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## VIEWPOINTS

# Making Sure Liability Policy Claims Are Paid

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Here we go again.

An overheated market cools suddenly. A wave of bankruptcies is followed by a flood of private litigation and government investigations. Now it's subprime lenders' turn.

Whether your organization is a subprime lender under siege or a bank that assumed a portfolio of "second chance" loans, your professional liability insurance policy should offer some protection from these actions.

Unfortunately, the claims process itself is often fraught with conflict. Here are some typical insurance company defenses and how to counter them.

### FIRST STEPS

Both directors and officers (D&O) and executive and officers (E&O) policies are available to corporations targeted by government agencies or private claimants for questionable subprime lending practices.

D&O insurance typically covers the corporate policyholder (where entity coverage is present) and its out-of-pocket loss in indemnifying and defending its directors and officers for alleged wrongful acts in carrying out their responsibilities. The insurance also covers the directors and officers directly.

Similarly, standard-form E&O policies protect the corporation and its employees and affiliates — such as securities brokers and dealers working for investment banks — from loss arising from their alleged wrongful acts committed in their capacities as managers, representatives, or agents of the corporation.

Many policies include "investigations

by any governmental entity into possible violation of law" in the definition of "claim." The policies also normally cover "defense costs" incurred from responding to a government or regulatory examination. The definition of "loss" will include coverage for settlements and judgments arising from the underlying claim.

At the outset of litigation, it is important for the company to provide timely notice of claim to the insurance companies — an obligation the insured or policyholder must complete before seeking coverage. Most D&O and E&O policies put a specific limit on when notice can be provided

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after the claim is filed, while others require notice "as soon as practicable."

It is vital that this notice obligation is satisfied, or the entire claim could be jeopardized.

### INSURER DEFENSES

If the litigation against your institution and management is in the form of a shareholder derivative claim, the insurance company may try to deny coverage for the internal investigation costs incurred by the board committee empaneled to determine the claim's merits.

Typically, when a stockholder brings a derivative claim, the board forms a special litigation committee of independent

directors who are not involved in the allegations to investigate their veracity. Unless they are expressly excluded, the costs of that committee's investigation should be covered by D&O insurance.

The insurance company may also cite various exclusions and coverage limitations in the policy language in the hopes of preventing recovery. One of the most prominent exclusions invariably found in D&O and E&O policies covers "bad acts." Under this type of exclusion, many policies will exclude coverage if the directors and officers are facing liability based on allegations of fraud, criminal acts, or intentional conduct arising from improper subprime lending practices.

However, the exclusion is not triggered just because a fraud is alleged. The insurer can use this exclusion only after the underlying claim is adjudicated. Until a final determination is reached, the insureds are entitled to the advancement of legal costs incurred in defending against the claim.

Other exclusions could have an "in fact" trigger, such as fraud, gaining an illegal personal profit, or violating a statute. Even under this type of exclusion, courts have held insurance companies must prove the wrongful conduct actually occurred before coverage can be denied.

If your company decides to settle, the insurance company may attempt to deny coverage on the grounds that the alleged wrongdoing triggers a bad acts exclusion. But without a final adjudication of wrongdoing (which does not take place in a settlement), the exclusion cannot be applied, and the insurer is not entitled to relitigate the settled action.

Furthermore, if the policy was procured

through misrepresentations by management in the insurance application, the insurer may seek to rescind the policy in its entirety. Many investigations find that the corporation made misstatements in its financial filings, overestimating the value of its subprime loan assets.

The insurance company may assert that such misrepresentations provide grounds for policy rescission. The insurance company may also include a prior acts exclusion in its policy language, eliminating coverage for allegations in the underlying claim that purportedly occurred before a specific date.

Note that the burden to prove a rescission case is heavy and falls on the insurance company, which must show that any misrepresentation was made by the policy-

holder and was material to the decision to issue coverage. Also keep in mind that most rescission actions are unsuccessful.

If your corporation faces litigation or investigations as a result of its involvement in subprime lending, consult immediately with an insurance expert to assess what policies are in place and how much coverage is available. Litigation stemming from subprime lending could trigger either D&O or E&O insurance, or both, depending on the defendants.

Whether your company is a subprime loan originator, a purchaser of subprime portfolios, or an investment bank selling securities tied into the loans, insurance may be the last bastion against the plaintiff hordes.

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