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Subprime Mortgage Mess

Can Insurance Protect You From This Catastrophe?

By William G. Passannante and Pamela D. Hans


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The massive losses arising from the subprime mortgage mess will have various types of insurance applicable to them at various points in the lending and approval cycle. This insurance can help to lower or eliminate losses that policyholders otherwise might face.

D&O And E&O

At the uppermost level, investors in companies with a subprime exposure and losses make claims against officers and directors of such companies. These claims implicate D&O liability and perhaps fiduciary liability insurance policies. At the other end of the spectrum, real estate appraisers whose appraisals in retrospect turned out not to reflect current conditions face negligence claims; here, E&O liability insurance will respond. In between, loan originators, underwriters, rating agencies, investment banks, promoters, syndicators, and other players in the CDC (collateralized debt obligation) and CLO (collateralized loan obligation) universe face liability claims. Each of these parties has available insurance coverage.

The proliferation of home-mortgage defaults, particularly in the subprime market, has sent shock waves through the financial industry. Analysts cite falling home prices, rising interest rates, and over-leveraged home loans as the primary reasons for the dramatic increase in mortgage defaults. Subprime loans and the escalating rate of default has sent a ripple of uncertainty throughout the economy, and has caused a spike in litigation relating to the sale of subprime mortgages and the purchase, sale, and investment in securities whose value is tied to those loans. These claims may trigger coverage under your corporation's D&O, E&O, and other insurance policies.

The Subprime Mess

In general, subprime mortgages are loans to high risk borrowers, for amounts greater than they would be able to borrow in a conventional mortgage, and at a higher—and sometimes variable—interest rate. Banks and mortgage companies make these loans to home buyers and then package the loans and sell them to investment companies. Those investment companies pool the loans and repackage them as securities. The securities are typically priced and rated based upon the risk of the investment. With mortgage-backed securities, rating, price, and risk are a function of, among other things, interest payments, risk of default, and risk of prepayment.

"...claims may trigger coverage under your corporation's D&O, E&O, and other insurance policies..."

In recent months, subprime loans have been in the news for a number of reasons. With rising interest rates and increasing defaults and foreclosures, consumers have been looking for help in the form of lower interest rates or an increase in the limit of a conventional mortgage. For the financial industry, however, subprime mortgages

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are making headlines because of the astronomical losses that investment firms have suffered because of the record number of defaults.

Billions In Losses

Companies that have sustained particularly large losses as a result of the subprime defaults include mortgage companies such as American Home Mortgage and New Century, both of which filed for bankruptcy. In recent months, Merrill Lynch, USB, Citigroup, and Deutsche Bank each has reported losses of more than $3 billion, while Morgan Stanley and JP Morgan have reported losses of more than $2 billion. Insurance companies, which are supposed to stand behind subprime mortgages and protect investors from default, have also been impacted by the number of claims, resulting in some companies filing for bankruptcy protection.

With the large number of defaults, and the extent to which individuals, corporations, banks, mutual funds, pension funds, and hedge funds have invested in mortgage-backed securities and watched the value of their investments plummet, the current crisis in the subprime market has caused industry-wide losses, investor discontent, and multi-billion dollar losses in the banking industry, as well as plummeting stock prices.

Like the junk bonds of the 1980s, and the savings and loan crisis that followed, the bottom falling out of the subprime market has led to a multitude of lawsuits by individuals, corporations, and government regulatory agencies. Shareholders, institutional investors, lenders, and borrowers are the typical claimants. Shareholders have filed class actions, derivative suits, and ERISA claims. Institutional investors, lenders, and other individuals and entities who relied upon investment advice have filed lawsuits alleging breach of fiduciary duty, misrepresentation, breach of contract, and other claims allegedly arising out of their reliance on investment advice. Borrowers—who may have been victimized by predatory lending practices—are also lining up to bring claims.

> ***"Several types of insurance policies may provide coverage for claims and liabilities relating to failed investments in securities that are tied to subprime mortgages."***

Litigation Targets

The targets of litigation relating to the subprime crisis include accountants, appraisers, analysts, and other professionals who provided advice in connection with the value of the CDO, the risk of the investment, and the price and value of the security; they also may face claims by individuals and entities who relied on their professional advice and expertise. Institutional investors, corporations, mutual funds, financial mangers, and brokers are also potential targets of litigation. As the impact of the subprime crisis deepens, the number and variety of lawsuits also will increase.

In addition to private lawsuits, investment banks, mortgage companies, and others also may be the target of regulatory investigations. Thus far, the Attorneys General of Alaska, Idaho, Massachusetts, New York, and Ohio have started regulatory investigations. The Securities and

Mark Your Calendar

Anderson Kill & Olick, P.C. Presents
Fifth Annual D&O Seminar

D&O Liabilities & Insurance:
Strategies and Tactics to Avoid Liability and Maximize Coverage

March 5, 2008

Time: Seminar 3-5:30 pm
Cocktail Reception 5:30-6:30 pm

Location: The Harvard Club
27 West 44th Street
New York City

Program Overview:
The seminar will examine emerging issues in the D&O insurance claims process and its intersection with the corporate boardroom and securities litigation. This program will also cover strategies and tactics to minimize D&O liability and maximize the return on liability insurance.

For further information or to register, please visit our website at www.andersonkill.com or contact Cindy Gratton at (212) 278-1400.

Exchange Commission has also initiated a number of investigations including inquiries into hedge fund investments in securities that are tied to subprime mortgages.

Insurance Coverage

Several types of insurance policies may provide coverage for claims and liabilities relating to failed investments in securities that are tied to subprime mortgages. For corporate directors and officers faced with shareholder class action or derivative claims, it is likely that the Directors & Officers Liability policy will provide defense and indemnity. In general, a D&O policy will cover a corporate entity (where "entity coverage" is included). It also should pay for the corporation's defense and the defense of its directors and officers against claims that those individuals failed to fulfill their corporate responsibilities and obligations. Additionally, the D&O policy should provide for settlements reached or judgments entered in shareholder suits.

Errors and omissions (E&O) policies also may provide coverage to corporations that are the targets of lawsuits and investigations. These insurance policies provide insurance coverage to the corporation and its employees, including investment advisors, accountants, brokers, and others, for allegations of wrongdoing, professional malpractice, and other misconduct in the course of their duties as representatives of the corporation. Since many of the issues relating to the subprime crisis, as it relates to the investment and banking industry, relate to the assessment of the risk of those investments, it is likely that many of the claims will implicate coverage under E&O insurance policies as well as D&O insurance policies.

Costs that a corporation incurs because of a government or regulatory investigation into its investment practices, accounting, or other activities also may be covered by its insurance policies. However, whether those costs are covered depends on a number of factors, including how the policy defines a "claim" and what constitutes a "defense."

Steps To Take

A corporation should provide notice of a claim to its insurance companies as soon as possible. The sooner that the policyholder gives notice, the better.

If your corporation faces litigation or investiga-

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Partial Win, Total Difference

By Mark Garbowski

Recent dealings with certain insurance companies have really emphasized just how good they can have it in their dealings with policyholders. In terms of the exchange of performance, they get that they want everything up front, when the policyholder pays its premiums.

The risk transfer is the point of the entire deal, of course, so that is fair enough. What isn't so fair is what happens when a policyholder does have a claim. If the insurance company is intent upon leveraging its advantageous position, there is much it can do.

First, the insurance company can almost always come up with some vaguely plausible argument for why the claim is not covered. During the time it takes to sort that out, the insurance company holds all the money.

Second, even for undisputed claims, or portions of claims, the insurance company can argue about the value of the claim. During the time it takes to sort that out, the insurance company holds all the money.

Third, while arguing over the value of the claim, but not paying the undisputed amount, the insurance company essentially acts as if the dispute is between whether the claims is worth \$0 or \$100, while in reality it is between \$50 and \$100. In doing so, it not only gets to hold the money and earn income during that period, but it also uses its failure to pay on a timely basis as a bargaining chip.

Fourth, even though the policyholder performed its most important act (paying premiums) up front, the insurance company will use any imperfection in the policyholder's ongoing obligations as an excuse not to pay, whether it relates to notice,

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cooperation, or settlement of an underlying claim.

Yes, it's good to be the insurance company.

Nevertheless, there are options for policyholders in these situations. It can take litigation, but some courts are demonstrating a will to push companies to pay undisputed claim amounts while litigation over disputed amounts continues. This can make a big difference. Early success on a motion for partial summary judgment, and more importantly an early partial payment, can make a big difference in how both sides view the overall litigation. Especially in situations where a bad faith claim might be hard to prove, one of the best ways for a policyholder to regain some of the insurance company's leverage is through an early victory on a limited but important point.

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tion because of losses related to the subprime mortgage mess, position your corporation to maximize its insurance recovery. It may be that an aggressive program is needed to obtain the insurance coverage for which you paid. In the subprime mortgage mess your insurance should respond to help protect you from this catastrophe. Policyholders should not take "No" for an answer.

William G. Passannante is a senior shareholder at Anderson Kill & Olick, P.C. and co-chair of the firm's Insurance Recovery Group. Mr. Passannante regularly represents policyholders in insurance coverage disputes and frequently publishes articles and speaks on D&O issues.
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