SUBPRIME MORTGAGE LITIGATION INVOLVING BANKRUPT INSUREDS: RESOLUTION STRATEGIES

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I. INTRODUCTION

The recent crisis in subprime mortgage lending has unleashed what promises to be a tidal wave of lawsuits. As always, litigation involving complex financial arrangements raises a host of issues relating to settlement strategies, both those involving insurers and those independent of insurers.

Given the workings of subprime mortgage lending and securitization, the collapse of the market has led not merely to lost profits and reduced lending, but to the collapse of lenders and mortgage brokers, raising the specter of multiple bankruptcy filings. While bankruptcy may complicate settlement, it also may permit the use of strategies that are not available, or are less effective, outside that realm.

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II. RESOLUTION STRATEGIES

- Play claimants against each other
  - Where there are multiple claims, claimants need to understand:
    - They are competing against each other for a limited pot of money.
    - Every day that passes means:
      - more defense costs,
      - greater chance of settling with other claimants
      - smaller pot of money for that particular claimant.
  - Use the same approach for each claimant.

- Divide & conquer (settle what you can)
  - Not all insureds are similarly situated – one size does not fit all.
  - Consider: settling out "innocent" insureds for whom an indemnity payment is almost certain for the insurer; consider establishing a limited defense fund, without recourse, for "bad actors" to limit further policy exposure and/or to permit greater access to funds for others.

- Consider voluntary rescission
  - If the insurer has strong grounds for rescission, a settlement which includes a voluntary rescission saves the costs (both of litigation and defending underlying claims) and the uncertainty of litigating, provides funds the insureds can use to satisfy claims, and pressures the claimants into smaller settlements (to get what little money there is).

- Use the insured entity's insolvency or bankruptcy status
  - The Conseco case is a good example. There, Conseco was able to pay only $20 million of a $120 million securities class action settlement; all of the D&O insurers' policy limits were needed to fund the remaining $100 million. While coverage litigation was ongoing, the primary carrier settled.
  - That situation enabled the 1st excess insurer (Royal), which had strong coverage defenses, to demand security from the securities settlement funds themselves (to

assure repayment in the event of a coverage litigation victory or settlement).

- Also, once the securities litigation settled, Royal was able to cut a deal with Conseco that benefitted Royal and Conseco because Conseco no longer had an incentive to fight Royal: Conseco would bear the costs of coverage litigation, but the securities plaintiffs would gain all the benefits. Then . . . Royal filed litigation to collect from the securities plaintiffs.

- Early mediation

  - Early mediation directs available funds to settlement rather than litigation.

  - The parties and the court may have motives to push for this. This is especially true if the insured is in bankruptcy proceedings.

  - A skilled, effective mediator is critical!! This is even more important in a bankruptcy situation, where bankruptcy expertise is extremely helpful.

  - This strategy may be used in concert with a rescission, voluntary or otherwise.

- Consider bankruptcy-specific processes

  - If debtor-owned claims are at issue (e.g., shareholder derivative claims under a D&O policy): consider a Bankruptcy Rule 9019 "offer of compromise" or a Bankruptcy Code Section 365 "purchase of claim."

  - These procedures normally are used where the debtor and the creditor with a claim agree to settle their dispute. But . . . nothing says it can't be used by a debtor and insurer to compel settlement over the creditor's objections.

  - These procedures can offer several benefits:

    - They afford an opportunity to present a settlement offer directly to the court.

    - Creditors' opinions while considered, do NOT control. This increases pressure on creditors by removing, or threatening to remove, at least some degree of control from them.
    - The procedures can result in obtaining a very broad release. For example, in the Seventh Circuit, the release can extent to essentially all claims owned by the company (including derivative claims). This is, potentially,

broader than a release that would be obtained just by settling derivative claims with the creditors' committee.

    - It may be easier to get a full policy release, rather than just a claim release.

- There are risks and downsides, to these procedures, however:

    - These procedures fall outside the scope of "normal" settlement approaches, so clients and lawyers may have potential discomfort with it.

    - They require the debtor-in-possession's or trustee's consent & cooperation, and they might not agree to the notion (although there likely is no harm in trying).

    - The initial offer has to be significant – substantially higher than a standard initial settlement offer.

    - Although creditors may not control the outcome, they can object, resulting in an expensive mini-trial (perhaps including experts).

    - The court might not approve a deal, resulting in extra costs to continue to litigate that issue and a potentially weaker bargaining position in further settlement negotiations

    - Also . . . the judge can set high a "floor" for future negotiations by rejecting the initial number.

    - Claims owned directly by creditors are not included. If those claims are relatively minor, this should not be a big problem; if they are major, the value of this approach is more limited.

    - There also is the risk of a waiver of the insured v. insured defense.

- The standards for approval are essentially the same as for the settlement or purchase of any other claim: is the resolution "fair" and "reasonable?"

    - Courts consider such elements as the probability of success in litigation; the complexity of the litigation; the expense, inconvenience & delay of litigation; and whether the estate is likely to get a better result if the matter is fully litigated.

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- What is the process?
  - The court evaluates the proposed settlement, via a mini-trial if necessary.
    - experts may be used
    - the court can consider coverage issues
  - In other words, it is an *economic* analysis, not just a legal analysis.
    - this allows the insurer and insureds to convince the court that:
      - coverage defenses are serious and will reduce any other recovery
      - an early, reasonable settlement is more beneficial and economically valuable to the estate than lengthy litigation with the hope of a large recovery down the road
  - Even if the court rejects the deal, it may hint at what would be acceptable.
- A Section 365 sale starts an automatic bidding process.
    - but . . . who is going to bid?

● <u>Consider filing a declaratory judgment action</u>

- First and foremost: there must be a good faith basis to do so, and their must be an actual controversy – not an anticipated one.
- A DJ action can put additional pressure on claimants to settle:
  - If the estate has funds to fight the coverage action, that will reduce the pot available to creditors.
  - If the estate lacks the funds to fight the coverage action, claimants will have to finance it, reducing their potential recovery and giving them an additional incentive to settle.
- Remember the automatic stay!

- What are the risks or downsides?
  - The cost of coverage litigation multiplies the expenses.
  - If you don't have sterling facts, you may end up with an adverse decision – and an adverse precedent.
- A DJ action requires careful analysis: Who must be named as defendants? The company? The individual defendants? All insureds? Claimants/creditors? These depend on the coverage defenses, state law, etc.

● Settlement approval

- Get bankruptcy court blessing - even if you conclude that the policy proceeds are not property of the bankruptcy estate
  - this avoids or minimizes the risk of a later attack on the settlement by other creditors, etc.

III. CONCLUSION/SUMMARY

There are a number of strategies that can be employed, especially in the context of a bankruptcy, to maximize an insurer's influence on the outcomes, preserve policy limits and protect the insureds. The predicates for successfully using such strategies are an understanding of the bankruptcy process and the interests at stake, and a bit of informed creativity.

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