

ALERT

Subprime Lending Litigation— Insurance Coverage?

By R. Mark Keenan and Craig M. Hirsch

A sudden, but unsurprising wave of bankruptcy filings within the subprime lending industry is now spawning private litigations and government investigations. The targets of these actions are not only the insolvent lenders, but the third party financial institutions, including their directors and officers, that purchased the subprime loans and then “repackaged” the lenders’ portfolios. Whether your organization is the floundering subprime lender or the bank that assumed these “second chance” loans, the next question becomes: will your directors and officers (“D&O”) or professional liability (“E&O”) insurance policy “protect” you from these actions?

Subprime Lending

Subprime lenders offer mortgages, car loans and credit cards to individuals considered untouchable by the prime rate lending establishment—borrowers with poor credit ratings due to limited availability to cash, a troubled credit history or other debt issues. 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 or liquidity conditioned upon higher fees and interest payments.

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Proponents of subprime lending point to its “white knight” quality—supplying credit to consumers otherwise unable to procure credit. Skeptics cite to the seemingly predatory nature of the rigid conditions imposed by some subprime loan agreements. Notwithstanding the views of either side, when things are going well, the subprime lending industry boasts hundreds of billions of dollars in assets. Its enormous rates of return for financial institutions are the reason for the industry’s phenomenal growth.

The Recent Crisis

Now comes the down side. A sharp increase in high risk borrower defaults has caused numerous subprime lenders—including large subprime mortgage lenders—to become insolvent and run for cover to 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

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business practices in general. Left "holding the bag" 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 impecunious subprime lenders—agreements that are no longer worth the paper they are printed on. 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 prey upon directors and officers in their individual capacities alleging untoward conduct and egregious mismanagement.

Which Insurance Provides Coverage?

Both D&O and E&O insurance are available to the corporation 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 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 directly. Similarly, standard form 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.

From the outset of subprime litigation against your company, it is important for the company to provide timely notice of claim to the insurance companies. Notice of claim is an obligation the insured or policyholder must complete before seeking coverage. Most D&O and E&O policies put a specific time limitation on how late notice can be provided after the claim is filed, while others require notice "as soon as practicable." It is vital that this notice obligation is satisfied or you could jeopardize your entire insurance claim from day one.

Government investigations into a company's alleged improper subprime lending practices or accounting irregularities are also covered under many of these policies, which include "investigations by any governmental entity into possible violation of law" in the policy's definition of "claim." The insurance policies normally cover "defense costs" incurred from responding to a government or regulatory examination as well. The definition of "loss" will also include coverage for settlements and judgments arising from the underlying claim.

Keep in mind if the subprime litigation against your financial institution and its management is in 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 empanelled 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 uninformed in the allegations of wrongdoing. The SLC is charged with investigating the veracity of the allegations within the derivative lawsuit. Unless expressly excluded, the costs of

an SLC investigation should be covered by D&O insurance.

Further, the insurance company may cite to various exclusions and coverage limitations—some buried, some obvious—in the policy language in hopes of preventing your recovery. One of the most prominent exclusions invariably 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. However, 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. *Federal Ins. Co. v. Kozłowski*, 792 N.Y.S.2d 397, 404 (App. Div. 2005).

Other exclusions could have an “in fact” trigger—whether fraud, gaining an illegal personal profit, or violating a statute, etc. Even 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); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 378 (D. Del. 2002) (holding illegal profit or advantage exclusion is triggered only with proof that an illegal profit or advantage was actually gained).

It often makes economic sense for your company to settle a litigation 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. This is wrong because there has been no final adjudication. Keep in mind this coverage defense does not entitle the insurance company to relitigate the settled action in the subsequent coverage dispute with its insured. See, e.g., *City of Idaho Falls v. Home Indem. Co.*, 888 P.2d 383 (Idaho 1995); 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”).

Furthermore, 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 and eradicate the possibility of coverage. Many of the ongoing investigations could yield a finding that 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. For even more ammunition, 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. *Home Ins. Co. of Ill. (New Hampshire) v. Spectrum Information Tech.*, 930 F.Supp. 825, 843 (E.D.N.Y. 1996) (holding the insurance company did not carry its burden and may not rescind the policy). Remember: most rescission actions are unsuccessful.

Conclusion: Seek Help

If your corporation faces litigations or investigations created by its involvement in the subprime lending industry, it should immediately consult with an insurance expert to assess what insurance policies are in place and how much potential coverage is available. When the high risk of subprime borrowers comes to fruition and trouble besets your corporation, depending on the roll call of defendants, both D&O and E&O insurance could be triggered. This advice applies whether your company is an originator of subprime loans, a subsequent purchaser of subprime portfolios or an investment bank selling securities tied into the loans. When the legal actions begin alleging mismanagement or a failure to abide by general accounting principles with respect to subprime assets, companies should look to their insurance policies first and seek out help. Insurance may be the last bastion against the plaintiff hordes. ▲

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