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Are You Set for Subprime?

The lawsuits are coming. Policyholders should look to financial lines coverage.

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The subprime mortgage crisis has contributed to the downward drift of securities exchanges and has been the cause of recent multibillion-dollar write-downs for some of the world's leading financial institutions.

Some lawsuits have already been filed seeking damages for losses allegedly caused by subprime mortgages; more will likely follow. These lawsuits may, in turn, give rise to insurance coverage disputes between financial institutions and their insurers.

Policyholders unprepared for such disputes may be surprised by the lengths to which insurers will sometimes go to "run for cover rather than coverage."

Main Street to Wall Street

The key link between Main Street mortgage woes and Wall Street financial troubles is the issuance of securities based on pools of mortgages. A bank or other lender that retained all of its loans could soon run out of capital to issue new loans. By selling its mortgages, the mortgage lender frees up its capital to make a new set of mortgage loans and usually realizes an immediate profit.

Resold mortgages are assembled into pools considered sufficient to support the issuance of marketable securities. Typically a special purpose vehicle, or SPV, purchases a suitable pool of home mortgages. The funds are obtained by issuing several tiers of privately placed debt securities (i.e., bonds) known as residential mortgage backed securities, or RMBSs, that are secured by the income from those mortgages.

Typically, the tier of bonds with first call on generated income has seniority that ensures a AAA rating from debt-rating agencies. Other slices of the income stream are allocated to successively more junior and hence riskier RMBSs. The least secure underlying assets and excess cash, if any, is committed to a final, highest-risk security.

RMBSs have been issued in the U.S. market for decades. A more recent development has been to securitize portfolios of RMBSs or other income-generating instruments by similarly issuing a tiered set of bonds with ratings from AAA to unrated. Such securities are called CDOs, for collateralized debt obligations.

Mortgage Defaults

Underwriters of RMBSs and CDOs allowed for the risk that some of the underlying assets would be subject to slow payments, default, or foreclosure. The current experience of some loan pools, however, is that the number of delinquent loans has grown to unforeseen levels—in some cases as high as 25 percent or more of the pool. A contributing factor appears to be that some RMBSs were underwritten with unusually high proportions of "exception" loans—i.e., mortgages issued to borrowers not satisfying usual credit standards.

With uncertainty about which pools hold the most troubled assets and what the true extent of those troubles will be, the value of all RMBSs and related CDOs has suffered tremendously. The validity of the credit ratings of these bonds is also in doubt. Liquidity in the RMBS and CDO markets is thus severely impaired and, when such securities are sold, deep discounts are often obtained.

Accordingly, when banks and other significant holders

of unsold RMBSs and CDOs account for their securities on a "mark-to-market" basis, they may have vast paper losses, even on nondefaulting AAA-rated bonds. Other investors who sell their holdings must realize substantial actual losses.

Potential Litigation

Because RMBSs and CDOs permeated the financial sector, many lawsuits have already been filed relating to the subprime crisis, and there is the potential for lots of additional litigation.

The biggest headlines have been from multibillion-dollar losses at a number of the world's largest investment banks. Some of those banks already face shareholder class actions alleging securities fraud. Such lawsuits may also be filed against other companies, within and outside the financial services sector. Direct purchasers of RMBSs and CDOs might claim securities fraud against underwriters and issuers.

Claims of breach of fiduciary duty might be lodged against investment managers such as hedge funds, pension funds, and mutual funds that purchased RMBSs and CDOs. Government regulators may also make claims; several investigations by state attorneys general and the Securities and Exchange Commission are apparently already under way.

Three Financial Lines

With a high degree of exposure to subprime litigation, insurers are likely to resist providing coverage for such claims. Three "financial lines" of coverage will be most relevant: D&O (directors and officers coverage), E&O (errors and omissions, also known as professional liability or malpractice insurance) and fiduciary coverage.

D&O coverage is meant to address the risk of loss from third-party claims (typically securities litigation). It covers directors and officers for claims asserted against them in those capacities; it may also cover the corporate entity, both for its indemnification of directors and officers and for certain direct liability.

E&O coverage is intended to protect from the consequences of negligence of an entity's professionals, such as bankers, investment advisers, and underwriters. Fiduciary coverage is intended to cover the risk of breach of ERISA-imposed duties or similar duties by fiduciaries of pension and other employee benefit plans, such as choosing imprudent investments or poor advisers.

Although some claims may be adjusted without significant coverage disputes, policyholders should anticipate that some insurers will attempt to deny coverage.

Among the many defenses to coverage that insurers can be expected to consider will be allegations that the policy should be rescinded because there were material misrepresentations or omissions in Securities and Exchange Commission filings attached to or incorporated in the policyholder's insurance application; that there is no coverage by reason of exclusions for deliberate criminal or fraudulent acts; or that some or all of the liability is not damages or loss within the policy meaning or is otherwise uninsurable as a matter of public policy.

Rescission

For publicly reporting companies, applications for financial lines coverage typically include the applicant's SEC filings. A growing trend is for insurers to assert that they are entitled to rescind their policies if such filings were materially inaccurate or incomplete.

Such arguments are inherently inconsistent with a primary purpose of financial lines insurance, to protect corporations against the risk of claims alleging their financial statements are inaccurate. Perhaps in tacit acknowledgement of this point, until relatively recently, insurers rarely asserted such arguments.

At least one New York state court in 2006 rejected insurer rescission claims on the basis that it is inherently unreasonable for an insurer to rely on the accuracy of financial statements in deciding whether to issue an insurance policy to protect against the risk that claims will later be made challenging the accuracy of such statements. Other courts have allowed insurers to rescind policies on such a basis, however.

To reduce the risk that insurers will advance rescission arguments, many policies now include language that limits the ability of the insurer to rescind coverage for individual insureds. Some policies protect individual insureds who were unaware of improper disclosure in SEC filings; others protect all individual insureds. There are also instances in which policies protect the coverage of the corporation itself against rescission. This issue is so central to the value of D&O coverage that policyholders should seek such protective language.

Deliberate Crime or Fraud

Insurers often reserve the right to deny coverage for securities claims based on exclusions for deliberate crime or fraud.

Critically important is whether the policy language requires that there has "in fact" been such conduct or that there has been a "final adjudication" of such conduct. The former language is intended to make clear that coverage cannot be denied merely on the basis that the underlying claim includes allegations of deliberate crime or fraud. The latter language has been interpreted by the courts to mean that the exclusion does not apply unless there has been an adjudication in the underlying claim (not the coverage litigation) that such conduct occurred. Moreover, most D&O policies contain severability clauses so that the exclusion will be applied separately and the wrongdoing of one individual will not defeat coverage for another.

Insurable Damages or Loss

Insurers have recently begun to argue that certain types of settlement payments or judgments are not covered by their policies because they allegedly do not fall within the definition of "damages" or "loss" or are uninsurable as a matter of

public policy. These are attempts by insurers to avoid coverage based on alleged restrictions that are not in the express language of their policies.

For example, insurers often argue that any settlement payment or judgment that they can characterize as "disgorgement" or "restitution" does not fall within the definition of damages or loss or should be uninsurable as a matter of policy. Some insurers argue that all damages under Section 11 of the Securities Act of 1933 are uninsurable for these reasons.

A few courts have accepted insurer efforts to defeat coverage on this basis, ignoring the vast body of case law that holds that, wherever reasonably possible, coverage grants should be construed broadly in favor of coverage, and coverage restrictions should be construed narrowly. Fortunately for policyholders, the most recent decision rejected the insurers' arguments. In *Bank of America Corp. v. SR International Business Insurance Co.* (2007), a North Carolina court concluded that settlement payments in response to Section 11 claims were indeed covered under the policy.

This is only one battle, however. In the gathering war over subprime coverage, many more are sure to follow.

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