WHEN NEW FINANCIAL PRODUCTS AND HISTORICAL UNDERWRITING PRINCIPLES CLASH

Many international insurers and reinsurers remain embroiled in litigation that resulted from the financial meltdown, as Michael Barr explained to Intelligent Insurer.

While much of post-financial crisis litigation has centred on a swirl of litigation and regulatory investigations involving the major money centre banks, investment banks, and government-sponsored enterprises such as Fannie Mae, global insurers have suffered their share of actual or threatened losses from the collapse of structured financial products which they insured or in which they invested.

The resulting litigation, in which insurers have been plaintiffs as well as defendants, should compel a re-examination of some historic underwriting precepts and practices. Michael Barr, the US senior partner and a member of the global board of Dentons, has been litigating these cases on behalf of insurers since the collapse of Enron. He says that insurers can draw some key lessons for the future from what have proved to be the most hotly contested issues.

"You can trace many of these matters back to recent periods when multi-line carriers sought to expand their premium volume and margins by competing with mono-line insurers and banks to provide credit enhancement for a wave of new financial products, including collateralised debt obligations (CDOs), mortgage backed securities (MBS), and other securitised or pooled assets," says Barr.

These carriers got into this business by issuing surety bonds, debt service insurance policies, and other forms of credit enhancement to ensure payments to noteholders. The transactions insured were said to be so over-collateralised that, even if a portion of the underlying assets defaulted, the insurer should expect that it could in effect lend its balance sheet and credit rating, but end up making zero insurance payments—so-called 'zero-loss underwriting'.

Unfortunately, zero-loss underwriting proved to be anything but in all too many cases. Some losses were perhaps inevitable given the depth of the financial collapse, but insurers were also victimised by Ponzi schemes and other financial frauds, as well as broken promises and commitments from their counterparties. How could the insurers have better protected themselves?

WHO DO YOU UNDERWRITE AND WHO DOES THE UNDERWRITING?

Insurance is, of course, all about assessing the risk. But as financial products became ever more complex, insurers sometime lost sight of what risk they had to be underwriting—was it the risk of underlying assets defaulting or that the sponsoring entity was a fraudulent enterprise? Should the surety be underwriting the principals on a series of loans, or the entity that was pooling the loans and selling them to a third party? Insurers looking to insure structured products need to be certain that they are training their sights on evaluating the right risk and thus the right entity.

Barr emphasises that those questions help define the next question: who does the underwriting? "As insurance is used in increasingly complex transactions, the demands upon underwriters increase," he says. "However, for a number of companies, the underwriters on these complex deals were the same underwriters who handled traditional lines. Companies must make sure that their underwriters have the requisite skills, tools and support, and have access to and evaluate all of the relevant data. What you cannot understand, you cannot underwrite."

"Companies must make sure that their underwriters have the requisite skills, tools and support, and have access to and evaluate all of the relevant data." Michael Barr

HOW ARE THE COURTS VIEWING THE INSURER'S ROLE AND CONDUCT?

Many of the cases involving insurers, as well as other financial institutions, are still wending their way through the courts. Judicial decisions that have emerged are not following a consistent path and establishing bright-line rules, but rather are focusing on the particular facts and circumstances at issue. But some core conclusions can be reached to guide insurers' approach to litigation and future transactions.

"On the whole, courts have shown little sympathy for assertions that insurers and other investors did not fully understand the risks. Global financial institutions, with all their resources, are perceived and treated as very sophisticated parties," says Barr.

He notes that courts have generally taken a similar view in the weight they are affording what might be viewed as 'boilerplate' disclaimers of duties and representations by the sponsoring parties contained in offering circulars and similar transaction documents. While some courts have allowed cases to proceed based on representations and promises outside the written documents, others have dismissed seemingly meritorious claims based on those disclaimers and warnings.

OTHER CHALLENGES

Barr also points out that insurers today face more than the threat of (or need to pursue) litigation against other institutions. Insurers must increasingly contend with heightened regulatory scrutiny and investigations, as all levels of government react to the financial crisis and the failure of major institutions.

"Traditionally, the insurance sector has been supervised by state insurance departments," says Barr. "But state attorneys general are taking a more aggressive approach to insurer transactions and products, and federal regulators are also getting involved through agencies such as the Consumer Financial Protection Bureau, which has trained its sights on mortgage insurance and other products."

There is one piece of good news: the plaintiffs' class action bar seems to have turned its attention away from the insurance industry—at least for now. Barr believes this is because most plaintiffs are focusing on the central role of banks and their lending practices in the housing collapse. This follows two decades of widespread challenges to insurance sales practices. "Insurers have some respite for now," he says.

GET USED TO BEING A PLAINTIFF

One unusual result of the financial crisis fallout is that insurers are increasingly finding themselves on the plaintiff's side of the equation. This has meant suits against banks and other transaction sponsors to recoup money that insurers have paid out to noteholders on their policies. Insurers have even commenced recent high profile claims following losses on their portfolio investments, including lawsuits against the US Treasury for the recent government 'Net Worth Sweep' of all of the profits currently being earned by Fannie Mae and Freddie Mac from the housing rebound. While a welcome relief from their typical defensive posture, insurers must adopt an aggressive mindset as they pursue these claims.

"Insurers have learned to think twice about deals they do not fully understand. They also have come to realise there is no such thing as a guaranteed no-lose proposition—'zero loss' underwriting should just drop from the lexicon," says Barr. "Every potentially insured deal must be underwritten with fresh eyes and a fresh approach on its individual terms and merits." □

MEET MICHAEL BARR

Michael Barr has repeatedly been recognised by his clients and peers as a leading insurance litigator. He is the US senior partner of Dentons and co-chairs its insurance sector, as well as serving on the firm's global board. Over the past several years, his practice has focused on litigating issues that arose from the credit crisis on behalf of a number of global insurers.

He has served as lead counsel in a series of actions concerning failed securitisations (CMOs, CDOs and other collateralised obligations), credit default swaps, credit enhancement insurance, leveraged loans and surety bonds. He recently concluded two successful trials on behalf of sureties who demonstrated that they were the victims of a Ponzi scheme involving fraudulent equipment leases.

In addition to his work in the insurance industry, he has counselled and litigated for consortiums of international commercial banks and investment banks facing defaulted or defaulting loans on major real estate projects and highly leveraged corporate acquisitions. This recent work in the financial sector follows his lead trial role in a series of high profile trials and appeals over the past decade that concern the financial services and insurance industries, including the World Trade Center property litigation.

He can be contacted at michael.barr@dentons.com