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STRATEGIES FOR COVERAGE FOR SUBPRIME MORTGAGE-RELATED LIABILITIES

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SUBPRIME LENDING CRISIS—HOW INSURANCE COVERAGE SHOULD REDUCE THE DIRECT FALLOUT

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SUBPRIME LENDING CRISIS – HOW INSURANCE COVERAGE SHOULD REDUCE THE DIRECT FALLOUT

BY JOHN N. ELLISON[1]

As the billions of dollars in losses that have arisen from the subprime lending industry's collapse continue to grow and the resultant number of private litigations and government investigations mount, industry members and their affiliated business partners will be forced to turn to all sources of available protection to ensure that the consequences to their individual businesses do not mean bankruptcy or worse. The targets of these actions, direct and indirect lenders, third party financial institutions that purchased the subprime loans and then "repackaged" the lenders' portfolios, investment funds, brokers and borrowers, all face potentially debilitating losses that could threaten their continued survival. Fortunately, many of these entities have available to them a wide variety of insurance products that could provide a wide safety net against their potential responsibility for these losses. Beginning with directors and officers ("D&O") or professional liability ("E&O") insurance policies to more obscure types of insurance like credit risk insurance and pension trust liability insurance, players in the subprime arena may have more resources available to defend against, and rebound from, the market's collapse than they originally believed.

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What Is Subprime Lending?

Subprime lenders typically extend credit in the form of mortgages, car loans and credit cards to individuals considered untouchable by the prime rate lending establishment. These borrowers are completely shut out from the more favorable market rates accompanying standard loans, and the subprime lender fills this void by providing the desired credit in return for higher fees and interest payments.

Subprime lending advocates emphasize the positive economic stimulus of supplying credit to consumers otherwise unable to procure credit. Opponents of the entire subprime lending market point to the rigid conditions imposed by some subprime loan agreements and the arguably predatory nature of the industry's reason de etre. Whether for or against it, the reality is that the subprime lending industry encompasses assets well into the hundreds of billions of dollars. With the enormous rates of return for financial institutions that can be earned beyond the traditional prime market, it is not surprising that the industry's phenomenal growth occurred so broadly.

The Recent Crisis

With the recent rise in interest rates, increased unemployment figure and a general malaise seeping into the world's financial markets, a sharp increase in high risk borrower defaults has caused numerous subprime lenders to reach precarious financial states, including seeking the protection of the bankruptcy courts. Many of these companies are currently the subject of governmental investigations, scrutinizing the accounting principles they applied to their loan portfolios and their business practices in general. Feeling the fallout from this first-line of troubles are larger lenders, banks and financial institutions that purchased subprime loans from the smaller, defunct lenders that originated them. To protect their investments, many of these institutions executed

repurchase agreements with the now defunct or insolvent subprime lenders, agreements that no longer provide any recourse. The result has been securities litigations and the threat of additional actions against the subprime lenders, the subsequent purchasers of the loans, and even the investment banks that repackaged the loans in the form of securities. Plaintiffs may even pursue directors and officers in their individual capacities alleging rampant mismanagement.

Which Insurance Products Could Provide Coverage?

1. D&O and E&O Insurance

a. General Scope of Coverage

Both D&O and E&O insurance are available to the corporation targeted by government agencies or private claimants for subprime lending practices. D&O insurance typically covers the corporate policyholder (where entity coverage is present) and the corporation's out-of-pocket loss in indemnifying and defending its directors and officers for alleged wrongful acts in carrying out their corporate responsibilities. D&O insurance also covers the directors and officers individually. Similarly, typical E&O insurance policies protect the corporation and its various employees and affiliates, such as securities brokers and dealers working for investment banks, for loss arising from their alleged wrongful acts committed in their capacities as managers, representatives or agents of the corporation.

Both of these policies provide coverage for "wrongful acts" committed either in the course of carrying out corporate responsibilities or in rendering professional services. The coverage traditionally extends to non-intentional actions that cause injury

to a third party. While coverage extends to lawsuits by third parties and government agencies, some of these policies may also provide coverage for expenses incurred to investigate and prepare for a defense against potential claims. Government investigations into a company's alleged improper subprime lending practices or accounting irregularities would fall within policy language such as "investigations by any governmental entity into possible violation of law" in the policy's definition of "claim." In addition, all of these policies typically provide coverage for defense costs incurred in responding to lawsuits or investigative demands; some make that obligation a "pay as you go" duty, others require reimbursement of defense expenses after the fact. The definition of "loss" will also include coverage for settlements and judgments arising from the underlying claim.

b. Threshold Issues: Claims Made and Notice Provisions

From the outset of any potential subprime claims that your business may receive, it is important for the company to remember the nature of D&O and E&O policies, as well as to provide timely notice of claim to the insurance companies. These policies are claims-made policies, meaning they only cover claims that are made during the policy period. In addition to this prerequisite, timing provisions are found in these policies as to the date by which notice must be given in order for the policy's coverage to be available. Since courts have been quite strict in enforcing these timing provisions, monitoring of compliance with them is of paramount importance. While lawsuits clearly trigger the obligation to give notice, investigative demands, threatening letters and other forms of a "claim" may trigger notice obligations. Policyholders should be proactive in this respect, and be sure they know the particulars of their policy's requirements. Again,

it is vital that this notice obligation is satisfied or you could jeopardize your entire insurance claim from day one.

c. Potential Defenses and Exclusions

Your insurance company may cite to various exclusions and coverage limitations in the policy language in hopes of minimizing or eliminating the available coverage. One of the most prominent exclusions found in D&O and E&O policies is a "bad acts" exclusion. In other words, if the directors and officers of a financial institution face liability based on allegations of fraud, criminal acts or intentional conduct arising from improper subprime lending practices, many policies will exclude coverage. It is critical to note, however, that the exclusion is not triggered merely because a fraud is alleged. Only after the underlying claim is adjudicated in a court of law may the insurance company rely upon the exclusion. *In re Donald Sheldon & Co., Inc.*, 186 B.R. 364, 369- 70 (S.D.N.Y. 1995). Until a final determination is reached, the insureds will be entitled to the advancement of legal costs incurred in defending against the claim. *Cite for Adelphia case*.

If the claim related to subprime litigation takes the form of a shareholder derivative claim, the insurance company may attempt to deny coverage for the internal investigation costs incurred by the board committee created to determine the merits of the claim. Typically, when a stockholder brings a derivative claim, including complaints alleging mismanagement with respect to subprime lending, the board of directors forms a Special Litigation Committee ("SLC") comprised of independent directors uninvolved in the allegations of wrongdoing. The SLC is charged with investigating the allegations within the derivative lawsuit, and reporting to the full board as to how the allegations

should be defended, if at all. Unless expressly excluded, the costs of an SLC investigation should be covered by D&O insurance.

Other exclusions should are typically not triggered unless proven as a matter of fact, such as whether fraud, gaining an illegal personal profit, or violating a statute actually occurred. Under this type of exclusion, courts have held insurance companies must prove that the wrongful conduct actually occurred before coverage can be denied. *See PMI Mortg. Ins. Co. v. American Intern. Specialty Lines Ins. Co.*, No. C 02-1774 PJH, 2006 WL 825266, at *5 (N.D. Cal. Mar. 29, 2006).

The prudent course of action for a company involved in litigation is to settle the claim on behalf of itself and its officers and directors. The insurance company may contend that the claim or claims settled by the underlying parties are not covered by the insurance policy. As explained above, many times insurance companies inappropriately assert exclusions even thought there has been no final adjudication that triggers their application. Equally important, the insurance company is not entitled to relitigate the settled action in the subsequent coverage dispute with its policyholder. *See, e.g.,* 1 Windt, Insurance Claims and Disputes 4th § 6:31 (reasoning that after settlement "[t]he actual merit of each of the plaintiff's claims against the insured is not directly relevant").

Insurance companies have more aggressively asserted rescission defenses under D&O and E&O policies that require revisiting the entire underwriting process undertaken at the point of the policy's sale. Under this scenario, if the insurance policy was procured based on misrepresentations made by management within the application for insurance, the insurance company may seek to rescind the

policy in its entirety, which eliminates any coverage if successful. Many of the ongoing investigations involve looking at whether the corporation made misstatements in its public financial filings, overestimating the value of its subprime loan assets. The insurance company may assert that such misrepresentations provide grounds for policy rescission. Making this type of defense a greater concern, the insurance company may include a "prior acts" exclusion in its policy language, eliminating coverage for allegations in the underlying claim that purportedly occurred before a specific date. It is important to note that the burden to prove a rescission case is a heavy one and falls on the insurance company. The insurer must show that any misrepresentation was material to the decision to issue coverage and the misrepresentation was in fact made by the policyholder. As a result, most rescission actions are unsuccessful.

2. Other Insurance Products

a. Credit Risk Insurance

Many companies purchase credit risk policies that provide protection against the inability to collect accounts receivable. This type of insurance is triggered by the extension of credit by the policyholder to a client who then either fails to pay for some defined period of time or where the client has become insolvent. This insurance product is most common in industries where consumer credit or other loans are regular features of the policyholder's business. Mortgage insurance is one specific type of credit risk insurance that usually exists for the direct subprime lender.

These policies are implicated by the direct failure of the subprime borrower to meet its obligations. Another use of credit insurance in this context is for investment groups or hedge funds purchasing mortgage-backed securities ("MBS") to

cover a lender's failure to buy back its loans if required to do so by a repurchase agreement. If the direct lender fails to buy back loans under a repurchase agreement due to insolvency or lack of funds, credit risk insurance may step in to make these payments. The extent of available coverage is often tied to the specific contractual arrangements in place, so a thorough review of the underlying documents is mandatory. Coverage disagreements can often arise over provisions that exclude from coverage certain accounts receivable that are only disputed, not defaulted. How these concepts apply in unique factual situations need to be examined closely.

b. Pension Trust Liability and Fiduciary Liability Insurance

Claims relating to imprudent investments of employee assets in ERISA plans and improper administration of pension funds may trigger coverage under these types of policies. As the policy type suggests, coverage under these policies is triggered by allegations relating to the failure to meet governing standards in the oversight and handling of pension fund or ERISA plan assets or the failure to fulfill fiduciary obligations in that regard. With the sizable investments that many such plans had in the subprime industry, which have now lost substantial value, it is not difficult to conceive of potential claims that may be pursued for these losses. In that event, coverage under these types of policies should be investigated.

c. Mortgage Insurance

Finally, most lenders insist that mortgage insurance policies be purchased by subprime borrowers as a condition of the loan origination process. This requirement protects the lender in the event of default under the subprime mortgage. Many of these policies are also procured to protect investors in MBS so that in the even of a large

scale default by the subprime borrowers, the investor receives the insurance proceeds. Given these types of arrangements, it would be prudent for any investors in MBS to investigate whether they have any direct or indirect rights against mortgage insurance that should be in place for subprime loans that comprise the basis for their MBS. While this investigation may not be as simple as reviewing one's own insurance policies for potential coverage, the financial protection that could be found in the event direct or indirect coverage rights do exist warrant the effort.

Determine Your Potentially Available Coverage Now

If your corporation faces litigations or investigations created by its involvement in the subprime lending industry, it should immediately begin a thorough analysis of all potentially implicated insurance policies, both ones they purchased directly and ones under which they may have rights to access coverage. This practice should be followed by any entity having some connection to the subprime industry, whether it is in the capacity of a direct lender for subprime loans, a subsequent purchaser of subprime portfolios or an investment bank selling securities backed by the subprime loans. By doing so, when the formal investigations and/or legal actions begin alleging mismanagement or a failure to fulfill certain obligations concerning subprime loans, your company will be in a position to maximize the available sources of protection it has to best protect its assets from responding directly to any such losses.