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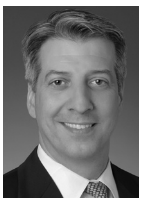
Is the Credit Crisis a Black Hole for D&O Liability Insurance?

By William G. Passannante


William G. Passannante

Will the credit crisis, like a black hole, draw most financial institutions—including major insurance companies —inwards towards crushing destruction? Have we passed a "point of no return" in the credit crisis and will the multi-faceted effect upon D&O liabilities as well as liability insurance companies change D&O insurance as we know it? The worst of times may be ahead.

The savings and loan crisis of the 1980's resulted in the failure of over 700 savings and loan associations. That crisis resulted in a huge wave of lawsuits and follow-on insurance recovery disputes.

The dot-com bubble in the mid-1990's lasted until March 10, 2000, when it burst. That crisis resulted in a huge wave of lawsuits and follow-on insurance recovery disputes.

The credit crisis of 2008 has resulted in Freddie Mac, Fannie Mac, AIG, Bear Stearns, Lehman Brothers and Washington Mutual all failing in one form of crisis or another. One might predict a huge wave of lawsuits and follow-on insurance recovery disputes.

The American International Group (AIG) is the largest seller of a number of lines of commercial insurance. According to a report by Advisen, AIG companies as a group are the leader in large account market position for: (1) Directors and Officers liability insurance; (2) employment practices liability insurance; and (3) property insurance and umbrella and excess liability insurance. Obviously, the credit crisis directly affecting the AIG parent company can have profound impacts in major insurance markets.

"When faced with a credit crisis loss, think 'insurance.'"

Mortgage Insurance and D&O and E&O Liability Insurance Should Respond

Several types of insurance policies may provide coverage for claims and liabilities relating to failed investments in securities that are tied to subprime mortgages. Obviously, mortgage insurance and other devices intended to cover default risk have been and will be tapped. Investors in companies with subprime 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. E&O liability insurance will respond. In between, loan originators, underwriters, rating agencies, investment banks, promoters, syndicators, and other players

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A Note from the Editor

This issue of AKO's Policyholder Advisor newsletter is dedicated to the credit crisis. In the lead article, Bill Passannante, co-chair of AKO's insurance recovery group, stands in the eye of the financial industry storm and maps out both the manifold types of liability to which various financial institutions are vulnerable and the types of insurance that will respond to those liabilities. Next, I provide a brief anatomy of one of the strangest beasts in the risk management zoo: the credit default swap. The CDS is neither insurance fish nor investment fowl, but rather a problematic hybrid.

—Mark Garbowski

in the CDC (collateralized debt obligation) and CLO (collateralized loan obligation) universe face liability claims. Each of these parties has available insurance coverage which can respond.

Litigation Targets

The proliferation of home-mortgage defaults, particularly in the subprime market, has sent shock waves through the financial industry. 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. These claims may trigger coverage under D&O, E&O, and other insurance policies.

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.

Insurance Coverage

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.

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. It is likely that many of the claims will implicate coverage under E&O insurance policies as well as D&O insurance policies.

Steps To Take

When faced with a credit crisis loss, think "insurance." First, find and review your insurance policies. Second, provide prompt notice of claims to your insurance company. Third, consider enlisting the assistance of your broker or accountant in developing claim information. Fourth, aggressively pursue the coverage for which you paid, as well as OPI (other people's insurance) where available.

If your organization faces losses related to the subprime mortgage mess, maximize your 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. Although, the credit crisis may be a Black Hole, policyholders should not take "No" for an answer.

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Credit Default Swaps: A Brief Insurance Primer

By Mark Garbowski


Mark Garbowski

Credit Default Swaps ("CDS") are part of a $62 trillion market, that have gone from obscure to infamous in a matter of months, if not weeks. Yet along the way, many people were left without a clear understanding of what CDS are—particularly, in what ways CDS are like or unlike insurance. In brief, a CDS is like insurance insofar as the buyer collects when an underlying security defaults or loses value in some other way defined by the contract. It is unlike insurance, however, in that the buyer need not have an "insurable interest" in the underlying security.

Defined as Similar to Insurance

A CDS appears a lot like insurance on an investment, in particular a debt obligation. As one court explained,

> A credit default swap is an arrangement similar to an insurance contract. The buyer of protection . . . pays a periodic fee, like an insur-

ance premium, to the seller of protection . . ., in exchange for compensation in the event that the insured security experiences default.

Merrill Lynch International v. XL Capital Assurance, Inc., (S.D.N.Y.). The triggering event that causes the Seller to pay is usually called a "Credit Event"—usually, though not always, defined to involve a default on the underlying security. Upon the occurrence of a Credit Event, the Buyer and Seller settle up in one of two methods. Under both methods, the Seller will pay to the Buyer the face value of the underlying debt security. In return, under a "physical settlement," the Buyer will deliver the underlying debt security

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Anderson Kill Sponsors Advisen Surveys of Risk Manager and Broker Response to AIG Bailout

Surveys find brokers more confident than risk managers in financial security of AIG commercial insurance units.

Advisen Ltd., the leading provider of content, analytics and technology to the global commercial insurance industry, recently released a special report based on a survey of brokers following the AIG liquidity crisis and will shortly release results from a similar survey of risk manager reaction. Thanks to Anderson Kill's sponsorship, reports on both surveys will be available free of charge to the general public.

The broker survey report, released on October 7, found that most brokers of commercial insurance are confident in AIG after the federal loan and few are recommending clients switch from AIG. At the same time, 47% of brokers believe that AIG will have to sell some units.

While the risk manager survey found that more than two thirds intend to get quotes from AIG's competitors at policy renewal, the brokers report that few buyers have yet given their broker firm instructions to replace AIG. Survey results show that most brokers have communicated to policyholders that AIG's insurance subsidiaries are secure. As yet, however, brokers don't yet know how much diversification clients will seek, or whether this crisis will impact overall market pricing or brokerage income.

Advisen's 11-page report on the broker survey can be downloaded free of charge at https://www.advisen.com/downloads/BrokersSpeakOutonAIG.pdf. The risk manager survey can be found at https://www.advisen.com/downloads/RMSpeakOutonAIG.pdf.

For Anderson Kill's free online guide to maximizing insurance coverage in the wake of the financial crisis, including articles, white papers and steps to take when faced with a credit crisis loss, please visit our home page, http://www.andersonkill.com, and click on "Insurance Lifelines in the Credit Vortex: An Anderson Kill Guide to Maximizing Coverage."

"Credit Default Swaps" continued from p3

to the Seller, and under a "cash settlement," the Buyer will offset the Seller's face value payment by the actual market value of the underlying security, sometimes determined through an auction.

Despite the differences between a CDS and insurance outlined below, pursuing recovery under both can be quite similar. The language of the agreement is very important. Although standardized forms exist and are commonly used, very often much of the controlling language will be drafted specifically for each swap.

Yet Not Quite Insurance

Yet although courts and other reference sources almost invariably describe CDS as similar to insurance, there is a broad consensus that, on the whole, CDS are not the equivalent of insurance policies.

The two main reasons most often given to support the conclusion that CDS are not insurance products are that (1) the Buyer does not have to own the underlying security, or otherwise have any insurable interest in that security, and (2) the Buyer does not in fact have to suffer any loss in order to recover on the CDS. As noted, under some CDS terms, a "Credit Event" can take place that does not involve an actual default for the underlying security, and, of course, if the CDS Buyer does not own the underlying security, it will not suffer a loss even if there is a loss for actual bondholders. In addition, a Credit Event could cause the Buyer who does hold the underlying debt to recover an amount that is greater than, or less than, any actual loss it suffers. The Buyer's recovery is determined by the contract terms—the amount of any loss it suffers is irrelevant.

CDS also differ from insurance contracts with regard to tax, accounting, bankruptcy and in regulatory jurisdiction. To date, for example, CDS have not been subject to state insurance regulations—although this might soon change. New York State has begun issuing guidelines to regulate that portion of the CDS market where the Buyer *does* own the underlying asset, *does* therefore have an insurable interest, and *does* suffer a loss upon default. CDS that share these characteristics do not support the two main reasons that CDS are generally considered not to be insurance, and New York insurance regulators believe they will be able to assert their powers over this part of the market.

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