SUB-PRIME RELATED ERISA LITIGATION

By: Rebecca Oldroyd & Michael P. Kreps, *Groom Law Group, Chtd.*

The effects of the failing sub-prime mortgage industry are widespread. Home owners, builders, lenders, and investors are all feeling the strain of the market turmoil, and the courts have been flooded with litigation ranging from consumer-related claims to claims against securities firms and credit-rating agencies. Retirement plans have also been negatively affected by the crisis, and as a result, a number of lawsuits have been filed raising claims under ERISA. The lawsuits seek to make plans and participants whole for millions, if not billions, of dollars of losses resulting from sub-prime related investments.

I. BACKGROUND

A. The Sub-Prime Lending Market

Sub-prime lending is the practice of making loans to borrowers who, because of their credit history, do not qualify for the best market rates. The term "sub-prime" refers to the borrower, not the interest rate, and generally includes those with credit scores under 620. Sub-prime loans come in a variety of forms, the most publicized of which is the sub-prime mortgage.

From 2004 through 2006, sub-prime mortgages accounted for approximately 20% of the total new mortgages in the United States and totaled nearly $600 billion. For those with poor credit, such mortgages – which come in a variety of forms including interest only mortgages, adjustable rate mortgages, and "pick a payment" mortgages – provide one of the only avenues to homeownership, but they carry a significant degree of risk for the party holding the repayment rights. As you would expect, sub-prime loans (also called "B-paper" or "second chance lending") carry higher than average interest rates in order to compensate the lender for the risk of borrowers with poor credit.

Although one-fifth of all mortgages in the United States are sub-prime, lenders usually do not bear the long-term risk of loss. Instead, the majority of sub-prime mortgages are securitized, allowing lenders to pass the risk of loss to other investors. Securitization involves the pooling of mortgages and selling the rights to a portion of the pool's cash flow as securities, called Mortgage Backed Securities (MBS), to investors. In some cases, MBS of varying quality are pooled into a Collateralized Debt Obligation (CDO). In the typical CDO, the rights to cash flow are grouped in different "tranches," thereby allowing individual investors in the same CDO to hold interests that bear different risk and reward characteristics.

Securitization has allowed the sub-prime industry to flourish, and because two-thirds of all sub-prime mortgages are securitized and sold to investors, sub-prime mortgage risk is widely spread throughout the economy. Employee benefit plans bear a portion of this risk as some plans are invested directly in MBS or CDOs, and most plans have a significant amount of indirect exposure to sub-prime mortgage investments through bond funds, stable value funds and money market funds. Additionally, plans that have securities-lending programs often receive sub-prime mortgage related investments as collateral.

B. The Sub-Prime Lending Crisis

Late in 2006, there were whispers of a storm brewing on the sub-prime horizon. Interest rates had begun to creep up, and, as a result, many people with variable interest rate mortgages saw their monthly payments increase dramatically. At the same time, housing prices were in decline, making escape from onerous mortgage payment schedules through refinancing difficult for many homeowners. By the beginning of 2007, the mortgage troubles developed into a full-blown sub-prime storm. Loan defaults increased dramatically, and in the first two quarters of 2007, there was a nearly 40% spike in foreclosures. Not surprisingly, the bulk of the foreclosures came from sub-prime mortgages. The problem has continued through the remainder of 2007, and currently, approximately 16% of sub-prime adjustable rate mortgages are 90 days into default or in foreclosure.

The sub-prime mortgage industry's collapse came as a shock to much of the market. MBS were often considered "safe" or "conservative" investments because it was assumed that people would pay their mortgages before buying other goods or services. However, many lenders had liberally approved spurious loans knowing that the risk would be spun-off to unrelated

Continued on page 12

provider failed to disclose under its disclosure obligations, request in writing that the service provider furnish the information;

- If the service provider fails to comply with the plan fiduciary's written request for the information that the service provider failed to disclose earlier within 90 days of the date of its request, the responsible plan fiduciary within 30 days thereafter must notify the Department of Labor of the service provider's failure;[17] and
- The responsible plan fiduciary, following discovery that the service provider failed to comply with its disclosure obligations, shall determine whether to terminate or continue the contract or arrangement. The responsible plan fiduciary will evaluate the nature of the particular disclosure failure and determine the actions necessary under the facts and circumstances. Such fiduciary shall consider, among other factors, the availability, qualifications and costs of potential replacement service providers, and the responsiveness of the service provider in furnishing the information that the service provider should have disclosed, but did not, under its disclosure obligations.

EXPECTED PRAISE AND CRITICISM OF THE PROPOSED REGULATION AND PROPOSED CLASS EXEMPTION

1. Expected Concerns from Service Providers

The Proposed Regulation creates uncertainty for the responsible plan fiduciary and plan sponsor who discover a disclosure failure by the service provider and must evaluate what obligation result from the late disclosure. Consider the following example:

> The service provider, an insurance consultant, provides consulting services for a flat fee. In connection with obtaining policies for the plan, the insurance consultant acts as broker and waives commission. Though no commission is charged by the insurance consultant or its affiliated brokerage through which the insurance is obtained for the particular policies placed for the plan, based upon the aggregate policies written with a particular carrier, the insurance consultant's affiliated brokerage firm receives an override commission.

In this case the override commission is a form of "compensation." Disclosure would appear to have been required by the Proposed Regulation even if no portion of the override was attributable to the policy obtained by the plan and required to be reported on Form 5500 Schedule A.[18] Disclosure in this case would be required if it would be material to evaluating the recommendation by the insurance consultant of a particular carrier among others.

In this example, if the responsible plan fiduciary determines that there was a disclosure failure, he or she could make a specific inquiry of the insurance consultant for the details. If the insurance consultant refuses or fails to provide the information, the responsible plan fiduciary would have to file a notice with the Department in order to protect itself from prohibited transaction liabilities. On the other hand, if the insurance consultant instead provides the requested information, the responsible plan fiduciary must determine what actions to take. If the responsible plan fiduciary, after consideration of all the information, determines that the additional information does not require any further action, it is unclear whether it must nonetheless disclose a prohibited transaction in its Form 5500 filing. Presumably, in this case the Proposed Regulation would have required disclosure as the information was properly taken into account in evaluating the vendors even if the information was not outcome-determinative. As a result, it would seem that a prohibited transaction occurred because the plan entered an arrangement that is deemed unreasonable as a result of the failure to provide the fiduciary with the requisite information, even though the amount involved would appear to be zero. In this situation, the Department might wish to clarify that the failure would not need to be classified as resulting in a prohibited transaction.

17 The following information must be provided to the Department: (i) The name of the plan; (ii) the three digit plan number used for the plan's Annual Report; (iii) the plan sponsor's name, address, and EIN; (iv) the name, address, and telephone number of the responsible fiduciary; (v) the name, address, phone number, and, if known, EIN of the service provider; (vi) a description of the services provided to the plan; (vii) a description of the information that the service provider failed to furnish; (viii) the date on which such information was requested in writing from the service provider; and (ix) a statement as to whether the service provider continues to provide services to the plan.

18 See ERISA Advisory Opinion 2005-02A for a discussion of how certain payments to brokers should be reported.

2. Expected Concerns for Participant Directed Arrangements

To the extent that the regulatory project was encouraged to assist participants to wisely manage their individual accounts in defined contribution plans, the regulations is likely to result in the development of an industry standard that will: deem certain expense information "material"; evolve a format for disclosure that will be uniform to enhance apples-to-apples comparisons; and enable plan sponsors to provide participants with access to such information timely, and in a manner where the plan sponsor will be comfortable that it is not exposing itself to liability for passing-through such information.

Also, Participant rights advocates will complain that the Proposed Regulation falls short because it does not require that the plan sponsor provide the expense information to participants even in participant directed investment plans, nor does it mandate a format of disclosure of such information.

3. Expected Concerns of Service Providers

As the regulation is directed to the responsible plan fiduciary, compliance may prove to be a challenge for hedge fund sponsors who agree to accept fiduciary responsibility for ERISA assets entrusted to them. One should anticipate that hedge fund sponsors, particularly fund-of-funds managers, will seek relief as in many cases they may not be able to access in any verifiable manner all elements of compensation obtained by the sub-managers the select.

CONCLUSION

The Proposed Regulation should prove helpful to plans and participants, so that each better understands the charges associated with services. Plans and their service providers will benefit by carefully considering the unexpected reach of the Proposed Regulation and the obstacles to collecting information across multi-service organizations. However, failure of Plans and their service providers giving sufficient consideration to the implementation of the Proposed Regulation is likely to lead to many difficulties in implementation of compliance efforts.

SUB-PRIME...

Continued from page 5

buyers through securitization. Despite investors' strong incentive to correctly analyze the risk, they failed to predict the potential scope of the market collapse because the complexity of securitized investment products led to confusion over the actual risks being assumed. Investors erroneously assumed that the risk of exotic products such as MBS and CDOs could be evaluated with traditional risk-management systems, and many relied heavily on credit rating agencies, which have been criticized for using faulty models and operating under various conflicts of interest. In the end, the market simply was not prepared for the sub-prime mortgage collapse, and the consequences have been severe.

Several major sub-prime lenders have experienced reduced earnings, substantial drops in stock price, and, in some cases, bankruptcy. Investor uncertainty over the value of stocks and bonds tainted by sub-prime exposure has resulted in significant illiquidity for those currently holding sub-prime related investments and companies that rely on the issuance of commercial paper to raise capital. The sub-prime turmoil is also taking its toll on employee benefit plans, which, while generally well diversified, have seen a reduction in anticipated returns from certain investments in the fixed-income and equity markets. Consequently, it was only a matter of time before disputes over sub-prime related investments made their way into the courts.

II. SUB-PRIME LITIGATION

Eight lawsuits asserting ERISA claims have been filed to recover plan losses related to sub-prime investments and seven of the lawsuits seek class certification. Although the litigation is in its nescient stages, two general categories of lawsuits have emerged. The first category includes three lawsuits based on breaches of fiduciary duty by those who manage bond funds in which retirement plan assets were invested. The second category consists of "stock drop" lawsuits filed against lending companies and plan fiduciaries after the value of company stock held in retirement plans decreased rapidly as a result of the sub-prime mortgage industry collapse.

A. State Street Litigation

Since October, three separate lawsuits have been filed against State Street Bank and Trust Company, a registered financial holding company, and State Street Global Advisors, Inc., a subsidiary of State Street Bank that provides investment management services, (collectively, "State

Street") alleging that State Street breached its fiduciary duties as an appointed investment advisor to numerous retirement plans.

The lawsuits focus on the poor performance of bond funds that State Street allegedly marketed as relatively low risk, conservative investments with stable returns. The bond funds at issue were collective trusts designed to match or exceed returns of a conservative Lehman Brothers bond index, and according to the complaints, State Street represented that the bond funds would invest only in investment grade assets. When the sub-prime mortgage industry collapsed, the State Street bond funds substantially underperformed the benchmark indexes, and retirement plans with plan assets invested in the bond fund achieved returns significantly lower than expected. According to the complaints, the losses were caused by the investment of the bond funds in sub-prime mortgage-related investments.

The plaintiffs claim that State Street breached the fiduciary duties set forth in ERISA section 404(a) by heavily investing the bond funds in sub-prime mortgage-related investments. Specifically, the complaints allege that:

(1) State Street deviated from the stated investment objectives of the bond funds by investing in high-risk investments, many of which were MBS that were not investment grade;

(2) State Street exposed the bond funds to excessive and undisclosed risk by leveraging the bond fund investments in order to purchase high risk investments;

(3) The bond fund investments were highly concentrated in sub-prime mortgages and State Street failed to diversify the investments;

(4) State Street misrepresented the fund investment strategy and objectives; and

(5) State Street did not provide notice of the altered investment strategy or fund objectives to plans or to plan participants with retirement assets invested in the bond funds.

The plaintiffs seek to recover investment losses caused by State Street's breach of fiduciary duty. Additionally, they request that the courts require State Street to disgorge all fees and other amounts received for providing services in connection with the bond funds.

The breach of fiduciary duty lawsuits filed against State Street is incredibly fact-intensive, and it is unlikely that other investment managers will face similar lawsuits. The lawsuits require that an investment manager actually deviate from the investment guidelines prescribed by the plan, which is difficult to substantiate because investment management agreements are often ambiguous and are drafted to give investment managers wide discretion. However, the risk of litigation may increase if it can be established that an investment manger has misrepresented or failed to disclose the nature of their investments to plans and participants.

B. Stock Drop Litigation

The rapid devaluation of company stock due to the sub-prime mortgage market collapse has triggered a wave of ERISA "stock drop" lawsuits. Stock drop suits initially appeared in the wake of the Enron scandal and the economic downturn at the beginning of the decade. They are filed by employee shareholders after company stock held in a retirement plan declines in value. Stock drop plaintiffs generally allege that various plan fiduciaries breached the duties owed to plan participants and beneficiaries under ERISA by allowing continued investment in employer securities despite knowledge that the investment may be imprudent.

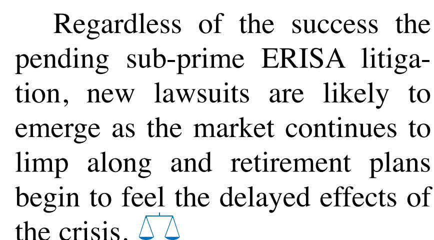
Currently, lawsuits have been filed by retirement plan participants against Countrywide Financial, one of the nation's largest independent mortgage lenders, Beazer Homes U.S.A., a home builder, and Citigroup. The plan participants allege that fiduciaries of the companies' retirement plans, including the companies, the companies' officers and the members of various company committees, breached their fiduciary duties by failing to prudently manage the assets of the plans in the best interests of the participants and beneficiaries. The lawsuits also allege that the fiduciaries failed to monitor, were subject to improper conflicts of interest and failed to provide complete and accurate information that would have informed the plan participants and beneficiaries of the risks of investing in company stock. The plaintiffs maintain that the fiduciaries knew or should have known that the companies' improper management and risky sub-prime lending practices exposed retirement plan investments in company stock to unacceptable risk.

Like the fiduciary breach lawsuits filed against State Street, the plaintiffs in the stock drop lawsuits request that retirement plans be made whole for losses suffered as a result of the fiduciary breaches, which, according to one complaint, total an estimated $1 billion.

Plaintiffs also ask that plan sponsors disgorge any profits made by the companies from the plans' investments in company stock.

It is unlikely that we will see more than a handful of additional sub-prime mortgage-related stock drop lawsuits. There is a limited number of companies with strong ties to the sub-prime industry, and there are even fewer that have experienced the kind of massive devaluation of company stock that is necessary to maintain a lawsuit. Additionally, earlier stock drop lawsuits garnered a mixed reception in the courts, so potential plaintiff may not be willing to roll the dice in the future.

Regardless of the success the pending sub-prime ERISA litigation, new lawsuits are likely to emerge as the market continues to limp along and retirement plans begin to feel the delayed effects of the crisis.



2008 TIPS CALENDAR

Date	Event	Location
March		
25-26	Staff Counsel National Program	InterContinental Hotel Chicago, IL
April		
3-5	2008 Property Insurance Law Committee Meeting	Four Seasons Aviara Hotel Carlsbad, CA
9-11	2008 Emerging Issues in Motor Vehicle Product Liability Litigation Meeting	The Arizona Biltmore Resort & Spa Phoenix, AZ
10-12	2008 Toxic Torts & Environmental Law Committee Meeting	The Arizona Biltmore Resort & Spa Phoenix, AZ
12-16	2008 TIPS National Trial Academy The National Judicial College	Harrah's Reno Hotel Reno, NV
May		
1-4	TIPS Spring Meeting	Red Rock Casino Resort & Spa Las Vegas, NV
	Fidelity and Surety Law Committee Spring Meeting	InterContinental Hotel Kansas City, MO