
Insurance Coverage for Losses Arising from the Subprime Lending Crisis

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2008

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I. INTRODUCTION

The subprime lending crisis officially is a worldwide catastrophe. Morgan Stanley, the second largest U.S. investment bank, recently suffered its first-ever loss because of poor investments in the subprime debt market. After taking a \$9.4 billion write-down, Morgan Stanley sold approximately a 10 percent interest in itself to a division of the Chinese government for a cash infusion of \$5 billion.¹ Citigroup, UBS, and other large U.S. banks have suffered similar fates.² This disaster's impact, though, is not limited to the United States. France's largest bank, BNP Paribas, froze more than \$2.2 billion in investments backed by subprime loans.³ The Federal Reserve has estimated that investors will lose between \$50 and \$100 billion as a result of this crisis.⁴ As a consequence, this meltdown has resulted in a wave of lawsuits involving borrowers, state governments, subprime lenders, brokers, loan issuers, banks that repackage loans into mortgage-backed securities (MBS), ratings agencies, real-estate appraisers, investment funds, and others. It is very important for companies to be aware of the potential insurance coverage available to all parties involved.

Subprime lending institutions, and their officers and directors, are being sued by a variety of plaintiffs and in a variety of contexts. Borrowers are asserting that their lenders, among other things, defrauded them, lied to them, and negligently misrepresented information about their loan interest rates.⁵ Investors are alleging claims for breach of contract and negligent misrepresentation, and claiming that a lender's mortgage insurance should be available for those losses.⁶ Shareholders are suing for various securities violations, including allegations that the

¹ Landon Thomas, Jr., *\$9.4 Billion Write-Down at Morgan Stanley*, N.Y. Times, Dec. 20, 2007, available at <http://www.nytimes.com/2007/12/20/business/20wall.html>.

² *Id.*

³ Norm Alster, *Signs of Weakness in a Sector Known for Its Strength*, N.Y. Times, Aug. 12, 2007, available at <http://www.nytimes.com/2007/08/12/business/yourmoney/12fina.html>.

⁴ Brooke Masters & Saskia Scholtes, *Payback Time: As Subprime Bites, US Investigators Look for Culprits*, Fin. Times, Aug. 9, 2007, at 5, available at <http://www.ft.com/cms/s/0/1f7200ca-4611-11dc-b359-0000779fd2ac.html>; *Bernanke: Subprime Hit Could Top \$100B*, CNNMoney.com, July 19, 2007, <http://money.cnn.com/2007/07/19/news/economy/bernanke/index.htm>.

⁵ See, e.g., *Morris v. First Franklin Fin. Corp.*, No. 07-00614 (N.D. Ga. filed Mar. 16, 2007); Jason Szep, *As Subprime Crisis Deepens, Some Fight Back*, Mar. 16, 2007, Reuters, <http://www.reuters.com/article/ousiv/idUSN1516483920070316>; Gretchen Morgenson & Julie Creswell, *Borrowing Trouble*, N.Y. Times, Apr. 1, 2007, <http://www.nytimes.com/2007/04/01/business/yourmoney/01nova.html>.

⁶ See, e.g., *Bankers Life Ins. Co. v. Credit Suisse First Boston Corp.*, No. 07-690 (M.D. Fla. filed Apr. 23, 2007).

Because of the many variations in policy language, this white paper does not address all of the issues. This white paper also does not replace, and should not be relied on instead of, legal advice based on the specific policy language involved and an insured's particular situation. However, it does provide a starting point and is intended to be an aid in considering what sometimes is a maze of factual and legal issues. This white paper may be considered advertising in some states.

directors and officers gained illegal profits.⁷ To top it all off, some State Attorneys General have jumped into the fray and sued or investigated subprime lenders for allegedly violating state laws, including allegations that lenders failed to fund mortgages after closings.⁸ Indeed, two major American cities—Cleveland and Baltimore—have sued subprime lenders on public nuisance and racial discrimination grounds, respectively.⁹

But subprime lenders are not the only ones being sued or investigated. Ratings agencies have been sued by their shareholders and pension funds for allegedly over-valuing bonds backed by subprime mortgages.¹⁰ At least one real-estate appraiser has been sued by a State Attorney General for allegedly colluding with a savings and loan company to inflate the value of homes, which supposedly contributed to the subprime fallout.¹¹ One of the world's largest securities firms was sued for alleged improper investment of \$134 million of a client's cash reserves in subprime loans.¹² The filing of suits related to the subprime crisis does not appear to be slowing down any time soon.

Corporate defendants may very well have insurance protection for these liabilities under their directors and officers (D&O) or errors and omissions (E&O) policies. With the newest wave of lawsuits alleging public nuisance and racial discrimination, corporate defendants may be able to recover insurance proceeds for any resulting losses under their commercial general liability (CGL) and employment practices liability (EPL) policies. Given the very nature of the subprime crisis, companies that purchased credit risk insurance—sometimes called “accounts receivable insurance”—may have an additional and fruitful source of protection for their losses. Standard credit risk policies cover credit losses due to insolvency of a covered buyer or “protracted default” resulting from a covered buyer's slow payment. Even investment funds and other MBS owners may be able to collect on their credit risk insurance policies when lenders fail to “buy back” loans. Private Mortgage Insurance (PMI), a type of credit risk insurance, also may supply

⁷ See, e.g., *Grand Lodge of Pa. v. Coast Fin. Holdings*, No. 07-479-T26 (M.D. Fla. filed Mar. 20, 2007).

⁸ Press Release, Marc Dann, Ohio State Attorney General, Attorney General Dann moves to shut down New Century Financial in Ohio (Mar. 14, 2007), available at <http://www.ag.state.oh.us/press/07/03/pr070314.asp>.

⁹ Thomas J. Sheeran, *Cleveland Sues Banks Over Foreclosures*, Associated Press, Jan. 11, 2008, <http://ap.google.com/article/ALeqM5hEk5TzJabMT0LW09kiR9fkDEgqSAD8U3SGJG2> (alleging public nuisance); Ben Nuckols, *Baltimore Sues Wells Fargo for Subprimes*, Associated Press, Jan. 8, 2008, http://ap.google.com/article/ALeqM5ibTdmbrD_q5crguVP719R03LUugD8U20IB80 (alleging racial discrimination).

¹⁰ Yvette Essen, *Shareholders Act Against Ratings Agencies*, Telegraph.co.uk, <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/11/26/cnrate126.xml> (last updated Nov, 28, 2007).

¹¹ *New York Widens Inquiry on Mortgages*, N.Y. Times, Nov. 8, 2007, available at <http://www.nytimes.com/2007/11/08/business/08mortgage.html>; Vikas Bajaj, *New York Says Appraiser Inflated Value of Homes*, N.Y. Times, Nov. 2, 2007, available at <http://www.nytimes.com/2007/11/02/business/02appraise.html>.

¹² Anthony Aarons, *Merrill Lynch Is Sued by MetroPCS for Fraud, Misrepresentation*, Oct. 19, 2007, Bloomberg.com, <http://www.bloomberg.com/apps/news?sid=a8nJ93nljzCI&pid=20601103>.

subprime investors with reimbursement for losses. Depending on the facts of a particular case, an EPL policy also may be implicated where an employee alleges breach of an employment contract related to subprime lending. Real-estate investors may find solace in a Residual Value (RV) insurance policy, if their properties have dropped in value because appraisers inflated the values as part of a subprime scheme. In sum, one or more insurance policies that your company has purchased may cover your potential losses resulting from the subprime lending fallout.

II. YOU SHOULD PROMPTLY NOTIFY YOUR INSURANCE COMPANY OF A CLAIM OR POTENTIAL CLAIM

The language and provisions contained in D&O, E&O, and credit risk insurance policies tend to vary more than with many other types of insurance coverage. Thus, it is very important that policyholders have potentially relevant policies reviewed as soon as possible. In any event, given the nature of the insurance at issue, you should give timely notice as soon as possible to your insurance company for claims or losses relating to subprime lending activity.

Most D&O and E&O policies are claims-made policies,¹³ meaning that they typically cover only claims that are made against the policyholder, during the policy period. Some policies, however, provide coverage for claims that are made against the policyholder shortly after the policy period; insurance companies may contend that such a claim should be based on a wrongful act allegedly committed during the policy period. The policies frequently include specific provisions concerning timely notice of claims, giving the policyholder a discrete window of time from when it knows about a claim to notify its insurance company.

Insurance companies may argue that some D&O and E&O policies provide that both (a) the claim against the policyholder, and (b) notice to the insurance company of the claim, must occur during the policy period. Other policies may provide that the policyholder should give notice to the insurance company within a reasonable time after the claim is made against the policyholder, even if notice is given to the insurance company after the policy period. If a policyholder has purchased continuous coverage from the same insurance company, a claim made against the policyholder toward the end of the first policy period and reported to the insurance company during the second policy period should not preclude coverage. At least one court has held this to

¹³ Some older D&O and E&O policies are occurrence-based policies, which cover losses from injuries that occurred during the policy period, regardless of when the claim is made against the policyholder. For example, if a group of borrowers sues a subprime lender during the current policy period for alleged misrepresentations made to the borrowers during the previous policy period, the earlier policy will apply if it is an occurrence policy because the occurrence—the alleged misrepresentations—transpired during the occurrence-based policy’s policy period. (The current policy also will apply if it is a claims-made policy because the policyholder was sued, that is, a claim was made against the policyholder, during the current policy’s policy period.) Recent policies typically are claims-made, but some may be occurrence-based, and a company’s older policies may be relevant to a current claim if they are occurrence-based.

be the rule even when the earlier policy provided that the claim should be made against the policyholder and notice should be given to the insurance company during the policy period. *See Brown-Spaulding & Assocs., Inc. v. Int'l Surplus Lines Ins. Co.*, 254 Cal. Rptr. 192, 196 (1998) (refusing to enforce a “claims made and reported” provision against a policyholder that failed to notify its insurance company of a claim against it until after the policy expired, and holding that the policy’s “reporting provision” was void as against public policy because “the result of the notice provisions in the policy issued by [the insurance company] is to deprive [the policyholder] of retroactive coverage for claims made against it near the end of the policy period. Such narrow coverage provisions are so oppressive and unfair as to be violative of public policy”).

Courts generally enforce notice, or reporting, provisions as a condition of coverage. However, depending on the applicable state law, a policyholder’s failure to give timely notice to its insurance company may not bar coverage if the insurance company is not prejudiced by the late notice. *See, e.g., Transportes Ferreos de Venezuela II CA v. NKK Corp.*, 239 F.3d 555, 561 (3d Cir. 2001) (applying New Jersey law); *Sherwood Brands, Inc. v. Hartford Accident & Indem. Co.*, 698 A.2d 1078, 1082 (Md. 1997); *Struna v. Concord Ins. Servs., Inc.*, 11 S.W.3d 355, 359-60 (Tex. App. 2000). In California, for instance, a delay in notice typically will not be a bar to coverage unless the insurance company proves that it actually and substantially is prejudiced by the delay. *See, e.g., Shell Oil Co. v. Winterthur Swiss Ins. Co.*, 12 Cal. App. 4th 715, 760-61, 15 Cal. Rptr. 2d 815 (1993) (“California law is settled that a defense based on an insured’s failure to give timely notice requires the insurer to prove that it suffered substantial prejudice. Prejudice is not presumed from delayed notice alone. The insurer must show actual prejudice, not the mere possibility of prejudice.”) (citations omitted).

It may be even more important for companies to notify their insurance companies of circumstances that may later give rise to a claim. Most D&O and E&O policies contain clauses that provide coverage for claims occurring after the policy period where related facts took place during the policy period, so long as the policyholder gave notice of those facts during the policy period. For example, if during the policy period an investment company sends a letter requesting information about certain loans to a subprime lender from which it purchased MBS, the letter may not constitute a claim if it does not demand anything. After the policy period, when the investment company sues the lender based on those same loans, losses resulting from the suit (which certainly is a claim) may not be covered if the lender did not notify its insurance company when it received the request letter. But if the lender had given notice, it would have coverage for a claim first made against it after the policy period. These provisions generally have strict reporting conditions. Thus, it is imperative that companies also notify their insurance carriers of potential claims—of facts or circumstances that potentially may give rise to a claim.

III. A CLAIM IS A DEMAND FOR RELIEF

D&O and E&O policies typically define a claim as “a written demand for monetary or non-monetary relief; or a criminal proceeding commenced by the return of an indictment . . . against the insured for a wrongful act.” When a subprime lender, or its directors and officers, are sued (or indicted), it is clear that a claim exists under a D&O or E&O policy. Regardless of whether the policy defines claim, a court may still find that a demand letter, a notice of a regulatory investigation, a demand for regulatory compliance, an initiation of arbitration proceedings, a grand jury investigation, a subpoena for documents, and even questioning by a prosecutor all constitute a claim. *See, e.g., Polychron v. Crum & Forster Ins. Cos.*, 916 F.2d 461, 463 (8th Cir. 1990) (holding that a subpoena for documents, a grand jury investigation, and questioning by an assistant U. S. attorney each in its own right, and all together, constituted a claim under Arkansas law) (claim not defined); *Minuteman Int’l, Inc. v. Great Am. Ins. Co.*, No. 03 C 6067, 2004 WL 603482, at *2 (N.D. Ill. Mar. 22, 2004) (holding that a subpoena for documents and testimony constitute a claim where policy defined claim as “demand for . . . non-monetary relief”); *Nat’l Stock Exch. v. Fed. Ins. Co.*, No. 06 C 1603, 2007 WL 1030293, at 1, *3 (N.D. Ill. Mar. 30, 2007) (same where policy defined claim as “formal investigative order or similar document”).

If the policy does not define, or provides only a brief definition for, “claim,” courts frequently will deem communications to be claims when they actually demand something, assert a legal right, or threaten formal consequences for failure to comply. *See, e.g., Richardson Elecs., Ltd. v. Fed. Ins. Co.*, 120 F. Supp. 2d 698, 701 (N.D. Ill. 2000) (“A claim is a demand for *something* due. A demand for money is not required for [it to be] a claim,” and finding that a demand requiring the policyholder to comply constitutes a claim); *Phoenix Ins. Co. v. Sukut Constr. Co.*, 136 Cal. App. 3d 673, 677, 186 Cal. Rptr. 513 (1982) (A claim is a “demand for something as a right, or as due. A formal lawsuit is not required before a claim is made.”). Generally, if a reasonable person would assume that the communication was making a claim, then a court likely will find that the communication indeed constitutes a claim. *See, e.g., Bendis v. Fed. Ins. Co.*, 958 F.2d 960, 962 (10th Cir. 1991) (applying Kansas law).

Credit risk policies frequently contain very short deadlines both for filing a claim for loss against insolvent or troubled buyers (sometimes as quickly as 10 days from learning of a buyer insolvency) and for filing a proof of a “covered loss” with the insurance company. Many credit risk forms also include detailed claim-filing conditions, akin to proof-of-loss conditions in property policies.

IV. D&O AND E&O POLICIES COVER ACTUAL AND ALLEGED WRONGFUL ACTS

D&O policies cover liability arising out of actual or alleged wrongful acts committed by directors and officers in carrying out their corporate responsibilities. These policies often provide Side A, Side B, and Side C coverage. Side A coverage pays the directors and officers directly for losses that they suffer. Side B coverage pays the company when it indemnifies its directors and officers for their losses. Side C, also called entity, coverage protects the corporate policyholder when it suffers losses resulting from claims made directly against it. It is a somewhat common misconception that Side C coverage is available only for losses related to securities claims. This is not always, or even often, the case; hence, the corporate policyholder may have coverage for all types of subprime losses it suffers, whether or not they flow from securities claims.

E&O policies cover liability arising out of alleged wrongful acts committed in rendering or failing to render professional services. E&O policies sometimes are tailored to the professional services specific to a policyholder's line of business. Hence, the definition of professional services in a rating agency's policy may contain language related to developing bond ratings, while in an investment company's policy the definition may relate to giving investment advice for a fee. If the type of professional service covered is not specified, courts typically define a professional act as "one arising out of a vocation, calling, occupation, or employment involving specialized knowledge, labor, or skill [which is] predominantly mental or intellectual, rather than physical or manual." *PMI Mortg. Ins. Co. v. Am. Int'l. Specialty Lines Ins. Co.*, 394 F.3d 761, 766 (9th Cir. 2005) (quoting *Bank of Cal., N. A. v. Opie*, 663 F.2d 977, 981 (9th Cir. 1981) (applying Washington law)) (applying California law).

Typically, losses that an insurance company contends are not covered by one policy will be covered by the other. Accordingly, just because an insurance company may argue that a D&O policy's professional services exclusion bars coverage for losses from claims made against a real-estate appraiser by a customer for over-valuing property, the appraiser's E&O policy should step in to cover those very losses.

V. LOSS IS CONSTRUED BROADLY

For a "loss" to be covered under a D&O or E&O policy, it must be an amount of money that the subprime lender or its officers and directors "becomes legally obligated to pay, . . . including but not limited to damages, judgments, settlements, pre-judgment and post-judgment interest, and defense costs." Sometimes "loss" will be defined to include "punitive or exemplary damages, where insurable by law," as some states allow punitive damages to be insured. *See, e.g., Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026, 1029-30 (5th Cir. 1978) (insurance covering

liability for punitive damages does not violate public policy) (applying Texas law); *Meijer, Inc. v. Gen. Star Indem. Co.*, 826 F. Supp. 241, 247 (W.D. Mich. 1993) (same) (applying Michigan law), *aff'd*, 61 F.3d 903 (6th Cir. 1995).

The definition of “loss” in some policies does not include costs incurred to comply with an order for “injunctive or other non-monetary relief.” This should not preclude coverage for monetary payments that at first blush appear to be injunctions. For instance, an investor suing a subprime lender for not buying back defaulted loans may request specific performance, just as a State Attorney General may try to enjoin subprime lenders to fund mortgage loans after closings. While an insurance company may assert that these are requests for injunctions and thus do not fall under the definition of “loss,” the requested specific performance is for the lender to pay money; it is monetary relief. Accordingly, these losses should not fall under the injunction/non-monetary relief exception to the definition of “loss.”

VI. D&O AND E&O POLICIES SHOULD PAY FOR DEFENSE COSTS, A FRUITFUL SOURCE OF SECURITY

In many situations, a subprime actor’s only losses may be legal fees. D&O and E&O policies thus provide a fruitful source of protection for those players in the subprime world who ultimately may never be held liable for claims asserted against them. A good example is a State Attorney General’s investigation that ends with no finding of liability. A subprime lender may very well spend millions of dollars in responding to such an investigation. One of the most beneficial aspects of a D&O or E&O policy, therefore, is the insurance company’s promise to pay the policyholder for defense costs that it incurs in responding to a claim. This is a contemporaneous obligation; the insurance company must pay the defense costs as they are incurred by the policyholder. *Gon v. First State Ins. Co.*, 871 F.2d 863, 868 (9th Cir.1989) (applying California law).¹⁴

Moreover, if a particular claim contains covered and uncovered matters, the insurance company often must pay defense costs for the entire claim, either because state law requires it to¹⁵ or because the policy contains a provision explicitly providing 100 percent of defense costs for claims that include covered and uncovered issues. What this means is that if a subprime lender, for instance, is sued by a group of borrowers for allegedly committing fraud and negligence, the insurance company likely will be required to pay for the entire defense, even though it may argue

¹⁴ See also *Little v. MGIC Indem. Corp.*, 836 F.2d 789, 793-94 (3d Cir. 1987) (applying Pennsylvania law); *Okada v. MGIC Indem. Corp.*, 823 F.2d 276, 280 (9th Cir. 1986) (applying Hawaii law); *Fight Against Coercive Tactics Network, Inc. v. Coregis Ins. Co.*, 926 F. Supp. 1426, 1432-34 (D. Colo. 1996); *FDIC v. Booth*, 824 F. Supp. 76, 80-81 (M.D. La. 1993); *Nat’l Union Fire Ins. v. Brown*, 787 F. Supp. 1424, 1430 (S.D. Fla. 1991) *aff’d*, 963 F.2d 385 (11th Cir. 1992); *FSLIC v. Burdette*, 718 F. Supp. 649, 661 (E.D. Tenn. 1989); *Am. Cas. Co. v. Bank of Mont. Sys.*, 675 F. Supp. 538, 543-44 (D. Minn. 1987).

¹⁵ See, e.g., *Seaboard Sur. Co. v. Gillette Co.*, 64 N.Y.2d 304, 311 (1984).

that the fraud allegations are not covered. This also is the case where a claim is made against covered and uncovered parties. If, for example, a credit agency purchased a D&O policy that covers losses from claims asserted only against its directors and officers,¹⁶ but someone sues both the directors and the credit agency, the insurance company likely will have to pay 100 percent of the defense costs incurred by both the credit agency and the directors, even though the insurance company may maintain that judgments against, or settlements entered into by, the credit agency alone are not covered by the policy. Several insurance companies, however, have begun to add express allocation language regarding both indemnity and defense costs, trying, for example, to exclude coverage for costs spent in defending uncovered issues or parties. The extent to which a policyholder is entitled to coverage for defense costs, therefore, may depend upon express policy language.

Ultimately, the legal fees associated with the subprime lending crisis are expected to be astronomical, and insurance coverage should protect those losses.

A. Government Investigations

Since the subprime crisis exploded, State Attorneys General and other government agencies with enforcement powers have been investigating subprime actors for their alleged wrongdoing. Such an investigation can be one of the most harrowing experiences a company and its officers and directors ever will encounter. It involves responding to demands for documents and other information, testifying before grand juries, being pressured to sign admissions of wrongdoing, and other unpleasant experiences. Thus, it is the precise situation for which a policyholder expects coverage under its D&O and/or E&O policies. Insurance companies, however, often contend that these investigations are not claims, but rather potential claims, circumstances that could give rise to a claim if, for instance, the Attorney General decides to sue the policyholder. This contention is incorrect; policyholders need not forfeit the huge sums of money they expend in defending such investigations.

Insurance companies often will maintain that subpoenas, served as part of an investigation, requiring testimony and the production of documents, do not constitute claims because they are not demands for relief. Courts throughout the country have disagreed with that position, holding that under a claims-made D&O policy, a subpoena is a claim because it commands compliance and threatens formal consequences for failure to comply. *See Minuteman*, 2004 WL 603482, at *5-*7; *Nat'l Stock Exch.*, 2007 WL 1030293, at *3. Other courts have arrived at the same conclusion in noting the seriousness of an investigation accompanied by subpoenas. *See, e.g., Cal. Union Ins. Co. v. Am. Diversified Sav. Bank*, 914 F.2d 1271, 1276 (9th Cir. 1990) (applying

¹⁶ This would be a policy with Side A, and perhaps Side B, coverage, but not Side C coverage.

California law); *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035, 1047-48 (C.D. Ill. 2003) (“*Foster*”); *Abifadel v. Cigna Ins. Co.*, 8 Cal. App. 4th 145, 167 (Cal. App. 1992).

VII. INSURANCE COMPANY POSITIONS ON D&O AND E&O POLICIES AND COURTS’ RECOGNITION OF COVERAGE

Insurance companies likely will assert a variety of positions to avoid paying out claims under their D&O and E&O policies. These arguments often will be based on policy exclusions. Courts, however, construe exclusions narrowly and place the burden on the insurance company to prove that a particular exclusion applies. *See, e.g., HS Servs., Inc. v. Nationwide Mut. Ins. Co.*, 109 F.3d 642, 645 (9th Cir. 1997) (applying California law); *Universal Cas. Co. v. Lopez*, 876 N.E.2d 273, 278 (Ill. App. Ct. 2007); *Allmerica Fin. Corp. v. Certain Underwriters at Lloyd’s, London*, 871 N.E.2d 418, 425 (Mass. 2007); *SMI Realty Mgmt. Corp. v. Underwriters at Lloyd’s, London*, 179 S.W.3d 619, 624 (Tex. App. 2005). What is more, courts have interpreted many of the exclusions that may arise in the subprime lending context in ways that are beneficial for policyholders. Below are the exclusions an insurance company is most likely to assert and courts’ recognition that these exclusions must be construed very narrowly to allow coverage when possible.

A. Fraud/Dishonesty (D&O and E&O)

The fraud/dishonesty exclusion addresses losses resulting from a director’s or officer’s intentionally dishonest or fraudulent acts. For instance, the exclusion may provide that the insurance company may not pay for losses “based upon, arising from, or in consequence of . . . any deliberately fraudulent or dishonest act or omission or any willful violation of any statute or regulation by any insured.” Not all policies will provide that the fraud or dishonesty be deliberate. While some policies may reference both fraud and dishonesty, others may refer to only one or the other. Courts typically treat all of these permutations similarly. Indeed, one court interpreted a provision purportedly excluding losses “brought about or contributed to by the dishonesty of the directors or officers” to exclude only knowing acts of dishonesty. *Faulkner v. Am. Cas. Co.*, 584 A.2d 734, 751 (Md. Ct. Spec. App. 1991). Reckless acts that defraud the plaintiff in the underlying matter are not excluded. *Id.* (emphasizing that “[a] reckless, careless, negligent error, misstatement, misleading statement, act, or omission is within the definition of a ‘wrongful act,’ for which the policy provides coverage,” and the fraud/dishonesty exclusion does not remove that coverage).

Some policies, moreover, provide that for the fraud/dishonesty exclusion even potentially to be applicable there must be a “final adjudication” of fraud/dishonesty on the merits, that is, a final verdict in the underlying case that the directors or officers committed actual fraud. A settlement of the underlying case where the directors and officers do not concede liability, therefore, would

not constitute a final adjudication. Most courts have held that the words “final adjudication” in a fraud/dishonesty exclusion preclude the insurance company from litigating in the coverage action whether the director or officer actually committed fraud; the insurance company is stuck with the judgment entered in the underlying case. *See, e.g., Atl. Permanent Fed. Sav. & Loan Ass’n v. Am. Cas. Co.*, 839 F.2d 212, 216-17 (4th Cir. 1988) (per curiam) (applying Virginia law); *Nat’l Union Fire Ins. Co. v. Cont’l Ill. Corp.*, 666 F. Supp. 1180, 1197-98 (N.D. Ill. 1987); *Graham v. Preferred Abstainers Ins. Co.*, 689 So. 2d 188, 190 (Ala. Civ. App. 1997). Other policies, however, exclude fraud “in-fact” or a “final determination” or “establishment” of fraud. Insurance companies may assert—incorrectly we believe—that this language permits them to litigate in the coverage action whether the directors and officers actually committed fraud, even if the underlying case never reached a final adjudication on that issue.

B. Illegal Profit (D&O and E&O)

A typical illegal profit exclusion states that a policyholder may not receive insurance proceeds for losses based upon or arising from the policyholder’s “having gained in fact any profit, remuneration, or other advantage to which [he/she] was not legally entitled.” If the profit results from an illegal act but is not in fact an illegal profit, or the directors and officers are sued for certain wrongful conduct from which they gained an advantage but the profit is not the basis of the claims, then this exclusion should not bar coverage. *See Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 398-401 (D. Del. 2002).

For instance, if a subprime lender’s directors and officers made illegal securities misrepresentations, and as a by-product received a private gain, this exclusion would not apply because the actual gain was not illegal. *See id.* at 400. In contrast, insurance companies may contend that this exclusion would apply if the directors and officers committed insider trading, because insider trading is a form of theft, a profit that is against the law. *See id.* In essence, this exclusion does not bar coverage for “improper” profits; it may, at most, preclude coverage for “illegal” profits. *See id.* (the illegal profit exclusion “requires a profit or gain that is illegal; not an illegal act that produces a profit or gain to the insured as a by-product”).

Moreover, as with the fraud/dishonesty exclusion, policies vary on whether a “final adjudication” or “final determination” that the directors and officers gained an illegal profit is necessary for this exclusion potentially to apply. *See, e.g., PMI Mortgage Ins. Co. v. Am. Int’l Specialty Lines Ins. Co.*, No. C 02-1774 PJH, 2006 WL 825266, at *4 (N.D. Cal. Mar. 29, 2006) (profit exclusion did not apply because “adjudication is necessary to determine whether there was, in fact, any illegal profit or gain”); *see also Foster*, 268 F. Supp. 2d at 1045 (construing the “in fact” language in a profit exclusion to require a final adjudication of an illegal profit).

C. Insured v. Insured (D&O and E&O)

The insured v. insured exclusion provides that the insurance company is not liable for a claim “brought or maintained by or on behalf of any insured in any capacity”; that is, for a claim made by one insured against another. Insurance companies may assert that the exclusion is implicated in the case of derivative lawsuits, but most courts have held that the exclusion’s purpose is to prevent collusion between the named insureds, which is not an issue in derivative suits. *See, e.g., Twp. of Ctr., Butler County, Pa. v. First Mercury Syndicate, Inc.*, 117 F.3d 115, 119 (3d Cir. 1997) (“[t]he primary focus of the exclusion is to prevent collusive suits”) (applying Pennsylvania law); *Fid. & Deposit Co. v. Zandstra*, 756 F. Supp. 429, 431 (N.D. Cal. 1990) (“[t]he obvious intent behind the ‘insured v. insured’ exclusion is to protect [the insurance company] against collusive suits”). Likewise, if a subprime lender refuses to indemnify its directors and officers for a claim covered under the policy, the insured v. insured exclusion should not bar coverage for a suit brought by the directors and officers against the lender for indemnification. Indeed, many newer policies carve out exceptions for both of these situations, so these issues often will not arise.

This exclusion, however, may become relevant in bankruptcy proceedings and receiverships. The receiver of a bankrupt subprime lending bank that sues the bank’s directors and officers may face a coverage denial from the bank’s insurance company on the ground that the receiver has stepped into the shoes of the bank, making the suit in essence one between two policyholders. Courts, however, have disagreed with the insurance companies, finding that the insured v. insured exclusion does not bar coverage in this context because the exclusion does not clearly exclude suits brought by receivers such as the Federal Deposit Insurance Corporation (FDIC).¹⁷ *St. Paul Fire & Marine Ins. Co. v. FDIC*, 765 F. Supp. 538, 548 (D. Minn. 1991), *aff’d*, 968 F.2d 695 (8th Cir. 1992). Similarly, a bankruptcy trustee that has taken over a company that is not a bank but has gone bankrupt because of the subprime crisis (for example, an investment company or brokerage group) may face these same coverage denials if it sues the company’s directors and officers. Because the trustee is acting “for the benefit of the [bank’s] creditors,” not the benefit of the bank, courts also have ruled that the exclusion does not apply to suits brought by bankruptcy trustees. *Pintlar Corp. v. Fid. & Cas. Co. (In re Pintlar Corp.)*, 205 B.R. 945, 948 (Bankr. D. Idaho 1997).

D. Securities Violations (D&O)

Some older D&O policies specifically identified certain securities violations for which they would not pay, such as a claim “related to, based upon, or arising from any violation of the

¹⁷ Some D&O policies provide that they may not reimburse losses resulting from claims that are based upon actions brought by regulatory agencies, frequently including the FDIC. Those are not the sort of receivership actions that might be implicated by the insured v. insured exclusion. The regulatory exclusion, moreover, is narrowly construed.

Securities Act of 1934.” Newer policies, however, generally have removed these exclusions because securities violations are the precise sort of wrongful acts for which corporations seek coverage when purchasing a D&O policy. Some policies also contain exclusions for losses arising directly or indirectly from securities trades, but those typically concern losses related to market forces.

E. Breach of Contract (D&O)

Almost all banks have converted their subprime loans into MBS, which they have sold to hedge funds and other investors. Those sales typically take place through a purchase agreement, which may include provisions requiring the bank to provide financial information to the investors about the borrowers and to buy back the loans if the borrowers default within a certain time period (often three months). Investors have sued subprime lenders for allegedly breaching these buy-back provisions and for negligently providing false or inaccurate information about the borrowers. A subprime lender requesting coverage for losses resulting from such a suit may encounter a denial from its insurance company based on the breach of contract exclusion in its D&O policy.

A standard breach of contract exclusion provides that the insurance company may not be liable for losses “based upon, arising from, or in consequence of any actual or alleged breach of a written or oral contract where the claim is brought by or on behalf of a party to such contract.” Insurance companies may contend that breach of contract claims against a subprime lender are excluded and that negligence claims also are not covered because they arise out of the alleged breach of contract. However, if the alleged conduct would have been negligent regardless of whether the parties had entered into a contract or if the contract simply provided the context for the alleged conduct to take place but did not cause the conduct, the exclusion should not apply. *See, e.g., Admiral Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 463 (N.D. Tex. 2003). This exclusion will not bar coverage when “the gist” of the allegations rises in tort and not in contract, or when the type of relief the plaintiff requests is not contractual in nature. *See Cont’l Cas. Co. v. County of Chester*, 244 F. Supp. 2d 403, 410 (E.D. Pa. 2003).

What is more, in some policies this exclusion is present only in Side C, the entity coverage part, meaning that it does not apply when directors and officers are the defendants. If both the corporation and the directors and officers are defendants, at the very least, the insurance company will be responsible for all losses sustained by the directors and officers and the defense costs incurred by the corporation; depending on policy language, the insurance company may be required to pay out all defense costs and losses.

VIII. CGL AND EPL INSURANCE MAY BE APPLICABLE TO SOME LIABILITIES IN THE SUBPRIME CONTEXT

Subprime lenders facing suits by cities (and others) for discrimination or public nuisance because of their alleged wrongful business practices should have insurance coverage under their CGL and EPL policies for attorneys' fees and any resulting losses. Although CGL policies typically cover claims alleging "bodily injury" or "property damage," they also often cover claims involving "personal and advertising injury." "Personal and advertising injury" is defined to mean injuries arising out of specified "offenses," including false arrest, detention or imprisonment, malicious prosecution, wrongful eviction or wrongful entry, invasion of the right of private occupancy, and oral or written publication of "material that slanders or libels a person or organization or disparages a person's or organization's goods, products or services" or violates a person's "right of privacy." Indeed, some "personal injury" clauses explicitly provide coverage for "racial or religious discrimination."

Courts across the country have interpreted "personal and advertising injury" clauses to provide extremely broad insurance coverage for claims alleging business wrongs, including those asserting race discrimination and nuisance. The court in *Gardner v. Romano*, for example, required a liability insurance company to pay a policyholder's defense costs when it was sued for racial discrimination. 688 F. Supp. 489, 492-93 (E.D. Wis. 1988). The court held that "interpreting the 'personal injury' definition to include claims for race discrimination . . . comports with the reasonable expectations of the insureds." *Id.* at 493. The United States District Court for the Central District of California, in *State Farm Fire & Casualty Co. v. Westchester Inv. Co.*, adopted the holding in *Gardner* and ruled that claims alleging racial discrimination are covered by the "personal injury" provision of a liability insurance policy. 721 F. Supp. 1165, 1167-68 (C.D. Cal. 1989); *see also Clinton v. Aetna Life & Sur. Co.*, 594 A.2d 1046, 1048-49 (Conn. Super. Ct. 1991) (applying Florida law) (interpreting "personal injury" clause as requiring a liability insurance company to pay the policyholder's defense costs in a race discrimination suit).

Courts also have held that the "personal injury" clause provides coverage for nuisance claims. *See Martin Marietta Corp. v. Ins. Co. of N. Am.*, 40 Cal. App. 4th 1113, 1123-36, 47 Cal. Rptr. 2d 670 (1995). In *Hirschberg v. Lumbermens Mutual Casualty*, for example, the United States District Court for the Northern District of California held that a "personal injury" provision provided coverage for claims alleging nuisance, which the court defined as an interference with the interest in the private use and enjoyment of land. 798 F. Supp. 600, 604 (N.D. Cal. 1992).

EPL policies similarly should cover defense costs and losses arising from discrimination claims. EPL policies generally provide coverage for an employee's discriminatory acts. Claims against a subprime lender for allegedly committing discrimination in its lending practices necessarily

implicate those employees who committed the discrimination. EPL policies thus should cover the defense costs and losses resulting from those claims.

IX. CREDIT RISK INSURANCE IS ANOTHER VALUABLE SOURCE OF PROTECTION

Credit risk insurance policies offer companies an effective solution for minimizing risk by providing coverage for accounts receivable. The insurance is triggered by the indebtedness of a policyholder's clients, those in protracted default on their payments, or those that have become insolvent. Historically, industries that rely on consumer credit or loans benefit most from credit insurance. Consumer lending companies have always had a certain percentage of customers that will default on their obligations regardless of how strictly the company sets its credit requirements.

An investment group or a hedge fund might have credit insurance on its MBS to cover a lender's failure to buy back the loans, if required by a repurchase agreement. Many insolvent subprime lenders have failed to buy back these loans, and credit risk insurance may step in to make these expected payments. For example, PMI is one specific type of credit risk insurance that is relevant to the original subprime lender. Most lenders already have PMI policies because they require their subprime borrowers to purchase mortgage insurance to protect them in the event that the borrowers default on their mortgage payments.

Many mortgage insurance policies were procured specifically to protect investors in MBS, so that in the event that borrowers default, the investor receives the insurance proceeds. These policies, therefore, will be very relevant as subprime litigation progresses. In one case, for instance, an MBS investor sued, among others, the lender's mortgage insurance company, alleging that it breached its contract by not indemnifying the investor for securities' losses resulting from defaulted loans. *See Bankers Life Ins. Co. v. Credit Suisse First Boston Mortgage Sec. Corp.*, No. 8:07-cv-00690 (M.D. Fla. filed Apr. 23, 2007). The master mortgage policy at issue in this case had limits in excess of \$312 million, covering 3,416 loans.

Insurance companies may raise a fraud or negligence exclusion to avoid fulfilling their agreements under a PMI policy. The exclusion typically addresses losses resulting from negligence that is "material to the acceptance of the risk by the insurance company, materially contributed to the [borrower's] default resulting in such claim, or increased the amount of the claim." To deny a claim based on this exclusion, an insurance company will have to prove fraud or negligence as to each loan at issue; proving a pervasive fraud, for instance, is not sufficient to exclude coverage for all of the loans at issue. *See, e.g., Citizens Sav. Bank, F.S.B. v. Verex Assurance, Inc.*, 883 F.2d 299, 303 (4th Cir. 1989) (applying South Carolina law).

Perhaps even more than in the case of other policies, the total level of coverage within each of the policies is greatly affected by the specific contractual provisions. Some policies feature waiting-period insolvency that can affect payouts, and others either specifically include or exclude coverage for particular instances of insolvency. For instance, many credit risk policies contain provisions—which effectively operate as exclusions—that condition payment of insurance proceeds upon the buyer’s actually being in debt to the policyholder. In short, if a subprime lender disputes that it is obligated to repurchase loans it sold to an investor, the credit insurer may argue that the insurance does not kick in to reimburse the investor for that loss. So long as the subprime lender admits that it owes and cannot pay the debt to the investment company, however, the policy will cover the loss.

X. CONCLUSION

The current crisis presents numerous fact patterns for a putative defendant, all of which have different nuances that could affect the scope and type of insurance coverage potentially available to a policyholder. To maximize their insurances assets, companies that have suffered, or may suffer, losses resulting from the subprime lending crisis should perform at least two tasks. First, they should carefully review the relevant underlying issues and all of their corporate insurance policies. Second, corporate policyholders should promptly notify their insurance companies of any claims or potential claims asserted against them. By doing so, they will be taking advantage of the substantial financial benefit their policies provide.

ABOUT DICKSTEIN SHAPIRO LLP

Firm Profile

Dickstein Shapiro LLP, founded in 1953, is a multiservice law firm with more than 400 attorneys in Washington, DC, New York, and Los Angeles, representing clients in diverse industries with a wide variety of requirements. While Dickstein Shapiro's work generally originates from a client's need for legal representation, the Firm is mindful that legal service is but one ingredient in achieving a client's strategic business goals. The Firm prides itself on learning and understanding client objectives and partnering with clients to generate genuine business value.

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Insurance Coverage Practice

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Representative Insurance Coverage Attorney Biographies

Jerold Oshinsky joined Dickstein Shapiro in 1996 and is founder of the Firm's Insurance Coverage Practice. Referred to by his peers as "the dean of the policyholder bar," Jerry Oshinsky is "energetic and creative" with the "uncanny ability to size up the strengths and weaknesses of a dispute." Mr. Oshinsky focuses his practice on insurance coverage litigation on behalf of policyholders in federal and state courts throughout the country and on counseling clients nationwide on insurance coverage and related matters. In October 2007, Mr. Oshinsky was named as "The Leading Lawyer in Insurance" for Washington, DC by the *Legal Times*. He was chosen from among 10 finalists based on independent research and nominations from peers, clients, and other members of the legal industry. Mr. Oshinsky also is ranked in *Chambers USA: America's Leading Lawyers for Business* annual guide as a leading individual in the area of Insurance: Policy Holder (National and the District of Columbia). He also has been named in *The Best Lawyers in America*, *Washington DC Super Lawyers*, *Marguis Who's Who in America*,

The International Who's Who of Insurance and Reinsurance Lawyers, and *The Lawdragon 500 Leading Lawyers*. Mr. Oshinsky is a principal author and editor of *Practitioner's Guide to Litigating Insurance Coverage Actions* (Aspen Law & Business, Second Edition 2002), a multivolume set, updated yearly, that includes legal commentary, practical advice, and forms for attorneys and legal staffs involved in insurance coverage litigation. He has also published numerous articles in various publications. He may be reached at oshinskyj@dicksteinshapiro.com

Kirk A. Pasich is leader of Dickstein Shapiro LLP's Insurance Coverage Practice and serves on the Firm's Executive Committee. He has been named by *Lawdragon* as one of the nation's 500 "Leading Lawyers." According to *Chambers USA: America's Leading Lawyers for Business*, Mr. Pasich "is an unmistakable feature of California's insurance landscape" and is "the policyholder lawyer most likely to come up with a new argument or perspective concerning policy language." Mr. Pasich conducts an active trial and appellate practice, representing insureds in a wide range of complex insurance coverage matters. He has represented insureds in procuring coverage for a wide range of claims, including claims alleging anticompetitive practices, housing discrimination, and allegedly improper business practices. He has negotiated large insurance recoveries for his clients, including recoveries of \$100 million and more, and has served as lead trial counsel in jury trials in which his clients have obtained verdicts that ranked among the ten largest verdicts of the year in California. Mr. Pasich also is the author or co-author of several books, including *Casualty and Liability Insurance*, and the author of more than 400 articles regarding insurance issues. He may be reached at pasichk@dicksteinshapiro.com.

James R. Murray joined Dickstein Shapiro LLP in 2007 as a partner in the Insurance Coverage Practice. According to *Chambers USA: America's Leading Lawyer's for Business*, the "astute" Mr. Murray is well known in the insurance sector and ". . . he understands the issues and where the bottom line is and he makes the winning argument based on reason." Mr. Murray's trial experience has ranged from environmental contribution cases to breach of contract, bank fraud, trademark infringement, and professional liability. He has more than 20 years of experience in the litigation and settlement of insurance coverage matters on behalf of policyholders, including disputes involving casualty insurance, first-party property policies, aviation coverages, broker liability, kidnap and ransom coverage, clergy abuse claims, directors and officers lines, and all manner of London-market issues. Mr. Murray also tries and arbitrates an array of other commercial matters. He may be reached at murrayj@dicksteinshapiro.com.

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