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MONTHLY ELECTRONIC SUBROGATION NEWSLETTER OCTOBER 2008

TO CLIENTS AND FRIENDS OF MATTHIESEN, WICKERT & LEHRER, S.C.:

This monthly electronic subrogation newsletter is a service provided exclusively to clients and friends of Matthiesen, Wickert & Lehrer, S.C. The vagaries and complexity of nationwide subrogation have, for many lawyers and insurance professionals, made keeping current with changing subrogation law in all fifty states an arduous and laborious task. It is the goal of Matthiesen, Wickert & Lehrer, S.C. and this electronic subrogation newsletter, to assist in the dissemination of new developments in subrogation law and the continuing education of recovery professionals. If anyone has co-workers or associates who wish to be placed on or removed from our e-mail mailing list, please provide their e-mail addresses to Rose Thomson at rthomson@mwl-law.com. We appreciate your friendship and your business.

IN THIS ISSUE . . . .

Subrogation and the Subprime Mortgage Crisis 1
What Are the Other Guys Doing? 4
MWL to Represent NASP as Amicus Curiae Before the Wisconsin Supreme Court 6
Visit the MWL Exhibit Booth at the Annual NASP Conference in Hollywood, Florida 8

INSURANCE SUBROGATION

SUBROGATION AND THE SUBPRIME MORTGAGE CRISIS

Gary L. Wickert

Gary L. Wickert

I have had several clients ask our opinion on the cause of the subprime mortgage crisis and its effect on the insurance industry. We offer this opinion as both an answer to those inquiries and as something of general interest to our subrogation clients. This financial crisis flows directly from the U.S. housing market, where fallout from the imploding subprime mortgage market has spilled over into the credit markets, domestic and global stock markets, and the insurance industry. Obviously, this has trickle-down effects for subrogation professionals.

The stock markets will rebound. They always do. Instinctively, politicians call for more regulations to fix the problem. However, it was not necessarily a paucity of regulations that got us into this mess. There is plenty of blame to go around. Partly to blame is government's involvement in the free market system and Congress' social engineering with government agencies and tax dollars. Individual greed both on Capitol Hill and in the troubled organizations now in the news also played a role. The problem can be said to transcend partisan politics (although it's not likely to play out that way) because Democrats ran and profited from the government-sponsored enterprises which ran into problems while there were some Republicans who did the same with private enterprises. Politicians on both sides of the aisle took donations from some of the culprits in this crisis. In order to understand what happened, a brief explanation of the players involved is in order.

Subprime mortgages are mortgages given at a higher interest rate to people who, according to traditional banking models, will not be able to repay the loans. They are known also as B-paper, near-prime, non-prime, or second chance mortgages. They are usually given away to poorer borrowers with bad credit who would not otherwise qualify for such a mortgage. They are traditionally accompanied by higher interest rates, fees and costs, and frequently with adjustable rates which, unless the homeowner is able to continually refinance in an era of inflated housing prices, will eventually result in default of the loan. They involve giving loans to people who are "higher risk" than traditional borrowers. More than 14% of U.S. mortgages are subprime. Washington even found a way to award subprime mortgages with little or no down payment, little or no closing costs, and little risk to anybody except the taxpayer.

Fannie Mae was created in 1938 as part of FDR's New Deal. Fannie Mae (short for Federal National Mortgage Association) was established as a "government-sponsored enterprise" (GSE) in order to provide local banks with access to federal dollars in an attempt to provide "affordable housing" for those who couldn't afford mortgages. How nice. This led to the secondary mortgage market, where Fannie Mae borrowed from other institutions and even foreign governments at low rates and used the money to buy these subprime mortgages from legitimate mortgage lenders, even reselling many of them to Wall Street investment firms. Fannie Mae began operating as a GSE, generating profits for stock holders while enjoying the benefits of government backing and exemption from taxation.

Freddie Mac (short for Federal Home Loan Mortgage Corporation), a similar GSE which was created in 1970 to avoid monopolization of the market, and Fannie Mae controlled more than 90% of the secondary mortgage market. Their assets are nearly 50% greater than the nation's largest bank, which is why when they started to be used as a political tool, things went awry.

Both Fannie Mae and Freddie Mac are overseen and regulated by another huge federal bureaucracy known as the Office of Federal Housing Enterprise Oversight (OFHEO). Despite plenty of government regulation, Fannie Mae approved and purchased from complying lending institutions plenty of high-risk mortgages in an effort to provide "affordable housing".

In 1974, President Carter and Congress pushed for and passed the Housing and Community Development Act. This legislation pressured private financial institutions to make subprime loans to people with a higher rate of delinquencies, bankruptcies, job instability, and high debt-to-income ratios. These loans would not have been made using traditional banking and mortgage guidelines and practices.

Subprime lenders saw what Fannie Mae and Freddie Mac were doing and started to move away from using their own deposits to back their mortgages. They began borrowing money from Wall Street investment firms, who thus became intertwined in the practice. Wall Street bundled the mortgages and sold the cash flow from them as bonds – known as "mortgage-backed securities". Wall Street's ability to purchase and securitize these obligations caused local lenders to ignore risks they otherwise wouldn't have. The entire practice of subprime lending, with Fannie Mae and Freddie Mac leading by example, was encouraged – and even compelled – by Washington. The securitization of all manner of credit made it extremely profitable for every financial institution to pile up the debt and leverage, including large insurance companies who invested in these mortgage-backed securities.

In 1995, President Clinton renewed efforts to compel private mortgage companies and lenders to create "affordable housing" for people who wouldn't qualify for traditional mortgages. Attorney General Janet Reno and Assistant Secretary for Fair Housing and Equal Opportunity, Roberta Achtenberg, implemented even more regulations focused on putting pressure on legitimate mortgage institutions to give

more and more risky loans. Reno and Achtenberg threatened these institutions with government sanctions if the private companies didn't follow these regulations. “There will be investigations if you do not follow these regulations, if you don’t make loans to these people,” Reno is quoted as saying. Thus the subprime market was “forced” onto private companies, as legitimate Wall Street mortgage lenders and brokers were compelled to buy more of the risky paper from Fannie Mae, Freddie Mac, and even traditional mortgage lenders. More and more people began to enjoy home ownership.

Countrywide Financial Corp., the nation’s largest mortgage lender and home loan servicer, tried to emulate the success of Fannie Mae. Its CEO, Angelo Mozilo, gave speeches on mortgage social engineering and his dream of everybody owning a home. Countrywide gave cut-rate mortgages to congressmen, journalists and other V.I.P.s in an effort to curry favor. As long as the value of homes continued to rise, things were fine.

A 2003 investigation by the Justice Department and the SEC into the accounting practices at Freddie Mac revealed fraudulent accounting practices to the tune of nearly $5 billion and resulted in the termination of three of the company's top executives. This included Fannie Mae chairman and CEO Franklin Raines, who had benefitted to the tune of more than $90 million from 1998 to 2003. Combine that with the fact that from 2001 to 2005, American homeowners took a ride on the world housing bubble. Home prices climbed and climbed, peaking in 2005. This rise in home prices masked the risky loans made or purchased by Fannie Mae, Freddie Mac, and other subprimers, because even a foreclosure would leave the lender with property worth more than the loan balance.

Then the housing bubble burst. Values of residential property plummeted, interest rates rose, and more than 1.5 million people lost their homes. There are more than 8,000 new foreclosure filings every day. Wall Street investors started withdrawing money and mortgage insurers, MGIC, were the first responders called on to clean up the mess. Lenders, with less cash, offered fewer loans and fewer opportunities to refinance high interest loans and ARMs. Suddenly, Wall Street was at risk and the unintended consequences of those pushing the risky loans were laid bare.

The U.S. Treasury and Federal Reserve began looking at the prospect of a $700 billion to $1 trillion bailout for some of the troubled institutions, in order to prevent the subprime crisis from crashing the world economy. The Bear Stearns bailout, Lehman Brothers’ bankruptcy, sale of Merrill Lynch & Company, and now a drop of more than 62% in AIG’s share price, all flowed from Fannie Mae, Freddie Mac and Washington’s subprime practice.

Computers and the Internet made it possible to create fantastically complex financial instruments and asset-backed securities and derivatives. This made immense amounts of money available for credit. Then, the Internet made it possible for brokerages to get millions of people trading online, for next to nothing. Since there was very little or no incentive for stock brokers and financial gurus to gain an income stream from commissions that dropped to pennies a trade, they naturally applied their financial genius to creating the biggest piles of money, securitized credit, which even at ridiculously low commissions, generated hundreds of billions of dollars in commissions a year for brokers. Wall Street then figured out that they could make more money by creating a Credit Default Swap (CDS), which is merely an insurance policy that is bought against someone’s bonds, and for a modest fee, someone like AIG would guarantee it against a default. It has been reported that AIG issued nearly $440 billion of these guarantees in recent years. As home prices plummeted, AIG’s CDSs were called on to make good on the losses. It didn’t take long for even a financial giant like AIG to become insolvent.

Lehman Brothers had the same problem, and most banks, insurance companies, and brokers, worldwide are involved in these complex securitized financial derivatives to some extent. This is why the problem could become widespread and affect the entire U.S. and world economy.

Expect plenty of litigation flowing from this crisis, with some potential for subrogation. Borrowers, banks and agencies are suing lenders. Borrowers are accusing the financial institutions of predatory lending and selling mortgage products that did not adequately fit the borrowers' needs. A recent class action in Washington alleges that brokers and lenders received kickbacks and rewards for steering borrowers toward loan products with higher rates, hidden fees, and costs. *Pierce v. NovaStar Mortgage,* 238 F.R.D. 624 (W.D. Wash. 2006).

State and local governments are also alleging improprieties and are suing lenders. This has already happened in Ohio and Illinois. Countrywide Financial will be the target of litigation from all sides, not to mention being the target of an F.B.I. investigation. Subprime losses will result in millions of insurance claims. Insurance companies will likely pay out in the range of $8 to $9 billion in claims. Most of these claims will be on Directors and Officers (D&O) and Errors and Omissions (E&O) policies. Clearly, there will be many coverage disputes going hand and hand with these claims. Dishonesty exclusions will come into play, but they can be ambiguous and fact-dependent and frequently do not void coverage. Providing a defense and payment of defense cost issues will be a big issue as well. "Personal Profit" exclusions will also come into play. And we haven't even begun to discuss the myriad of securities allegations that might be made against trusts, mutual funds, hedge funds and other entities that invested heavily in mortgage-backed securities.

Errors and Omissions policies and Directors and Officers policies frequently have subrogation clauses. In the flood of claims that are sure to strike most U.S. insurers, the prospect of subrogation should not be overlooked. Instead, subrogation potential – in policies where the subrogation right has not been "bought back" by the insured – should be considered from the day the claim hits the desk of the insurance claims handler. When the claims hit, please contact Gary Wickert or Doug Lehrer to evaluate your subrogation, reimbursement and/or contribution rights, as well as your coverage issues regarding the claims. These unfortunate claims are on their way and will be complicated. Don't make them more unfortunate by passing up on recovery opportunities which are there for the taking.

INSURANCE SUBROGATION

WHAT ARE THE OTHER GUYS DOING?

Subrogation is a continually-moving target. The better educated subrogation professionals become, the better the results they can achieve. For this reason, MWL offers continuing education programs, which are described in detail on our website. If our clients are educated in the area of subrogation, our job becomes easier and the subrogation results we can achieve for them are enhanced. But what about the trial lawyers who are sworn to represent the injured worker or health plan beneficiary in a lawsuit in which you have a right of subrogation or reimbursement? Are they training also?

It appears they are. Trial lawyers are taking their job very seriously. They are training and keeping themselves informed every bit as much, if not more, than subrogation professionals. The nation's preeminent organization of trial lawyers is the American Association for Justice (AAJ). Formerly known as the Association of Trial Lawyers of America (ATLA), the AAJ is well-funded and quite zealous in providing its members with research, resources, memoranda, briefs, and education explaining how to most effectively cut the subrogated carrier off at the knees. How do we know this? Because some of our attorneys are members of AAJ. Here, the adage "keep your friends close, but your enemies closer" is good advice. Consequently, we remain active members of the AAJ and even contribute

to their publications which focus on recognizing and creating liability. After all, we are plaintiffs' lawyers for the insurance industry. Training ourselves in a plaintiff's mind set is a necessary prerequisite to aggressive, creative, and successful subrogation representation. While defense lawyers tend to carry with them a defense myopia on a broad array of liability issues – and be thankful they do because that is their job – subrogation lawyers must remain on the cutting edge of litigation trends, issues and techniques that are shared by trial lawyers.

A recent AAJ offering to its members with regard to ERISA and Medicare/Medicaid reimbursement claims drives this point home very nicely. The AAJ Exchange is a service AAJ provides whereby trial lawyers can obtain, share, and discuss how to create liability, prove their cases, get the best experts, and destroy subrogation rights. After all, that is their job. AAJ is offering two new litigation packets to trial lawyers.

The first packet being offered is called "ERISA REIMBURSEMENT CLAIMS SURVIVAL GUIDE." This 777-page packet contains cases, tricks, and successful practices of trial lawyers setting forth precisely what plaintiffs' lawyers should know to protect their client and themselves when confronted with ERISA reimbursement claims. It provides tips on how to determine what their clients owe, how to negotiate subrogation interest, defenses and limitations on insurer recoveries and ethical considerations. It also contains material regarding:

- How to identify an ERISA Plan;
- How to use the Common Fund Doctrine and Made Whole Doctrine;
- The meaning of "appropriate equitable relief" in the ERISA statute;
- Social Security Disability issues; and
- Traditional equitable defenses to health insurance subrogation.

The next packet is entitled "MEDICARE AND MEDICAID REIMBURSEMENT CLAIMS SURVIVAL GUIDE." This 904-page packet contains information and law teaching plaintiffs' attorneys what they need to know to help eliminate Medicare and Medicaid reimbursement claims. It addresses the handling of such claims from beginning to end, complying with government regulations, settlement issues, and how waivers can be used effectively. It includes sample letters regarding coordination of benefits and forms to be used for declaratory relief and the like.

Trial lawyers are educating themselves on the vagaries of destroying subrogation and reimbursement rights in order to put more money into the pockets of their clients. In light of this, subrogation professionals must be even more vigilant and prudent in seeking the best subrogation education available. National conferences with organizations such as National Other Party Liability Group (NOPLG), National Association of Subrogation Professionals (NASP) and National Association of Mutual Insurance Companies (NAMIC) can be an excellent source of training and education. However, if you cannot make the conference, how about making the conference come to you.

At Matthiesen, Wickert & Lehrer, S.C., we believe that education is the key to a successful recovery program. MWL offers a broad array of subrogation education and classes which provide our clients with an opportunity to receive the most up-to-date and functional training that claims handlers and insurance professionals can receive. As many carriers attempt to both centralize their subrogation efforts and improve their investigation, subrogation professionals are faced with the daunting challenge of becoming knowledgeable with the subrogation laws of many different states. Claims professionals must educate themselves with the nuances of multi-state workers' compensation subrogation and on the various issues which have become vogue in the subrogation arena and are essential for effective subrogation recoveries. Claims professionals, who are not familiar with subrogation law and its advanced concepts, will be ill-equipped to deal with the various defenses and roadblocks which are ultimately thrown in their path. Prompt and effective action must be taken by competent subrogation personnel or subrogation counsel immediately upon recognition or suspicion of third-party

liability for a worker's compensation carrier's claimant's injuries, in order to effect a complete recovery of a workers' compensation lien.

If your company/group is interested in having MWL come in and present a seminar, please contact our marketing coordinator, Jamie Breen, at jbreen@mwl-law.com. MWL has been providing seminars to clients for more than a decade throughout North America and remains one of the leaders in continuing subrogation education for the insurance industry. While there are costs in both time and travel associated with the presentation of our seminars, we offer these programs completely free-of-charge to clients for whom we handle a volume of work. Many of our clients have sent us more recovery work to get discounts on our seminars or, if the volume of work referred is sufficient, to receive our seminars free-of-charge.

The cost and timing of seminars for newer and potential clients and friends of our firm must be discussed on a case-by-case basis as there may be some travel and/or presentation costs involved - although our goal is to keep costs down in order to make our seminars affordable - we are all about cost-effectiveness. We're working on producing webinars, podcasts and live Internet seminars, but good things move slowly. Please feel free to contact our marketing coordinator, Jamie Breen, at jbreen@mwl-law.com regarding obtaining a cost estimate for one of our seminars anywhere in North America (we come to you) or for coordinating the scheduling of such seminars. A complete list of the seminars offered by MWL, along with course descriptions, can be found on our website at www.mwl-law.com.

The Key to Success
It's yours for the taking!

Trial lawyers around the country are educating themselves with the latest law and techniques on how to strip you of your rights of subrogation and reimbursement. They are doing their job. Let's be sure that we do ours.

PROPERTY SUBROGATION

Ryan L. Woody

MWL TO REPRESENT NASP AS AMICUS CURIAE BEFORE THE WISCONSIN SUPREME COURT

By Ryan L. Woody

On February 12, 2000, a fire destroyed a home owned by David Ronaldson. As a result of the fire, his property insurer, American Family Mutual Insurance Company, incurred at least $165,000.00 in costs for rebuilding the home. However, prior to rebuilding, American Family retained two cause and origin experts to investigate the loss, who documented their inspection with photographs. The experts were able to determine that the fire was caused by faulty roofing work done by Golke Brothers Roofing and Siding, LLC. American Family immediately notified Golke Brothers via regular mail of the loss through its principals, David Golke, Charles Golke and Joseph Golke. Both Golke Brothers, and its insurer, Indiana Insurance Company, had actual notice of the loss and were afforded opportunity to inspect the site. However, neither Golke Brothers nor Indiana Insurance requested to inspect the site nor instructed American Family to preserve any specific evidence. Approximately two months after the fire, American Family authorized Mr. Ronaldson to raze and rebuild his home.

American Family later brought a subrogation lawsuit against Golke Brothers and Indiana Insurance alleging that their negligence was the cause of the fire that destroyed Mr. Ronaldson's home. At trial, the defendants raised a spoliation defense, arguing that American Family had a duty to preserve significant amounts of physical evidence from the fire, and lacking this tangible evidence, the case should be dismissed. Although American Family's experts had documented the scene with photographs, the trial court found that American Family failed to adequately preserve the evidence. The trial court then dismissed the action based on spoliation. It determined that American Family had a duty to preserve much of the physical debris and evidence from the fire despite the fact that the defendants had notice and an opportunity to inspect the entire scene for two months following the accident. Specifically, the trial court held:

> *"American Family failed to preserve the scene in ways that were possible, taking adequate photographs, perhaps taking a videotape, I don't know; but clearly all, everyone agreed that it was possible to remove the dog house, the chase, and the appropriate chimney element; and since those weren't done, I'm satisfied that this is a clear case of spoliation every bit as bad, and I would argue the conduct of American Family is far worse than Sentry engaged in which led to the dismissal of the claim, of Sentry's claim…So at this point and time I am going to dismiss the action based on spoliation."*

The Wisconsin Court of Appeals reviewed the case and immediately certified it for the Supreme Court. Specifically, the Court of Appeals asked, "under what circumstances may evidence crucial to a potential legal claim be destroyed and what notice must be given to a civil litigant before evidence is destroyed?" The Wisconsin Supreme Court will have an opportunity to fashion an important new test for spoliation law in Wisconsin. NASP felt that this was an important issue for its members and Matthiesen, Wickert & Lehrer volunteered to prepare the Amicus Curiae Brief.

Madison is Wisconsin's State Capitol - Wisconsin's Capitol Building was modeled after the U.S. Capitol building in Washington, DC

Under current Wisconsin law, dismissal as a sanction for the destruction of evidence "requires the finding of egregious conduct, which, in this context, consists of a conscious attempt to affect the outcome of litigation or a flagrant knowing disregard of the judicial process." *Garfoot v. Fireman's Fund Ins. Co.*, 228 Wis.2d 707, 724, 599 N.W.2d 411 (Ct. App. 1999). NASP is taking the position that a subrogated insurer should be able to rebut the allegation of egregious conduct in destroying evidence with a showing that it provided its opponent with actual notice and a reasonable opportunity to inspect. Under any test, however, American Family's actions of providing actual notice and a reasonable opportunity to inspect the fire scene lead to the conclusion that (1) its actions were in good faith, and (2) the subsequent destruction of the fire scene was not "a conscious attempt to affect the outcome of litigation or a flagrant knowing disregard of the judicial process." *Garfoot*, 228 Wis.2d at 724.

Even leading defense lawyers agree that a subrogated plaintiff discharges its burden once notice and an opportunity to inspect is provided. Touchstone for Insurers Pursuing Subrogation: Save the Evidence, 70 *Defense Counsel Journal* 365 (July, 2003). The article states in relevant part:

> *"If the responsible parties can be put on notice before the destruction of the fire scene, the subrogee will not be put in the position of defending whether destruction of the fire scene was within its control or contained relevant evidence. As long as potentially responsible parties are put on notice and given an opportunity to inspect, they cannot effectively pursue a claim that they were prejudiced. In analyzing whether to impose sanctions following the destruction of evidence, courts will look at the efforts taken by the defendant in attempting to investigate the claim. If it is determined that the defendant did not make a reasonable effort, sanctions will not be imposed against the plaintiff."*

In addition, residential and commercial fire losses pose unique concerns that make retaining all possible relevant debris a Herculean task. Although the costs associated with photographing and/or videotaping the defective construction is minimal, the costs of retaining part or all of the structure can be prohibitive. While one party may want limited physical evidence near the area of origin, another party may claim spoliation where every piece of physical evidence is not retained so that all possible alternative theories can be pursued. Additionally, in fire loss cases, the need to timely mitigate damages and eliminate environmental contamination is critical. Also, an insurer must consider its contractual obligation to its insured that allows the insured to get back to business as soon as possible. Accordingly, NASP believes that courts must be free to consider both the context of the destruction of evidence and the costs associated with retaining all relevant evidence.

Further, the trial court's decision creates a "do-nothing" defense for potential defendants. By ignoring the notices sent by American Family and the invitations to inspect, the defendants have benefitted by simply doing nothing. Indiana Insurance Company is an example of a sophisticated defendant. Indiana Insurance Company acknowledged American Family's subrogation claim in writing, yet took no action to investigate the claim. Courts should not create a judicial rule that rewards inaction to the benefit of potential tortfeasors. Instead a potential tortfeasor, who, with notice and opportunity to inspect fails to do so, should not be allowed to later object to the quantum of evidence retained.

Should you have any questions about this case or about one of your own, please feel free to contact Attorneys Gary Wickert at gwickert@mwl-law.com or Ryan Woody at rwoody@mwl-law.com.

VISIT THE MWL EXHIBIT BOOTH AT THE ANNUAL NASP CONFERENCE IN HOLLYWOOD, FLORIDA

MWL will be exhibiting at the Annual NASP Conference taking place November 2-5, 2008, in Hollywood, Florida. Our booth number is **122**. We hope that you stop by our booth for a visit. For conference attendees only, we will be selling our books at a special discounted rate. If you would like to purchase one of our books while at the conference, we will have a sign-up sheet at our booth where you can indicate the book(s) you would like to purchase and, after the conference concludes, we will send the books to you, along with an invoice for same. We will also have information about our National Subrogation Program, published subrogation articles and other goodies. If you have any questions regarding our services or our books while at the conference, please see a booth attendant. We are looking forward to meeting you!

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