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Subprime Lending and Securities Litigation — Insurance Coverage? (Part III)

The Credit Exposure Questionnaire

By R. Mark Keenan and Brian M. Giehl

The implosion of the subprime lending market has spawned an explosion of litigation. With all the fireworks, risk managers are scrambling to determine coverage issues regarding insurance policies. Specifically, they are considering whether their D&O, E&O, and F1 Bond policies offer protection to their financial institutions from the torrent of legal actions stemming from the collapse of the subprime securities marketplace.

As we initially reported in May 2007, the $565.3 billion subprime marketplace has been bombarded with an explosive wave of bankruptcy filings. Insurance companies are not immune to this burgeoning crisis, with AIG, the world's largest carrier, potentially on the hook for $2.3 billion in losses linked to subprime securities.

The result has been securities litigations against the subprime lenders and the investment banks that rushed to sell subprime securities. Investor-plaintiffs have even begun to prey upon directors and officers in their individual capacities, alleging untoward conduct and egregious mismanagement. And this is only the tip of the iceberg as more subprime players declare horrific losses with each passing day.

The Credit Exposure Quagmire

Insurance companies will employ myriad tactics and assert various policy exclusions to avoid coverage. One shield insurance companies may seek to hide behind could be the preliminary Credit Exposure Questionnaire. The questionnaire is a recent development in the application process. It was developed in response to the meltdown of the subprime lending market and could have a profound effect on both the accessibility of coverage and the liability of insurance carriers. The "questionnaire" is given to potential policyholders prior to issuing an insurance policy.

Statements and answers given in application questionnaires may be "incorporated into, attached to, and deemed part of the proposed policy and any application for insurance submitted in connection with the Proposed Policy should the Proposed Policy be issued." (AIG Member Companies of America International Group, Inc., Credit Exposure Questionnaire). These questions include:

- "Does the organization originate or acquire sub-prime products?"
- "Does the Organization securitize the sub-prime assets or retain them for investment purposes? If yes, is the organization experiencing difficulty securitizing assets at this time and does it expect to encounter such diffi-

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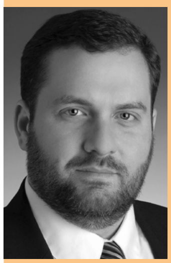

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culties in the next few months? And, what is the average amount of equity the organization retains in securitizations?"

- "Please describe the percentage breakdown of the organization's loan portfolio based on loans held for investment, and retained loans. Within each category listed, please describe what percentage is agency backed as opposed to non-agency backed. What percentage of your loan portfolio contains mortgages originated (or serviced) for clients with a FICO score between 629 and 659? ______ below 620? ______ . What percentage of the Organization's loan portfolio held or in the form of retained interest contains sub-prime and Alt-A mortgages? _____."?

Why the Questionnaire? What is There to Worry About?

If the insurance company does not like one or more responses to the "Credit Exposure Questionnaire," the insurance company may seek to rescind the policy in its entirety and eradicate the possibility of coverage. In addition, many of the subprime litigations and government investigations could yield a finding that the corporation made misstatements in its public financial filings (commonly "adopted" as a part of the application), overestimating the value of its subprime loan assets. The insurance company may assert that such misrepresentations provide grounds for policy rescission. 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). Accordingly, companies should take care when filling out a Credit Exposure Questionnaire. In fact, your best course of action when presented with a Credit Exposure Questionnaire is to avoid signing the questionnaire. In lieu of signing, attempt to have a meeting with your insurance agent or a representative from the insurance company. A question such as, "Has the Organization received any inquiries from regulators regarding any of their sub-prime business practices" could become a potential basis for denial of coverage, or even denial of issuance of a policy.

If your corporation is presented with a Credit Exposure Questionnaire, litigations, or investigations regarding involvement in the subprime lending industry, it should immediately consult with an insurance expert to review the questionnaire, assess what insurance policies are in place and how much, if any, potential coverage is available.

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