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Expert Testimony Is Key In RMBS Liability

Law360, New York (March 04, 2013, 11:19 AM ET) -- In the wake of the worldwide economic debacle attributed, in substantial part, to the rupture of the housing bubble and residential mortgage-backed securities (RMBS) market, insurers and financial institutions continue to lock horns in various disputes over who should be on the hook for billions in losses.

Insurance companies have long had major involvement with the global RMBS market as both investors and insurers. Estimates vary, but industry sources and commentators often cite $500 billion as the amount of RMBS owned by the U.S. insurance industry as of Dec. 31, 2010. And many companies issued financial guaranty, fiduciary and other policies to lenders and other entities whose RMBS portfolios "crashed" during 2007 to 2008 and whose RMBS-related activities have since been challenged by governmental regulators, investors and others.

A carrier will typically become involved as an insurer in the RMBS market when an entity seeking to sell a pool or another aggregation of RMBS seeks financial guaranty insurance to enhance the quality of its offering — a security backed by such insurance will generally garner a higher rating and will thus be more appealing to investors. As part of its underwriting process, the insurer will attempt to assess the quality of the RMBS portfolio based (among other things) on independent diligence.

Significantly, the decision about whether to issue a policy is usually made in reliance upon representations and warranties — including assurances that the loans comprising the pool at issue meet certain minimum lending criteria — made by the entity seeking a financial guaranty policy.

As RMBS disputes between sophisticated insurers and financial entities continue and intensify, expert testimony is emerging as a critical factor in determining whether, and the extent to which, insurers can avoid liability and potentially recoup some of the hundreds of millions in losses already realized by the industry.

The Flagstar Decision

In a very recent case on point, the U.S. District Court for the Southern District of New York granted a big win for the insurance industry in Assured Guaranty Municipal Corp. v. Flagstar Bank FSB, 2013 U.S. Dist. (S.D.N.Y. Feb. 5, 2013). Following a 12-day bench trial conducted last fall, Judge Jed S. Rakoff held that Flagstar Bank FSB breached various representations and warranties made to Assured Guaranty Municipal Corp., which materially increased the company's risk of loss. The court awarded Assured $90.1 million plus interest, legal fees, expert expenses and other costs.

The conflict related to a transaction whereby Assured agreed to insure two separate RMBS-backed securitizations comprised of thousands of home equity lines of credit (HELOC) that had been underwritten, marketed and sold by Flagstar or its affiliates.

As a part of its agreement with Assured, Flagstar made numerous representations and warranties relating to the HELOCs, including representations that all loans were made in good faith and in accordance with Flagstar's underwriting guidelines and that there were no errors, omissions, misrepresentations, negligence or fraud by any person involved at any point in the loan process. Notably, Assured conducted substantial independent diligence before entering into the agreement with Flagstar.

After the failure of many HELOCs triggered Assured's duty to pay guaranty claims, Assured alleged that Flagstar breached its reps and warranties — in particular, Assured claimed that the underlying loans either were fraudulent or the product of material underwriting defects in breach of the representations made by Flagstar. As a result, Assured eventually brought suit seeking to be reimbursed for the substantial claim amounts it paid to bondholders.

Most of the trial focused on the question whether the HELOCs underlying the transactions materially breached the contractual representations and warranties made by Flagstar. Before trial, the court imposed a "risk of loss" standard, holding that "the causation that must here be shown is that the alleged breaches [by Flagstar] caused [Assured] to incur an increased risk of loss."

In order to address that standard and in light of the voluminous number of underlying loans and attendant complexities, the outcome of the case hinged on what the court described as a "war of experts." Both sides introduced testimony from a cast of experts, whose conclusions and opinions stemmed from a random sampling of the underlying loans at issue, and related statistical and formulaic analysis.

The Expert Witnesses

Assured's principal expert witness was a mortgage origination and underwriting expert, who persuasively opined (among other things) that "Flagstar's underwriting process was uncontrolled and inconsistent," that Flagstar underwriters seemed to have "rubber-stamped" loan approvals and that Flagstar personnel "failed to address 'red flags' and indicia of fraud or inconsistencies" relating to a significant number of loan files. Rakoff found that with minor exceptions, the opinions offered by Assured's expert were "fully credible and corroborated in numerous ways."

As the court's decision reflects, Assured's experts created a scientific, representative sample of loans to examine, developed and utilized clear and consistent procedures for analyzing loan data and utilized conservative estimates when considering debt-to-income ratios and other indices relevant to the analyses.

In contrast, Flagstar's experts focused mainly on disproving the methodology employed by Assured's experts rather than creating a more credible model of their own for assessing the underlying loans. Rakoff found that the attacks on Assured's methodology were not well-founded and that Flagstar's experts had not identified actual instances in which the loan files themselves were free from material breaches of the guidelines. Flagstar also attempted, in vain, to exclude most of the testimony offered by Assured's experts.

In the end, Assured prevailed because its experts did well while Flagstar's experts did not — perhaps because the facts simply were not on their side. Having adjudged that the "war of experts" had been won by Assured, the court went on to hold that Flagstar had breached material reps and warranties, that Flagstar was made aware of the material breaches and that Flagstar was given a chance to cure but failed to do so.

The Flagstar decision illustrates the importance of a well-conceived and well-executed expert witness strategy, particularly in cases in which the volume of the underlying loans is large, and the applicable loan underwriting criteria is complex. The decision may well serve as a useful road map for insurance companies in the many pending and anticipated actions against financial institutions that packaged, marketed and sold RMBS securitizations.

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