Coverage for Subprime Lawsuits

by Robert M. Horkovich

The subprime mortgage collapse and the resulting bank failures and market loss is clearly the most important risk event of 2008. Lawsuits have already begun against virtually anyone involved in the securitization of mortgages. Many of those lawsuits may be covered under standard insurance policies already purchased prior to the financial crisis that may cover costs of defending the lawsuits and costs of settlements or judgments in the lawsuits. Depending on the case, coverage may be found in directors and officers (D&O) insurance, professional liability (E&O) insurance, fiduciary liability insurance or financial institution bonds.

D&O coverage has improved since the savings and loan (S&L) crisis of the 1980s. In contrast to many 1980s-era D&O policies that excluded specific types of securities violations, many newer policies specifically provide coverage for securities claims because protection from allegations of securities violations was precisely the type of "wrongful act" for which coverage was sought.

The insurance companies asserted several defenses based on exclusions during the S&L crisis and can be expected to do so again. First, they likely will assert an "insured v. insured exclusion," which typically excludes indemnification of claims against directors and officers alleged by other directors and officers or corporate policyholders under the very same D&O policy. Policy wording varies. Some "insured v. insured exclusions" except shareholder derivative actions, wrongful termination claims, and claims for contribution or indemnity brought by an insured against another insured. Courts interpreting the exclusion frequently have looked its purpose, to prevent collusion between named insureds.

Insurance companies also relied on the "bad acts" exclusion as a defense when faced with claims arising out of the S&L crisis lawsuits. This exclusion typically excludes coverage for fraud, criminal acts or intentional misconduct. Courts generally have ruled that the insurance company cannot rely on the "bad acts" exclusion until the underlying claim is adjudicated in a court of law. Until then, the director or officer is entitled to the advancement of defense costs incurred in defending against the underlying lawsuit.

By contrast, D&O policies typically expressly cover "wrongful acts," which include: "any breach of duty, neglect, error or misstatement, misleading statement, omission or act by directors or officers in their capacity as such." Courts generally have held that intentional acts leading to unintended consequences are covered.

During the S&L crisis, insurers also relied on a "regulatory exclusion" excluding claims arising from actions brought by regulatory agencies. Since then, D&O and E&O policies have been changed to expressly cover governmental investigations.

D&O insurance covers directors and officers as well as the corporate policyholder (where entity coverage has been purchased) and E&O insurance covers the corporate policyholder and its directors, officers, employees and affiliates (possibly including securities brokers and dealers working for financial institutions and investment banks) for errors and omissions.

Fiduciary liability insurance and financial institution bonds fill voids left by D&O and E&O coverage. They cover policyholders with losses in employee retirement or similar funds and for employee fraud and dishonesty as well as forgery, false pretenses and other offenses. Fiduciary liability insurance especially applies when a financial institution serves as a trustee of a pension fund. Financial institution bonds typically provide coverage if there are dishonest acts by a policyholder's managers or employees accompanied by financial gain beyond commissions or salary. A recent form of financial institution bond provides coverage to financial institutions undertaking transactions to extend credit to subprime investors, issue subprime securities or act with respect to a subprime mortgage where the transactional document is signed under false pretenses or because of fraud or duress.

Responsible policyholders should gather and review all insurance policies that could potentially provide coverage for lawsuits arising out of subprime mortgage losses. If potential coverage exists, provide notice to the insurance companies immediately after a lawsuit surfaces—many insurance policies state that notice has to be provided "as soon as practicable." Do not jeopardize your coverage by hesitation or delay and do not take "no" for an answer from your insurance company. ■