Resolving Financial Crisis Claims Through Mediation

By Joseph T. McLaughlin

Mediation, which is voluntary, can be used to resolve complex disputes involving multiple financial institutions.

The aftermath of the current financial crisis will likely be with us for at least five years—the typical life cycle of litigation and systemic bankruptcies. No one method of resolving disputes among financial institutions will eliminate the litigation overhang, but prudent use of mediation can—and has—resolved financial crisis disputes quickly, efficiently and fairly.

In the wake of the financial crisis, the likely litigants are institutional parties with potential claims against a multitude of industry participants.[1] Potential litigants include originators, sponsors, sellers, underwriters, institutions and hedge funds, among others.

There are complicated agreements by and between institutional players at every level/tranche of the claim extending from the borrowers (typically individuals) on the original debt instruments (typically residential mortgages) through the institutional players described above.[2] Claims may include the following:

- Against originators for breach of contract, unjust enrichment or fraud/negligent misrepresentation
- Against sponsors (which may also be originators) for breach of contract and to enforce repurchase agreements for loans in breach of representations, warranties and covenants and for loans that went into early default
- By insurers for fraud, negligent misrepresentation, rescission and/or declaratory judgment regarding scope of policy
- By certificate holders for fraud, negligent misrepresentation and breach of repurchase agreements
- Against trustees for breach of contract, breach of duty to avoid conflicts of interest, breach of duty to perform ministered, nondiscretionary tasks
- Against trustees by certificate holders for failure to distribute properly principal and interest, failure to enforce repurchase agreements, failure to pursue insurance claims or guarantees
- Against credit default swap counterparties or insurers for breach of contract
- Against servicers by trustees, certificate holders and insurers for breach of duty under relevant agreements
- Against underwriters and issuers by certificate holders for breach of contract, fraud and federal securities laws violation
- Against credit rating agencies by certificate holders for breach of contract and fraud with respect to connection between agencies' fee structure and assignment of investment-grade ratings to subprime mortgage-backed securities, collateralized debt obligations (CDOs) and structured investment vehicles

In 2008, 576 credit crisis/subprime mortgage-related cases were filed, an almost 100-percent increase in the number of cases filed in 2007. About half of those cases are before courts in New York and California. Of the 866 credit crisis/subprime mortgage-related cases filed since January 2007, 69 percent are active; that is, approximately 31 percent of cases have been resolved or dismissed.[3]

Complications of Litigation

There are significant variations in the length of time required to pursue a claim in the federal

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courts and in the 50 separate state courts. These differences should be carefully considered before pursuing litigation.

As of September 30, 2008 (the most recent statistical information available), the average disposition time of a civil action commenced in a U.S. district court through the completion of any appeal to the circuit courts was 32.7 months.[4] For the same time period, cases litigated through trial before U.S. district courts, without taking into account time for appeals, were disposed of on an average of 32.9 months from date of filing.[5] Civil litigation in state court varies depending upon the method by which the case is decided. Cases tried by a jury took, on average, 26.1 months from filing to disposition, while bench trials were disposed of in an average of 20.3 months.[6]

Frequently, when funds are insufficient to make payments to the different tranches of debt and the equity, trustees will commence interpleader actions, typically in a federal court. Interpleader actions are governed by F.R. Civ. P. 22, which "enables a person or entity in possession of a tangible res or fund of money (the 'stakeholder') to join in a single suit two or more 'claimants' asserting mutually exclusive claims to that stake. The stakeholder institutes interpleader, usually as an initial proceeding, by filing a complaint and joining the claimants."[7] For example, Bank of New York (BONY), in its capacity as indenture trustee, commenced an interpleader action against private investors and the Federal Deposit Insurance Corporation (FDIC), each of whom had an interest in funds held by BONY in a trust established by NextBank, N.A., created in connection with a securitization transaction.

Every litigation presents the same issues of delay, cost and publicity that draw the attention of shareholders and regulators, and faces a 100-percent–win/lose outcome.

Overview of Mediation

Is there a better way to resolve these disputes? The short answer to that question is mediation, a nonbinding alternative dispute resolution procedure where parties meet with a mutually selected mediator or neutral to reach agreement in lieu of litigation.[8]

Mediation services in the United States are provided principally by JAMS and CPR. Mediators can be selected from JAMS Panels (*www.jamsadr.com*); CPR International Institute for Dispute Resolution Panel of Distinguished Neutrals (*www.cpradr.org*); or from the American Arbitration Association (AAA), which maintains a roster of approximately 8,000 neutrals, each with at least eight to 10 years' experience in their respective fields.[9]

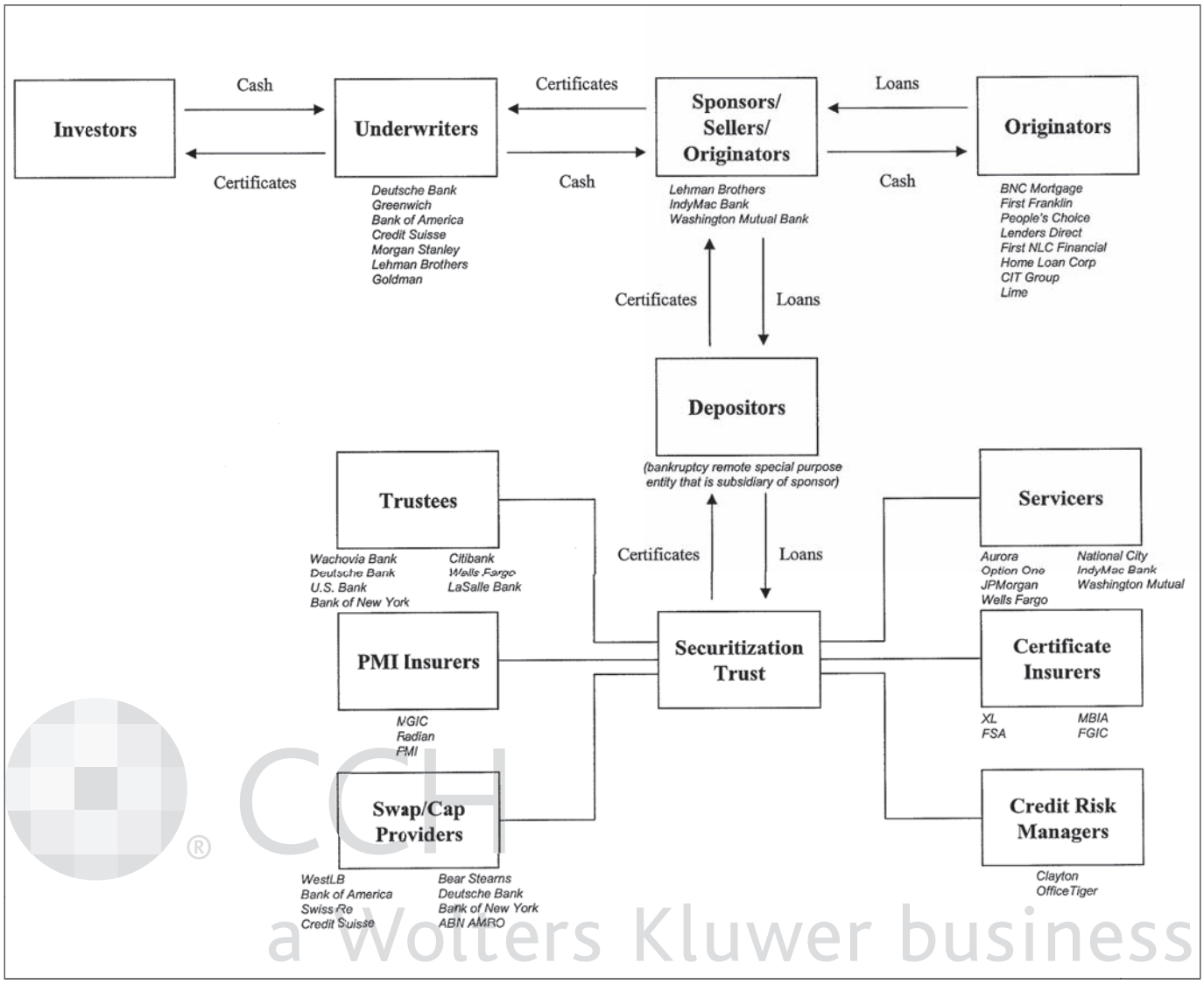
When selecting a mediator, ask: Who do you want your mediator to be? A person with extensive mediation process expertise? Or a person with financial services and/or credit markets expertise? Ideally, the mediator would possess both, but which qualification, if any, do you want to specify in writing in a mediation clause? Given the complexity of the documents constituting the various agreements between and among multiple parties, requiring the mediator to be a lawyer is a given.

Mediation is voluntary: Parties are required to agree in writing, whether prior to the dispute or, if no prior written agreement exists, through a written "submission to mediation."[10] Very generally, the mediation process starts with a joint discussion of the case and is followed by the mediator working closely with the parties, either separately or as a group, to resolve the case.[11] Approximately 85 percent of commercial matters submitted to mediation result in a written settlement agreement.[12] This is a reflection of the parties' willingness to consider an alternative to litigation and the skill of the mediator.

Mediation conferences can be scheduled quickly, with some cases taking mere hours to resolve.[13] Of course, how long it takes to resolve the dispute depends on the facts of the case, as well as on the willingness of the parties to work together to reach an amicable solution. Credit crisis mediations will likely require two or more mediation sessions, as well as serious preparation time for all involved.

The mediator acts as facilitator—and sometimes as a challenger to the preconceived notions of each side—working to prevent any new disagreements and guiding the parties to an acceptable solution that does not result in either side achieving a 100-percent "victory" as that term is used in the context of litigation. Because the mediation process is voluntary and nonbinding, absent agreement to bring the relevant players with separate contracts into the room, is there another way these disputes can be resolved without litigation?[14]

Exhibit 1. Mortgage Loan Securitizations/Participants



Example: Mediation in Practice

Disputes that arise from the credit crisis are particularly complex, primarily due to the large number of parties involved and the requirement that, in some cases, the parties cannot enter an agreement without the approval of a third party (Exhibit 1). The example below shows how, in mediation, the parties can craft elements of an agreement resolving a dispute between an underwriter and an insurer related to a CDO.

A bank underwriter sought to recover payments allegedly owed to it by an insurer in connection with a credit default swap entered into by the CDO investment vehicle as issuer and underwritten by the underwriter and a wholly owned subsidiary of the insurer. The credit default swap constituted part of the security for the CDO liabilities and served as a credit enhancement mechanism.

It became apparent that the CDO investment vehicle would owe the underwriter certain payments based on the credit default swap. Several questions then arose, the principal one being whether the insurer, as an affiliate of the credit default swap counterparty, owed any money to the CDO investment vehicle or whether the insurer owed any money to the underwriter. Importantly,

the insurer argued that the transaction documents limited the amount owed to a contractually specified cap. The underwriter sought the full amount it believed it was owed, without the application of any cap.

The parties agreed to mediate the dispute. Both submitted written initial statements and responses, which were considered by the mediator. At the close of the mediation, the underwriter agreed in a memorandum of understanding (MOU) to accept a percentage of the total amount allegedly owed by the insurer and, in fact, less than the threshold set forth in the transaction documents. This was driven by the impact the credit crisis had on the value of the collateral supporting the CDO liabilities. The funds paid were proportionate to the liquidation value of the supporting assets. Notably, liquidation of the CDO investment vehicle could not take place without the consent of the trustee. In disputes based on the securitization of subprime mortgage loans, it is often not enough to structure an agreement between a few parties in the transaction chain. Rather, it will likely be the case that a third party (for example, a trustee) must agree to the terms of the settlement before it can take effect.

The underwriter agreed further to release all claims against the insurer upon the receipt of payment. The MOU also required the insurer to attempt to settle related interpleader litigation pending in federal court, with a provision that the underwriter would substitute itself for the insurer in the litigation under certain circumstances. To that end, the MOU provided that the underwriter would indemnify the insurer for all legal fees incurred in connection with the pending litigation. The insurer could not settle that litigation without first obtaining the underwriter's permission.

To the extent the parties have difficulty drafting a complete agreement embodying the agreed-upon terms of an MOU, the MOU provides that the mediator is available to assist the parties.

Mediation Can Accommodate Complex Situations

Disputes among financial industries players resulting from the virtually unprecedented turmoil in the financial markets share characteristics that can be accommodated in mediation:

- Highly complex documentation
- Very large devalued asset pools
- Multiple parties including virtually every type of financial institution
- Relatively clear law applicable to often ambiguous contracts
- Need to quantify and limit corporate life-threatening contingent liabilities

In mediation, the parties, with help from a skillful mediator, can fashion a solution taking into account these characteristics.

Endnotes

1 *See* Faten Sabry and Thomas Schopflocher, *The Subprime Meltdown: A Primer*, NERA (June 21, 2007), *available at www.nera.com/publication.asp?p_ID=3209.*

2 Not included in this analysis are claims by borrowers, shareholders or individual purchasers of subordinated notes and/or equity. Such claims are more often than not brought as class actions, which create a different settlement dynamic.

3 Jeff Nielsen, *Subprime Mortgage and Related Litigation 2008: Seeking Relief*, Navigant Consulting (Mar. 2009).

4 *See* Median Time Intervals in Months for Merit Terminations of Appeals Arising from the U.S. District Courts, by Circuit, During the 12-Month Period Ending September 30, 2008, Table B-4A, *available at www.uscourts.gov/judbus2008/appendices/B04A Sep08.pdf.*

5 *See* U.S. District Courts—Median Time Intervals From Filing to Disposition of Civil Cases Terminated by District and Method of Disposition, During the 12-Month Period Ending September 30, 2008, Table C-5, *available at www.uscourts.gov/judbus2008/appendices/C05Sep08.pdf.*

6 *See* Lynn Langton, M.A., and Thomas H. Cohen, Ph.D, Civil Bench and Jury Trials in State Courts, 2005, Office of Justice Programs, Bureau of Justice Statistics (Oct. 2008), *available at www.ojp.usdoj.gov/bjs/pub/pdf/cbjtsc05 .pdf.*

7 Richard D. Freer, Moore's Fed. Practice—Civil, § 22.02. For example, in *Bank of New York v. First Millennium, Inc.*, 2009 U.S. Dist. LEXIS 14421 (S.D.N.Y. Feb. 24, 2009).

8 *See* JAMS, *Mediation Defined, available at www.jamsadr.com/mediation/ defined.asp.*

9 *See* AAA, *A Guide to AAA Disaster Recovery Claims Mediation Procedures, available at www.adr.org/si.asp?id=3775.*

10 Sample Submission to Mediation form can be found at *www.adr.org.*

11 *See* JAMS, *A Guide to Mediation for Lawyers and their Clients*

(2003), *available at www.jamsadr.com/mediation/guide.asp.*

[12] *See* AAA, *A Guide to Mediation and Arbitration for Business People,* Sept. 1, 2007, at 2, available at *www.adr.org/si.asp?id=4121.*

[13] *See A Guide to Mediation, supra* note 11, at 3.

[14] The answer is arbitration. Unlike mediation, arbitration is a binding alternative to litigation. JAMS defines "arbitration" as a "binding, adjudicatory process" that is "often 'administered' by a private organization that maintains lists of available arbitrators and provides rules under which the arbitration will be conducted." (JAMS, *Arbitration Defined, available at www.jamsadr.com/arbitration/defined.asp.*) Resort to arbitration presents a host of issues and possibilities beyond the scope of this article.