SUBPRIME BLUES:
The Crisis and its Cause

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"Insurer downgrades, auction failures, rate resets, penalty rates, and material event disclosures" are words being heard more and more frequently by city treasurers and financial directors due to the subprime credit crisis.

In early May 2008, the Wall Street Journal reported that loss estimates in the credit markets caused by a plague of home loan mortgage defaults and foreclosures on substandard credit risks range between $400 billion to over $1 trillion. This crisis has resulted in the recent demise of Bear Stearns and financial rating downgrades by rating agencies of many primary bond insurers, including Ambac, MBIA, XL Capital, and FGIC. On May 21, Moody's downgraded CIFG (a French bond insurer) from A1 to a "junk" rating of Ba2.

Some say the root cause of these insurance downgrades was the decision by the insurers to start underwriting the sale of instruments called Collateralized Debt Obligations (CDOs). Marilyn Cohen, in the "Capital Markets" column for the May 19, 2008, issue of *Forbes* magazine, succinctly described the problem:

> *The once big-three municipal bond insurers, Ambac Financial Group, MBIA, and Financial Guaranty Insurance Co., desecrated their businesses by taking up a sideline that had nothing to do with municipal finance. They insured collateralized debt obligations. Those securities typically contained rotten components like subprime mortgages. Last October (2007), as the CDO market wobbled, institutional municipal bond managers and traders came to realize that insured munis were in for a shock. Their insurers were on the hook for tens of billions in CDOs.*

The AAA Insurer Rating Downgrades

In mid-2007, the underlying mortgages backing the CDOs started going into default in record numbers. This, in turn, caused the bond insurance companies to be hit with billions of dollars in potential claims, thereby decreasing their financial rating to something less than AAA.

These downgrades are a matter of primary concern for any Texas city that has purchased bond insurance in connection with the issuance of debt obligations. Bond documents may include provisions for required material event disclosures, increased interest rates, and—depending on the level of downgrade—mandatory tender or a substantial acceleration of the bonds.

Likewise, the insurance policy itself may contain non-cancellation provisions and choice-of-law clauses that may be used to inhibit a city from seeking the return of unearned premium and terminating the insurance.

So Why Purchase Bond Insurance?

All of this brings into question the value of purchasing bond insurance in the first place. Many Texas cities are beginning to wonder if they essentially paid a premium for nothing. It remains to be seen if a wasted insurance premium may be the best case scenario given the greater danger of worse losses that are lurking in the credit marketplace.

Unanticipated Interest Expenses and Other Costs

Recent bond auction failures and rating downgrades have already caused the resetting of some bond interest rates to a much higher level. Such a nasty surprise can, of course, result in millions of dollars of additional unanticipated interest expense not budgeted by the affected city. A March 6 Bloomberg report revealed that one large Texas city was suffering $3 million per month in increased interest costs alone resulting from a single auction failure. Such losses cannot simply continue unabated.

A city that is sustaining such losses will be faced with taking immediate action to stop the financial hemorrhage. The choices available are redemption or refinancing. Either option would require additional, and perhaps substantial, expenses and legal fees which were not in the city's budget.

Another possible option would be to purchase an additional insurance policy from a different bond insurer, if any, that still enjoys an AAA rating. This, of course, would cost the city additional, unbudgeted (and no doubt higher) insurance premiums.

Protecting the Taxpayer's Money—Beginning the Claims Process

So what can city stewards do to seek return of taxpayer dollars that have been diverted from their intended and budgeted purpose?

Careful preparation must be made to make a claim against all parties responsible for creating the losses so that those to blame can be held accountable. To be in the best negotiating position possible, the city must be confident of both the facts and the law before commencing even informal claim discussions.

City staff must identify each adversely affected bond issue and review the contents of both the bond documents and the insurance policy. This is fundamental to advising the mayor and council as to any loss that may have occurred as well as possible future losses.

A designated person should be appointed to monitor evolving events and to keep the city attorney apprised of any unanticipated changes that might result in any further unpleasant budget surprises.

Losses should be immediately identified, quantified, and analyzed as to nature, extent, and duration. Unearned premiums, increased interest expense, refinancing costs, and attorneys' fees incurred in mitigating damages are all likely candidates for inclusion in a city's damage model. It may become necessary to consider the engagement of expert professionals to assist in this process if the damages are difficult to quantify and appear to be ongoing in nature.

All documents related to the bond issue and purchase of the insurance policy should be assembled under the custody and control of the city attorney or some other responsible staff member. Electronic documents (e-mails and sales representations) are particularly important to show the staff's reliance on representations made in connection with the sale of the bond insurance. These items should be kept secure in case it is determined that a viable claim can be made for return of premium and/or recovery of damages and attorney's fees.

Once a reasonable damage model has been established as to all past and future losses, the claims process can begin with an eye on any applicable statute of limitation that might affect the timing of settlement negotiations. Since the subprime crisis did not begin to develop until the July through September 2007 timeframe, it is not anticipated that there is any current danger of a two-year or four-year statute of limitation barring any claim that might be brought within the next year. If informal settlement proceedings fail, then litigation will have to be considered as a last resort.

Application of Texas Law

Texas laws should apply absent any choice-of-law provisions mandating another jurisdiction. Causes of action appear to be plentiful under Texas law—with some being more attractive than others. Of course, negligence, negligent misrepresentation, and fraud jump immediately to mind. However, Chapter 541 of the Texas Insurance Code and common law breach of fiduciary duty may offer the most desirable avenues of recovering damages and/or attorney's fees from those persons or companies responsible for the losses.

Section 541.152 of the Texas Insurance Code provides victimized cities with a statutory cause of action against wrongdoers engaged in the business of insurance. Defendants might include insurers, agents, and others engaged in the business of insurance (possibly including financial advisors). Recovery of actual damages, court costs and attorneys fees are available to a city proving an unfair or deceptive act or practice as defined in Chapter 541 of the Insurance Code or Section 17.46(b) of the Business and Commerce Code (the Deceptive Trade Practices Act). Treble damages are available where it is proven that a defendant "knowingly" committed the prohibited conduct.

Breach of fiduciary duty may also be available as a common law cause of action where the city is in a special relationship of trust with a person or company, such as a financial advisor, investment banker, securities dealer, attorney, accountant, or actuary. Damages are generally limited to actual damages only, with the possibility of exemplary damages available with the proof required by Chapter 41 of the Texas Civil Practices and Remedies Code. Recovery of attorney's fees from the wrongdoer is not available except as part of exemplary damages.

Conclusion

Moves are already afoot by the bond insurance companies to inhibit cities from seeking refunds of premiums and cancellation of insurance policies. Dakin Campbell, writing for the May 19 issue of *The Bond Buyer*, notes that some cities seeking "to rid themselves" of the bond insurance polices have been "…told by the bond insurers that if there was a non-cancellation clause, the policy could not be terminated…."

Hence, if the bond insurers are not willing to return the premiums paid by the cities for a worthless AAA rating that no longer exists, it is highly unlikely that these same companies will embrace their responsibility for payment of other damages caused by their financial indiscretions.

Indeed, the regulator of insurance for the State of New York (the state of domicile for most of the insurers) has shown no willingness to assist municipal bond issuers seeking to cancel the insurance to obtain a premium refund. Recently issued is Circular Letter No. 12 (May 9, 2008), wherein the New York Superintendent of Insurance has graciously opined that he would "…not object to the cancellation…of such policies…provided that the municipality, FGI [Financial Guaranty Insurer] and bondholders…all consent to the cancellation…."

Such conduct by the state officer charged with regulating the conduct of the culprits in this mess makes clear that any city seeking damages from the wrongdoers must be prepared to resort to the courts. Knowledge and preparation will serve cities well when faced with a decision to either accept large subprime losses, or to take actions required to seek return of taxpayer dollars taken as the result of unfair, deceptive, and unsound insurance practices.

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[1] Austin lawyer Joe K. Longley (www.joelongley.com) was the principal drafter of the DTPA and Texas Insurance Code remedies discussed in this article. These remedies were first enacted by the legislature in 1973 when Mr. Longley was Chief of the Antitrust and Consumer Protection Division of the Texas Attorney General's Office. In 2000, *Texas Lawyer* named Mr. Longley to its exclusive list of *100 Texas Legal Legends* for his pioneering efforts in creating and developing Texas consumer law. In 2003, he was again honored by being selected as *Texas Lawyer's* Number One *"Go-To-Lawyer"* in the field of Insurance Law. He has taught Insurance Law as an Adjunct Professor at the University of Texas School of Law, and has sometimes been referred to by his colleagues as "The Number One Enemy of the Fine Print."