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Maximizing Coverage

Steps a company can take to ensure its insurance carrier covers subprime litigation losses

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THE SUBPRIME MORTGAGE CRISIS and related financial meltdown has led to a wave of litigation involving not just lenders and financial institutions but also diverse companies holding mortgage-related investments. Among the types of actions being brought are: (1) securities claims against lenders and holders of mortgage-backed securities; (2) derivative actions; (3) negligence claims against professionals, such as accountants and law firms; and (4) individual and class actions alleging predatory lending and other improper practices. Of course, given the broader economic troubles, there also has been an increase in

EXECUTIVE SUMMARY

The wave of litigation from the subprime mortgage meltdown is striking not just lenders and financial institutions but also professional service firms and diverse companies holding mortgage-related investments. Defendants in such litigation should be prepared to face opposition from insurers, who will likely assert a variety of coverage defenses and exclusions. Companies can take measures, however, to maximize their chances of recovering some or all of their defense costs and potential losses from insurance carriers.

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the number of litigation matters being pursued in bankruptcy courts.

The availability of insurance coverage for these claims will be an important—and likely highly contested—issue as these cases go forward and settlements are negotiated. Although some of the largest potential defendants carry large self-insured retentions, most defendants will be looking to their carriers to provide money for defense costs, settlements, and judgments. Given their complexity and the amounts at stake, such cases will be expensive to defend and will likely not be resolved cheaply. Estimates of the amount that insurers will end up paying on these and related claims vary, from $3 billion to as high as $9.6 billion.

With so much money at stake, one can expect coverage issues to garner a great deal of attention. This article examines which coverage issues are most likely to arise in these cases, with a particular focus on the largest category of cases—securities actions on behalf of investors. It also examines how those issues compare with those addressed in prior litigation waves, including the savings and loan scandal of the 1980s and the more recent options-backdating scandals. Though defenses will be raised against coverage, insurers are likely to be on the hook for much of the damages sought in these cases.

STEPS FOR INCREASING CHANCES OF RECOVERY

- Provide prompt notice of claims—formal or informal—to potentially relevant carriers.
- Determine the implications of a bankruptcy by your company on the availability of insurance coverage.
- Anticipate coverage defenses based on bad acts, prior litigation, and insured-versus-insured exclusions.
- Prepare for potential rescission arguments by reviewing your company's insurance application and its disclosures.
- Consider retaining experienced coverage counsel.

Insurance-Coverage Issues

Many of the claims brought against professional services firms, corporate defendants, or individual officers and directors relating to subprime losses generally should fall within the scope of the defendants' directors and officers (D&O) or errors and omissions (E&O) policies. D&O policies cover directors and officers of a company for liability arising out of any alleged wrongful acts they commit in carrying out their corporate responsibilities. The policies also cover the company for defending and indemnifying the directors and officers against such liability. In addition, many D&O policies include "entity" coverage that protects the company itself. E&O policies generally cover a company for liability arising out of conduct in connection with the rendering of professional services.

Though losses related to subprime claims generally fall within the scope of the 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 will likely be the same as the ones that have occurred in connection with prior types of securities litigation, including the options-backdating lawsuits and suits arising out of the savings and loan crisis. 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 options-backdating cases. In many of the backdating cases, responsibility for a corporation's challenged policies and practices was often assigned to one or more officers or directors. Plaintiffs asserted that those individuals had acted fraudulently and/or had obtained a personal illegal profit as a result of the backdating practices.

Most policies specify that the exclusion is only triggered if the insured "in fact" committed the improper conduct or was "finally adjudicated" to have committed the improper conduct. Nonetheless, if the allegations of wrongful conduct are sufficiently egregious, insurers are likely to use the allegations as a justification to extract at least a contribution from the insureds to any settlement.

In cases involving subprime losses, the issue of culpability is likely to be complex. Although some cases may involve insider trading, obvious misrepresentations, or similar misconduct, 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 be able to credibly disclaim any actual fraud in connection with their representations, thereby preserving coverage.

Defendants may get some help in this respect from the courts. To date, several courts have indicated that plaintiffs—in order to plead scienter and survive a motion to dismiss—must allege more than vague statements or engaging in aggressive business practices preceding the financial meltdown. It may therefore be more difficult for insurers to disclaim

coverage on the grounds of intentional misconduct, at least in securities cases.

Rescission Rights

In connection with a number of options-backdating cases, insurers asserted that they had the right to rescind their policies based on misrepresentations made in the policyholders' insurance applications. In two well-known cases (outside of the backdating context), courts had upheld a rescission even when the directors and officers seeking the coverage had not themselves signed the insurance application and were unaware of the false statements. And 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, though 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, insurers may be less able to obtain rescission if the particular officers and directors seeking coverage were not aware of the alleged misstatements if the policy contains one of the newer, more favorable provisions.

Insured-Versus-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–versus-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 parties in these cases. However, the insured exclusion could be triggered by subprime litigation pursued through a derivative action. Though the exclusion has an exception for derivative claims, the exception applies only if the derivative action is maintained by a shareholder who is not also a director or officer of the company, and also if 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 of coverage. To date, this scenario appears less likely in subprime litigation than in backdating litigation, as the nature of the activity does not appear to pit the company or special litigation committee against a few targeted scapegoats.

Another way this exclusion may arise is in cases brought by receivers—such as the FDIC, liquidators, or bankruptcy trustees—against an insolvent institution's officers and directors. Courts have split on the issue of whether these parties should be viewed as essentially the same, thereby triggering the insured-versus-insured exclusion. Insurance companies can be expected to raise this exclusion in actions involving bankrupt entities, much as they did during the prior S&L crisis.

Maximizing the Potential for Coverage

Corporations or individuals should provide notice of any claim to their insurers as soon as possible, and they should provide such notice under any and all policies that could potentially apply to the claim. If the defendant entity is in bankruptcy, it should analyze whether any policies remain available to the individual officers and directors or constitute an asset of the estate.

The insured should adopt an aggressive strategy to respond to the common coverage defenses set forth above, and it should strive to defend the case, to the extent possible, in a way that does not undercut its coverage position. Because the issues are likely to be complex and coverage likely to be contested, companies would be wise to consult with coverage counsel as soon as they become aware of a regulatory investigation or receive notice (formal or informal) of a claim that appears to pose a legitimate threat of significant liability. ■

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