ASSOCIATION OF CORPORATE COUNSEL

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PRESENTED BY: **ACC's Corporate & Securities Law Committee**
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MODERATOR: **Michael Campbell,** NY Federal Reserve

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Operator: Welcome to this ACC webcast. Michael, please go ahead.

Mike Campbell: Good afternoon, my name is Mike Campbell, and I'm today's moderator for "What Your Company Needs to Know About the Subprime Crisis." I'm counsel at the Federal Reserve Bank of New York. My areas of focus are on bank and bank holding company regulation, consumer protection laws, privacy and corporate governance.

I just wanted to get a few housekeeping points out of the way up front. One is that the opinions I express today are mine and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System. And also, there'll be a Q&A session at the end. I ask you to please type questions into the lower left box and hit the send button. You can send these questions any time during this presentation. Also, if you would please fill out the webcast evaluation form, which is number one in the links box. And I'll get started.

As of the start of this year, it was reported that well over a hundred companies had announced write-downs. It was estimated that the total amount of write-downs could easily exceed $300 billion. So it can be a surprise to no one that following closely on the heels of these disclosures has come increased securities litigation and supervisory inquiries from state and federal authorities. In addition, problems in the subprime mortgage market and the resulting credit crunch have spread beyond U.S. borders to foreign financial markets, giving us yet another example of the connection between markets in the global financial system.

The response by state and federal authorities has been to explore solutions to the mortgage crisis through proposed legislation and regulation. The proposals include items for preserving the vitality of neighborhoods by avoiding foreclosure and on regulating the activities of players involved in the origination and securitization of mortgages.

Now, the first slide I'm going to move on to here is a bit humorous, also I suppose a bit sad. I think of it is a sad commentary on the deterioration in underwriting standards. The next slide here

illustrates the basic structure of how the securitization of these mortgages work. This is meant to be just a model for discussion purposes.

As many of you know out there, it's a much more complicated system than meets the eye. You know, I'll go through some of the players here. You have borrowers who are taking out mortgages. You have aggregators who are generally commercial banks and investment banks. Before the borrowers – the first contact the borrower may have, however, could be with a broker network, which is not illustrated on here. The network would usually be responsible for underwriting standards and compliance with consumer laws. The assets would then be put into a trust or special-purpose vehicle that is bankruptcy remote.

Another important player here is the servicer, who will service the underlying mortgage loans and may be responsible for things such as principal interest payment. The servicer – I want to just pause a second and focus on that particular player, who's really been at the eye of the storm lately, especially with respect to loan modification. What people have to keep their eye on here, however, is that many of these securitizations are done in the form of REMIC, so there are some real tax consequences if you modify the underlying loans and get it wrong.

The other thing to focus on is that the servicer is really responsible for acting in the best interest of the holders. And so a stark example of some of the problems with loan modification is that occasionally people will have tranches that are paid based on prepayment penalties. So if the servicer tries to modify a lot of loans by saying that, well, OK, we'll give you a new loan or we'll refinance your loan, and we won't require to pay a prepayment penalty, that has a deleterious effect on anybody who holds a tranche, of course, that's depending on the prepayment penalty. So, again, a lot more difficulty there than meets the eye.

What else? The rating agencies here, of course, are responsible for rating the different tranches. If they can't get a rating on these certificates, they just can't be sold. There may be certain credit enhancement. So, for example, the entity that's responsible for trenching these pieces might hold a residual piece, which is sometimes referred to in the industry as toxic waste. These perform pretty much like equity. Either you make a lot of money on these or you lose. But I think it is really meant to inject some accountability into this whole structure.

However, many times those pieces can be pooled themselves into CDOs and sold to many of these types of holders you see or investors you see on the right here, REITs or hedge funds, for example. The underwriter, of course, is responsible for selling these things.

What have I left out? The trustee would, of course, hold the interest in the underlying assets for the security holders. And I guess the other thing to keep in mind here is that one party can play multiple roles. So they can originate loans. They can underwrite. They can be responsible for trenching these things. They can retain servicing rights or be responsible for issuing the trust.

So that's the diagram that we'll be focusing on going forward and I think will be referred to from time to time. So let me get into the main part of the program now. We have several distinguished speakers today from Edwards Angell Palmer & Dodge and PricewaterhouseCoopers.

Our first speaker is Stanley Keller of Edwards Angell who will discuss corporate governance and financing repercussions of the credit crisis. Stan is a nationally recognized corporate and securities lawyer who focuses on public and private securities offerings, advising publicly traded companies on compliance with SEC rules, mergers and acquisitions and corporate governance.

Stan?

Stanley Keller: Thank you, Mike. As Mike said, I'm going to talk about the corporate governance aspects of the credit crisis that we've seen. And it really focuses on the issues surrounding risk management and resulting deficiencies or alleged deficiencies in disclosure.

And maybe a good starting point is to think about the duties, responsibilities and role of directors and officers in this process. So the first slide shows the basic duties that we all know. The key duty here is going to be the duty of care. And within the duty of care, I think we're talking about what has been defined in Delaware as the Caremark duty of oversight, and that is the responsibility to make sure that there are systems and controls in place to provide for proper governance and running of the business.

And one of the interesting things is, while we've generally thought about that duty, the so-called Caremark duty, in the context of the duty of directors, indeed it's a duty that applies to officers too, to management. And there's a very recent Delaware Bankruptcy Court decision – the federal bankruptcy court in Delaware – Miller v. McDonald, April 8, 2008, which hammers home the point, and one can disagree with its conclusion, but basically saying the Caremark duty of oversight and care applies to officers.

In this case, the officer involved was general counsel of a company in which the president engaged in fraud, and the allegation is there was a breach of duty by the general counsel in failing to ensure that there were proper systems in place to forestall that fraud, something all of you in-house folks might think about. And I think the key here – and we'll get back to this when we talk about liability – is the business judgment rule should apply here because we're not talking about breaches of duty of loyalty but the business judgment rule of presumption that judgments made, actions taken will be sustained as dependent upon fulfilling the duty of care.

If in past years, the focus was on the audit committee and the audit process, on internal controls, I think it's fair to say that the focus this year going forward as a result of all we've seen is going to be on risk management within enterprises, clearly risk management in the financial services industry, where this has been centered on, but I really think the principle applies more broadly to all companies focusing on risk management. The easy area is companies that have had to have write-downs because they were investors in various securities on which there's been illiquidity reduction in value, but risk management really is a pervasive concept.

It's a responsibility, I think initially, of management, something to be focused on at the senior level, as well as having the operational systems in place to deal with risk management. It's the responsibility of the board in their oversight role to make sure that those systems are in place and to monitor that they're being properly applied. Companies handle it differently. Typically, a committee of the board will have responsibility over risk management. It may be a separate committee. In many companies, it's a part of the audit committee's overall responsibility as fitting into it.

I think risk management can be viewed as a stand-alone function within companies, but it also needs to be integrated and thought of as part of the overall control structure, as part of the operational aspects of the company and certainly part of its strategic planning. I think a key to focusing on risk management is to approach it in a disciplined way, as a disciplined process, but tailored for each particular company based upon its industry and its circumstances.

Financial service company issues are very different from those of technology companies, for example, but they all have risk management issues that should be focused on. And in a way, this is no different than all of us coming to the table and suddenly learning about internal controls and a disciplined structure in approaching internal controls. And I think we need to take those lessons and bring them to bear in the risk management process and mitigation of risks as part of that process. Many companies use specialized resources to deal with risk management, obviously depends upon the size of the company, the nature of its industry, but someone should have that responsibility as part of management, and the board should be focusing on it.

One way of approaching risk management – and I'm really just going to touch the surface of these issues but at least give an example of the approach – is to think first in terms of the

elements of risk management. Identification of risks – what in fact are the risks? Stepping back, thinking broadly, thinking creatively, make the list without differentiating. What are the risks of the business?

I represented a taxi financing company, and when the CEO was asked what keeps him up at night, he said that they should close the borders of Pakistan. Well, if you think about cab drivers in New York, you understand, and that's a risk of the business. So identify the risks.

Assessment – what's the likely impact of the particular risk? Evaluation – how likely is the risk to occur? And if it does, how significant is it to the business? And part of that is stress testing, taking the extreme examples to see what the impact would be and then ongoing monitoring, treating risk as a dynamic rather than static concept and dynamic process.

Mitigation – what measures can be taken to eliminate, reduce or hedge the risk? And part of what's going on – and this requires senior management attention – is the balance between the company's risk appetite and the gains and profits that result from it and the risk controls.

Valuation – we'll hear more about that from Doug – is really quantification of applying the risks and quantifying your assets for accounting purposes, both for financial reporting as an external measure and for a management tool for understanding the business and running the business. And finally, testing and verifying your risk management approach to look back and see if, in fact, the assumptions work.

What are the types of risks? Well, there are operational risks, the impact on the business. What can affect the business? If you're running an airline, you know that fuel prices are a key element. Foreign currency exchange issues for companies with operations abroad, an operational risk. Performance or profitability – what are the risks to the continued earning stream of the business? The capital of the company and its assets – put another way, the availability of capital, and what's the impact on the balance sheet and the relevant ratios that the company uses, leverage ratios for example? And another element, liquidity, which is really funding liquidity in this concept, the short-term funding position of the enterprise, the ability to meet current demands.

I think all of this then rolls into the disclosure obligations associated with risks. And there are, I think, positions, views that have been typically understood but haven't necessarily been brought to bear in a robust way in thinking about disclosure of risks. And that disclosure comes up in the context of financial reporting, and you'll hear more about that momentarily from Doug. Management discussion and analysis, MD&A – identification of known trends and uncertainties, and a part of that are critical accounting estimates. And when we talk about valuation of assets and of liabilities, particularly in an uncertain fair-market-value era where there are lots of assumptions, you have to be thinking about the disclosures through your critical accounting estimates. Risk factors are clearly relevant to risks.

We've gotten some recent guidance, which I'd refer you to, from the SEC. First, in a December 2007 letter that was really focused to the financial services industry, where there were heavy structured investments, CDOs and the like, other off-balance-sheet obligations, setting up a structure, a list of questions, that people should be thinking of in their MD&A disclosure. That's December 2007, and it's available on the SEC Web site. Go to corp. fin. guidance page on that.

And then there was the letter that was sent out in March 2008 which was much more broadly circulated, not just limited to the financial services industry but to a whole range of companies with significant amount of asset-backed securities, loans carried at fair value, derivative assets and liabilities on their financial statements. So I think the guidance should be read as really not limited to that but really calling upon companies and with some level of detail to disclose the underlying assumptions and the consequences of making various assumptions in their MD&A to discuss the impact of those assumptions and changes of assumptions on their financial results for the year.

To wrap this up, really two points: One – and this will lead into the liability discussion later – obviously there's a lot of second-guessing of the disclosures that were made in the past, regarding past performance and past financial position. I think for things that happened in the past, there are going to be good defenses based upon what people knew and didn't know.

The most dangerous period, I think, is dealing with the situation after the problems have been revealed. The need to be forthcoming, the need not to be hesitant, to look hard at the write-downs that need to be taken, to look hard at the litigation reserves with litigation now pending. It's going to be those cases that are based upon failures of disclosure or failures in the financial reporting after everybody became aware of the problems that are going to be the most difficult. In terms of risk, really the whole subject of the structure of risk assessment, risk analysis, I'd refer you to the Senior Supervisors Group report. The Senior Supervisors Group is a group of seven multinational supervisory agencies, including in the U.S. the Federal Reserve and the OCC and the SEC. In their report, issued March 6, on observations on risk management practices during recent market turbulence – I guess turbulence is maybe a better way to put it than crisis.

But I think there's some very enlightening analysis of what the risk assessment mitigation process is all about and looking at those companies that fail to do it well and what were the indicia of those that in fact did it well. And I think that should be on the reading list of counsels for all companies, not just those in the financial services industry.

Why don't I end there?

Mike Campbell: Thanks very much, Stan. I think that will be very, very helpful. Yes, I think the point about turbulence versus crisis, of course, is that our view here is that there's no point in being alarmist.

Our next speaker is Douglas Summa of PricewaterhouseCoopers. Doug advises clients on various financial and risk management issues related to market risk, credit risk and capital measurement. He has assisted numerous financial institutions with the development of risk management frameworks and in the implementation and execution of a best-practices approach to risk management and measurement. Doug will be speaking to us today about the fair-value accounting aspects of securitized debt obligations.

OK, Doug.

Douglas Summa: Thanks, Mike.

I think the best place to start when one thinks about fair value is trying to say, well, under what rules are you trying to measure fair value? And for any company that is reporting under U.S. GAAP, those standards are now outlined in FAS 157 and 159. There is a similar set of standards under IAS, but I'll be speaking mainly about the U.S. standards over the next couple of minutes.

FAS 157 and 159 try to tackle two big issues. One is, again, how you think about fair value. And one is how does one let a reader understand the quality of the fair values that are in the financial statements? The 157 definition of fair value seems pretty straightforward. Well, you know, fair value's the price that would be received for an asset or paid to transfer a liability in a current transaction between market participants in the reference market for that asset or liability. It seems fairly straightforward, fairly benign.

Well, now we look at what's going on in the world. And now you look at some of those words and you say, gee, some of that could be pretty difficult to execute on. For example, a current transaction – I look at the subprime market, or we look at many of the markets, quite frankly. These markets are locked up. There are no current transactions.

Thinking about a reference market, that can also be very challenging because sometimes the reference market that you thought was the market you would transact in a month ago, a year ago, might not be that same market. Why? Because there is no liquidity. So you have to think about potentially looking at different markets.

Also embedded in this, and getting back to the comment or the thoughts on the current transaction, one of the big challenges is some of those transactions that are occurring may be perceived as fire sales. They may be forced sellers. Well, that isn't also what the FASB was intending when they were thinking about fair value – again, trying to avoid the fire sale. But as someone who is trying to come up with that fair-value estimate, sometimes it's very difficult to now – are these fire-sale transactions or not?

At the end of the day, the goal of 157 and 159 is clearly to arrive at a fair value. But there's also another twist to this. The twist is that there is a requirement or at least a preference that you use as much observable data as possible, again a potential challenge for someone who's developing fair values, given that there may not be a lot of observability. So there may be more judgment involved.

The Center for Audit Quality, who's a group that impacts the audit firms and therefore are going to impact any preparer of financial statements, has made it very clear that there is, you know, that if there are actual transactions, that is the best evidence you have of fair value. And so now there's – a series of questions one can ask is how far do I have to go? How do I actually identify those transactions?

As I said, 157 and 159 tried to talk about fair value. One other thing, though, that I think is very important about 157 and 159 is it also talks about the quality of those values. And it does so by putting fair values into three buckets. And the way I think about the three buckets is that, you know, one is literally observable, something that one can, you know, see on a screen or read in a paper. One that is – there's a proxy to – that you can proxy from real transactions.

And the last one is the one which has the most management judgment or has significant amounts of management judgment, and that would be what we call Level 3 input in FAS 157. The goal there is trying to help the reader understand how much management judgment is in the value versus how much should everyone at least in theory be agreeing to the value, which is what at Level 1 that fair value would have.

Let's talk a little bit about some of the challenges. I've touched on a number of them, but we clearly are seeing more and more challenges. And until liquidity comes into the market, I think there are going to be many challenges, particularly in the area of subprime. As I said, you know, limited transactions, lots of structures, you know, both cash positions, synthetic positions on the same type of underlying – things get packaged and then repackaged and potentially repackaged again. All of this makes determining fair value very difficult, particularly where there is no liquidity, where there have been no transactions.

And one of the real challenges for a preparer of financial statements at this point is that there're also lots of data points that are somewhat helpful but maybe not perfectly helpful, again not a real transaction but maybe an indication of value. And so types of things I'm thinking about include vendor data, brokers offering indicative pricing. In certain types of structures, you may see margin calls or collateral calls. And every so often, you may get a real price and maybe at a tradable level. But as a preparer of financial statements, you have to figure out what do I do with all of those points. Clearly the last is the strongest data point, but what about the rest? How do I think about that? You know, the clear challenge.

And this has forced companies to really either enhance their processes or potentially develop processes to think about fair value differently. It may force them to think about, you know, using proxies. Clearly no transactions are occurring, so everything's a proxy in one sense.

Models are becoming used more and more. And where one has a modeled price, one needs to be very confident that the model represents ultimately a market-clearing level. I've worked with a number of firms over the last nine to 12 months dealing with some very complicated modeling issues and trying to think about how do we model to determine fair value.

And sometimes the models are very clever but may not get you to fair value. They may only get you to a sense of value, but it may not be what someone would transact at. It may be a sense of, you know, for example, loss or some other problem you're trying to understand or some other exposure you're trying to measure, but maybe not fair value.

Another thing that people clearly have to work to think through is what is the value of rating agency data, not to say that there is no value? There clearly is value to it, but it is how do you rate that value? How do you deal with some of the rapid downgrades or significant downgrades that have occurred? You know, how does that impact your value?

And finally, thinking about control processes – Stan talked a little bit about risk and some governance issues. In the absence of something objective to point to, one needs to think harder about the judgments that are made and whether you have adequate controls over those judgments. Is there the right level of supervision? Do people understand this? Is there the right level of challenge? Are the models correct? Are you really measuring the right thing? All of those things are becoming very important. And embedded in that is also documentation, making sure that you have clear documentation that explains what your decisions have been – contemporaneous documentation to stress that – but really laying out exactly what you've done, how you've thought about it and why you believe that your values are appropriate.

We talked about a lot of the challenges. I guess I have some observations on some of the outcomes that have occurred related to reporting these fair values, just some observations on this. There clearly is a lot of discussion about the volatility of earnings. And I think that there are a couple of different ways to analyze this, but clearly, clearly there are, you know, some very significant write-offs, as we all know.

But the volatility is really a question in many people's minds of whether it's real losses or whether they are only paper losses. And that, I think, is one of the bigger challenges. Or is it really an issue of timing? If it's an issue of timing, I think that that's one – that may not be the worst thing to record your losses faster, if it's really whether the losses are really indicative of what you ultimately believe you're going to pay out. That's the arguable part, and that's the part where people – many debates have occurred and many more debates will occur about whether fair value is really reporting the appropriate thing.

One of the bigger things that I think, though, is happening is that it's very difficult to make some of these numbers comparable. When you look across some of the large financial institutions that have taken these very large write-downs, you look at the numbers and it is very difficult to understand why one firm has taken the write-down that it has versus another. The numbers just don't seem comparable. Now maybe data, but it's going to be – there are a number of other issues.

The last two things, just quickly – clearly businesses and business processes have been impacted. People have decided that they don't necessarily want to keep a business, or others have found opportunity in some of this. So it's not as if it's all bad. There are clearly those who are finding opportunity. And I've already touched on a number of the processes that have changed, but clearly business processes have changed dissociated ph from this.

I think I'll stop at this point.

Mike Campbell: Thanks very much, Doug.

Our next two speakers, Michael Gass and Matthew Martel of Edwards Angell, will discuss specific legal issues that are likely to arise in subprime litigation and government enforcement along with potential claims and defenses. Mike chairs the firm's Securities, Government Enforcement and Corporate Governance Practice Group. His areas of concentration are securities and shareholder litigation defense, corporate governance and officer and director liability and investigations and proceedings brought by the SEC, NASD and other regulatory bodies.

Matt Martel practices in the area of business litigation. He represents clients in disputes in areas including corporate governance and shareholder litigation, litigation arising from mergers and acquisitions, bankruptcy litigation and other complex commercial litigation.

Matthew Martel: Thanks, Mike.

Mike Campbell: Sure.

Matthew Martel: So Stan talked for a few moments about proper risk management and disclosure. Doug spoke as well about proper approaches to evaluation. I'm here to talk about – and Mike is here as well – we're here to talk about what happens to those who allegedly got it wrong. The answer is investor and shareholder lawsuits, among other things. We unfortunately do not have time today to talk about borrower-type lawsuits or fiduciary duty lawsuits or other kind of liability that may fall on some of the actors who are involved in the securitization process. We're going to focus primarily on investor-shareholder, class-action-type lawsuits.

Bringing you back to the structure of the deal that Mike described at the very beginning, everyone on this page is subject to a potential shareholder-investor lawsuit, with the exception of the investors, of course, on the right-hand side, and the borrower is the first box in the top left-hand side. So I just want to refer you back to this organizational structure because we'll be using it in describing what sorts of claims have been brought against these folks.

So investors are pretty upset about the downfall in the subprime mortgage market. Lots of investors have allegedly suffered substantial losses arising out of their investments in companies. And one group of defendants that they have pursued actions against are the holders of the CDOs. So these are the folks in the green boxes on the right-hand side of the flowchart.

And, you know, one such group of CDO holders are the, you know, sort of the Citigroups of the world, an entity that may play several roles in the securitization process but, at the end of the day, may end up holding some tranche or tranches, these CDOs. Their own shareholders are upset at them because, as the market took a downturn, those companies of course had to take substantial write-downs.

And their investors have alleged that they, you know, should have seen it coming or saw it coming and didn't disclose it. And ultimately when it was here, they didn't write them down fast enough, didn't write the investments down – the investment write-downs were not substantial enough. So they're currently faced with a number of such shareholder lawsuits.

Investment funds, investment companies are also subject to such lawsuits. There's the well-known Morgan Keegan case. And the allegations there are that investors in mutual funds and – went and invested through investment companies and used investment advisors – were told that their particular money would be invested in some safe investment. But according to these plaintiffs, the monies were then put into subprime investments, and when the fund suffered losses, so too did the investors.

We've seen plenty of litigation with respect to those two groups of defendants. What we haven't yet seen a lot of is litigation against other publicly held companies who may have taken some money off of their balance sheet and invested it into some of these CDOs. A number of publicly

held companies have said, yes, they did so on a short-term basis, but they got sort of caught in the net as the subprime market declined, and, as a result, they have suffered substantial losses. What we haven't yet seen but may see is investors in those publicly held companies alleging that the directors and officers of the company should not have invested in that fashion, or if they did invest the cash in that fashion, they should have disclosed it to shareholders.

Other players in these securitized transactions who are subject to liability – well, who have been sued – are the underwriters of the world, the Merrill Lynches who've been sued several, several times, based on allegations that you participated in the process, you took your allotment as an underwriter, and you were still holding onto that allotment when the bottom fell out of the market. You had to take substantial write-downs, and you're responsible to us for failing to tell us that those investments would in fact decline as they had.

The investment banks who participated in the process, the trusts and trustees who are involved in the process as well – the servicers, of course; you know, they've been sued on several occasions. And the allegations there are that the servicers failed to disclose to their own shareholders that their servicing revenues would fall off, that they would lose the servicing rights altogether under circumstances where a subprime lender entered bankruptcy, and the servicing rights may get caught up in a repo agreement, those sorts of things.

One other important group of defendants I think to mention here are the publicly held companies themselves that act as lenders. They've been sued numerous times. Many of them are currently in bankruptcy as well. But the accredited home lenders of the world – and it's alleged that they failed to disclose to their own investors that they would be subject to substantial repurchase obligation or that originations would fall off or that their mortgage portfolio overall would decline as a result of all of this.

One of the final groups of companies that have been sued are companies that you all have heard a lot about. One is credit risk insurers. The other is the rating agencies. So you've heard plenty about this. So we won't spend a whole heck of a lot of time on it, but it is worth describing the allegations against these companies.

With respect to Moody's and Standard & Poor's, or S&P's parent company, McGraw-Hill, the allegations are that you, credit rating agency, were out their issuing ratings on these particular investment vehicles, these CDOs. You knew or should have known that the underlying mortgages were questionable. You were issuing great ratings on them when you shouldn't have been.

And here's the causation argument the plaintiffs make: Ultimately when you told the world that you needed to reconsider your ratings of these companies, your stock declined greatly. And as a result, the investors in Moody's and Standard and Poor's allege that they have been harmed as a result of that decline.

With respect to the insurers, the allegations are very, very similar, that you were out there insuring these things; you didn't disclose to the world that you could be subject to substantial loss coverage figures; you weren't reserving properly. But ultimately, with respect to causation, it's the actual disclosure to the market that the insurers may have these substantial coverage issues and that they would have to take larger reserves. That disclosure itself, the plaintiffs allege, harmed them because the insurers stocked and dropped off. And the companies that are mentioned most often in this respect are, of course, MBIA and Ambac, which everyone's written a whole lot about.

The last category of defendants that we just want to mention are the accountants and the lawyers, two groups that are, you know – I'm sure there are appointed accountants and lawyers on the phone today. The accountants have already been roped into some of these securities litigations. And there, you know, it seems as though many of those suits may be subject to

dismissal, but they've been named none the less, KPMG and the New Century litigation being one of the most famous defendants in this respect. And the allegations there are simply that, you know, you knew it was coming; you put together the financials in a way that was irresponsible under the circumstances. And then ultimately when it hit, you didn't do your job with respect to valuation.

Finally, with respect to the lawyers, we haven't seen those allegations yet. There may be some suits out there that we simply have not uncovered, but you would expect that the allegations against the lawyers would be somewhat similar to those allegations against the accountants and other professionals that have been sued.

And Mike Gass is going to now describe to us what the actual substantive positive action are against some of these defendants.

Michael Gass: Thanks, Matt.

There have certainly been predictions of a tidal wave of litigation flowing from this, as we have come to expect from any Wall Street crisis. And also predictions not only in legal circles but in the popular press that once all the lawsuits start flying that we will find some sort of fraud that underlies the crisis and that people will be made to pay.

What I'd like to do for a few minutes is to drill down beyond those kind of general reactions to some of the very real issues that will be faced by plaintiffs trying to use litigation for recovery in these cases. And the conclusion is that, while there certainly may be successful litigation that comes out of this – and there certainly will be a lot of litigation, whether it's successful or not – there are some very real obstacles to a plaintiff individual or a plaintiff class trying to obtain recovery out of this whole mess.

And the reason for that primarily, at least when it comes to the securities cases, is that the underlying event here, which caused and is causing shareholder losses and potential losses in value, is really a market-wide or macro event. That is a decline in the housing market, an increase in defaults and widespread effects on the credit markets that have come about as a result of that. This differs markedly from the typical securities case, particularly the typical securities fraud case, where you have a single company or a very easily to identify subset of companies, who disclose to the market some problem, some issue, that that company has. And the allegation is that the company knew, should have known, should have disclosed that issue much sooner, and, as a result, shareholders who bought or invested in or held during that time period were damaged.

When you have a market-wide, macro event, such as occurred here, with the entire market, stock market, being affected, whole industry sectors, including the financial services market, going down in unison, it's much more difficult to identify a particular instance of alleged fraud or an alleged misstatement that is going to give rise to some sort of liability. And I'd like to hearken back briefly to something Stan said earlier, which is I think it is going to be important in these cases to look at the point in time or the timeframe that is being challenged.

And by that I mean if you're looking at time periods prior to the time where the crisis generally hit the stock markets and the allegation is there were misstatements, there were omissions or there was some deliberate fraud being committed, it's going to be very difficult to prove, absent some very detailed evidence, that there was fraud being committed or misstatements knowingly being made, when in fact entire markets were making the same statements, making the same representations and operating under the same assumptions going forward. It may, however, be a very different story if you're focusing on periods after people knew or people should have known that they were sitting on rapidly deteriorating assets, facing other types of potential harm to the company and yet did not immediately give full disclosure with respect to those issues.

So let me take that general theme and very briefly apply it to some of the main causes of action, legal causes of action that we're likely to see here. I'm going to start off with the 1934 act, taking it a little bit out of sequence from what's on the slides. The 1934 act, which contains Rule 10b-5, is the broadest and furthest reaching of the fraud provisions in the securities laws. That is so because it reaches all market transactions, not simply direct transactions, so that this is where most of the large shareholder class actions arise in which the basis of the claim is that there was a misstatement or omission made by the issuer or those related to the issuer in a variety of formats, including SEC filings, press releases or any other public statements.

If you're looking at the period before the crisis hit here, you'd have to identify a misstatement or omission that was made. And if you're stepping into the shoes of someone making the statement with respect to the value of their assets, the level of risk involved in holding or issuing those assets, they may have been wrong about what would happen in the future, but it's very difficult to say that, at that point in time, what they said was actually a misstatement of fact.

Adding to the risk, with respect to these claims, are the changes to the law which allow companies to couch statements about risk and future events as so-called forward-looking statements, which provides a safe harbor, of sorts, under the statute. But if you're talking about what the likelihood is of risks in the future or the value of the assets in the future and it's couched as a forward-looking statement, as most companies do, there is an added level of protection.

In addition, under the 1934 act claim, a plaintiff must show scienter, which is an intent to deceive. And again, that creates a serious issue before the crisis hit, because even if statements were wrong and even if they were to some extent negligent, there is going to be a difficulty in showing the state of mind necessary to get recovery under the '34 act claim. What adds to the difficulty in these types of claims for a plaintiff is that the Supreme Court has really tightened up the ability to get past a motion to dismiss on a lot of these claims.

In other words, you can no longer simply allege scienter in a way that makes it possible that there was an intent to defraud here and thereby get past a motion to dismiss and get into discovery, where you may be able to find e-mails that go back several months before the crisis actually hit where people were raising questions internally about what the value of these assets were or whether they may be facing a mortgage crisis down the road. Under Tellabs, which is the recent Supreme Court case, it is much more difficult to get past that motion to dismiss and even get into that type of discovery.

And then finally, loss causation under the Dura case issued by the Supreme Court has really raised the bar in showing that whatever alleged misstatement is at issue actually caused a loss to the plaintiffs. And here, where the defendants can point to broader market forces that actually bring about the losses, those facts tend to rebut any argument that a specific act by the defendant actually caused the loss.

I'm going to move ahead very quickly now because our time is going to start running short. But a lot of the arguments that relate to the '34 act claims relate to others as well. So, for example, when you have '33 act claims, those claims do not apply to broadly traded securities on the securities markets but typically or do relate to issues directly by the issuer in either an IPO or another offering, debt offering or equity offering, which automatically limits the number of plaintiffs involved and, again, creates the same kind of problems of establishing that was said at the time that the security was issued, either in the registration statement, in a prospectus or otherwise, was false at the time. Typically, companies are very good at putting the appropriate disclaimers around those types of representations and very difficult to show that anything improper was done that would trigger liability under the 1933 acts.

The only other statute I'm going to mention at this point is actually not a securities statute but is playing an increasingly important role in these kind of cases, and that is ERISA. A lot of the holders of securities that were impacted by these are going to be in some way related to pension

funds. ERISA applies to those claims, and it is a fiduciary standard under ERISA, not a fraud standard. So the question that is addressed there is whether the fiduciaries responsible for the investment exercise their duty of care and whether the investments were prudent, obviously a lower standard than trying to prove some sort of fraud.

I am going to kick it back to Matt now to finish up on the litigation portion, and then Mary-Pat's going to finish off with the insurance issue.

Matthew Martel: So of course you all know that none of this has escaped government scrutiny. The states are hot and heavy after theses issues. The FTC is, the Department of Justice is, HUD is, and one of the government agencies that's been most vocal in this area is the SEC. The commission has had a whole lot to say about the subprime crisis. The SEC's Subprime Task Force was formed approximately a year ago or so, and it has really ramped up its efforts, at least according to the government.

It was last reported that they have about even more than a hundred lawyers in New York alone working on these matters for the SEC. The SEC recently disclosed that there are 48 active investigations. That was last week when they said that, so there very well could be more as of now. And, you know, Commissioner Cox and Enforcement Director Thomsen have been speaking regularly on these, essentially telling a lot of the role-players that we talked about before that, you know, they're coming for them.

The commission's even gone so far as to identify some of the folks that it's most interested in. And the next slide identifies some of those people. I'm not going to detail the commission's concerns about the role that each one of those groups or individuals may have played. They're all out there on the slide. But I just want to note that many of these folks are already people that have been sued in the private securities class-action lawsuits.

The real difference here is that the commission also seems to be going after broker-dealers, or they're focusing on them. But they're also focusing on folks who may have engaged in insider trading as well. So stay tuned for more new on the SEC's actions in this area.

Mike Campbell: Thanks very much to both of you. We're really running tight on time now. And I don't know if we're going to have time for Q&A the way things are turning out, but I want to introduce our next speaker, our last for the day, Mary-Pat Cormier of Edwards Angell, who will be discussing the very important topic of whether your potential legal exposure is covered by insurance.

Mary-Pat focuses her practice in the area of financial services and securities litigation, including disputes arising out of bad-faith claims handling against professional and specialty lines liability carriers, banking, creditors' rights and limited partnership disputes.

Mary?

Mary-Pat Cormier: I'll keep my comments brief so that we can get in a couple of questions, and I would encourage anybody to give me a call or look me up on the Web site and send me an e-mail if you want.

Essentially, obviously your broker's – anybody who works in a company, a broker's best advice is going to say that your best practice is to put all of these policies on notice which are listed here on this slide. And in connection with an ERISA claim, that's obviously – any time there's a 401(k) plan implicated, an employee beneficiary plan, essentially any time where there's a trust involved and perhaps there were plan assets invested in CDOs, that potentially could give rise to a claim, an ERISA-type claim, which could trigger coverage under the ERISA policy.

With respect to directors and officers insurance, what we're seeing mostly in connection with that is, as Matt pointed out at slide 14, I think, the types of claims where shareholders are suing holders or purchasers of collateralized debt obligations or mortgage-backed securities without properly disclosing that. And those shareholders are suing, and there are D&O claims which are arising out of that. The E&O claims are – what we're seeing mainly is obviously financial institutions, investment advisors, hedge funds that advised the purchase of these. Also on the E&O side, obviously, are the accountants malpractice and attorney malpractice policies, as was pointed out in slide 17 by Matt as well.

One of the things that I think is noteworthy also are the costs of corrections endorsements on a lot of the E&O policies and how that coverage is implicated. Particularly important for those of you who are with some of the financial institutions that have E&O costs of corrections is to pay particularly close attention to both the notice and consent issues with respect to the operation of the costs of corrections coverage and how that works. How that works in connection with triggering coverage is obviously important.

Some of the issues that we're seeing or that you'd want to be aware of, it seems to me, in connection with the actual coverage issues, kicking off with the insuring agreement and the definitions, are – and this is particularly important in the consumer class-action context – the professional services definition under errors and omissions policies. The professional services definition is often much narrower than the broad scope which is defined in some of the complaints which are being brought in the consumer class actions or which can be contemplated. So you'd want to be aware of that.

Also loss, not necessarily covering either restitution or any sort of fees; also fee exclusions would come into play there. With respect to the D&O policies, you know, checking to make sure that what is in fact has been alleged is a securities claim as opposed to simply some sort of professional services claim, which would not necessarily trigger coverage under a directors and officers policy.

And finally, as we were just noting just a minute ago, the regulatory activity in connection with respect to the subprime crisis may or may not constitute a claim under the policies which are out there, nor may the regulatory subpoenas which are going to be issued and are starting to be issued. So that's clearly important.

Some of the more important exclusions which I think you need to be aware of are the diminution of value exclusions. Again, they particularly apply with respect to costs of corrections, often don't pick up pure market loss or ex gratia payments. And also professional services exclusions, unless there's a failure-to-supervise allegation, would not be picked up on the directors and officers cover either.

And one thing that you, again, have to be very aware of, particularly in connection with ERISA-type claims are the ERISA exclusions which operate in both D&O and E&O policies. And unless there's been ERISA cover provided, it can become problematic. And also one of the other things – well, a couple of the other issues that need to be, I think, pointed out are the consent issues and subrogation issues. This particularly comes into play, obviously, where there are indemnity agreements between various parties and how those subrogation rights may play out in connection with any potential settlement involving any claims.

So, again, I don't want to keep anybody because I think there are probably a couple of questions. But if anybody has any questions for me that they want to ask offline that I haven't covered here, you can contact me separately.

Mike Campbell: Thanks very much, Mary-Pat. Now, unless the administrative folks cut me off, I'm going to try to make time for only one question. And this would go to Matt and Michael.

Michael Gass: OK, the question is mortgage services are the only ones still actually working these loans and securities. What can they do to mitigate their risks to investor liability?

I'll start off and anybody else can feel free to jump in. The first answer to any current question about any liability you might be creating is on the disclosure end, making sure that you are giving full disclosure as to the state of your business and the servicing obligations that you have, what kind of default or pre-payment experience you are having and what the impact is on the business. In some ways, having already experienced a big drop in the market and having had the credit markets already experience a lot of the hit here, you know, exposure may be less now than it was if you went back some number of months. But keeping your disclosures current and accurate as to the current state of play and what you're seeing in terms of default experience, I think, is a key to mitigating risk.

Anybody else have any thoughts on that front?

Stanley Keller: Well, being realistic about what the current situation is – I mean, you have the past situation, but making sure that you properly documented your current procedures, your current valuations, so you can point to a disciplined process for exercising judgment, I think is a key, both as to valuing the assets and properly booking reserves for the known problems in liabilities and litigation exposure that's out there.

Mike Campbell: Stan, I'm going to have to wrap this up now, I've been told. I want to thank everybody for attending, and I please ask that you fill out your evaluation forms. It was a pleasure for all of us to speak on this very important topic today. And you're now disconnected.

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