chairman Mark Olson, Senators John Kerry (D-Mass.) and Olympia Snowe (R-Maine) of the Senate Committee on Small Business and Entrepreneurship expressed concerns about the ability of small public companies to comply with new internal control regulations because such companies need time to remedy any weaknesses or difficulties they encounter during the initial assessment of their internal controls. The Senators noted their strong support of Section 404 of the Act and the willingness of small companies to comply with the Act's new rules regarding internal controls, but emphasized that "properly implementing and calibrating internal controls requires time and repetition," and that "small companies need appropriate time to evaluate and adjust for any weaknesses they find" in their internal controls, which they will be unable to do if the final rules require them to immediately furnish their management assessment to the SEC. In making their request, the Senators cited testimony that, once the new rules are released, there could be a severe shortage of qualified accounting, consultant, and internal control professionals available to help small companies comply with the law. A shortage of these professionals could lead to higher costs for small businesses, which would undermine the cost savings that the final rules are supposed to achieve.

Specifically, the letter requested the following:

- The postponement of the implementation date for Section 404 of the Sarbanes-Oxley Act for non-accelerated filers for up to one year after the final rules are issued;
- A full assessment of the cost of the new rules under the Regulatory Flexibility Act, 5 U.S.C. § 601 *et seq.* upon publication of the final rules and prior to them becoming effective;
- A small business compliance guide to assist small companies in implementing new internal controls requirements;

DICKSTEINSHAPIRO LLP

Looking for Light at the End of the Tunnel – Navigating the Subprime Mortgage Derivatives Market in Bankruptcy

Arnold Gulkowitz & Brian E. Goldberg
2007

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I. INTRODUCTION

The much heralded "subprime crisis" has recently rocked our capital markets and our global economy like a tsunami. The predicted flood of defaults under so-called "subprime" residential mortgages[1] is an issue that cannot be ignored. This subprime crisis and its concomitant evaporation of liquidity transcends industry category and geographic location.[2] Of particular import for this article are issues specifically arising when parties involved in the subprime mortgage derivatives industry file for bankruptcy.

There are multiple important bankruptcy issues for parties at all levels of the subprime mortgage industry. This article, however, focuses primarily on the implications for parties involved in the derivative and securitization markets, and addresses those issues faced by institutional investors in the secondary mortgage market when their transaction counterparties threaten to, or file for, bankruptcy.[3]

II. BACKGROUND

The issues (bankruptcy or otherwise) related to subprime mortgages are important largely because of the scope of the subprime mortgage industry. This is not a small isolated segment of the mortgage market. Depending on one's definition of "subprime,"[4] these loans now account for approximately 600 billion dollars in originations per year, or twenty percent of the approximately three trillion dollar per year mortgage industry.[5] Moreover, the legal and financial issues plaguing the subprime mortgage system have now also entered some of the other tranches of debt,[6] particularly the so-called "Alt-A" levels of mortgage debt, which itself is now a significant component of the mortgage industry.[7] Issuances of Alt-A mortgage debt have mushroomed in the past several years from approximately 20 billion dollars in originations in the fourth quarter of 2003 to approximately 386 billion dollars in 2006.[8] Accordingly, any institutional participant in the mortgage industry almost by definition has substantial involvement in the subprime and/or Alt-A markets, with a corresponding exposure to the risks attendant thereto, all of which risk ultimately stems from borrowers struggling (and sometimes failing) to make their mortgage payments. It is estimated that one of every five subprime mortgages issued in the past year will end in foreclosure.[9]

Importantly, though, the risks related to subprime mortgages are not confined to the individual homeowners. The entire mortgage system is interdependent, with difficulties (or even perceived difficulties) by the individual subprime borrowers directly or indirectly causing payment or other contract defaults and other economic losses for parties throughout the mortgage industry, which can ultimately force such parties into bankruptcy. In fact, this crisis has already resulted in the bankruptcy of several institutional participants in the subprime and/or Alt-A mortgage markets,[10] with other major participants also showing signs of distress.[11] Moreover, several foreign institutions have recently fallen victim to this crisis, including a German state-run bank that was recently sold,[12] as well as British subprime mortgage lender Victoria Mortgage Funding Ltd. recently going into "administration"[13] (similar to an American receivership or liquidation).

This article will help (i) identify and explain some of the key bankruptcy issues facing institutional investors in the subprime mortgage market, and (ii) discuss potential strategies and analysis for addressing both current and possible future situations. In sum, there are concrete steps that a party can take to minimize its risks and to protect its interests when dealing with bankruptcy situations, and certain legal protections of which a party should be aware.

III. BANKRUPTCY 101

The right of individuals and companies to seek bankruptcy protection is embedded in the United States Constitution.[14] However, parties are obviously concerned not only when they are facing their own possible bankruptcy,[15] but also when they are transacting business with a company that has either threatened to, or does in fact, file for bankruptcy protection. When a company's business counterpart files for bankruptcy, there is an immediate risk of non-recovery for the non-bankrupt company's investments. Moreover, efforts (albeit prudent) to protect one's economic interests may in fact violate one or more of the myriad (and sometimes non-intuitive) provisions of the United States Bankruptcy Code.[16] To avoid this, a better understanding of some basic concepts of bankruptcy law can help parties to plan accordingly and to avoid costly mistakes.

In addition to understanding the so-called "safe harbor" bankruptcy provisions that are specifically addressed to the derivatives and securities markets, parties should be aware of a few basic bankruptcy concepts that help to define the bankruptcy process and are of particular concern to creditors and others whose contractual or transactional counterparties file for bankruptcy. Accordingly, immediately below is (i) an introduction to the bankruptcy safe harbor provisions, followed by a discussion of some core bankruptcy concepts: (ii) the so-called "automatic stay,"[17] (iii) the concept of an "estate,"[18] (iv) the rights of a debtor to control its so-called "executory" contracts,[19] (v) the so-called "avoidance powers" that assist the debtor and the bankruptcy court to enforce the Bankruptcy Code's claim priority framework,[20] and (vi) the claim priority framework established by the Bankruptcy Code.[21] Each will be discussed in turn, along with a corresponding discussion of steps a party can take in response, including use of the safe harbor provisions.

IV. SPECIAL "SAFE HARBOR" PROTECTIONS FOR INVESTMENT COMMUNITY

Fortunately for the secondary mortgage market, there are several so-called "safe harbor" provisions within the Bankruptcy Code (which were even recently expanded) that provide some protection to the non-bankrupt parties in transactions involving derivatives, securities, or similar contracts whose counterparties are in bankruptcy. In some instances these transactions have replaced more traditional arrangements that were designed to accomplish similar end results,[22] but that did not have the benefit of the safe harbor protections.

The safe harbor provisions clarify or even modify the debtor's ability to assert some of the otherwise applicable protective provisions of the Bankruptcy Code. These special rules generally apply to the following types of contracts -- a securities contract,[23] commodity contract,[24] forward contract,[25] repurchase agreement,[26] swap agreement[27] (collectively, "Financial Contracts"), and/or a master netting agreement (discussed in more detail below)[28] (together with Financial Contracts, collectively, "Safe Harbor Contracts") executed in connection with one or more Financial Contracts. Many of these safe harbor provisions were added or substantially enhanced in the 2005 amendments to the Bankruptcy Code embodied in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").[29]

In addition to strengthening the substantive protections under the safe harbor provisions, the BAPCPA amendments also expanded both the types of transactions and even the categories of institutions expressly covered by these provisions.

Of particular importance for the mortgage industry, the Bankruptcy Code now expressly clarifies that certain mortgage-related transactions are Safe Harbor Contracts and thus covered by the safe harbor provisions -- (i) by defining "repurchase agreements" to include agreements relating to the transfer of mortgage related securities, mortgage loans, and interests in mortgage related securities, as well as any security agreements or credit enhancements related to the foregoing[30] and defining (ii) "securities contracts" to include contracts for the purchase, sale, or loan of a mortgage loan or interest therein or a group or index of mortgage loans or interests therein, as well as to include certain repurchase and "reverse repurchase" transactions.[31] Other BAPCPA revisions also expand the applicability of certain safe harbor provisions to certain governmental parties.[32]

Also important to the derivatives and security industry is the BAPCPA amendment creating a new category of Safe Harbor Contract -- "master netting agreement" -- as well as the corresponding amendment to the Bankruptcy Code that created Section 561 of the Bankruptcy Code,[33] which expressly clarifies that parties may contractually agree not only to net claims and transactions under Financial Contracts (and the corresponding safe harbor protections provided to such netting and setoff transactions), but may net across product lines, e.g., a swap agreement can be netted against a repurchase agreement. This is a powerful tool because it increases the number of transactions to which a non-bankruptcy counterparty can look to set off its claims against a debtor. However, even cross-product netting or set-off still requires that both parties (bankrupt and non-bankrupt) to all transactions be the same. For example, an investor cannot create a master netting agreement to net (a) its claims against a debtor in connection with a swap agreement against (b) the debtor's obligations under a repurchase agreement, if the repurchase agreement is between the debtor and the investor's affiliate, rather than the investor itself. Accordingly, to implement a master netting arrangement, parties must ensure that both they and their counterparties are actually executing the underlying transactions and the netting agreement in the name of the same corporate entity (and not different affiliates for each contract). Once bankruptcy commences it is too late to correct this structural flaw.

Additionally, "swap agreements," for purposes of the safe harbor provisions, now expressly include many types of transactions whose inclusion was previously unclear at best, including equity swaps, total return swaps, credit swaps, as well as "any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that . . . is presently, or in the future becomes, the subject of recurrent dealings in the" swap markets.[34]

Congress also expanded the safe harbor provisions to apply to a newly created category of institution -- so-called "financial participants"[35] -- in addition to the other types of institutions who otherwise previously qualified. To be a financial participant, a party must have one or more Safe Harbor Contracts aggregating $1 billion or more in notional or actual principal amount, or $100 million in gross mark-to-market positions outstanding, on any day in the fifteen months prior to the bankruptcy, aggregated across all counterparties (and not just to debtor or debtor's affiliates).[36]

Finally, Congress clarified that the safe harbor protections apply with equal force to a case commenced as a Chapter 15 cross-border proceeding rather than a traditional bankruptcy under Chapters 7 or 11 of the Bankruptcy Code.[37] The statutory language is clear with no stated exceptions, and thus should apply even if the pertinent foreign jurisdiction has no comparable safe harbor protections. A Chapter 15 proceeding is typically a cross-border parallel proceeding commenced after a debtor has already sought liquidation, insolvency, or similar protections in another country, and seeks to support that foreign proceeding by enjoining creditor actions in the United States against the debtor or its assets.[38]

V. AUTOMATIC STAY

The automatic stay generally acts as an injunction against a creditor with a pre-bankruptcy claim from exercising its rights or remedies in any way against the debtor or the debtor's assets post-bankruptcy.[39] Parties who willfully violate this provision against an individual are potentially liable for actual damages, as well as costs and attorneys' fees and possibly punitive damages.[40] Moreover, some courts have found damage awards appropriate for violations of the stay even when the bankrupt party was a corporation, based on the court's general contempt power,[41] and many courts define "willful" in this context generally as being aware of the bankruptcy filing.[42]

For all transactions (whether or not they constitute Safe Harbor Contracts), there are still several traditional methods available to creditors to plan in advance for a possible debtor bankruptcy and the impact of the automatic stay[43]: require the debtor to provide co-liable parties such as guarantors[44] or require the debtor to provide a letter of credit or collateral pledge.[45] Creditors should also closely monitor all ongoing relationships to avoid burgeoning receivables delinquencies, and similarly monitor the counterparty's preservation of any assets that either belong to the creditor or constitute collateral securing obligations to it. In many instances, insurance policies and hedging transactions are also utilized by parties to limit their negative credit exposure.

Finally, once a company is in bankruptcy, the non-bankrupt counterparty must be vigilant in ensuring that its carefully planned pre-bankruptcy transactions and structures are maintained. This is especially so if the debtor is holding property that belongs to the non-bankrupt party, and even more so if the property in question is cash, which can be easily commingled or simply dissipated. Relatedly, non-bankrupt parties who have delivered property to the debtors should work with their counsel carefully to review the bankruptcy case pleadings to ensure no other party (such as a post-petition secured lender) is seeking to assert any liens, claims or interests against such property, and should be prepared to file appropriate objections or other pleadings in the event the debtor is not cooperating in this process.

Parties should also always endeavor to structure their transactions to qualify as a Safe Harbor Contract to insure the benefit of these exceptions to the automatic stay. In particular, counterparties to certain Safe Harbor Contracts may exercise setoff rights against a debtor with respect to certain payments or other transfers of property without prior court approval, including, depending on the Safe Harbor Contract at issue, and as applicable, margin payments or settlement payments,[46] and in certain instances, any payment or other transfer of property due from the debtor.[47] Additionally, the debtor is precluded from trying to interfere indirectly with this automatic stay exemption by seeking an injunction under any other provision of the

Bankruptcy Code.[48] In addition, parties may now liquidate, terminate, or accelerate Safe Harbor Contracts if provisions in such contracts provide for such relief upon the bankruptcy or insolvency of the now-bankrupt party.[49]

It is also important to remember that in the event an investor obtains a mortgage in the secondary market, either individually or bundled into a securitization, and the underlying borrower files for bankruptcy,[50] the safe harbor exemptions to the automatic stay do *not* apply to any foreclosure or other enforcement proceedings brought against the individual consumer borrower, even if the mortgage was obtained through a Safe Harbor Contract. However, the Bankruptcy Code does provide a mechanism for a secured party to have the court "lift" the automatic stay (and proceed with a foreclosure) if certain conditions are met.[51]

VI. BANKRUPTCY ESTATE

The Bankruptcy Code broadly defines the debtor's estate, essentially as all property interests of the debtor not otherwise specifically excluded.[52] Property of the estate is subject to the protections of the Bankruptcy Code, including the automatic stay, and generally falls within the debtor's control and the bankruptcy court's reviewing jurisdiction.

As discussed above, if a contract qualifies as a Safe Harbor Contract, the non-bankrupt counterparty may generally exercise setoff rights without first seeking approval of the court, even against property of the debtor pledged to the non-bankrupt party to secure its obligations.[53] Additionally, in addition to the use of Safe Harbor Contracts (which do not apply to all transactions), parties can try to structure their transactions such that there is an actual transfer of title to the non-bankrupt party of any assets in question in a transaction, rather than simply a lease, license, or similar arrangement that would possibly be governed by the executory contract provisions discussed below.[54]

VII. EXECUTORY CONTRACTS

Related to the concept of a debtor's estate is the debtor's right to determine which of its so-called "executory contracts"[55] are accepted (i.e., continued) and which are rejected (i.e., terminated with or without cause), with any rejection being deemed to occur the day prior to the bankruptcy, with damages ordinarily determined as of that day and paid like any other general unsecured creditor with a pre-petition claim (i.e., typically less than full value).[56] Moreover, the Bankruptcy Code generally invalidates a non-bankrupt counterparty's purported termination, acceleration, or liquidation of a contract with the debtor pursuant to a so-called "ipso facto" clause (i.e., termination simply because of the debtor's insolvent condition or filing a bankruptcy petition).[57]

However, with respect to Safe Harbor Contracts, the non-bankrupt party may enforce "ipso facto" provisions and may exercise rights of termination, acceleration or liquidation with respect to the Safe Harbor Contract based solely on the bankruptcy or insolvency of the bankrupt party. Moreover, unlike other executory contracts, in the event the debtor terminates a Safe Harbor Contract, damages are measured as of the date of the termination rather than the commencement of the bankruptcy case.[58] Finally, whether an agreement is a Safe Harbor Contract or not, parties to executory contracts can protect their interests by seeking guarantors or pledges of collateral.

VIII. AVOIDANCE POWERS

The Bankruptcy Code empowers the debtor's trustee with certain so-called "avoidance powers" to help protect the integrity of the claim distribution priority scheme (discussed *infra*) set forth in the Bankruptcy Code. Specifically, the Bankruptcy Code permits the debtor to recover certain property transferred to creditors prior to the commencement of the bankruptcy case.[59] The most common of these avoidable transfers is the "preference," which is a transfer made within ninety days prior to the bankruptcy filing on account of an antecedent debt (subject to certain exceptions and defenses).[60] Any property recovered pursuant to an avoidance action then becomes part of the bankruptcy estate,[61] to be redistributed in accordance with the Bankruptcy Code priority provisions discussed *infra*.

However, the safe harbor provisions provide that substantially all pre-petition transfers pursuant to a Safe Harbor Contract are exempt from the debtor's avoidance powers, with the only limitation being such transfer cannot have been an "actual" fraudulent conveyance,[62] which would require the transfer be for less than fair value and with actual intent to hinder, delay, or defraud creditors,[63] and the Bankruptcy Code creates a presumption in favor of finding value in connection with Safe Harbor Contracts[64] (in addition to the extreme evidentiary burden in proving actual intent to hinder, delay, or defraud creditors).

Additionally, if a transfer is challenged as a preference, even if not in connection with a Safe Harbor Contract, the BAPCPA amendments also lessened the burden for a transferee to establish an "ordinary course" defense against a preference allegation.[65] The transferee need only prove that the transfer was in connection with the ordinary course of the parties' practices or the industry norm, but not both, which is further incentive for parties to monitor receivables and assets on a regular basis, and not wait for their counterparties to be in distressed/pre-bankruptcy status.

IX. BANKRUPTCY PRIORITY PROVISIONS

The Bankruptcy Code has a carefully designed priority scheme that generally sets forth the order in which different types of creditors will be paid on account of their claims from the assets of the debtor's estate. This framework attempts to ensure equality of distributions among creditors of the same priority class by generally providing for parties of the same priority to receive distributions on a pro rata basis. This system further provides, with certain exceptions, for absolute priority, i.e., that creditors of a lower priority will not receive more than those of a higher priority. The order of claim priority is substantially identical for both Chapter 7 (liquidation) and Chapter 11 (reorganization) debtors.[66]

However, as discussed above, many of the remedies available under the safe harbor provisions are exercisable without court intervention or approval, thereby effectively providing parties to Safe Harbor Contracts with an exemption from the otherwise applicable priority provisions. Additionally, parties can request their non-bankrupt counterparties grant them a consensual lien because if a counterparty files for bankruptcy, secured creditors generally receive a higher priority on their claims than unsecured creditors.[67]

X. CONCLUSION

Although the subprime crisis has indeed increased the likelihood that institutional investors' counterparties may file for bankruptcy, there are many steps that parties can take to minimize the impact of such occurrences both before and during the bankruptcy process. Parties should always structure their transactions as Safe Harbor Contracts to take advantage of the so-called "safe harbor" provisions of the Bankruptcy Code, even if the counterparty is a foreign company that might file its main insolvency proceeding in another country. Similarly, parties should seriously consider structuring their Safe Harbor Contracts to enable maximum use of netting and setoff rights under the Bankruptcy Code, including the implementation of master netting agreements. Finally, in the event a bankruptcy actually occurs, institutions should be proactive working with counsel to protect their assets, excess collateral, security interests and investments that are within the possession or control of the bankrupt party.

ABOUT DICKSTEIN SHAPIRO LLP

Firm Profile

Dickstein Shapiro LLP, founded in 1953, is a multiservice law firm with more than 400 attorneys in Washington, DC, New York City, and Los Angeles, representing clients in diverse industries with a wide variety of requirements. While Dickstein Shapiro's work generally originates from a client's need for legal representation, the Firm is mindful that legal service is but one ingredient in achieving a client's strategic business goals. The Firm prides itself on learning and understanding client objectives and partnering with clients to generate genuine business value.

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[1] Subprime loans are loans (often on non-conventional terms) issued to borrowers who have low credit scores, and often are not supported by traditional ratio requirements either of (a) borrower debtload to income and/or (2) mortgage loan amount to value of home.
[2] British subprime mortgage lender Victoria Mortgage Funding Ltd. recently went into administration, and Landesbank Sachsen Girozentrale, a German state-run bank, was recently sold due in part to the subprime mortgage crisis and related global liquidity crisis.
[3] However, as a practical matter, even participants in the secondary mortgage market may have at least some involvement with the underlying loan transaction, and thus the article does explore these issues to a limited extent, as applicable.
[4] Typically borrowers with a Fair Isaac & Co. (FICO) credit score of less than 620. *See, e.g.*, E. Scott Reckard, *Subprime Borrowers Not Alone*, L.A. Times, Aug. 30, 2007, *available at* http://www.latimes.com/business/la-fi-loans30aug30,1,463269.story?coll=la-headlines-business. Some parties define subprime as loans to borrowers with credit scores below 660. *See, e.g.*, Office of Inspector General, U.S. Dep't of the Treasury, Audit Report No. OIG 03-024, *Material Loss Review of NextBank, NA* (Nov. 26, 2002), *available at* http://www.treasury.gov/inspector-general/audit-reports/2003/oig03024.pdf (referring to credit card debt).
[5] *See* John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets*, *in* IMF Country Report 07/265 United States, Selected Issues, 37, 40 (2007).
[6] *See, e.g.*, Chris Isidore, *'Liar Loans': Mortgage Woes Beyond Subprime*, cnnmoney.com, Mar. 19, 2007, http://money.cnn.com/2007/03/19/news/economy/next_subprime/index.htm.
[7] Mortgage loans issued to borrowers with credit scores above the subprime level, but not quite prime (i.e., 620-660/680). *See, e.g.*, Christine Haughney, *The Battle for a Mortgage*, N.Y. Times, Apr. 1, 2007, *available at* http://www.nytimes.com/2007/04/01/realestate/01cov.html?ex=1333080000&en=0faf0f506649afdc&ei=5088&partners=rssnyt&emc=rss. Alternatively, these are loans issued to borrowers with "prime" credit scores, but whose loans have other non-traditional components creating additional risk, such as unverified borrower income or assets (also called "Stated Income/Stated Asset" or "low doc/no doc").
[8] Isidore, *supra* note 8 (citing Standard & Poors estimates).

[9] Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* 3 (2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

[10] Recent bankruptcy filings include New Century Financial Corp. (subprime mortgage issuer), American Home Mortgage Investment Corp. (issuer of Alt-A mortgages), Aegis Mortgage Corporation (issuer of subprime mortgages), and two hedge funds managed by Bear Stearns that were heavily invested in mortgage securities -- High Grade Structured Credit Strategies Enhanced Leveraged Fund and the High Grade Structured Credit Strategies Fund.

[11] For example, Countrywide Financial Corp., the largest United States home lender, recently announced plans to lay off up to 12,000 of its approximately 60,000 employees, and Indymac Bancorp announced plans to lay off 1,000 employees.

[12] Landesbank Sachsen Girozentrale. *See* Nicola Clark, *Mortgage Crisis Forces Sale of German Bank*, N.Y. Times, Aug. 27, 2007, at C2.

[13] *UK Subprime Lender Victoria Mortgages Goes into Administration*, Forbes.com, Sept. 11, 2007, http://www.forbes.com/afxnewslimited/feeds/afx/2007/09/11/afx4103047.html.

[14] U.S. Const. art. I, § 8, cl. 4.

[15] Although clearly not the focus of this article, a party facing its own bankruptcy has to address a variety of issues relating to its very survival to a point in time where reorganization can be attempted (and hopefully implemented), or at least an orderly liquidation can be conducted. For example, a bankrupt party would typically try to hoard cash pre-bankruptcy to ensure it has some funds to pay basic expenses, as well as negotiate a form of post-petition lending agreement to ensure it has access to working capital for the duration of the case. A bankrupt company would also want to take steps to ensure its key employees remain with the company during the case, and that its key suppliers and customers remain loyal throughout the bankruptcy process. Additionally, a party filing for bankruptcy would examine its leases and contracts and decide which to retain and which to reject. Moreover, a bankrupt company that is part of the mortgage industry would also likely try to comply with the applicable regulatory guidelines, particularly because enforcement of such regulatory requirements against a debtor is likely exempt from the types of limitations imposed on private actors.

[16] For example, absent certain exceptions, a debtor can often force a creditor to return payments it received from the debtor within ninety days prior to a bankruptcy filing, to the extent the payment was on account of a prior debt. *See* 11 U.S.C. § 547(b).

[17] 11 U.S.C. § 362.

[18] 11 U.S.C. § 541.

[19] 11 U.S.C. § 365. The rights of a debtor regarding executory contracts are subject to certain important exceptions, including the protections provided to the non-bankrupt party to any Safe Harbor Contracts (as defined and discussed *infra*).

[20] 11 U.S.C. §§ 547, 548, 549, 550.

[21] 11 U.S.C. §§ 503, 507, 1129(a)(7)-(9), 1129(b).

[22] For example, parties often would have issued revolving loans, either on a secured or unsecured basis. For the purposes of this article, the authors assume that a court does not re-characterize any of the Safe Harbor Contracts as either secured or unsecured lending arrangements or otherwise not subject to the safe harbor provisions.

[23] 11 U.S.C. § 741(7).

[24] 11 U.S.C. § 761(4).

[25] 11 U.S.C. § 101(25).

[26] 11 U.S.C. § 101(47).

[27] 11 U.S.C. § 101(53B).

[28] 11 U.S.C. § 101(38A).

[29] However, Congress did not enact certain proposed BAPCPA provisions specifically relating to the placing of mortgage loans or other assets into securitization trusts, which would have expressly exempted such assets from the definition of a bankrupt's estate. Such provisions did exist in earlier versions of the proposed amendments to the Bankruptcy Code. Bankruptcy Reform Act of 1999, S. Rep. No. 106-49, at 58-60. Nonetheless, the BAPCPA amendments to the provisions relating to repurchase agreements and security contracts still provide some comfort to securitization parties because repurchase agreements or other security contracts are often used in connection with the implementation of the securitization. Additionally, several states have helpful language in their Uniform Commercial Code or the commentary thereto, and property interests in bankruptcy are determined according to governing non-bankruptcy law, which is typically state law. *See, e.g.*, *Butner v. United States*, 440 U.S. 48, 55 (1979).

[30] 11 U.S.C. § 101(47).

[31] 11 U.S.C. § 741(7). The express inclusion within "securities contract" of certain repurchase and reverse repurchase transactions is noteworthy because the safe harbor protections for "repurchase agreements" contain certain limitations not applicable if the transaction can be characterized as a security contract.

[32] For example, the BAPCPA amendments to the Bankruptcy Code revised the definition of who can be a "forward contract merchant" to include an "entity" rather than any "person." 11 U.S.C. § 101(26). This change was likely to address the holding in *In re Mirant Corp.*, 303 B.R. 319 (Bankr. N.D. Tex. 2003), that certain government entities were not "persons" eligible for the safe harbor provisions applicable to forward contracts. Of course, one of the largest players in the mortgage industry, the Government National Mortgage Association (aka "Ginnie Mae") is generally exempt from application of many of the Bankruptcy Code's limitations.

[33] 11 U.S.C. § 561.

[34] 11 U.S.C. § 101(53B)(A)(ii)(I).

[35] 11 U.S.C. § 101(22A).

[36] 11 U.S.C. § 101(22A).

[37] *See* 11 U.S.C. § 561(d).

[38] Without a corresponding Chapter 15 proceeding, a foreign insolvency proceeding's impact on a debtor's United States assets or creditors is limited because a foreign court generally has no jurisdiction in the United States.

[39] 11 U.S.C. § 362.

[40] 11 U.S.C. § 362(k) (formerly 11 U.S.C. § 362(h)).

[41] *See, e.g.*, *Jove Eng'g, Inc. v. IRS*, 92 F.3d 1539, 1555-57 (11th Cir. 1996).

[42] *See, e.g.*, *Brown v. Chestnut (In re Chestnut)*, 422 F.3d 298, 302 (5th Cir. 2005); *Fleet Mortgage Group, Inc. v. Kaneb*, 196 F.3d 265, 269 (1st Cir. 1999); *Cuffee v. Atl. Bus. & Cmty. Dev. Corp. (In re Atl. Bus. & Cmty. Corp.*), 901 F.2d 325, 329 (3d Cir. 1990); *Knaus v. Concordia Lumber Co. (In re Knaus)*, 889 F.2d 773, 775 (8th Cir. 1989); *Goichman v. Bloom (In re Bloom)*, 875 F.2d 224, 227 (9th Cir. 1989).

[43] All of these pre-bankruptcy planning steps should be done in consultation with legal counsel. For example, a federal appellate court recently issued a decision that could have significant impact on how parties structure and enforce guaranties. *See Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power LLC (In re Nat'l Energy & Gas Transmission, Inc.)*, 492 F.3d 297 (4th Cir. 2007) (claim against debtor reduced by amount paid by non-debtor guarantor that was purported to be allocated to post-petition interest, but court allocated payment first to principal and pre-petition interest because post-petition interest is not payable by debtor).

[44] Generally, third parties such as guarantors are not protected by the automatic stay, *see, e.g.*, *Sav-A-Trip, Inc. v. Belfort*, 164 F.3d 1137, 1139 (8th Cir. 1999), and remain liable on the debt despite the debtor's bankruptcy filing. *See* 11 U.S.C. § 524(e). The debtor also remains liable on the claim, but only to the extent of the claims resolution and distribution process of the Bankruptcy Code.

[45] As discussed herein, the pledge of collateral to secure a debt is also particularly helpful in the context of Safe Harbor Contracts because liquidating the collateral in connection therewith may not even require court approval.

[46] 11 U.S.C. § 362(b)(6), (7).

[47] *See, e.g.*, 11 U.S.C. § 362(b)(17), (27).

[48] 11 U.S.C. § 362(o). This provision prevents a debtor from seeking an injunction under Section 105 of the Bankruptcy Code, which otherwise permits a bankruptcy court to issue any "necessary or appropriate" order.

[49] 11 U.S.C. §§ 555, 556, 559, 560, 561.

[50] A very possible event given the types of mortgages under discussion (i.e., borrowers with subprime credit, or Alt-A borrowers who provided little or no evidence of income or assets sufficient to satisfy the mortgage).

[51] Like any other secured party, a mortgagee may demonstrate to the court that its interests in the collateral securing its claim against the debtor is not adequately protected, and/or the debtor has no equity in the property. *See* 11 U.S.C. § 362(d). Historically, the lack of equity was rare for residential real estate, but part of the ongoing "crisis" is because for the past several years many subprime and Alt-A mortgages required no down payment (and thus no equity cushion), and often involved so-called "exotic" payment arrangements that included initial artificially low interest payments and no payments toward the principal of the loans, at least for the first year or years of the loan. *See, e.g.*, B. Sullivan, "Homeowners place faith in 'exotic' mortgages," MSNBC, July 18, 2005. Moreover, in many areas property values are declining, further diminishing whatever equity may have existed for these mortgages. *See, e.g.*, Sonja Steptoe, *California's Real Estate Tailspin*, Time, July 27, 2007, *available at* http://www.time.com/time/business/article/0,8599,1647607,00.html.

[52] 11 U.S.C. § 541.

[53] *See* 11 U.S.C. §§ 555, 556, 559, 560, 561; 11 U.S.C. § 362(b)(6), (7), (17), (27). This is in contrast to even a secured creditor, who typically needs court approval before enforcing rights or exercising remedies against debtor's property pledged as collateral.

[54] An example of this in the mortgage industry is the transfer of the rights to service one or more mortgages. If a party purchases servicing rights from the debtor, the debtor cannot terminate servicing because it no longer owns these rights. In contrast, if a party simply enters into a license or a servicing contract, but the debtor still "owns" the servicing rights, then the debtor is free to terminate the servicing arrangements or to use the threat of termination as leverage to force the non-bankrupt servicer to make concessions.

[55] An executory contract is typically defined as a contract under which substantial performance obligations remain as to both sides such that "'failure of either to complete performance would constitute a material breach excusing performance of the other.'" *Sharon Steel Corp. v. Nat'l Fuel Gas Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989) (quoting Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973)).

[56] 11 U.S.C. § 502(g).

[57] 11 U.S.C. § 365(e)(1).

[58] 11 U.S.C. § 562. This overturns the otherwise applicable holding of *In re Enron Corp.*, 330 B.R. 387 (Bankr. S.D.N.Y. 2005), which construed pre-BAPCPA bankruptcy provisions to calculate rejection damages as of day prior to bankruptcy filing for a power supply agreement.

[59] *See, e.g.*, 11 U.S.C. §§ 547, 548, 550.

[60] 11 U.S.C. § 547.

[61] 11 U.S.C. § 541(a)(3).

[62] 11 U.S.C. § 546(e)-(g); 11 U.S.C. § 548(a)(1)(A).

[63] 11 U.S.C. § 548.

[64] 11 U.S.C. § 548(d).

[65] 11 U.S.C. § 547(c).

[66] There are multiple Bankruptcy Code provisions which when read together collectively set forth much of the priority framework for Chapter 7 and Chapter 11 debtors. *See, e.g.*, 11 U.S.C. §§ 503, 507, 1129(a)(7)-(9), 1129(b). (Section 1129 only applies to Chapter 11 debtors.) Relatedly, the Bankruptcy Code provides that absent certain limited exceptions, a creditor of a Chapter 11 debtor must receive property in consideration for its claim of a value at least as much as it would receive if the case were filed under Chapter 7. *See* 11 U.S.C. § 1129(a)(7)(A)(ii).

[67] *See, e.g.*, 11 U.S.C. § 1129(b)(2).

DICKSTEINSHAPIRO LLP

And the Left Hand Taketh (Or Does It?): Specific Coverage Exclusions Most Likely to Arise in the Subprime Lending Context

By James R. Murray and Avner E. Mizrahi
2007

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I. INTRODUCTION[1]

Subprime lending institutions, and their officers and directors, are being sued by a variety of plaintiffs and in a variety of contexts. Borrowers are asserting that their lenders, among other things, defrauded them, lied to them, and negligently misrepresented information about their loan interest rates. Investors are alleging claims for breach of contract and negligent misrepresentation, and claiming that a lender's mortgage insurance should be available for those losses. Shareholders are suing for various securities violations, including allegations that the directors and officers gained illegal profits. To top it all off, some State Attorneys General have jumped into the fray and sued at least one subprime lender for violating state laws, including allegations that lenders failed to fund mortgages after closings.

A subprime lender facing such suits should review its insurance policies for potential coverage. Three types of insurance policies–and potentially more–may apply to these losses: directors and officers (D&O), errors and omissions (E&O), and credit risk insurance (including private mortgage insurance (PMI)). A lender, therefore, should closely examine all of its insurance policies, particularly the definitions and exclusions sections.

An insurance company may deny coverage without referring to the exclusions, arguing instead that the allegations against the subprime lender do not fall within the policy's definitions of "loss" or "claim." If the particular facts of the case satisfy the definitions, an insurance company still may deny coverage for subprime lending losses based on one of the various exclusions in a policy. The most common exclusions a subprime lender may encounter are: fraud/dishonesty (D&O and E&O); illegal personal profit (D&O and E&O); insured v. insured (D&O and E&O); securities violations (D&O); breach of contract (D&O); disputed indebtedness (credit risk) (which functions as an exclusion but typically is listed under a credit insurance policy's conditions section); negligence and fraud (PMI); and "balloon payment" (PMI).

Even if the policy covers the loss and no exclusions apply, an insurance company still may argue that the policy should be rescinded because a company's director or the company itself submitted false or misleading information in the insurance application. Innocent directors and officers, however, should not fear; almost all policies explicitly state that one manager's bad acts will not be imputed to the others.

A subprime lender, whose policy not only is valid but also covers the losses at issue, may nonetheless receive no proceeds from its D&O policy. If that policy contains a priority of

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[1] This article is intended to discuss the specific insurance coverage exclusions that may arise out of the subprime lending crisis. Because of the many variations in policy language, it does not address all of the issues. This article also does not replace, and should not be relied on instead of, legal advice based on the specific policy language involved and an insured's particular situation. However, it does provide a starting point and is intended to be an aid in considering what sometimes is a maze of factual and legal issues. This article may be considered advertising in some states.

payments provision, which requires the insurance company to pay the directors and officers before the lender, the subprime lender will receive coverage only if the insurance paid to the directors and officers does not reach the policy's limits.

In short, various policy provisions–ranging from definitions and exclusions to rescission and priority of payments clauses–may be used by insurance companies trying to preclude a subprime lender and/or its directors and officers from receiving insurance coverage. It is crucial to understand how these policy provisions work.

II. DEFINITIONS

When a subprime lender receives a communication from an adverse party–whether it be a demand letter, a complaint, a notice of investigation, an indictment, or some other communication–the first step to take in reviewing its insurance policies is to determine whether the allegations, and the loss that might result from them, fit into the policy's definitions for "loss" and "claim."

A. "Claim"

D&O and E&O policies typically define a claim as "a written demand for monetary damages; or a criminal proceeding commenced by the return of an indictment . . . against the insured for a wrongful act."[2] When a subprime lender, or its directors and officers, are sued (or indicted), it is clear that a claim exists under a D&O or E&O policy. A demand letter, a notice of a regulatory investigation, a demand for regulatory compliance, an initiation of arbitration proceedings, a grand jury investigation, a subpoena for documents, and even questioning by a prosecutor all may constitute a claim. *See, e.g.*, *Polychron v. Crum & Forster Ins. Cos.*, 916 F.2d 461, 463 (8th Cir. 1990) (holding that a subpoena for documents, a grand jury investigation, and questioning by an assistant U. S. attorney each in its own right, and all together, constituted a claim under Arkansas law).

If the policy does not define, or provides only a brief definition for, "claim," courts frequently will deem communications to be claims when they actually demand something, assert a legal right, or threaten formal consequences for failure to comply. *See, e.g.*, *Richardson Elects., Ltd. v. Fed. Ins. Co.*, 120 F. Supp. 2d 698, 701 (N.D. Ill. 2000) ("A claim is a demand for *something* due. A demand for money is not required for [it to be] a claim," and finding that requiring the policyholder to comply constitutes a claim). Generally, if a reasonable person would assume that the communication was making a claim, then a court likely will find that the communication indeed constitutes a claim. *See, e.g.*, *Bendis v. Fed. Ins. Co.*, 958 F.2d 960, 963 (10th Cir. 1991) (applying Kansas law).

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[2] A claim under a credit risk policy is not complicated, nor does it raise any interesting issues; it is nothing more than the policyholder's request to receive benefits under the policy because a borrower or buyer defaulted.

B. “Loss”

For a “loss” to be covered under a D&O or E&O policy, it must be an amount of money that the subprime lender or its officers and directors “become legally obligated to pay, . . . including but not limited to damages, judgments, settlements, pre-judgment and post-judgment interest, and defense costs.” Sometimes “loss” will be defined to include “punitive or exemplary damages, where insurable by law,” as some states allow punitive damages to be insured. *See, e.g., Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026, 1029-30 (5th Cir. 1978) (insurance covering liability for punitive damages does not violate public policy) (applying Texas law); *Meijer, Inc. v. Gen. Star Indem. Co.*, 826 F. Supp. 241, 247 (W.D. Mich. 1993) (same) (applying Michigan law); *see also* Michael A. Rosenhouse, Annotation, *Liability Insurance Coverage as Extending to Liability for Punitive or Exemplary Damages*, 16 A.L.R. 4th 11 (1982).

“Loss,” as defined, typically does not include costs incurred to comply with an order for “injunctive or other non-monetary relief.” For instance, an investor suing a subprime lender for not buying back defaulted loans may request specific performance just as a State Attorney General may try to enjoin subprime lenders to fund mortgage loans after closings. While an insurance company may assert that these are requests for injunctions and thus do not fall under the definition of “loss,” the requested specific performance is for the lender to pay money; it is monetary relief. Accordingly, these losses should not fall under the injunction/non-monetary relief exception to the definition of “loss.”

III. EXCLUSIONS

Even when allegations made against a subprime lender satisfy a policy’s definitions for “claim” and “loss,” the insurance company still may assert that an exclusion restricts or bars coverage. In the subprime lending context, the following exclusions are likely to arise.

A. Fraud/Dishonesty (D&O and E&O)

The fraud/dishonesty exclusion typically is found in D&O and E&O policies, and addresses losses resulting from a manager’s intentionally dishonest or fraudulent acts. For instance, the exclusion may provide that the insurance company will not pay for losses “based upon, arising from, or in consequence of . . . any deliberately fraudulent or dishonest act or omission or any willful violation of any statute or regulation by any insured.” Not all policies will require the fraud or dishonesty to be deliberate. While some policies will exclude both fraud and dishonesty, others will exclude only one or the other. Courts typically treat all of these permutations similarly. Indeed, one court interpreted a provision excluding losses “brought about or contributed to by the dishonesty of the Directors or Officers” to exclude only knowing acts of dishonesty. *Faulkner v. Am. Cas. Co.*, 584 A.2d 734, 751 (Md. Ct. Spec. App. 1991). Reckless acts that defraud the plaintiff in the underlying matter are not excluded. *Id.* (emphasizing that “[a] reckless, careless, negligent error, misstatement, misleading statement, act, or omission is within the definition of a ‘wrongful act,’ for which the policy provides coverage,” and the fraud/dishonesty exclusion does not remove that coverage).

Some policies, moreover, exclude coverage only for a “final adjudication” of fraud/dishonesty on the merits, that is, a final verdict in the underlying case that the directors or officers committed actual fraud. A settlement of the underlying case where the directors and officers do not concede liability, therefore, would not constitute a final adjudication. Most courts have held that the words “final adjudication” in a fraud/dishonesty exclusion preclude the insurance company from litigating in the coverage action whether the director or officer actually committed fraud; the insurance company is stuck with the judgment entered in the underlying case. *See, e.g.*, *Graham v. Preferred Abstainers Ins. Co.*, 689 So. 2d 188, 190 (Ala. Ci. App. 1997); *Atl. Permanent Fed. Sav. & Loan Ass’n v. Am. Cas. Co.*, 839 F.2d 212, 216-17 (4th Cir. 1988) (per curiam) (applying Virginia law); *Nat’l Union Fire Ins. Co. v. Cont’l Ill. Corp.*, 666 F. Supp. 1180, 1197-98 (N.D. Ill. 1987). Other policies, however, exclude fraud “in-fact” or a “final determination” or “establishment” of fraud. Insurers may assert–incorrectly we believe–that this language permits them to litigate in the coverage action whether the directors and officers actually committed fraud, even if the underlying case never reached a final adjudication on that issue.

B. Illegal Personal Profit (D&O and E&O)

A typical personal profit exclusion states that a policyholder will not receive insurance proceeds for losses based upon or arising from the policyholder’s “having gained in fact any profit, remuneration, or other advantage to which [he/she] was not legally entitled.” If the personal profit results from an illegal act but is not in fact an illegal profit, or the directors and officers are sued for certain wrongful conduct from which they gained an advantage but the profit is not the basis of the claims, then this exclusion should not bar coverage. *See Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 398-401 (D. Del. 2002).

For instance, if a subprime lender’s directors and officers made illegal securities misrepresentations, and as a by-product received a private gain, this exclusion would not apply because the actual gain was not illegal. *See id.* at 400. In contrast, insurance companies may contend that this exclusion would apply if the directors and officers committed insider trading because insider trading is a form of theft, a profit that is against the law. *See id.* In essence, this exclusion does not bar coverage for “improper” profits; it precludes coverage for “illegal” profits. *See id.* (the illegal personal profit exclusion “requires a profit or gain that is illegal; not an illegal act that produces a profit or gain to the insured as a by-product”).

Moreover, as with the fraud/dishonesty exclusion, policies vary on whether they require a “final adjudication” or a “final determination” that the directors and officers gained an illegal profit for this exclusion to apply.

C. Insured v. Insured (D&O and E&O)

The insured v. insured exclusion provides that the insurance company is not liable for a claim "brought or maintained by or on behalf of any insured in any capacity," that is, for a claim made by one insured against another. Insurance companies may assert that the exclusion is implicated in the case of derivative lawsuits, but most courts have held that the exclusion's purpose is to prevent collusion between the named insureds, which is not an issue in derivative suits. *See, e.g., Township of Center, Butler County, Pa. v. First Mercury Syndicate, Inc.*, 117 F.3d 115, 119 (3d Cir. 1997) ("[t]he primary focus of the exclusion is to prevent collusive suits") (applying Pennsylvania law); *Fid. & Deposit Co. v. Zandstra*, 756 F. Supp. 429, 431 (N.D. Cal. 1990) ("[t]he obvious intent behind the 'insured v. insured' exclusion is to protect [the insurance company] against collusive suits"). Likewise, if a subprime lender refuses to indemnify its directors and officers for a claim covered under the policy, the insured v. insured exclusion should not bar coverage for a suit brought by the directors and officers against the lender for indemnification. Indeed, many newer policies carve out exceptions for both of these situations, so these issues often will not arise.

This exclusion, however, may become relevant in bankruptcy proceedings and receiverships. The receiver of a bankrupt subprime lending bank that sues the bank's directors and officers may face a coverage denial from the bank's insurance company on the ground that the receiver has stepped into the shoes of the bank, making the suit in essence one between two policyholders. Courts, however, have disagreed with the insurance companies, finding that the insured v. insured exclusion does not bar coverage in this context because the exclusion does not clearly exclude suits brought by receivers such as the Federal Deposit Insurance Corporation (FDIC).[3] *St. Paul Fire & Marine Ins. Co. v. FDIC*, 765 F., Supp. 538, 548 (D. Minn. 1991), *aff'd*, 968 F.2d 695 (8th Cir. 1992). Similarly, a bankruptcy trustee that has taken over a company that is not a bank but has gone bankrupt because of the subprime crisis (for example, an investment company or brokerage group) may face these same coverage denials if it sues the company's directors and officers. Because the trustee is acting "for the benefit of the [bank's] creditors," not the benefit of the bank, courts also have ruled that the exclusion does not apply to suits brought by bankruptcy trustees. *Pintlar Corp. v. Fid. & Cas. Co.(In re Pintlar Corp.)*, 205 B.R. 945, 948 (Bankr. D. Idaho 1997).

D. Securities Violations (D&O)

Some older D&O policies specifically identified certain securities violations for which they would not pay, such as a claim "related to, based upon, or arising from any violation of the Securities Act of 1934." Newer policies, however, generally have removed these exclusions because securities violations are the precise sort of wrongful acts for which corporations seek

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[3] Some D&O policies provide that they will not reimburse losses resulting from claims that are based upon actions brought by regulatory agencies, frequently including the FDIC. Those are not the sort of receivership actions that might be implicated by the insured v. insured exclusion. The regulatory exclusion, moreover, is narrowly construed, and in any event, most of the subprime liabilities or losses are in the private, civil context.

coverage when purchasing a D&O policy. Some policies also contain exclusions for losses arising directly or indirectly from securities trades, but those typically concern losses related to market forces.

E. Breach of Contract (D&O)

Almost all banks have converted their subprime loans into mortgage-backed securities, which they have sold to hedge funds and other investors. Those sales typically take place through a purchase agreement, which may include provisions requiring the bank to provide financial information to the investors about the borrowers, and to buy back the loans if the borrowers default within a certain time period (often three months). Investors have sued subprime lenders for allegedly breaching these buy-back provisions and for negligently providing false or inaccurate information about the borrowers. A subprime lender requesting coverage for losses resulting from such a suit may encounter a denial from its insurance company based on the breach of contract exclusion in its D&O policy.

A standard breach of contract exclusion provides that the insurance company will not be liable for losses "based upon, arising from, or in consequence of any actual or alleged breach of a written or oral contract where the claim is brought by or on behalf of a party to such contract." Insurance companies may contend that breach of contract claims against a subprime lender are excluded and that negligence claims also are not covered because they arise out of the alleged breach of contract. However, if the alleged conduct would have been negligent regardless of whether the parties had entered into a contract or if the contract simply provided the context for the alleged conduct to take place but did not cause the conduct, the exclusion should not apply. *See, e.g.*, *Admiral Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 463 (N.D. Tex. 2003). This exclusion will not bar coverage when "the gist" of the allegations rises in tort and not in contract, or when the type of relief the plaintiff requests is not contractual in nature. *See Cont'l Cas. Co. v. County of Chester*, 244 F. Supp. 2d 403, 410 (E.D. Pa. 2003).

What is more, in some policies this exclusion is present only in the entity coverage part, meaning that it does not apply when directors and officers are the defendants. If both the corporation and the directors and officers are defendants, the insurance company will be responsible at least for the directors' and officers' defense costs and losses, and, depending on policy language, possibly all defense costs and losses.

F. Disputed Indebtedness (Credit Risk)

Credit risk insurance policies offer companies an effective solution for minimizing risk by providing coverage for accounts receivable. An investment group or a hedge fund, for instance, might have credit insurance on its mortgage-backed securities to cover a lender's failure to buy back the subprime loans, if required by a repurchase agreement. Many insolvent subprime lenders have failed to buy back these loans, and credit risk insurance may step in to make these expected payments.

These credit risk policies, however, sometimes contain provisions–which effectively operate as exclusions–that condition payment of insurance proceeds upon the buyer actually being in debt to the policyholder. In short, if a subprime lender disputes that it is obligated to repurchase the loans, the credit insurer may argue that the insurance does not kick in to reimburse the investor for that loss. So long as the subprime lender admits that it owes and cannot pay the debt to the investment company, however, the policy will cover the loss.

G. Negligence and Fraud (PMI)

Consumer lending companies have always had a certain percentage of customers that will default on their obligations regardless of how strictly the company sets its credit requirements; thus they often obtain mortgage insurance, one specific type of credit risk insurance. Indeed, all lenders require subprime borrowers to buy mortgage insurance policies naming the lender as the policyholder. These policies' exclusions, therefore, may be particularly relevant to subprime lenders.

Mortgage insurance policies commonly contain a negligence and fraud exclusion that is similar to the fraud/dishonesty exclusion present in D&O and E&O policies. The exclusion, however, also typically addresses losses resulting from negligence that is "material to the acceptance of the risk by the insurance company, materially contributed to the [borrower's] default resulting in such claim, or increased the amount of the claim." To deny a claim based on this exclusion, an insurance company will have to prove fraud or negligence as to each loan at issue; proving a pervasive fraud, for instance, is not sufficient to exclude coverage for all of the loans at issue. *See, e.g., Citizens Sav. Bank, F.S.B. v. Verex Assurance, Inc.*, 883 F.2d 299, 303 (4th Cir. 1989).

This exclusion, moreover, may prove troublesome not only for the subprime lender but also for the plaintiff that hopes to recover insurance proceeds from the lender's mortgage insurance policies. An investor that purchased MBS from a subprime lender may sue the lender for negligently misrepresenting information about the borrowers, directly or indirectly alleging that the lender did not properly investigate borrowers' financial backgrounds; that investor may be digging its own grave. By succeeding on the merits of its claim, the investor may be providing the insurance company with an argument for denying coverage under the policy's negligence and fraud exclusion.

H. "Balloon Payment" (PMI)

Some mortgage insurance policies contain a "balloon payments" exclusion. A balloon mortgage is a loan that requires the borrower to pay off the entire remaining principal in one large lump sum after a certain period, typically five to seven years; this final, lump sum payment commonly is referred to as a "balloon payment." This exclusion is relevant because many subprime mortgages were set up as balloon loans. Although insurance companies may claim that the exclusion applies when borrowers default on the actual "balloon payment," the exclusion does not preclude coverage when borrowers default on an earlier periodic payment.

IV. RESCISSION/SEVERABILITY

Even if a subprime lender's losses are covered by a D&O, E&O, or credit risk policy, or by a combination of some or all of those policies, and no exclusions apply, the insurance company still may try to rescind the policy based upon the same wrongful acts for which the lender is now requesting coverage. *See Nat'l Union Fire Ins. Co. v. Sahlen*, 999 F.2d 1532, 1534-36 (11th Cir. 1993) (rescinding the insurance policy based on material misrepresentations in the policyholder's regulatory filings, which were the basis for suits against the policyholder for which the policyholder requested coverage) (applying Florida law). For instance, if a group of shareholders claims that the lender made material misrepresentations in its SEC filings, and the insurance company relied on those same filings in determining the premium and other coverage provisions for the policy, the company may assert that the policy should be rescinded.

Many D&O and E&O policies,[4] however, contain "severability" clauses, which explicitly prevent the rescission from applying to innocent directors and officers. They provide that a company's "application for coverage shall be construed as a separate application for coverage by each insured," and thus any "declaration or statement in the application or knowledge possessed by any insured shall not be imputed to any other Insured person." If a policy does not contain such a "severability" clause, an insurance company still should not be able to rescind the policy as to "innocent" directors and officers because they did not know about the misrepresentations in the application for coverage.

V. PRIORITY OF PAYMENTS

Some D&O policies contain provisions that grant first priority of payment to the directors and officers. These clauses typically are found in policy endorsements and require the insurance company to distribute insurance proceeds to the directors and officers before paying the corporate entity. If, for example, a subprime lender and its directors and officers are sued, a policy with a "priority of payments" clause will pay for the directors' and officers' defense, and any losses resulting from the suit, before paying any money for the corporation's defense and losses. The corporation will receive insurance proceeds under the D&O policy's entity coverage only if the limit has not already been exhausted by the directors and officers. Accordingly, a first-priority provision may operate to preclude coverage for the subprime lending bank. Subprime lenders may be able to argue, however, that policies without first-priority provisions should pay the subprime lender first because the policy is a corporate asset, not an asset of the individual directors and officers. Although very little case law addresses this issue, at least one court has held that an insurance company deliberately prioritizing payments to one

[4] Severability clauses typically do not exist in credit risk policies since credit risk policies usually have only one named insured: the bank, or investment group.

policyholder over another, when the policy does not contain a first-priority provision, has acted in bad faith. *See Smoral v. Hanover Ins. Co.*, 322 N.Y.S.2d 12, 14 (1971).

Timing issues also may complicate this provision's application. If a subprime bank and its directors and officers' are sued separately, and the bank's case settles first, confusion may arise over whether the insurance company should pay the bank immediately or wait until the directors and officers case is resolved before making any payments. Some courts have followed a "first in time, first in right" principle, holding that the policyholder whose claim is first due, gets paid first. *See, e.g.*, *In re Drexel Burnham Lambert Group, Inc*., 134 B.R. 493, (Bankr. S.D.N.Y. 1991); *David v. Bauman*, 196 N.Y.S.2d 746, 748 (Sup. Ct. Spec. Term 1960); *Gerdes v. Travelers Ins. Co.*, 440 N.Y.S.2d 976, 978 (Sup. Ct. Spec. Term 1981).

VI. CONCLUSION

The present crisis presents numerous fact patterns for a putative defendant, all of which have different nuances that could affect the scope and type of insurance coverage potentially available to a policyholder. To maximize its insurances assets, a company that has suffered, or may suffer, losses resulting from the subprime lending disaster should carefully review the relevant underlying issues and all of its corporate insurance policies.

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