

Preparing for the Storm: D&O Insurers Face Uncertainty in Coverage Amidst a Massive Influx of Subprime Mortgage Related Claims

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The United States housing/mortgage debacle, and the resulting near-collapse of the global financial markets, has become the biggest economic story of the last half-century. The origins of the crisis lie in the widespread failure of financial institutions to properly assess and address risk resulting from mortgage-backed securities. However, fault also lies at the feet of a broad spectrum of professionals whose role is to serve as gatekeepers at various levels in the real estate and financial sectors. While most of these professionals simply failed to recognize the flaws of a real estate model leveraged on unfettered, double-digit annual growth, others certainly committed intentional wrongdoing for personal gain.

In light of the above, there has been a spike in litigation against financial institutions and various professionals such as mortgage broker/bankers, lawyers, real estate agents, appraisers, and developers. This article examines the impact the mortgage meltdown is having on a particular group of professionals, directors and officers, and how their insurers are coping with mounting claims against their insureds for alleged wrongdoing associated with subprime mortgages. We begin with a brief history of the subprime loan, followed by a summary of the rising tide of subprime mortgage related litigation, and, finally, we discuss potential solutions for how insurers can address coverage for subprime related claims.

History of the Subprime Loan

Initially, there is no single or simple definition for the term subprime loan. A subprime loan is neither a particular type of product, nor a loan capped at a certain dollar amount. Rather, the term generally refers to any loan made to a borrower with FICO scores below 660, who could not otherwise obtain a conventional loan. This may be because the individual has a poor credit history or simply no credit history at all (i.e., college students, recent immigrants, etc.). Although the form of the loan may vary, lenders offering subprime loans use risk-based pricing whereby borrowers with low credit scores are classified into lower-rated tiers and charged accordingly. In other words, subprime borrowers pay more than prime borrowers (i.e., those with a good credit history – often a FICO score above 700) to borrow the same amount of money.

Two decades ago, borrowers without sufficient credit scores simply would have been denied a mortgage loan, due in part to the fact that lenders were restricted by usury laws that prevented them from charging rates commensurate with the risk of lending to subprime borrowers. However, the adoption of the Depository Institutions Deregulatory and Monetary Control Act in 1980 eliminated rate caps, and made subprime lending feasible (and more appealing) for lenders. Later, the Tax Reform Act of 1986 helped spur on the subprime lending movement by incentivizing borrowers to purchase homes and use mortgage debt as a tax deduction. In response to these legislative reforms and higher demand for loans by individuals with lower credit, lenders developed high interest rate loans to deliver risk-adjusted pricing to high-risk borrowers.

Notwithstanding the above, it was not until the mid-1990s that subprime lending began to gain traction. Rising interest rates led to declining loan origination volumes for banks, which in turn led to greater competition in the lending market for borrowers, including the expansion of subprime loans to maintain revenues. In this connection, between 1994 and 1997 subprime originations grew from \$535 billion to \$5.125 trillion. During that same period of time, the number of subprime lenders operating in the United States tripled from 70 to 210.

At the beginning of this decade, historically low interest rates coupled with escalating home prices resulted in the rapid expansion of subprime loans. Whereas in 1994, subprime loans accounted for less than 5 percent of total originations, they accounted for 63 percent of total originations in 2006.

As home prices soared between 1997 and 2005, homeowners who ran into financial trouble could easily sell their homes for more than they owed, avoiding default and foreclosure. However, as the housing market began to decline, subprime borrowers increasingly were unable to pay back the loans, and have been forced into default in record numbers. It is estimated that by 2009 there will be 2 million subprime defaults.

As the number of subprime loans rose, lenders became creative in selling them on the secondary market. Subprime loans were sold to securitization conduits – special purpose entities that issue residential mortgage backed securities, bonds, and other investment vehicles for resale to pension funds and other fixed income investors. According to the prevailing theory, even if the underlying borrower defaulted, the loan could be repaid by simply reselling the property, which was presumed to have appreciated. Of course, the harsh reality failed to match the theory. As the housing market inevitably declined, defaults rapidly increased, and the holders of securitized mortgages as well as the underlying notes have suffered catastrophic losses. It is estimated that losses associated with subprime loans will run into the hundreds of billions of dollars.

Subprime Litigation

As a result of the mountain of defaults and losses suffered by investors holding mortgage backed securities, litigation associated with subprime mortgages has drastically increased. Borrowers, investors and governments have filed suit against mortgage brokers and securities firms seeking to recoup their losses. These lawsuits often allege that the defendants misled or omitted pertinent information related to the securities and the underlying loans.

More than 300 civil lawsuits were filed in federal courts in the last two years relating to the subprime crisis. Some of the major classes of litigation include:

- Lawsuits by borrowers who have lost their homes or are unable to maintain payments – For example, in April 2007, Wells Fargo Financial, Inc. agreed to pay up to \$6.8 million to settle a class-action lawsuit over its nonprime mortgage lending practices. The lawsuit alleged that Wells Fargo failed to properly disclose points and prepayment penalties to borrowers and inaccurately reported loan balances for some California customers to credit reporting agencies.
- Class action lawsuits by the shareholders and public bondholders of the subprime lenders – As an example, in November of 2007, Citigroup, Inc. as well as former CEO Charles Prince and other executives were sued over losses related to the bank's subprime mortgage-backed securities portfolio. The shareholders alleged that Citigroup recklessly purchased subprime loans to be used for future collateralized debt obligations and then made improper statements regarding the financial services company's exposure to the subprime market meltdown.
- Lawsuits by state and federal regulators regarding misrepresentations to investors and borrowers – Prominent among this type of claim is the government investigation of Countrywide Home Loans. The investigation revealed that the company encouraged its sales force to shoehorn borrowers, who would have qualified for a standard fixed-rate mortgage, into exotic loan products with much higher fees and interest rates. In addition, the company had little regard for a borrowers' ability to repay the loan. One company manual stated that the lender would underwrite a loan that left only \$1,000 a month in disposable income after mortgage payments, for a family of four.
- Lawsuits against the subprime lenders and underwriters of the securitized loans by institutional investors who have lost money on what they purchased – One of the earliest of these claims was brought In April 2007, when Credit Suisse was

sued by Bankers Life Insurance Company in a lawsuit in which the insurer claimed it lost money on the investment grade bonds backed by subprime mortgages that Credit Suisse had sold. The plaintiff alleged that Credit Suisse accepted inferior loans, failed to buy back fraudulent loans and covered up delinquencies.

D&O Coverage Issues

The above litigation has caused a spike in the number of claims submitted to professional liability and D&O insurers. Although there are numerous policy exclusions and other coverage defenses that are likely to impact an insurer's obligation to defend or indemnify subprime-related claims, the relative infancy of the subprime meltdown means that the effect of these exclusions on coverage largely has not been addressed by courts.

When a subprime related claim is tendered to a D&O insurer, what sort of coverage issues does the insurer face? Prominent among the coverage issues to be considered are: (1) rescission; (2) bad acts/personal profit exclusions; (3) insured v. insured exclusions; (4) securities exclusions; and (5) predatory lending exclusions.

Rescission

Rescission may be available to an insurer confronted with a demand for coverage of subprime related litigation. In the past, insurance applications did not ask specific questions regarding subprime mortgages or lending practices. However, one of the first responses to the subprime crisis has been to increase underwriting scrutiny of subprime exposures. Applications have been developed by insurers to determine whether applicants make home loans to the riskiest borrowers or invest in securities backed by them. Separate from application questionnaires, insurers are conducting independent underwriting investigations of an applicant's potential subprime exposures.

Where material misrepresentations are made in an insurance application, an insurer may seek to rescind the policy. However, uncertainty may arise if application questions are not precisely defined and unambiguously written. Moreover, some brokers now recommend that their clients not give written responses to detailed insurance applications and instead give verbal responses. This can increase the difficulties insurers face in rescinding a policy, even in the face of independently verifiable misrepresentations by an insured.

Bad Acts / Personal Profit Exclusions

Most D&O policies contain exclusions precluding coverage for fraudulent acts and the gaining of profit to which the insured was not entitled. Most of these exclusions have "in fact" exceptions which make the exclusion applicable only upon a final adjudication. These exclusions may be used to defeat an insurer's indemnity obligation. However, the "in fact" exception typically requires that the insurer provide a defense or reimburse defense fees and costs.

Insured v. Insured Exclusions

Another common exclusion found in D&O policies is the insured versus insured exclusion. Although the precise language of these exclusions differs considerably among policies, these exclusions preclude coverage where a claim is brought by an insured. Moreover, in some cases these exclusions preclude coverage where a claim is merely "assisted by an insured."

As discussed above, many subprime claims may be brought by shareholders who also may be defined as insureds under the insurance policy. Suit may also be brought by company employees who invested in their own firm. However, sometimes these exclusions are drafted such that the exclusion does not apply to claims brought by insureds who are bringing suit solely in their capacity as a customer or client. Moreover, even if the policy's insured versus insured exclusion was drafted in a way to defeat coverage, public policy might still require that coverage exist. As one court noted:

The unreasonableness of Gulf's interpretation of the exclusion is further demonstrated by the fact that, if the Court were to adopt Gulf's interpretation, the exclusion would tread dangerously close to violating the public policy of the State of California. As Gulf admitted at oral argument, its interpretation of the exclusion would create a strong incentive for companies to prevent their directors and officers from providing information to securities fraud plaintiffs in order to avoid the loss of insurance coverage.

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Finally, Gulf's interpretation of the exclusion is unreasonable because it would render the coverage provided by the policy illusory. Under Gulf's interpretation, a director or officer would no longer be covered any time that any other director or officer provided any information that aided the plaintiffs in a securities fraud action. The circumstances under which this could happen are quite broad, as noted above. No reasonable insured would expect to have the continuation of his or her insurance coverage depend upon chance in such a manner.

For all these reasons, Gulf's interpretation of the term "assistance" as used in the exclusion is patently unreasonable. The Court instead holds that the exclusion bars coverage for securities fraud claims only if a director or officer actively and voluntarily provided substantial aid or help to a securities fraud plaintiff with the intent to aid the prosecution of the lawsuit in order to obtain an economic benefit. This interpretation avoids the problems of absurdity, violations of public policy, and illusory coverage inherent in Gulf's proposed interpretation, while providing Gulf with protection from collusive suits, which was apparently the primary reason that such exclusions were adopted.

Harris v. Gulf Insurance Co., 297 F.Supp.2d 1220, 1226-27 (N.D. Cal. 2003)(internal citations omitted).

Security Exclusions

A D&O policy may have an exclusion precluding coverage for loss arising out of "any security holder's or investor's interest in securities or obligations backed by mortgage loans . . ." As discussed above, much of the subprime litigation is brought against companies and directors and officers for loss suffered by investors. A security exclusion would likely preclude coverage for this type of litigation.

Predatory Lending Exclusions

Insurers have also drafted exclusions to specifically address the problem of subprime mortgages. These exclusions are typically called predatory lending exclusions, and preclude coverage for "predatory, abusive, unfair or deceptive mortgage lending practices." These terms are sometimes left undefined. However, the exclusion often lists a series of acts that are considered "predatory, abusive, unfair or deceptive." For example, one such exclusion lists the following acts:

1. Equity Stripping and Fee Packing;
2. Loan Flipping;
3. Refinancing of Special Mortgages;
4. Encouragement of Default;
5. Financing single premium credit life, disability or unemployment insurance;
6. Negative amortization, involving a payment schedule where regular periodic payments result in an increase in the loan principal balance;

7. Balloon payments in short term transactions;
8. Improper prepayment penalties;
9. Improper post-default interest rate increases;
10. Loans made without regard to the consumer's ability to pay;
11. Pricing terms that result in the loan being subject to the provisions of the Home Ownership and Equity Protection Act, 15 U.S.C. § 1639 et seq.;
12. Original principal balances of the loan in excess of 125% of appraised value;
13. Payment schedules which consolidate more than two periodic payments and pay them in advance from the loan proceeds;
14. Payments to home improvement contractors under a home improvement contract from the proceeds of a residential mortgage loan other than by an instrument payable to the consumer, jointly to the consumer and the contractor or through an independent third party escrow agent.

This type of exclusion has two notable features. First, in an effort to restrict coverage it is phrased broadly. The intent of the exclusion is to incorporate so-called predatory lending acts passed by the federal and state governments into insurance policies. See, e.g. 15 U.S.C. § 1639, et seq. Second, it appears the specific acts listed are common and in some cases rampant in the subprime industry. Given the breadth of the exclusion and how it is specifically targeted at subprime lending practices, insurers should be able to use these types of exclusions to bar coverage for subprime related claims.

Where Do We Go From Here?

The interpretation of the D&O policy provisions discussed here is only beginning to be tested in the subprime context. However, it is likely that many of these policy provisions will provide strong coverage defenses for D&O insurers faced with mounting subprime claims. In the future, the best way for the D&O insurance market to control subprime risks is through strong underwriting. Insurers should spell out precisely the loan-related risks they are willing to cover or exclude, and draft policy applications with specific questions designed to determine if subprime mortgages are originated by the applicant

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