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What's the State of Your State? E&O Risk Uneven across the Country

Where will lightning strike in the ongoing credit crisis? The collapse of the subprime market means that E&O litigation for real estate industry professionals is probably around the corner, with a wide range of potential victims. What will determine the risk of litigation? A familiar maxim: location, location, location. Where a mortgage industry professional practices can impact the likelihood of a lawsuit. There is no single indicator of E&O litigation risk, but the right combination of litigation attorney concentration, the frequency of Truth in Lending lawsuits, mortgage delinquencies and other factors can tell you where the lightning bolt may land.

Introduction

After financial loss, you can expect litigation to follow. Victims look for someone to blame, and plaintiff attorneys are ready to help them find the most lucrative targets. With a substantial percentage of all US households in foreclosure (RealtyTrac) and nearly 15% of all subprime mortgages in the US delinquent (Mortgage Bankers Association), it's not hard to see plaintiff attorneys girding themselves and their clients for battle.

The risk of litigation is not uniform across the country. Professionals in businesses related to the mortgage industry may have more cause to worry depending on the states in which they practice. Some states are safer than others. Ultimately, the risk of Errors and Omissions (E&O) litigation related to the subprime mortgage fiasco comes from the convergence of a variety of legal and business conditions that create an overall climate of risk. In order to gauge the likelihood of litigation, Guy Carpenter & Company, LLC ("Guy Carpenter") has developed the Guy Carpenter Subprime E&O Litigation Index. This index measures the combination of factors that influence litigation in a way that describes the overall E&O litigation climate. As a result, it is possible to assess the risk of litigation on a state by state basis.

To determine which states are riskiest for E&O coverage, Guy Carpenter studied six characteristics pertaining to the subprime mortgage market:

- Percentage of mortgages in foreclosure
- Percentage of subprime mortgages that are delinquent
- Number of litigation attorneys per mortgage industry professional
- Frequency of Truth in Lending lawsuits (per million households) through Q32006
- Frequency of banking-related lawsuits (per million households) through Q32006
- Extent to which a state is plaintiff-friendly, i.e., is deemed a "Judicial Hellhole" by the American Tort Reform Association (ATRA)

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The Guy Carpenter Subprime E&O Litigation Index shows in which states the risk of lawsuits is potentially highest. No single characteristic is enough to predict the likelihood of subprime-driven E&O litigation, but taken together, they show the overall risk climate that can lead to time in court and insured losses. The subprime mortgage crisis does not treat every state equally; some simply are riskier than others.

What Causes Litigation Risk?

In some states, litigation pays. High rates of mortgage delinquency and foreclosure, a concentrated attorney population and a tendency to favor plaintiffs turn a state in to a lightning rod for lawsuits. The frequency of litigation pertaining to Truth in Lending and banking laws (which govern mortgage brokers) signal further risk of subprime E&O litigation. The collapse of the subprime mortgage market may draw plaintiff attorneys to pursue E&O action against professionals in the real estate industry. As the number of foreclosures increases and borrowers become delinquent in their mortgages, the likelihood of E&O lawsuits increases.

Litigation seems like a natural fit in the current mortgage climate. Across the US, an average of 15% of subprime mortgages is delinquent; for one out of every seven subprime mortgage borrowers, this crisis is not abstract. There is a ready market for plaintiff attorneys who are eager to take advantage of the negative perception of the real estate industry in order to pursue potentially large settlements and judgments. States in which there are high concentrations of attorneys and affected parties would appear to be likely markets for disproportionate E&O litigation.

"For one out of every seven subprime mortgage borrowers, this crisis is not abstract."

The highest risk states for subprime-related E&O litigation (according to the index) rarely stand out in any one category. In fact, only four of the country's riskiest E&O states are among the top 10 in mortgage foreclosures, and only six are in the top 10 for subprime mortgage delinquencies. As litigation begets more litigation, high rates of Truth in Lending and banking lawsuits–and high concentrations of attorneys–drive the index and related E&O litigation risk upward. The collapse of the subprime market may be the trigger that sets off E&O litigation, but the expected characteristics, namely foreclosure and subprime mortgage delinquency rates, do not necessarily determine the total E&O litigation risk. In fact, they do not even wield substantial influence.

The risk of E&O litigation comes from a "perfect storm" that consists of above average rankings in most categories and an extremely high result in one category which makes the state's overall index score "pop." Simply having above average scores in each category can put a state at high risk of subprime E&O litigation but will not place it in the top 10. Also, having an extremely high score in one category rarely has a disproportionate influence.

Arizona, for example, has one of the highest foreclosure rates in the country and still maintains a subprime Guy Carpenter E&O Subprime E&O Litigation Index of "Very Low." Nevada, which has the highest foreclosure rate in the country, has only a "Medium" risk of subprime E&O. While foreclosures are high, the overall subprime risk environments are stable. Massachusetts, on the other hand, is roughly at or slightly above average in most categories. The convergence of these factors that are slightly high, though, can lead to an extremely high risk outcome.

Illinois illustrates how factors can converge to create a climate that favors subprime-related E&O. The state's foreclosure rate is below the national average, and its subprime mortgage delinquency rate is only slightly above average. But, the ATRA ranks Illinois as a "judicial hellhole," an assessment that is supported by the fact that there are 0.22 attorneys for every mortgage professional (Bureau of Labor Statistics), nearly 20% higher than the national average of 0.19, and plenty of Truth in Lending and banking litigation. In fact, Illinois' rates of both Truth in Lending and banking litigation are more than 300% greater than the national average. If you are a plaintiff in Illinois, the legal environment appears to be favorable.

State	Foreclosure Rate	Subprime Mortgage Delinquency Rate	Litigation Attorneys per Mortgage Professional	Truth in Lending Litigation[1]	Bank/ Banking Litigation[2]	Litigation-Friendly State[3]
AL	0.3%	16.8%	0.32	11.1	4.3	Low
CT	1.3%	14.2%	0.31	9.1	6.0	Low
GA	1.9%	17.2%	0.17	6.5	3.3	Low
IL	1.2%	15.3%	0.22	17.5	11.9	Very High
LA	0.3%	17.7%	0.34	3.9	3.1	High
MA	1.2%	17.0%	0.25	3.1	3.4	Medium
MI	2.2%	20.8%	0.16	10.8	5.6	Low
PA	0.5%	15.0%	0.20	5.2	4.2	High
RI	0.5%	16.5%	0.16	33.5	24.5	Medium
TN	1.3%	17.3%	0.26	2.8	2.5	Low
WV	0.1%	18.1%	0.34	8.6	4.0	Very High
US AVG	*1.3%*	*14.5%*	*0.19*	*4.3*	*2.9*	*N/A*

Source: Guy Carpenter & Company, LLC

Joining Illinois in the states ranking "Very High" on the E&O subprime litigation index, Michigan has high rates of subprime mortgage delinquency, Truth in Lending lawsuits and banking litigation make it a likely state for E&O litigation, despite the fact that the ATRA is not critical of it. Alabama also has high rates of Truth in Lending and banking litigation, despite not being a "Judicial Hellhole" (as defined by the ATRA). Tennessee, Louisiana, Massachusetts and Pennsylvania lack a distinguishing risk feature, but retain "Very High" Guy Carpenter Subprime E&O Litigation Index levels because of slightly above average exposure in nearly every category.

[1] Per million households
[2] Per million households
[3] Based on data from *Judicial Hellholes® 2006* by ATRA

As one would expect, the states with the lowest risk of E&O litigation as a result of the subprime mortgage crisis show both an aversion to litigation and a lower prevalence of potential causes. In general, there are fewer attorneys per mortgage industry professional and fewer lawsuits related to Truth in Lending or banking. Most foreclosure rates are extremely low, and subprime mortgage delinquency rates tend to fall below the national average. There may be an occasional spike on one category, e.g., Arizona's 2% foreclosure rate (RealtyTrac) or Hawaii's 5.1 Truth in Lending lawsuits per million households (Mortgage Bankers Association), but it is offset by more modest scores in the remaining categories.

State	Foreclosure Rate	Subprime Mortgage Delinquency Rate	Litigation Attorneys per Mortgage Professional	Truth in Lending Litigation[4]	Bank/ Banking Litigation[5]	Litigation-Friendly State[6]
AZ	2.0%	10.2%	0.09	1.2	0.6	Low
HI	0.2%	8.6%	0.34	5.1	0.0	Low
IA	0.4%	14.5%	0.08	0.8	0.8	Low
KS	0.3%	13.1%	0.11	0.0	0.0	Low
ME	0.1%	14.6%	0.16	0.0	0.0	Low
ND	0.1%	10.9%	0.12	0.0	3.3	Low
OK	0.6%	12.5%	0.19	0.3	0.6	Low
OR	0.5%	8.7%	0.11	1.0	1.6	Low
SD	0.1%	12.0%	0.11	1.4	0.0	Low
VT	0.0%	13.0%	0.17	0.0	0.0	Low
WY	0.1%	9.4%	0.19	0.0	0.0	Low
US AVG	*1.3%*	*14.5%*	*0.19*	*4.3*	*2.9*	*N/A*

Source: Guy Carpenter & Company, LLC

An evolving claims and litigation environment is likely to reshape risk going forward. The economic effects of the subprime collapse are still unfolding. Some states may see increases in foreclosures or delinquency rates in the coming months, while states with high delinquency or foreclosure rates may signal that a wave of Truth in Lending or banking-related lawsuits are on the horizon.

Mississippi looks like it is ready for the situation to turn for the worse. The high subprime mortgage delinquency rate of 21.5% (Mortgage Bankers Association) and extremely low foreclosure rate of 0.1% (RealtyTrac) may mean that foreclosures could be poised to jump. This may indicate that lenders are not ready to foreclose on homes … yet. A shift from delinquency to foreclosure may also lead to increases in banking and Truth in Lending lawsuits which would affect an overall change in the state's risk profile. If delinquencies lead to foreclosures, the chain of events that could follow may push Mississippi to "High" or "Very High" on the Guy Carpenter Subprime E&O Litigation Index.

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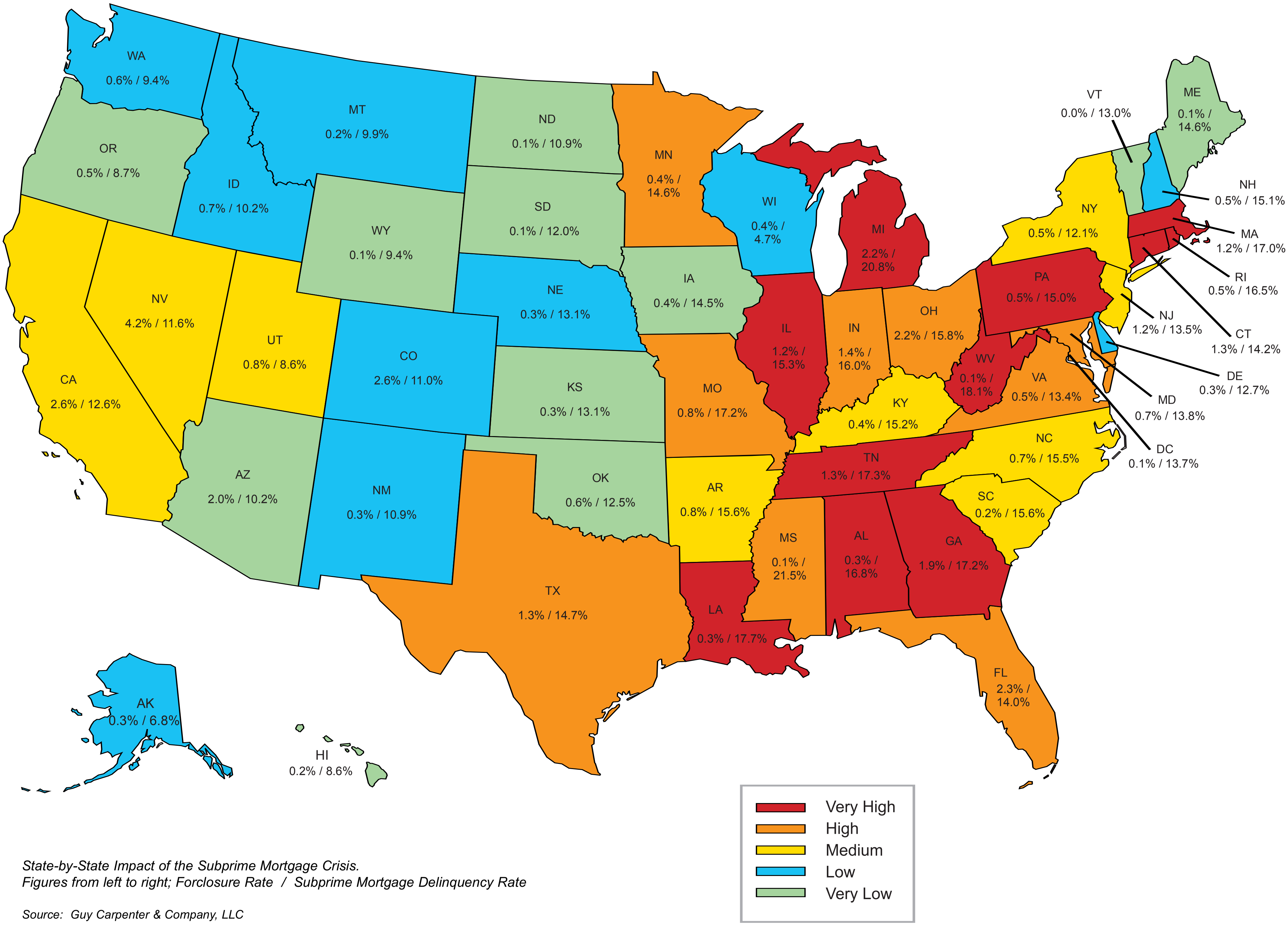
4 Per million households

5 Per million households

6 Based on data from *Judicial Hellholes® 2006* by ATRA



State-by-State Impact of the Subprime Mortgage Crisis.
Figures from left to right; Forclosure Rate / Subprime Mortgage Delinquency Rate

Source: Guy Carpenter & Company, LLC

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State	Subprime E&O Litigation Index	Foreclosure Rate	Subprime Mortgage Delinquency Rate	Likely Change of Direction
California	Medium	2.6%	12.6%	Down
Colorado	Low	2.6%	11.0%	Down
Indiana	High	1.4%	16.0%	Uncertain
Mississippi	High	0.1%	21.5%	Up
Nevada	Medium	4.2%	11.6%	Down
Ohio	High	2.2%	15.8%	Uncertain

Source: Guy Carpenter & Company, LLC

On the other hand, Nevada, Colorado and California seem to have run their respective courses. All have foreclosure rates above 2% (RealtyTrac), which one would think indicates that the risk of subprime E&O lawsuits is increasing. Nevada stands out with a seemingly excessive foreclosure rate of 4.2%, more than 50% higher than California and Colorado, which are tied for second at 2.6%. The fact that these states have low subprime mortgage delinquency rates may mean that the crisis has passed. The delinquencies, it seems, have led to all the foreclosures that are likely to occur. Quite simply, it looks like there may not to be much more action here. Indiana and Ohio still could be in the throes of the mortgage crisis, as high foreclosure rates are joined by high subprime mortgage delinquency rates.

Determining Your Risk

Identifying the states with the highest potential for litigation is an important first step in understanding exposure to E&O litigation as a result of the subprime mortgage market's collapse. Next, it is important to understand the magnitude of the exposure, particularly in key states where insured losses could grow quickly. It is possible to determine the potential risk presented in each state by determining the frequency and severity of potential claims relative to the number of professionals engaged in businesses related to the real estate industry.

Insured Risk = Number of Mortgage-Related Professionals X Potential E&O Litigation Frequency X Severity per Claim

Consider Massachusetts, which scores "Very High" on the Guy Carpenter E&O Subprime Litigation Index. Assume that there is a claim frequency of 5% among 26,220 professionals in businesses related to the mortgage industry (Bureau of Labor Statistics). Further, include a severity per claim of $100,000. The resulting exposure is $131,100,000. Given that claim frequency and severity can vary, it may be prudent to model a few scenarios. In Massachusetts, a claim frequency rate ranging from 3% to 7% and a severity per claim that starts at $75,000 and can reach $100,000 shows that the exposure could be as little as $59 million or reach more than $180 million.

Source: Guy Carpenter & Company, LLC

While you may not be able to pinpoint the exposure, it is possible to get an idea of the range of possibilities. In the Massachusetts example, the gap between best- and worst-case scenarios (given the assumptions used) is approximately $125 million. The spread is likely to shrink in lower-risk states, as the range of realistic possibilities becomes smaller.

Risk may not be where you expect to find it. E&O litigation related to the subprime mortgage market could occur anywhere, even in states that do not appear to be risky. But, it is evident that litigation is more likely to occur in some states than others, with Illinois, Michigan and Massachusetts topping the list. Today's risk havens may not hold the distinction forever, though, as Mississippi appears ready to spike, and Indiana and Ohio could follow. As the subprime mortgage crisis continues to unfold, the states claiming the highest risk levels are likely to change as well.