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Subprime Lending and Securities Litigation-Insurance Coverage? (Part II)

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This article is part two of an article concerning insurance coverage issues relating to subprime lending and securities litigation. Part one appeared in the Spring 2007 issue.

Will my insurance portfolio protect my financial institution from the torrent of legal actions stemming from the collapse of our subprime securities marketplace? This is the white-hot question on every Wall Street risk manager's lips. As we initially reported in Anderson Kill's *Financial Services Alert* in May, after a sudden, explosive wave of bankruptcy filings within the subprime lending industry—an industry with $565.3 billion hooked into the United States subprime mortgage marketplace[1]—financial institutions and hedge funds that pooled together subprime loans into mortgage-backed subprime securities have come under attack. Even the 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.[2] Investors purchasing these securities have suffered titanic losses in many instances as these mortgage institutions, loan originators, and hedge funds begin to go belly up with the exponential rise of mortgages defaults. The safety of these investments has become an illusion as an estimated one in five subprime mortgages became past due or in default by April 2007.[3]

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The result has been securities litigations against the subprime lenders and the investment banks that sold 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.

Whether your organization is the floundering subprime lender or the financial institution that gobbled up these "second chance" loans to create millions of dollars in subprime securities, risk managers are about to rely on the promise of coverage from the insurance policies they put in place. But will the insurance companies honor this promise? In this volatile climate with new subprime lawsuits filed each day, it is absolutely essential to know what

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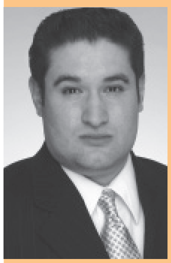

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insurance coverage your financial institution is entitled to and how the insurance companies will attempt to deny coverage.

Which Insurance Provides Coverage?

The most obvious coverage will be found in your directors and officers ("D&O"), professional liability ("E&O"), and Financial Institution Bond ("FI Bond") insurance coverage. D&O insurance typically covers the directors and officers of the financial institutions, and the corporate policyholder (where entity coverage is present). Similarly, standard form E&O insurance policies protect the corporation and its various directors, officers, employees and affiliates, including securities brokers and dealers working for financial institutions and investment banks, for loss arising from their alleged wrongful acts committed in their capacities as managers, representatives or agents of the corporation. Finally, FI Bond coverage fills the void left by D&O and E&O insurance, covering financial institutions experiencing direct loss for their employee's fraud and dishonesty, as well as losses caused by forgery, false pretenses and the like. All three lines of coverage may respond to subprime litigation against an organization.

D&O and E&O Insurance Coverage

The Importance of Notice

From the outset of subprime litigation against your company, it is important 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. *See, e.g., Andy Warhol Foundation For The Visual Arts, Inc. v. Federal Ins. Co.*, 189 F.3d 208, 215 (2d Cir. 1999) ("[L]ate notice of a claim vitiates coverage . . ."). Many D&O and E&O policies may contain a "notice of circumstances" provision permitting the financial institution to report informal complaints as to its subprimes practices to lock into the policy period if a subsequent lawsuit develops from these circumstances. It is important for a risk manager to stay informed of your financial institution's current involvement with the subprime industry and relay information to your insurance companies once subprime litigation is triggered.

Government Investigations

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. Be careful—insurance companies will argue (and at least one court has upheld) that an informal document request regarding your financial institution's subprime activities, as compared to a formal investigation with the exercise of subpoena power, by the Securities and Exchange Commission will *not* be considered a "Claim" as defined by most D&O and E&O policies. *See National Stock Exchange v. Federal Ins. Co.*, No. 6 C 1603, 2007 WL 1030293 (N.D. Ill. March 30, 2007).

Common Exclusions

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. The insurance companies will attempt to deny coverage 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. However, in the vast majority of cases, 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. *See, e.g, In re Donald Sheldon & Co., Inc.*, 186 B.R. 364, 369-70 (S.D.N.Y. 1995). The insureds will be entitled to the advancement of legal costs incurred in defending against the claim, which funds are only subject to recoupment by the insurance company if a final adjudication shows the claim is not covered. *See, e.g., Federal Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397, 404 (App. Div. 2005).

Other exclusions could have an "in fact" trigger (a more amorphous term than "final adjudication")—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, e.g., 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 a company to settle a subprime 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" or "in fact" finding of excluded wrongdoing. 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").

Rescission

Furthermore, if your D&O or E&O insurance policy was procured based on misrepresentations made by your financial institution's 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 subprime litigations and government 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. *See, e.g., 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.

FI Bond Insurance

FI Bond insurance could provide shelter from the subprime storm for a financial institution that suffered a first party loss from the sinister acts of a deceptive employee or manager who committed fraud. In any circumstance, FI Bond insurance provides coverage to the financial institution directly resulting from its employee's dishonesty or fraudulent acts that are committed with the intent to cause the corporation a loss while at the same time gaining an illicit profit. This could include coverage for dishonest employees who cause a subprime loan or securities loss to the financial institution resulting in an improper financial benefit (not including commissions or other compensation paid as part of the normal course of employment). FI Bond coverage may also apply to an investment bank or financial institution giving value for a subprime security, including a mortgage, containing a forgery, created by fraud or that is utterly a worthless counterfeit. Finally, a more recent form of FI Bond offers coverage to financial institutions undertaking transactions to extend credit to subprime investors, issue subprime securities or act with respect to a subprime mortgage where the transactional document is signed under false pretenses or because of fraud or duress. It could also be the conniving subprime broker or conniving subprime hedge fund manager employed by a financial institution who siphoned off money from the corporate coffers earmarked to back the subprime securities. Check the wording of your FI Bond to see who is covered and what level of culpability is necessary on the part of the employee to trigger coverage.

Other Insurance Coverage

While D&O, E&O and FI Bond coverage may be the "first responders" to a subprime loss, there may be other types of insurance policies that may be triggered by the onset of subprime litigation. Commercial General Liability ("CGL") insurance may apply depending on the wording of the insuring agreements within the specific policy. If the CGL policy has a broad definition of "advertising injury" and narrow exclusions, a subprime loss recovery may be possible. Furthermore, if a pension or retirement fund is largely invested into subprime securities that go sour, fiduciary liability insurance may apply, especially when a financial institution administers or serves as trustee of the pension fund. The prudent risk manager will check the policy language of all lines of insurance when facing a subprime litigation. It's your role to keep as many avenues to coverage open as possible.

Conclusion: Seek Help

Risk managers be warned! The rainy day is here for the subprime industry! If your financial institution is fortifying its defenses against countless litigations or investigations now marring the initial promise of subprime lending and securitization, it is vital that you consult with an insurance expert to assess what insurance policies are in place and how much potential coverage is available. The high risk of subprime borrowers has come to fruition and subprime litigation is exploding. When this trouble reaches your financial institution's doorstep, depending on the roll call of defendants and the loss involved, D&O, E&O and FI Bond insurance coverage 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. Look to your insurance policies first and seek out help when the allegations of mismanagement, fraud and wrongdoing with respect to subprime loans and securities begin to surface. Insurance may be your last defense against the plaintiff hoards besieging your financial institution.

[1] *S&P: Whoops! A $5 billion subprime blunder*, CNNMoney.com, July 12, 2007, http://money.cnn.com/2007/07/12/news/companies/subprime_blunder.reut/index.htm (last visited on August 8, 2007).

[2] *AIG Subprime Debt May Cost $2.3 Billion, Analysts Say (Update4)*, Bloomberg.com, August 13, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid =aWGOYSOtQz44&refer=home (last visited on August 13, 2007).

[3] Bill Marsh and Vikas Bajaj, *Housing Busts and Hedge Fund Meltdowns: A Spectator's Guide*, August 5, 2007, at § 4(4).