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Insurance Coverage and the Subprime Crisis: A Broad Overview

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HOW DID WE GET HERE?

- In 2005, subprime loans accounted for 20% of all mortgage loans, up from 5% only a decade ago.
- Between 2003 and 2007, the raw total of subprime debt outstanding increased almost three-fold from $332 billion to almost $1.3 trillion…

HOW DID WE GET HERE?

- Housing market cooled off for several reasons. Also, when interest rates climbed and homeowners could not re-finance or sell, foreclosure rates jumped
  - The foreclosure rate increased by 90% from 2006 to 2007
  - In the third quarter of 2007, it was higher than it had been since 1972…

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HOW DID WE GET HERE?

- The damage caused by the subprime meltdown has been compounded because many subprime mortgages (about 63% in 2006) are securitized
- Estimates as of late 2007 projected that investors around the world would lose $300-400 billion

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The Litigation Begins: Borrower Lawsuits

- As of early 2008, approximately 140-170 lawsuits and investigations had been commenced by or on behalf of subprime borrowers
- The most numerous of subprime-related litigations
  - Borrowers have sued mortgage lenders and other participants in the real estate closing process like title insurers
  - Some have settled – in June 2007, the mortgage lender Novastar paid $5 million to settle a borrower class action alleging that it violated Washington State Consumer Protection Laws when it failed to disclose to prospective borrowers that it paid “yield spread premiums.”

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Borrowers Class Actions Allege:

- Predatory lending practices
- Misleading loan documents
- Misleading representations by mortgage brokers
- Fabrications of credit information
- Collection of illegal or otherwise improper interest
- Overcharges for settlement services

Claims for Relief

- Under many State and Federal consumer protection statutes, claims for relief are:
  - The Truth in Lending Act
  - Real Estate Settlement Procedures Act
  - RICO
  - Fair Housing and Equal Credit Opportunity Acts
    - In those suits alleging that low income African-American and Hispanic customers were particular targets of risky or inappropriate loans

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State Attorney General Actions Brought By:

- Ohio against ten mortgage lenders (pressuring real estate appraisers to inflate house values)
- New York against First American Title regarding inflated housing appraisal values
- Massachusetts against Fremont General (excessive fees)
- District of Columbia against New Century (Equity stripping)

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Lawsuits

- Baltimore has sued lenders:
  - Alleging violation of the Fair Housing Act by lenders targeting minority residents for inappropriate loans
- Cleveland has sued lenders:
  - Alleging that negligent lending practices in general led to the abandonment of houses across the city due to foreclosure, resulting in urban blight
- Borrowers have sued Lehman Brothers and Merrill Lynch
  - Alleging that they aided and abetted allegedly predatory behavior by subprime lenders through their participation in the mortgage securitization process

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Investor Lawsuits

- Investors have initiated approximately 15 lawsuits
- The most popular target has been financial institutions from whom many investors purchased subprime mortgage-backed securities (MBS)

- Bankers Life v. Credit Suisse First Boston (M.D. Fla)
  - Bankers alleges that it was induced to purchase MBS by defendants' representations that they were safe, low-risk, fixed income products
  - Lack of due diligence
  - Negligent Misrepresentations, common law fraud, breach of the duty of care, violations of Federal and State Securities Disclosures Laws and civil conspiracy

Investor Lawsuits

- Triad Guarantee Insurance also sued – the insurer that provided "credit enhancement" coverage for the Securities and Bank of New York, the trustee for the underling mortgage loans
  - Policyholders were not the investors, but the trustee and lender, who are alleged to have failed to take all necessary steps to preserve coverage when Triad began to deny claims on the basis that many of the underlying loans had been fraudulently procured
  - This jeopardized one of the main sources of investor protection
- State Street Bank Suits

Credit Rating Agencies

- Being investigated by the SEC and Attorney General of Ohio and New York
- Allegations that they fueled the growth of market for subprime mortgage-backed securities by understating the risk posed and maintaining inappropriately high ratings
- There are several individual actions now pending against some of the credit rating agencies

Shareholder Lawsuits

- There are currently approximately 100 shareholder suits against:
  - Mortgage lenders, financial institutions that served as underwriters, providers of credit enhancement insurance, companies that invested in subprime MBS, credit rating agencies
  - Most of these suits include one or more officers or directors

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Shareholder Lawsuits

- Suit against Countrywide and its CEO and CFO
- Suit against UBS and its three top executives
- Class Action against CFO of Moody's alleging that the CFO "misrepresented or failed to disclose that the company assigned excessively high ratings to bonds backed by risky subprime mortgages…."

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- Parties such as Deloitte and Touche
  - Action was connected to a secondary offering of 4 million shares by American Home Mortgage, which was completed April 4, 2007, less than 4 months before American Home went bankrupt
  - Alleged that Deloitte certified certain public reports and statements used in the offering that were materially inaccurate

ERISA Beneficiary Lawsuits

- At least 30-40 suits targeting trustees or company-sponsored retirement plans (usually either company executives or third-party financial institutions)
  - Alleged that plan trustees invested recklessly in subprime mortgage-backed securities, thereby failing to manage plan assets prudently in compliance with their fiduciary duties under ERISA

Buyback Lawsuits

- Actions initiated by underwriters and investors against lenders who refused to buy back defaulted loans, allegedly in violation of their contractual representations and warranties as to the loans

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Applicable Insurance Coverage

- Directors and Officers Liability
- Errors and Omissions Liability
- Fiduciary Liability
- Credit Risk Coverage

D&O and E&O Coverage

- Wrongful Acts coverage for individuals committed in their capacity as directors and officers or the entity under certain circumstances (securities claims)
  - Side A
  - Side B or reimbursement coverage
  - Side C or entity coverage
- Claims made coverage
- Advancement of defense costs

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E&O Coverage:

- Professional liability coverage affording coverage for losses arising out of alleged wrongful acts committed in the course of providing “professional services”
  - Lawyers, mortgage lenders, bankers, auditors and business entities for which such individuals work
- Virtually every lawsuit and investigation mentioned above alleges some kind of “wrongful act” by directors, officers, professionals or the defendant entities themselves
- Acts such as negligent or reckless misrepresentations about companies’ subprime activities or failures to perform adequate due diligence

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Fiduciary Liability

- Coverage for ERISA plan trustees in connection with acts, errors or omissions in the context of trust or plans
  - Wrongful Act means: "With respect to any **trust** or **plan**, any breach of the responsibilities, obligations or duties imposed upon fiduciaries of the trust or plan by the [ERISA] of 1974…or any negligent act, error or omission in the **administration** of any **trust or plan"**

Credit Risk Coverage

- Sometimes referred to as accounts receivable coverage
  - Usually covers losses due to default by a borrower on a loan or mortgage insurance
  - Many borrowers are required to purchase private mortgage insurance or PMI, a type of credit risk coverage that protects the lender in the event that an individual borrower defaults

Credit Risk Coverage

- Bond insurance – in the paper a lot lately
  - Traditionally used to increase the credit rating of municipal bonds by guaranteeing against default by issuer and making the cost of credit cheaper
  - In the past 10 years or so, bond insurers began to market their product to lenders and underwriters as a credit enhancement for mortgage-backed securities

Potential Defenses to Coverage

- Dishonesty and Fraud Exclusion
  - "In fact"
  - "Final adjudication" – doesn't help carriers on settlements
  - Bernie Ebbers, who was convicted of conspiracy, continued to receive D&O insurance coverage until the day he was found guilty – that's the way this is supposed to work

Potential Defenses to Coverage

- Prior Acts or Prior Knowledge Exclusion
- Insured v. Insured Exclusion
  - Review exceptions – especially for non-collusive derivative claims

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Rescission: The Nuclear Defense

- Sometimes asserted; rarely successful
- Carriers claim that they are asserting less often
- Risk managers not happy – not good business; Only in egregious circumstances
- Broad severability clauses and relationship to rescission defense – carriers say unrelated; but policy must be read as a whole

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Rescission: The Nuclear Defense

- Bottom line – purpose of severability clause is to prevent total loss of coverage if one director knew of misstatements on application – must operate to prevent rescission
- Cutter & Buck (W.D. Wash. 2004); affirmed 9th Cir. (2005)

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Rescission:
The Nuclear Defense

- ClearOne Communications v. National Union – D. Utah (2005) 10th Cir. (2007) affirmed in part, remanded on basis that fact issues existed as to whether certifying officer knew or should have known of inaccuracies in application (the CEO)
- In re Healthsouth – (N.D. Ala. 2004) benefits of broad severability clause

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Other Coverage Issues

- Notice
  - Notice of Claim
  - Notice of Circumstances
- Is it a “claim”?
  - Came up in late trading/market timing context; here again
  - Is a threatening letter a claim?
    - If so, what is effect of failure to report?

Other Coverage Issues

- Is there a “loss”?
  - Disgorgement
  - Restitution
  - Return of Ill-gotten gain
  - Bank of America v. SR International (2007 NCBC Lexis 36; N.C. Super. Ct. December 19, 2007)
    - Identifies limitations on Level 3 (7th Circuit)
- Enron – priority of payments clause

Consideration of Duty to Defend

- Independent of potential application of exclusions
  - No defense coverage if carrier demonstrates no conceivable basis for coverage (Sun-Times Media Group v. Royal Sunalliance Ins. Co. of Canada, Et al., (Del. Super. Ct. June 20, 2007)
- Any potentially covered claims justify defense of entire action
- Exclusions based on facts developed in underlying action; relate to indemnification

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Consideration of Duty to Defend

- Cannot assume existence of adverse facts to support application of exclusions to bar defense coverage
- Defense coverage is huge in these matters
- Does policy include duty to defend (E&O) or duty to reimburse defense costs (D&O)
  - Many courts hold that duty to reimburse is same as duty to defend
- Attempted “allocation” of covered v. uncovered entities or issues – impact upon handling of claim
- Litigation management guidelines – new effort to control costs

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Risk of Default of Bond Insurers

- What would that mean?
- Credit enhancement has become a liability
  - Investors counting on availability of bond insurance for mortgage-backed securities are left empty-handed
- Suits against ACA Capital, Security Capital Assurance, Radian Group
  - Allegations that companies materially concealed their involvement in the subprime market

Risk of Default of Bond Insurers

- Credit rating agencies considering further downgrades of ratings
  - MGIC, Ambac, Triad Group already downgraded
  - When Ambac was downgraded, its stock fell 52% in one day
  - Moody's intends to review ratings of Ambac and MBIA

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Conclusion

- What the Future Holds…

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THANK YOU FOR YOUR ATTENTION

PLEASE CONTACT US WITH ANY QUESTIONS

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Hot Topics in Insurance Law:
A Seminar on Recent Developments and the Market Response

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