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Will Insurers Be On the Hook for Losses Arising From Subprime Related Securities Litigation?

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The subprime mortgage meltdown has led to a wave of litigation involving not just lenders and financial institutions, but also diverse companies holding mortgage-related investments. This litigation has taken various forms, including class actions brought by borrowers against lenders, suits by financial institutions against lenders and regulatory actions.

One of the largest and potentially costliest categories of litigation to arise from the subprime meltdown is that of securities class actions brought by investors against lenders, investment banks, hedge funds and others with subprime holdings.

To date, more than 40 securities cases have been filed.[1] More are to be expected as companies continue to announce write-downs in the value of their mortgage-related assets, causing corresponding drops in their share prices. The amount at stake in these cases likely will far exceed the claims related to stock-option backdating, the corporate restatement scandals of 2000 and 2001, or the savings-and-loan meltdown of the late 1980s and early 1990s.

The availability of insurance coverage for these claims will be an important and likely contested issue as these cases go forward and settlements are negotiated. While some of the largest potential defendants carry large self-insured retentions, most defendants will be looking to their carriers for defense costs, settlements and judgments. Given their complexity and the amounts at stake, these cases will be expensive to defend and likely will not be resolved cheaply. Estimates of the amount insurers will end up paying on these and related claims vary, with low estimates of $3 billion to as high as 9 billion.[2]

With so much money at stake, one can expect that coverage issues will be the subject of a great deal of attention. This article examines what coverage issues are most likely to arise in these securities cases and how those issues compare to those addressed in the context of prior securities litigation waves, including the recent options backdating cases. It concludes that, while there will be defenses raised against coverage, insurers are likely to be on the hook for much of the damages sought in subprime-related securities cases, and many of the coverage defenses available in the backdating cases are likely to be less problematic for insureds in this new litigation wave.

Insurance Coverage Issues

Securities claims brought against either corporate defendants or individual officers and directors relating to subprime losses generally should fall within the scope of the defendants' directors-and-officers or errors-and-omissions policies.

D&O policies cover directors and officers of a company for liability arising from their alleged wrongful acts committed in carrying out their corporate responsibilities and cover the company for defending and indemnifying the directors and officers against such liability. Many D&O policies also include "entity" coverage that protects the company itself.

E&O policies generally cover a company for liability arising from conduct in connection with the rendering of professional services.

While the losses related to these claims (as is true of most securities claims) generally will fall within the scope of the

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D&O or E&O policies, that does not necessarily mean that insurers will step up to pay all such losses. Insurers can be expected to raise a variety of defenses and obstacles to coverage, including the application of certain policy exclusions. Many of these issues likely will be the same as the ones that have arisen in connection with prior types of securities litigation, including the options backdating lawsuits. One can expect that several issues that have been prominent in the backdating cases will again be raised by insurers. Their resolution, however, may be different in this context. Three such issues are discussed below.

'Bad Acts' and 'Personal Profit' Exclusions

D&O and E&O policies typically exclude from coverage liability based on fraud, criminal acts or intentional misconduct by the insureds. This exclusion was frequently invoked in backdating cases.

In many of the backdating cases, responsibility for the corporation's challenged policies and practices often was assigned to one or more officers or directors. Plaintiffs asserted that those individuals had acted fraudulently or had illegally obtained a personal profit as a result of the backdating practices. While most policies specify that the exclusion is triggered only if the insured "in fact" or was "finally adjudicated" to have committed the improper conduct, if the allegations of wrongful conduct are sufficiently egregious, insurers are likely to resist resolving these claims without attempting to extract at least some contribution from the insureds.

In cases involving subprime losses the issue of culpability is likely to be more complex. While some cases may involve insider trading, obvious misrepresentations or similar conduct, many more are likely to involve disputed evidence about what the corporate defendant knew or should have known about the risks and value of the mortgage-related investments. Given the speed with which the subprime mortgage situation deteriorated, defendants may credibly be able to disclaim any actual fraud in connection with their representations, thereby preserving coverage.

Rescission

In connection with a number of backdating cases, insurers asserted that they had the right to rescind their policies based on misrepresentations made in the insurance applications. In two well-known cases outside the backdating context, courts upheld the rescission even when the directors and officers seeking the coverage had not themselves signed the insurance application and were unaware of the false statements. *See*, *e.g.*, *TIG Ins. Co. v. Homestore Inc.*, 137 Cal. App. 4th 749 (Cal. Ct. App. 2006); *Cutter & Buck v. Genesis Ins. Co.*, 2005 WL 1799397, at **1 (9th Cir. 2005) (holding that material misrepresentations known to the director or officer who signed the application were imputed to innocent directors and officers).

Even when insurers did not actually rescind the policies, they were able to use the threat of rescission to obtain a reduction in the amount of payments to their insureds.

In recent years, however, the severability provisions of most D&O policies have been modified in favor of coverage. Under most current provisions, the knowledge of others within the organization is not imputed to the individual insured defendants, and often only certain individuals' knowledge is imputed to the company.

Thus, while insurers may argue in the subprime cases that statements (such as representations in financial statements concerning the value of the insured's mortgage-related assets) were material misrepresentations justifying rescission, if the policy contains one of the newer, more favorable provisions insurers may be less able to obtain rescission where the particular executives seeking coverage were not aware of the alleged misstatements.

Insured vs. Insured Exclusion

Most D&O and E&O policies contain an exclusion for claims brought by one insured (*e.g.*, the company) versus another insured (*e.g.*, an officer or director). Because companies involved in backdating cases often pointed to particular officers as the ones responsible for the backdating decisions, the individual insureds sometimes found themselves adverse to the company, thereby potentially triggering the insured vs. insured exclusion.

Although most of the subprime securities cases that have been filed name individual officers and directors as defendants, there is not yet evidence that the companies and individuals are likely to become adverse in these cases.

To the extent, however, that the subprime litigation is pursued through a derivative action, there is a risk that the exclusion could be triggered. While the exclusion has an exception for derivative claims, it only applies if the derivative action is maintained by a security holder who is not also a director or officer of the company and the action is maintained without the assistance or participation of the company or any individual insureds.

Thus, a company's decision to take over the derivative action against the director or officer could result in a loss

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of coverage. To date, however, this scenario appears less likely in subprime litigation than in backdating litigation, as the nature of the scandal does not appear to pit the company or special litigation committee against a few targeted scapegoats.

Conclusion

Defendants in subprime securities litigation should be prepared to face opposition from insurers who are trying to minimize their own losses from the subprime meltdown. While certain of the arguments insurers use to gain leverage in restatement or backdating cases will be issues in the subprime cases, defendants should find themselves with solid responses that will favor coverage. Because the issues are likely to be complex, however, defendants facing significant potential liability would be well advised to consult with coverage counsel.

Notes

[1] Kevin LaCroix, "Counting the Subprime Lender Lawsuits," *The D&O Diary*, http://www.dandodiary.com (updated Feb. 14, 2008).

[2] David Bradford, "The Crisis in the Subprime Mortgage Market and Its Impact on D&O and E&O Insurers" (Feb. 11, 2008) (Advisen); Susanne Sclafance and Mark Ruquet, "D&O/E&O Subprime Impact on the Rise," Nat'l Underwriter, www.propertyandcasualtyinsurancenews.com.

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