Published in issue 121 of the Journal of the British Insurance Lawyers Association

Lehman Brothers: insurance and reinsurance implications

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The downfall

The fall from grace was rapid. The reasons and the chronology are set out in the nine-volume Report by Anton R. Valukas[1] into the failure of Lehman Brothers ("LB"), published on 11 March 2010.

On 29 January 2008 the holding company, Lehman Brothers Holdings Inc. ("LBH"), reported revenues of US$60 billion and its share price reached US$65.73. On 12 September 2008 the share price was under US$4. An attempt to save LB agreed with Barclays Bank was scuppered at the last minute when the UK Financial Services Authority refused to waive shareholder approval, and on 15 September 2008 LBH sought Chapter 11 protection, giving rise to the largest bankruptcy proceeding ever filed. Valukas found as follows.

The failure was the result of: the economic climate; the conduct of LB executives who were guilty of serious but non-culpable errors of business judgment; actionable balance-sheet manipulation so that LB could maintain its rating; the adoption of a flawed investment bank business model which involved high risk and high leverage (long term assets and short term liabilities); deep involvement in the sub-prime market, which increased rather than diminished as the problems became apparent; regulatory shortcomings; and loss of confidence in LB following the collapse of Bear Sterns five months earlier.

The most serious problem was the use of "Repo 105", a repurchase and sale program which deceived investors about LB's leverage. It had the effect of reducing LB's balance sheet by US$49.1 billion in the first quarter of 2008 and US$50.4 billion in the second quarter of 2008. The use of Repo 105 was not disclosed to the Government, to rating agencies, to investors or even to the Board of Directors, although the auditors, Ernst & Young, were aware of it.

The key findings related to the conduct of various individuals within LB, and also LB's auditors. The Valukas Report found that the operation of Repo 105, although not of itself improper, had been used solely as a means of balance sheet manipulation, and gave rise to grounds for legal claims against certain individuals. The standard used by the Report was that of "colorable claims", a higher standard than simply allegations, and consisting of claims which were supported by sufficient credible evidence to justify proceedings. The Report more or less invited the following claims.

- Dick Fuld (chief executive), breach of fiduciary duty: "There is sufficient credible evidence to support a determination that Fuld's failure to make a deliberate decision about Lehman's disclosure obligations was grossly negligent or demonstrated a conscious disregard of his duties."

- Chris O'Meara (chief financial officer), breach of fiduciary duty: "The Examiner finds there is sufficient evidence to support a colorable claim that O'Meara breached his fiduciary duties by permitting the expansion of Lehman's Repo 105 practice". He had limited knowledge of it but consented to its use.
- Erin Callan (chief financial officer), gross negligence: "Callan ... had ample red flags to alert her to potential problems arising from Lehman's Repo 105 program before she signed Lehman's first quarter form 10Q. Callan ignored these red flags."
- Ian Lowitt (chief financial officer), gross negligence: "There is sufficient evidence to support a finding by the trier of fact that Lowitt was at least grossly negligent in causing Lehman to file materially misleading financial statements."

The Valukas Report thought that no other Board members or senior officers were liable for breach of fiduciary duty, and it was only in respect of Repo 105 that claims were possible. As far as the Board of Directors was concerned, they had not failed in their duty to monitor LB risks and to permit excess of risk limits. This was because of the "business judgment" rule, recognised in the United States of America (and, relevant to the present case, Delaware) which assumes that directors and officers have acted in good faith and imposes liability only where there has been gross negligence, recklessness or irrationality. None of those things had been proved against others.

The "business judgment" rule has its origins in *Otis & Co v Pennsylvania R Co*,[2] a derivative action in which it was alleged that the directors had failed to achieve the best price for securities sold on behalf of the company. The court ruled that "mistakes or errors in the exercise of honest business judgment do not subject the officers and directors to liability for negligence in the discharge of their appointed duties." It has since been extended to other situations and, in Delaware, to officers as well as directors. Gross negligence has to be proved, as in *Smith v Van Gorkom*,[3] where the directors were held not to be protected by the business judgment rule when selling the company for a sum far below its true worth. There was no evidence of bad faith, but there was nevertheless liability on the facts. The business judgment rule is in effect a strong presumption of non-liability for bad business decisions. The rule is now enshrined in the Delaware General Corporation Law[4].

What gave rise to the colorable claims in the LB case was the failure to disclose, and indeed the cover up, of the effects of the mistaken business judgments.

The Valukas Report raised questions about the conduct of LB's auditor, Ernst & Young, and also its London solicitors Linklaters, criticising them both for allowing a misleading picture of Lehman's financial position to be given to investors, but not alleging any illegality.

Finally, Valukas identified colorable claims against JP Morgan and Citibank for the avoidance of assets transferred to them on the ground that they constituted unfair preferences. There was found to be no colorable claim on this basis against Barclays Bank.

Macro implications: shifting the credit risk

The failure of LB triggered financial uncertainty, particularly in the US markets, leading in particular to the need to rescue AIG. That caused the parties to reinsurance contracts to take steps to minimise the financial risk in the event of failure. Note that the European Union ("EU") rules[5] which make insurance creditors of insurance undertakings preferred creditors do not apply to claims under reinsurance contracts. That may lead reinsureds, or "cedants", to buy reinsurance from pure reinsurers, otherwise a mixed direct insurer/reinsurer's assets may be dissipated by prioritised claims under direct insurance contracts. There are various protections available from the cedant's side.

In the US, many states require a non-admitted reinsurer reinsuring a local cedant to post security for the sum due. Even where this is not the case, reinsurance contracts involving offshore reinsurers contain security clauses (if the reinsurer is willing to accept them of course).

Contracts increasingly use the downgrade clause. This confers upon the reinsured the right to terminate the policy, or to require the reinsurer to post security (eg, hold assets on trust), in the event of the reinsurer's rating being downgraded below A- by Standard and Poor's or A M Best. A similar clause is the special termination clause, which is triggered by, eg, the reinsurer going into run-off or becoming insolvent, by a material change in management, by substantial proceedings against the reinsurers, by a change in the law, or by a percentage loss in policyholders' surplus funds (as low as 10% change in some contracts, up to 30% in others). In either case there will be a pro-rata refund of premium.

There are also "cut through" clauses to the reinsurers' own reinsurers, "retrocessionaires". Such clauses are unlikely to be enforceable in English law. Although the privity problem is overcome by the Contracts (Rights of Third Parties) Act 1999, there are unresolved questions as to whether: (a) a cut-through clause is a charge on the reinsurers' assets, which is void against the liquidator unless registered under the Companies Act 2006; and (b), assuming that there is no registrable charge, whether payment under a cut-through clause would be an infringement of the *pari passu* rule under which all unsecured creditors are to be treated equally.

Note that the EU, unlike the US, regulates reinsurers in much the same way as direct insurers, so that there is less reliance on ratings in the EU. Further, the role of rating agencies in the financial crisis has been criticised because their AAA ratings proved to be unreliable and because rating agencies receive a fee, so that there is a conflict between their commercial interests and their objectivity. European Parliament and Council Regulation 1060/2009/EC on credit rating agencies, which applies only to CRAs registered in the EU, requires them to apply the Code of Conduct Fundamentals for credit rating agencies ("CRAs") issued by the International Organisation of Securities Commissions (IOSCO Code). Insurers are not permitted to use credit ratings for regulatory purposes unless they

emanate from CRAs registered in the EU, although they may use ratings from outside CRAs if they are endorsed by an EU CRA.

The Commission proposed in 2010 a draft regulation[6] transferring supervision of CRAs to the new European Securities and Markets Authority. CRAs must be registered. They are required to disclose their methodologies, models and assumptions. They must issue ratings only if based on proper information; and must eliminate conflicts of interest by, eg, having some independent directors whose remuneration does not depend upon the business performance of the rating agency. However, rating agencies will continue to be significant, because the value of assets is essential for measuring solvency, and that value often emanates from rating.

But do these downgrade clauses work? Illustrative is the collapse of reinsurer PXRE in 2005: it was downgraded after Hurricane Katrina. It lost much of its business in days and became insolvent. AIG is a further case in point: it had to post security following downgrading, and became insolvent, leading to a US$85 billion bail-out by the US government. So if all cedants have downgrade clauses, and they all exercise them, that of itself is going to exacerbate the problem. Also, downgrading may affect the cedant's own rating because it has lost its reinsurance. Further, some reinsurers refuse to accept downgrading clauses: Lloyd's and some big European pure reinsurers are rarely asked to agree to them.

From the reinsurers' side, special termination clauses may also be used and on the same grounds, e.g. where the cedant closes to new business (goes into run-off), becomes insolvent, or has a change of management. The reinsurers may thus seek set-off for premiums and include cut-through clauses allowing them to make payments directly to the assured (to counter the possible liability of the reinsurers to the assured independently, so that it has to pay twice). It is to be noted that "pay to be paid" clauses do not work: *Charter Re v Fagan*[7] holds that the clearest possible wording (and it is difficult to imagine wording more clear than that in the case itself – "and shall actually have paid") is necessary to require prepayment by the cedant as a condition to payment by reinsurers.

Micro implications: claims and insurance responses

The claims which potentially arise out of the collapse of LB are set out below. They are all liability claims, and may fall within the scope of Directors' and Officers' ("D&O") Liability Policies and Professional Indemnity policies. It is not known whether the relevant policies are written in the US or in London, or whether they are reinsured in London, but the task here is to outline the key principles which apply to liability policies and then to apply them to the claims made to date.

D&O policies potentially cover three categories of claims:

- *Side A Cover*, whereby the insurers agree to pay any loss suffered by a director where the director has not been indemnified by the company;

- *Side B Cover*, which insures the company and covers any sums paid by the company to the director by way of indemnification for the director's own liability; and
- *Side C Cover*, under which the company insures against its own personal liability (although this is more usually bought as stand-alone cover, commonly as enterprise liability cover, as Side C cover may erode indemnity limits available for the directors).

Under a D&O policy the policyholder is the company, although the directors are composite assureds, which means that each has independent rights against the insurers and the inability of one to recover does not affect claims by others. It has also been held, albeit controversially, in *Arab Bank v Zurich Insurance Co*,[8] that failure by one director to disclose material facts, or material misrepresentation, does not permit the insurers to avoid the policy as against the other directors. D&O policies are written on a claims made ("rather than a "claims arising") basis, and are subject to per claim and aggregate limits. The amount recoverable will depend upon the form of aggregation wording used.

In *American Centennial Insurance Co* v. *INSCO Ltd*[9] a US savings and loans association collapsed as the result of financial mismanagement by fourteen of its officers, each of whom was separately insured against liability. Claims were made against each, and insurers paid fourteen separate claims. The insurers' outwards reinsurance provided for a per claim deductible of £250,000, although under an aggregate extension clause all claims arising out of any one event were to be treated as one claim. Mr. Justice Moore-Bick held that the clause did not assist the insurers: there were 14 separate claims and thus 14 deductibles, and although the bank's collapse could be said to be an "event", that event was not causally linked to the claims made against the officers as they could have been made independently of any collapse. D&O policies often exclude "insured v insured" claims and also claims arising out of insolvency.

All liability policies are subject to "*ex turpi causa*" limitations, namely, the common law principle that a person cannot make a claim arising from his own wrongdoing. Some of these limitations arise by operation of law, some are contractual, some are both. These are as follows:

- A claim may not be made in respect of an act which is designed to cause loss or is committed with reckless disregard of its consequences.
- No claim may be made for sums which the assured was not entitled to receive. As was said by Lord Phillips in *Stone & Rolls Ltd v Moore Stephens*:[10] "If a person starts with nothing and never legitimately acquires anything he cannot realistically be said to have suffered any loss."
- The *ex turpi causa* rule itself prevents the assured from relying upon his own

criminality. At one time there was thought to be a "public conscience" test, so that mere criminality did not preclude a claim. That was seemingly swept away by *Tinsley v Milligan*,[11] where discretion was replaced with a more simple test of whether the assured had to pray in aid his own illegality. However, there are hints of a return to the more liberal pre-*Tinsley* approach in *Stone & Rolls*. Later cases have decided that the *ex turpi causa* defence to recovery operates only where there is some degree of moral turpitude involved in the assured's criminality.[12] A criminal sanction or administrative penalty is not, therefore, an automatic bar to recovery. Most policies do go on to exclude civil liability arising from infringement of legislative provisions and from any deliberately dishonest or deliberately fraudulent act, but only if that state of mind is established by a court or tribunal.

- Fines for criminal conduct, punitive or exemplary damages and multiple damages are generally excluded from liability policies.

Defence costs may, depending upon the wording, be recoverable in both regulatory proceedings and civil proceedings. Some policies allow recovery in all circumstances, others allow recovery up to the point at which fraud has been proved, others will pay defence costs but subject to full repayment if fraud is shown.

It is apparent from this brief analysis that any relevant insurers may have a variety of possible defences: non-disclosure on renewal of potential claims; failure to notify circumstances insofar as later year cover excludes claims arises from circumstances which could have been notified under an earlier year; uninsurable losses; aggregation issues; and *ex turpi causa*.

It is possible to identify the following categories of claims and the insurance responses to them. Most of the claims will be in the US and thus governed by state and federal law, although there have been a few claims in England.

(1) Civil claims by shareholders and creditors against LB

There are none in England, other than one for £150,000, by an ex-employee, Elizabeth Spencer, for sex discrimination in that she was sacked following the birth of her son. None of the other 800 redundant employees have sued. There is a class action (see below) but LB is not a party by virtue of its Chapter 11 protection. Employee claims often form a part of enterprise liability covers.

(2) Civil claims by LB, shareholders and creditors against LB directors

In April 2010 a shareholder class action led by five pension funds was commenced. The other class members are purchasers of LB stock and investors in the relevant period, and the complaint says that "the members of the class are so numerous that joinder of all members is impracticable." The claims are under the US Securities Act and the US

Exchange Act for: the use of Repo 105; disregard of risk limits; overvaluation of assets; and failure to disclose exposure to toxic debts. The defendants include Dick Fuld, Chris O'Meara, Erin Callan and Ian Lowitt, as well as Joseph Gregory (President and Chief Operating Officer) and a number of other directors. Quoting from the claim: "The Security Act claims are not based on any allegation that any Defendant engaged in fraud or any other deliberate and intentional misconduct, and Plaintiffs specifically disclaim any reference to or reliance upon fraud allegations."[13] The rationale is obvious: if a court finds fraud or intentional misconduct, any D&O or other liability cover will be negatived.

A paradox is here created, because the business management rule prevents a successful claim against directors for mere negligence, and something far more substantial has to be proved. However, if there is proof of fraud or recklessness, there is no cover. The claimants thus have to try to find a grey area between negligence and fraud and to bring their claim home on that basis. But how successful is this device likely to be? The answer, at least in English law, is that it is doomed to failure.

The nature of the pleading is irrelevant, what matters is what is found by the court. If the court finds fraud, then cover will be negatived. This is illustrated by *Persimmon Homes Ltd v Great Lakes Reinsurance (UK) Plc*,[14] in which the claimant obtained an order for indemnity costs against the assured on the ground that the assured had fraudulently manufactured an action against the claimant. An attempt by the claimant to recover those costs from the assured's "after the event" insurers could succeed only if the claimant could show that the judge's ruling on fraud was incorrect: Mr. Justice David Steel held that the judge's views were unequivocal and that fraud had been established, so the claim against the insurers was bound to fail. The same point is made in a different context by *Omega Proteins Ltd v Aspen Insurance UK Ltd*,[15] in which the claimant succeeded against the assured on the basis of breach of contract, a peril excluded from the assured's liability policy. The claimant sought to recover from the assured's insurers on the ground that the action could have been brought in tort. The court agreed, holding that what mattered was the nature of the claim brought by the assured and not the manner in which it was framed: on the facts, there was a tort, so the insurers were liable. What this means is that if the court concludes that the reality of the claim against the assured is fraud, then there is no recovery whatever the pleadings may have been.

(3) Regulatory proceedings against LB directors

Defence costs may be recoverable here, depending upon how the policy is framed. If there are fines, they are likely to be excluded, although some wordings do permit the recovery of fines insofar as is permissible by the general law. So the outcome may depend upon *ex turpi causa*. In the UK the FSA Handbook forbids regulated firms from entering into, arranging, claiming on or making a payment under a contract of insurance that is intended to have, or has or would have, the effect of indemnifying any person against all or part of a financial penalty imposed by the FSA[16].

(4) Civil claims against LB advisers

Based on the Valukas Report, the shareholder class action commenced in April 2010 names Ernst & Young as a defendant, but not (at this stage) Linklaters. Care has been taken not to accuse the auditors of fraud. Professional indemnity insurance for accountants and solicitors is compulsory in the UK, and doubtless insurers are busy defending this claim.

(5) Civil claims by LB against third parties

The New York Times reported on 31 August 2010 that LBH's administrators have appointed a law firm which has demanded trading records and all manner of internal documents from prominent hedge funds and also Goldman Sachs and JP Morgan Chase. This is an attempt to determine whether their conduct pushed LB into insolvency, eg, by demanding security, taking steps to ensure that own claims ranked ahead of LB's, short-selling, spreading rumours and betting on LB's stock price. The process has been described as "looking under rocks". Lawsuits were subsequently filed against Barclays plc (alleging a US$11 billion windfall relating to the takeover of a LB's brokerage asset, a US investment bank), Nomura (which had purchased LB's European and Asian operations) and JP Morgan Chase (alleging use of inside knowledge as LB's bankers to extract US$8.6 billion of collateral just before LB's demise).

Proceedings have yet to be issued against the hedge funds. There are also claims against shareholders who received dividends after LB had become insolvent. None of these claims would be recoverable (at least in English law) under liability policies, because they relate to sums which should never have been earned in the first place.

(6) Regulatory proceedings against third parties

On 27 October 2009 the FSA published the findings of a review into the marketing and distribution of structured products backed by Lehman Brothers. Fines have subsequently been imposed. In February 2010 the FSA fined RSM Tenon Financial Services Ltd £700,000 for failures relating to Lehman-backed structured product sales. In September 2010 the FSA fined a law firm, Thorntons Law LLP £35,000, and one of its partners, Michael Royden, £10,500, in respect of its sale of Lehman-backed structured products. The FSA found that, in relation to its sales of Lehman-backed structured products, Thorntons did not give suitable advice to its customers in some cases, including recommending investments to people who could not afford to lose money, recommending the investment of inappropriate proportions of wealth, and misleading customers as to the degree of risk. Mr Royden, the partner in charge of compliance oversight, had failed to do his job. A fine of £28,000 was also imposed upon Robert Yarr, an independent financial adviser, for failure to give appropriate advice and to conduct research into the products being recommended. Whether these fines, and any defence costs involved, are recoverable depends upon policy wording and upon the *ex turpi causa* rule.

(7) Claims by debtors

There is a possibility of claims by debtors, but none are yet known

Endnotes

* University of Southampton and Norton Rose Group.

[1] http://lehmanreport.jenner.com/

[2] 61 F Supp 905 (DC Pa 1945).

[3] 488 A 2d 858 (Del 1985).

[4] §141(e).

[5] Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings, Article 10.

[6] COM(2010) 289 final

[7] [1996] 3 All ER 46.

[8] [1999] 1 Lloyd's Rep 262.

[9] [1996] LRLR 407.

[10] [2009] UKHL 39.

[11] [1993] 3 All ER 65.

[12] *Nayar v Denton Wilde Sapte* [2009] EWHC 3218 (QB); *Griffin v UHY Hacker Young & Partners* [2010] EWHC 146 (Ch); *Safeway Stores Ltd v Twigger* [2010] EWHC 11 (Comm), reversed on other grounds [2010] EWCA Civ 1472.

[13] See http://www.lehmansecuritieslitigation.com/pdf/2010-04-23%20Lehman%20Third%20Amended%20Complaint.pdf

[14] [2010] EWHC 1705 (Comm).

[15] [2010] EWHC 2280 (Comm)

[16] GEN 6.1.5R