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Subprime Primer: Where's the Primary Exposure?

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Subprime Primer: Where's the Primary Exposure?

This paper is intended to give an overview of some of the insurance issues related to the “subprime mortgage crisis” by briefly exploring three areas:

- Cause and scope of the crisis;
- Litigation perspective: potential plaintiffs, defendants, and theories of liability; and
- Potentially applicable insurance policies, coverage issues, and coverage defenses.

I. Cause and Scope of The Crisis

Most everyone now knows that subprime mortgages are loans made to high or higher risk borrowers for which a premium is paid – either a higher and/or variable interest rate that enables the lender to justify the risk. Typically the profile of a subprime loan involves borrowers with credit scores below a certain level (usually in the low to mid-600s), a debt to income ratio that exceeds 40 percent, and a loan in excess of 80 percent of the purchase price of the property, although allegations have surfaced of lenders forcing or luring even more credit-worthy borrowers to the subprime market. Interest rates on these loans are generally more than 2% higher than those for a conventional mortgage, and the default rate is estimated to be approximately five times as high. The vast majority (90% or so by most estimates) of these loans carry hybrid adjustable interest rates. During the housing market boom, which was fueled by low interest rates and rising real estate prices, borrowers could easily refinance these loans when the adjustable rates threatened to tick up. Other borrowers relied on the relatively low interest rates and rising real estate prices to leverage houses they already owned; many of the subprime loans were refinancing with cash-out or home equity loans and lines of credit. By 2007, subprime mortgages were estimated to constitute between 14 and 20% of all U.S. mortgages.

As the real estate bubble continued to expand, lenders became even more aggressive in courting high-risk borrowers. The increased use of “Alt-A” or (“alternative documentation” loans), in which traditional proof of income was not required and loans were extended primarily on the basis of credit score, represents the zenith (or nadir, depending on your viewpoint) of these aggressive lending practices. In fact, these loans are called “NINJA” loans – a loose acronym for “no income, no job, no assets.”

Once the real estate bubble burst, the inevitable fallout from these lending practices was compounded by the fact that many of the loans were non-recourse, i.e., the borrower is not responsible for anything more than return of the property in the even of default. The housing market drop also meant increased delinquencies in “prime” mortgages; traditional borrowers without sufficient equity in the home to pay off their mortgage became more likely to walk away from the property in the event of relocation or job loss. Thus, the term “subprime crisis,” while common parlance, no longer accurately reflects the scope of even the mortgage-related portion of the current financial meltdown.

While no clear consensus has emerged among economists and analysts as to the root cause of the so-called subprime crisis, many seem to agree that the tide of defaults on mortgages alone probably would not have become a crisis but for the chain of investment in which these mortgages are packaged and resold or “securitized.” Securitization refers to the process of pooling loans and then issuing bonds based on the loans which are sold to individual and institutional investors. Some of these securitized investments included only mortgage loans and are generally called “mortgage-backed securities.” However, the investment banks and other financial institutions that were responsible for creating these investment securities did not necessarily limit themselves to mortgages; mortgages could be combined with other types of asset-backed securities and transformed into “collateralized debt obligations” for sale to investors as well. On top of this, various types of “derivative” investments – intended to either insure against default of the underlying debt or create a secondary layer of investments – resulted in unregulated investments that were no longer tied to the collateral in a significant way. In addition to the original lenders and the financial institutions that underwrote and placed the securities, other actors were involved in the securitization process: credit rating agencies would rate the bonds, loan servicers would collect payment from the borrowers, and credit risk insurers would provide credit enhancement coverage to increase the ratings of the bonds.

Unlike some of the most recent financial accounting scandals (think Enron and WorldCom), the subprime crisis may actually have less to do with calculated fraud or conspiracy than with widespread, unrealistic expectations regarding the housing market and a lack of diligence on the part of the actors. Of course, the uncertainty of “who knew what and how much when” raises a wealth of litigation and insurance coverage issues.

II. Litigation Perspective

In terms of litigation, almost everyone in the chain of securitization is a potential plaintiff and defendant as each actor attempts to shift at least part of the responsibility to someone else in the chain. While much of the litigation has just begun or is in intermediate stages, a review of recent opinions and orders gives a sense of the breadth of the litigation:

- Borrower class action suits against mortgage lenders for fraud and against secondary investment banks for conspiracy to commit fraud. *E.g.*, *In re First Alliance Mortg. Co.*, 471 F.3d 977 (9th Cir. 2006); *Parker v. Long Beach Mortgage Co.*, 534 F.Supp.2d 528 (E.D. Pa. 2008). This is the largest category of subprime-related suits. In a suit that settled in 2007, *Pierce v. NovaStar Mtg.*, 238 F.R.D. 624 (W.D. Wash. 2006), borrowers sued the financial institution for “predatory” lending practices and for selling them mortgage products that did not meet their needs, alleging that brokers and lending officers received improper financial incentive for steering customers to loans with higher fees and interest rates. One court has defined a predatory lending practice as “the practice of making loans containing interest rates, fees or closing costs that are higher than they should be in light of the borrower’s credit and net income, or containing other

exploitative terms that the borrower does not comprehend.” *In re First Alliance Mortg. Co.*, 471 F.3d 977, 984 (9th Cir. 2006). Many of these suits assert causes of action under state consumer protection statutes and federal statutes such as the Truth in Lending Act (“TILA”), the Real Estate Settlement Procedures Act (“RESPA”), RICO, and even federal antitrust laws for conspiracies to inflate home values. Minority borrowers have also asserted violations of Fair Housing and Equal Credit Opportunity Acts.

- Shareholder actions for securities fraud against investment firms. *In re 2007 NovaStar Finan., Inc., Securities Litig.*, 2008 WL 2354367 (W.D. Mo. June 4, 2008).
- Shareholder actions against ratings firms and officers like Standard & Poor’s. *Reese v. Bahash*, 248 F.R.D. 58 (D.D.C. 2008) (firm’s failure to downgrade bonds backed by securities resulted in precipitous fall of S&P’s stock price).
- Investor suits against underwriters and auditors for stock issued by financial institutions issuing subprime loans. *Gold v. Morrice*, 2008 WL 467619 (C.D.Cal. Jan. 31, 2008).
- Investor suits against directors and officers of an investment bank under federal securities laws and theories of misrepresentation, fraud, and negligence for their participation or acquiescence in the securitization and marketing of subprime debt which exposed the company to far greater financial risk than it disclosed. *See, e.g., Banker’s Life v. Credit Suisse First Boston*, Cause No. 07-CV-00690 (M.D. Fla.). Banker’s Life sued not only the financial institution that sold the securities, but also the “credit enhancement” insurer and the trustee for the underlying loans.
- Investor suits against credit rating agencies. While purchasers of securities usually have no viable cause of action against rating agencies, some agencies are alleged to have helped bond issuers package loans to achieve certain ratings rather than acting as neutral third parties.
- Underwriter or investor suits against lenders that refuse to buy back defaulted loans.
- Employee class action suits against retirement plan administrators and trustees under ERISA. *See Alvidres v. Countrywide Finan. Corp.*, 2008 WL 2944866 (C.D. Cal. May 16, 2008).
- State and local government suits against lenders, banks, and developers for the increased costs associated with maintaining or demolishing abandoned and foreclosed properties or for consumer protection. Cities have brought suits under a variety of theories that will potentially trigger different types of coverage. Cleveland and Buffalo have alleged nuisance causes of action; Minneapolis sued a local developer for consumer fraud based on a scheme to illegally drive up

housing prices; and Baltimore brought a federal suit against Wells Fargo for Fair Housing Act violations. The attorneys general in Ohio, New York and Massachusetts have all filed consumer protection based suits against lenders, title insurers, and others.

- SEC and state securities fraud investigations.
- Lender suits against title agents or attorneys for professional negligence in closing fraudulent loans.

There is thus plenty of litigation to go around and a wide variety of allegedly negligent and wrongful conduct for which the defendant-participants will seek insurance coverage.

III. Insurance Coverage

Once the internal finger-pointing subsides, insurers should anticipate the shift of focus to insurance coverage. In general, standard commercial general liability policies will not be the policies responding to the economic losses resulting from the subprime crisis. Instead, insurance coverage litigation will focus on directors and officers (“D&O”), errors and omissions (“E&O”) or professional liability, fiduciary liability insurance, financial institution bond (“FI Bond”) insurance, and commercial crime insurance coverage. One insurance analyst estimated that insurers’ subprime exposure under D&O and E&O coverage alone may be in the range of \$8-9 billion. S. Sclafane, *Analyst Ups Estimate of D&O/E&O Subprime Impact to \$8-9B*, National Underwriter Online News Service, Jan. 28, 2008. With the recently expanding financial crisis and bailout/rescue that estimate from January 2008 may now be conservative.

D&O, E&O and the other policies that are likely to be called upon in response to the subprime crisis are not standardized and vary widely in the coverage they provide. Therefore, a careful review of the specific policy and insuring and exclusionary language is critical to any coverage determination. Many of these policies contain similar or related conditions and exclusions, however, and the following discussion is intended to alert the practitioner to some of the common coverage issues that are likely to arise, particularly with regard to D&O and E&O policies.

A. Initial Coverage Considerations: The Insured, The Claim, and Notice

1. Qualifying as an Insured

Determining whether the party against whom a claim is made qualifies as an insured is usually one of the first tasks in a coverage analysis. D&O policies provide three basic categories of coverage: side A covers the cost of defending and indemnifying directors and officers for claims not indemnified by the corporation; side B reimburses the corporation for its indemnification of directors and officers; and side C is “entity coverage” for the corporation itself. Not all D&O policies provide each type of coverage. Similarly, E&O policies protect against claims that arise from alleged “wrongful acts” by

those delivering “professional” services as defined by the policy and usually cover claims against both the individual actor and the business entity.

The inquiry does not end with simply identifying the actor as a scheduled insured or falling within a defined category of insured, however. The potential insured’s relationship to the insured entity and the nature of the defendant’s alleged malfeasance or misfeasance can also affect coverage. D&O and E&O policies usually define coverage in terms of “wrongful acts,” but limit coverage to wrongful acts performed within a specific capacity. For example, a director or officer might be covered against shareholder suits under a D&O policy for board actions, but might not be covered if the director’s liability stems from legal or accounting services rendered. In that case, E&O coverage might be triggered instead. On the other hand, the activity for which a “professional” is sued may not fall within the policy’s definition or a court’s construction of “professional service.” The policy might also expressly exclude certain activities, such as underwriting, from the definition of either wrongful acts or professional services. A review of the company’s bylaws may be necessary to determine whether the executives and managers named in a suit are considered “officers” for purposes of the policy. Allegations of *ultra vires* acts may also disqualify a party that would otherwise fall within a definition of insured.

2. Are the Claim and Loss Covered?

In addition to examining whether the actor qualifies as an insured, coverage counsel must confirm that the claims and loss alleged fall within the coverage provided by the insuring agreement and definitions. Generally, liability policies cover the insured’s legal liability for “damages” and not for equitable relief. Mortgage purchasers who are merely trying to get lenders to buy back their mortgages may be seeking only equitable relief or breach of contract damages that do not constitute a covered “loss.” The line between legal and equitable damages is also blurred when questions of restitution and disgorgement of profits arise, especially if these are not addressed in the policy’s definition of “loss.” Moreover, some policies define “claim” more narrowly than others and government investigations may or may not be covered under these policies, depending on the type of investigation. Many policies include governmental or regulatory investigations within the definition of “claim” and provide coverage for defense costs incurred in responding to these investigations, but these policies may or may not provide indemnity coverage for statutory penalties in addition to other settlement or judgments. If the regulatory request and investigation is informal and a settlement is made in compromise to avoid a formal investigation, coverage may be precluded entirely. *See National Stock Exch. v. Federal Ins. Co.*, 2007 WL 1030293 (N.D. Ill. March 30, 2007) (informal document request regarding subprime activities did not constitute “claim”). Similarly, costs of internal investigations or special litigation committees may not be covered unless the policy specifically includes them within a definition of litigation or defense costs.

3. Claims-Made v. Occurrence-Based Coverage and Notice

Another preliminary coverage issue that must be considered is whether the coverage is provided on a “claims-made” or “occurrence” basis. If the policy is occurrence based, the insured typically must provide notice of the claim “as soon as practicable” or within

some other similarly defined period. Under the Texas Supreme Court's recent holding in *PAJ, Inc. v. Hanover Ins. Co.*, 243 S.W.3d 630 (Tex. 2008), an insurer must show prejudice in order to rely on the insured's late notice as a defense to coverage. For insureds, this decision could not have come at a better time; for carriers, the decision renders late notice close to a dead-letter defense in the case of occurrence-based policies with vaguely defined notice clauses. In contrast, claims-made policies usually require that both the claim against the insured and the notice of the claim to the carrier occur within the policy period. Because notice is an integral part of the insurance bargain for claims-made policies, most jurisdictions have held that the insurer is not required to demonstrate prejudice when asserting a late-notice defense under a claims-made policy. Most D&O policies are claims-made policies.

Extended "discovery" periods, "prior acts" dates, or other types of tail coverage can affect the reporting and notice requirements under claims-made and, sometimes, even occurrence-based policies. Claims-made policies often contain "notice-of-circumstances" clauses, which enable policyholders to obtain coverage even for claims made after expiration of the policy if they give written notice of facts and circumstances that can reasonably be expected to lead to a claim. Because these clauses provide an exception to the general function of "claims-made" policies, they are strictly construed. *See, e.g., FDIC v. Barham*, 995 F.2d 600, 604-05 (5th Cir. 1993). Insureds must identify specific acts that could lead to claims outside the policy period, and general descriptions of exposure, worsening financial situation, or feared litigation are usually insufficient to satisfy the objective standard most courts apply. *See McCullough v. Fidelity & Deposit Co.*, 2 F.3d 110, 112 (5th Cir. 1993). In fact, some more recent versions of the clause require the insured to provide specific dates, names of potential plaintiffs and directors, officers, or employees involved, and nature and scope of the expected claim. *See id.* at 113. Insurers should probably expect to see more notification letters from insureds regarding their anticipated involvement in subprime litigation and will need to evaluate whether these letters are sufficiently specific to preserve coverage under these policies or whether they are mere "laundry list" attempts by insureds to improperly extend claims-made coverage.

B. Exclusions and Other Defenses

1. Dishonest/Fraudulent Acts Exclusions

Perhaps the most important category of exclusions with regard to the subprime crisis will be the dishonest and fraudulent acts exclusions. These exclusions became the focus of coverage litigation during the savings and loan scandal of the 1980s and will likely assume a prominent role in subprime-related coverage litigation as well.

Dishonesty exclusions can vary widely, some referring to "dishonest" acts and some more narrowly to "criminal" acts. While these exclusions probably do not require the same degree of scienter or intent to harm as intentional injury exclusions under CGL policies, some dishonesty exclusions require that the excluded conduct be "deliberate" or even "deliberate and active." The degree to which courts are willing to enforce these

exclusions is an open question; the justification for the exclusions is often that dishonest conduct should not be insurable as a matter of public policy. However, as the Texas Supreme Court recently opined in the context of punitive damages, public policy does not preclude the insurability of damages awarded for malicious conduct as a matter of course if the liability for those damages is vicarious or the insurance policy anticipates their coverage. *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 246 S.W.3d 653 (Tex. 2008). Courts in other jurisdictions have limited the reach of these exclusions, particularly when the policy appears to have been written to cover a specific class of claims. *See, e.g., Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002) (D&O policy did not apply only to unintentional conduct; entity coverage included “securities claims,” and securities fraud is among most common claims). Even in Texas, which does not follow the “reasonable expectations” doctrine of coverage, ambiguity between the insuring agreement and the exclusions will be construed in the insured’s favor and often produces a similar result.

Furthermore, most of these exclusions – particularly in D&O policies – require either proof of the dishonesty “in fact” or an adjudication to take effect. Mere allegations of dishonesty will not preclude the duty to defend in this case, although a final adjudication of fraud or a criminal conviction may result in an enforceable right to reimbursement of defense costs – whatever that is worth. *See In re Enron Corp. Secs. Derivative & “ERISA” Litig.*, 391 F.Supp.2d 541, 575 (S.D. Tex. 2005). If the underlying action is settled or concluded without a final “adjudication” of the director’s or officer’s dishonesty, Texas, unlike some states, does not preclude the insurer from litigating the exclusion in a separate coverage action.

2. Personal Profit Exclusion

As with dishonesty exclusions, this common exclusion of D&O and E&O policies is likely to be implicated in a wide range of subprime claims. While the language of this exclusion also varies, it commonly precludes coverage for losses “arising out of the gaining in fact of any personal profit or advantage to which the insured is not legally entitled.” In a sense, this exclusion simply confirms public policy and the legal principle that “losses” resulting from the disgorgement and restitution of ill-gotten gains are not covered – either because these losses are an aspect of an equitable remedy rather than legal “damages” suffered by the injured party or because proceeds from a crime are not insurable. Litigation involving this exclusion usually involves two primary issues: (1) whether the insured was “legally entitled” to receive the profits in the first place; and (2) the type and quantum of evidence required to establish the insured’s lack of entitlement. In addition, if the exclusion precludes coverage only for “the insured” who receives the profit, the insurer will be required to show that the insured for which coverage is challenged directly profited. *See TIG Specialty Ins. Co. v. Pinkmoney.com Inc.*, 375 F.3d 365, 371 (5th Cir. 2004) (exclusion barring coverage when “an insured” receives a profit bars coverage for all insureds regardless of which insured actually profits).

Although criminal conduct may provide the best evidence of forbidden profits, courts have often broadly construed the exclusion by focusing on terms such as “arising from”

and “advantage.” As with the dishonesty exclusions, the quantum of evidence required to demonstrate that the insured was not entitled “in fact” to the profit may require that the insurer defend, however, unless there is a prior criminal conviction or adjudication.

3. Insured v. Insured Exclusion

This exclusion came into common usage in the 1980s to prevent collusion after financial institutions began to sue their own directors and officers in order to access their D&O coverage for failed loans. Many D&O policies now expand the definition of “insured” to include employees, trustees, the entity itself, and others in addition to directors and officers. This expanded definition of insured can preclude shareholder derivative suits – since they are brought in the name of the company – unless the policy contains an exception for these suits. *Compare Level 3 Communication, Inc. v. Federal Ins. Co.*, 168 F.3d 956 (7th Cir. 1999) (exclusion applied to suit brought by minority shareholders which included former director of subsidiary) *with Fidelity & Deposit Co. of Md. v. Zandstra*, 756 F. Supp.429, 431-32 (N.D. Cal. 1990) (exception demonstrated insurer’s intent to cover risk of shareholder suits). This exclusion may also come into play with ERISA suits by employees or pensioners or suits by bankruptcy trustees against former directors and officers.

4. Rescission

The accounting adjustments many companies are expected to make as a result of the subprime crisis raise another potential defensive issue for carriers: rescission. While restatements of a company’s financial condition do not necessarily indicate fraudulent misrepresentations or omissions, significant adjustments or revisions warrant a review of the policy and application and investigation to determine (1) who made the representations; (2) what claims or actions and omissions were known at the time of the application; and (3) what the policy provides regarding rescission.

Rescission is an equitable remedy. In Texas, rescission of an insurance policy requires proof of the following five elements: “(1) the making of the representation; (2) the falsity of the representation; (3) reliance thereon by the insurer; (4) the intent to deceive on the part of the insured in making same; and (5) the materiality of the representation.” *May v. Massachusetts Mut. Life Ins. Co.*, 608 S.W.2d 612, 616 (Tex. 1980). A representation is made if the applicant signs a statement indicating the answers in the application are true and correct when the policy is delivered. *Id.* The representation is false if the answers were untrue at the time they were made. *Id.* The representation is material if it actually induces the insurance company to assume the risk. *Westchester Fire Ins. Co. v. English*, 543 S.W.2d 407, 412 (Tex. Civ. App.-Waco 1976, no writ). Intent to deceive may be established as a matter of law when the applicant warrants the representations to be true or when the applicant colludes with the insurance agent. *Diggs v. Enterprise Life Ins. Co.*, 646 S.W.2d 573, 576 (Tex. App.-Houston [1st Dist.] 1982, writ ref’d n.r.e.). Reliance is established when the insurer does not know the representations are false. *See Koral Indus., Inc. v. Security-Connecticut Life Ins. Co.*, 788 S.W.2d 136, 146 (Tex. App.-Dallas), *writ denied per curiam*, 802 S.W.2d 650 (Tex.1990) (finding that actual

knowledge of falsity defeats misrepresentation defense); *John Hancock Mut. Life Ins. Co. v. Brennan*, 324 S.W.2d 610, 614 (Tex. Civ. App.-San Antonio 1959, writ ref'd n.r.e.) (finding no reliance when insurer's independent investigation reveals false answers). Because Texas requires an intent to deceive on the part of the insured, the standard is essentially the same as fraud in the inducement.

Especially with regard to D&O coverage, the policy language may determine whether the representations and intent of the application's signers can be imputed to other insureds for purposes of rescission. For example, in *Federal Insurance Co. v. Homestore, Inc.*, 144 Fed. Appx. 641, 647 (9th Cir. 2005), the court held that the policy "anticipat[ed] rescinding coverage to all Insureds without knowledge of misrepresentations, based upon material misrepresentations known to a signer." In contrast, the court in *Executive Risk Indemnity, Inc. v. AFC Enterprises, Inc.*, 510 F. Supp.2d 1308, 1324-25 (N.D. Ga. 2007), held that the policy limited the insurer's ability to rescind only to those persons who knowingly made material misrepresentations and who signed the application. Thus, a careful examination of the policy language for "severability of application" provisions and the factual circumstances in each case will determine the availability of the insurer's rescission remedy.

IV. Conclusion

The proliferation of subprime mortgages and the subsequent collapse of the housing bubble helped spawn and expose weaknesses in our financial system of which we are just becoming aware. As the various players affected by the financial crisis explore and refine their theories for shifting or sharing liability, insurance companies will be pressed to provide defense and indemnity dollars under a variety of policies for the acts and omissions of directors, officers, trustees, management, professional service providers, and others in the chain of lending and securitization. Because most of these policies are not standardized and have not been judicially construed as often as CGL policies, specific policy language will provide both challenges and opportunities for insurance coverage practitioners as the contours of the fallout become more apparent.