

**NAVIGATING THE STORM: INSURANCE
COVERAGE ISSUES RAISED BY THE
GROWING WAVE OF SUBPRIME
MORTGAGE CRISIS LITIGATION**

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Biographical Information

Linda Woolf is the Managing Partner at the Baltimore law firm of Goodell, DeVries, Leech & Dann, LLP, and the head of its commercial litigation and insurance coverage departments. She graduated magna cum laude from the University of Baltimore Law School where she was the Managing Editor of the Law Review.

Linda regularly represents insurers in coverage litigation and has participated in protracted trials involving coverage disputes and bad faith claims against insurers in federal and state courts. She has represented insurers in disputes under financial lines policies, including D&O, banker and broker E&O policies. Linda is a frequent lecturer on insurance issues and has authored a number of articles in these areas, including articles on insurance coverage for claims against corporate directors and officers, business-related claims, personal and advertising injury, and employment-related claims.

Linda is a Vice Chair of the Commercial Litigation Section of the Federation and served as the Chair of the Nominating Committee at the 2008 Annual Meeting in

Banff, Canada. She has served on several of its ad hoc committees, including the Associate Retention Committee. She is a past Chair of the Network of Trial Law Firms, Inc. and a past member of the Executive Board of the Maryland Association of Defense Counsel and past Co-Chair of its Appellate Committee.

In 2007-2008, Linda was named as one of the Top 25 Women Super Lawyers in Maryland, was honored with the Leadership in Law Award and as one of the Top 100 Women in Maryland. She has been recognized by Best Lawyers in America for commercial litigation.

Navigating the Storm: Insurance Coverage Issues Raised by the Growing Wave of Subprime Mortgage Crisis Litigation

Introduction

In recent years, the health of the global economy grew precariously dependent on the accuracy of two faulty premises: (1) institutions will not lend money to homeowners who are unlikely to repay and (2) American home values will steadily rise. The untimely realization that *both* of these premises are false has triggered the most significant global economic crisis of modern times. In 2008 alone, the chaos of this crisis has caused trillions of dollars in losses globally and prompted governments to authorize previously inconceivable expenditures to try to contain the damage and prevent the crisis from worsening in 2009.

Where trillions of dollars are lost in a short period of time, it is a safe bet that significant litigation will soon follow. This paper addresses the fundamental changes to American subprime mortgage practices, which ultimately precipitated the global crisis, and the types of litigation that are most likely to ensue in its aftermath. Particular emphasis will be given to insurance coverage litigation.

I. The “Subprime Mortgage Crisis”

When the “dot.com bubble” of the late 1990s American bull market burst, investors sought a new and reliable profit source. Seizing upon the American housing market’s long record of robust growth and its apparent immunity to the turbulence in the stock market, investors put their money into securitized home mortgages, i.e., bundled mortgages converted into tradable securities and available to investors anywhere in the world. Confident in the stability of American housing prices and the due diligence that historically accompanied a bank’s decision to lend a homeowner money, investors generally did not consider mortgage-backed securities high-risk investments. See Jennifer E. Bethel, Allen Ferrell, & Gang Hu, Harvard Olin Center for Law, Economics, and Business Discussion Paper No. 612, “Law and Economic Issues in Subprime Litigation,” at 15 (March 2008) (“Harvard Discussion Paper No. 612”) http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf.

Fundamental changes in typical lending practices over the last decade and a half, however, eroded many of the safeguards that had always limited the risk of widespread mortgage default. First, the federal government, recognizing the positive social change attendant to increased levels of home ownership, encouraged banks to broaden the pool of potential borrowers to whom mortgages would be offered. See Luci Ellis,

Bank for International Settlements Paper No. 259: "The Housing Meltdown: Why Did It Happen in the United States?" at 5 (September 2008) <http://www.bis.org/publ/work259.pdf?noframes=1>. Second, banks and other loan originators, knowing that they would almost immediately re-sell new mortgages to be bundled and securitized, lost much of their incentive to scrutinize a mortgagee's ability to pay and the accuracy of his mortgage application. Harvard Discussion Paper No. 612, *supra* note 1, at 23-24; see also BNA Securities Regulation & Law Report, "Subprime Mortgage Lending: Possible Securities Litigation Exposure" ("BNA Subprime Report") Vol. 39, No. 37 p. 1455 (Sept. 24, 2007). Third, subprime mortgages, i.e., mortgages that were either offered to individuals with weak credit ratings or aggressively structured to minimize payments in the first few years of the loan, grew from a negligible portion of the mortgage market to approximately 20% of all new mortgages. Harvard Discussion Paper No. 612, *supra* note 1, at 23-24.; see also BNA Subprime Report, *supra* note 3, at 1455. In this environment, riskier home financing packages, such as interest-only mortgages and "teaser rate" hybrid adjustable rate mortgages, proliferated and were offered as a financing alternative to homeowners who could not afford a traditional 30-year fixed mortgage. BNA Subprime Report, *supra* note 3, n.5. The success of these mortgage practices, however, was predicated on the assumption that home values would continue to rise, which would allow many homeowners to refinance after a few years to keep their homes or allow banks that did foreclose on defaulting parties to cover their losses with foreclosure sales. Matthew L. Jacobs, Lorelie S. Masters and Daniel Weiner, *Coverage*, Vol. 18 No. 4, "Insurance Coverage and the Subprime Crisis: a Broad Overview," (July/August 2008) ("Insurance Coverage and the Subprime Crisis") http://www.jenner.com/files/tbl_s20Publications/RelatedDocumentsPDFs1252/2206/Coverage_07.08.pdf.

Securitization of subprime mortgages and the movement of these securities around the world set the stage for what many have dubbed "the subprime mortgage meltdown." American home prices not only stopped rising but also began a steady decline in 2006, just as many homeowners were moving from their low introductory rates to higher payments. Harvard Discussion Paper No. 612, *supra* note 1, at 19. Mortgage defaults spiked, and foreclosure sales did not come close to covering the balance of the mortgages. *Insurance Coverage and the Subprime Crisis*, *supra* note 6, at 2 (citing Centre for Responsible Lending, "A Snapshot of the Subprime Market" <http://www.responsiblelending.org/pdfs/snapshot-of-the-subprime-market.pdf> Nov. 28, 2007). While our economy has certainly had periods of high mortgage defaults in its past, never before had so many homes been financed through subprime mortgages and

never before had the rate of mortgage defaults been so intertwined with the stability of traded securities. The combination was catastrophic.

Problems beget problems as the rising default rates further depressed home values, thereby causing even more defaults. As the flow of revenue that upheld the value of these securities became seriously compromised and investors began to appreciate that the problem was likely to get much worse, the value of these securities plummeted. Institutions and individuals that had heavily invested in mortgage-backed securities believing that they had made a low-risk investment were stunned by their heavy losses. Soon banks and financial giants like Lehman Brothers and AIG began to collapse. See LawDragon: "The Financial Crisis and AIG: What Now?" (October 2008) http://www.lawdragon.com/index.php/newdragon/fullstory/the_financial_crisis_and_aig_what_now/. Banks essentially stopped lending money, even among themselves, in fear that their loans would not be honored. The Financial Times of London, "LIBOR Rates Show Banks Hoarding Cash," (Sept. 23, 2008) <http://loans.cbonds.info/eng/news/410281>. In less than a year, the Dow Jones Industrial Average lost nearly half its value. See <http://moneycentral.msn.com/investor/charts/chartdl.aspx?Symbol=%24indu&CP=0&PT=7> to chart Dow Jones Industrial Average from its peak in December 2007. Other countries suffered similar staggering losses while governments around the world hastily crafted rescue plans calling for the infusion of hundreds of billions of taxpayer dollars into their economies. The Emergency Economic Stabilization Act of 2008, signed into law on October 3, 2008, allocated \$700 Billion for the so-called "Wall Street Bailout." Pub. L. No. 110-343.

II. Where Litigation Is Emerging

With such widespread economic devastation, widespread litigation has followed. Paradoxically, the absence of any single entity that is clearly blameworthy for the subprime mortgage meltdown appears to have only *increased* litigation because the number of possible defendants is higher and each is capable of pointing the finger elsewhere. Litigants have attacked on multiple fronts, and some may be both a plaintiff and a defendant in litigation over the same set of events.

Borrower Lawsuits

Homeowners are suffering foreclosures at a staggering rate and have quickly emerged as the most common subprime mortgage litigant. See Paul Jackson, "Subprime Mortgage Litigation Continues to Explode" (April 23, 2008) <http://www.housingwire.com/2008/04/23/subprime-mortgage-litigation-continues-to-explode/>. Many are pursuing class

actions lawsuits under federal and state consumer protection laws alleging essentially that the loan originators misled them and signed them up for loans that they knew they could never repay. Insurance Coverage and the Subprime Crisis, *supra* note 6, at 3; see, e.g., *Morris v. First Franklin Fin. Corp.*, No. 07-614 (N.D. Ga.) (filed March 16, 2007). Some of the subprime borrower litigation is being brought by city and state governments on behalf of their residents. Insurance Coverage and the Subprime Crisis, *supra* note 6, at 3. The borrower suits seek recovery for a host of allegedly predatory lending practices, including affirmative misrepresentation, failure to make mandatory disclosures, falsifying credit information and home values, as well as various overcharges and kickbacks. *Id.* Some suits raise civil rights issues alleging that predatory lenders targeted low-income minority communities or caused urban blight. *Mayor and City Council of Baltimore v. Wells Fargo, N.A.*, No. 08-cv-00062 (D. Md.); *City of Buffalo v. ABN Amro Mortgage Group, Inc.*, (N.Y. S.Ct. Erie Cty.); *City of Cleveland v. Deutshce Bank Trust Co.*, No. cv 08 646970 (Ohio Ct. Cm. Pl. Cuyahoga Cty.).

Investor and Shareholder Lawsuits

Angry investors have already filed dozens of lawsuits focused on the financial institutions that invested heavily in mortgage-backed securities. Insurance Coverage and the Subprime Crisis, *supra* note 6, at 5. Typically brought under federal securities laws, these suits commonly allege active misrepresentation and/or lack of due diligence by the seller. Some investor suits have also named the insurer who provided credit enhancement insurance, which is designed to protect investors from losses if a portion of the loans default. *Banker's Life v. Credit Suisse First Boston*, No. 07-cv-00690 (M.D. Fla.). With such dramatic losses, these insurers are likely to deny coverage once they believe the policy limits have been reached. Many believe that the credit rating agencies who favorably rated the securities will have to defend numerous lawsuits due to their failure to keep the issuing entities at arms-length when rating their bonds. Significant government investigations of these rating agencies are already underway. In 2007, the Securities and Exchange Commission formed a 25-member working group within its Enforcement Division to investigate and pursue subprime mortgage cases. See Testimony of SEC Chairman Christopher Cox before House Subcommittee on Financial Services, Committee on Appropriations, June 26, 2007 (www.sec.gov/news/testimony.shtml). The States of New York, Massachusetts, Ohio, Connecticut, Alaska, and Illinois (and the District of Columbia) are among those that have filed subprime litigation. See, e.g., "Prosecutors Widen Probe into Subprime," *Wall St. J.* (Feb. 8, 2008).

Shareholder class actions have targeted a broad array of defendants, including lenders (*Pappas v. Countrywide Fin.*, No. 07-cv-05295 (C.D. Cal.), underwriters (*Jay Peter Kaufman Revocable Trust v. New Century Fin. Corp.*, C.D. Cal., No. 8:07-cv-00585 (filed May 22, 2007)), companies that invested in mortgage-backed securities (see, e.g., *Cornwell v. Credit Suisse Group*, No. 08 CIV 3758 (S.D.N.Y.) (Complaint Filed); *Wesner v. UBS AG*, No. 07-CV-11225 (S.D.N.Y.) (Complaint Filed); *Life Enrichment Found. v. Merrill Lynch & Co.*, No. 07-CV-9633 (S.D.N.Y.) (Complaint Filed); *Briarwood Investments, Inc. v. Care Investment Trust, Inc.*, No. 07-CV-8159 (S.D.N.Y.) (Complaint Filed); *Kornfield v. Opteum, Inc.*, No. 07-CV-14278 (S.D. Fla.) (Complaint Filed)), and credit rating agencies (*Reese v. Bahash*, D.D.C. No. 1:07-cv-01530 (filed Aug. 27, 2007); *Teamster's Local 282 Pension Trust Fund v. Moody's Corp.*, S.D.N.Y., No. 07-cv-8375 (filed Sept. 26, 2007)). These actions commonly allege that defendants unlawfully obscured and downplayed the extent of their involvement in the subprime mortgages, thereby artificially inflating their stock values. At least one investor recently sued a beneficiary of the federal government bailout, contending that the board of American International Group, Inc. (AIG) violated shareholder rights and Delaware corporate law by accepting federal funds and relinquishing a majority stake in the corporation to the federal government without permitting existing shareholders to vote on the proposal. *Wilma Walker v. American Int'l Group, Inc.*, CA 4142 (Del. Chanc'y Ct.) (reported in The (Maryland) Daily Record, Nov. 6, 2008, at 17A). In future suits, shareholder are likely to name auditors and even transactional lawyers as defendants.

ERISA Beneficiary Lawsuits

Employer retirement plan beneficiaries, who have seen the value of their company plans slashed, have already begun filing lawsuits against the plan trustees alleging that they violated ERISA by recklessly investing in securitized subprime mortgages. *Williams v. Regions Fin. Corp.*, N.D. Ala., No. 08-cv-00448 (filed March 12, 2008); *Unisystems Inc. Employees Profit Sharing Plan v. State Street Bank and Trust Co.*, S.D.N.Y., No. 07-cv-9319 (filed Oct. 17, 2007); *Chatman v. Countrywide Fin. Corp.*, C.D. Cal., No. 2:07-cv-06695 (filed Oct. 16, 2007). While much of this litigation has targeted employers that are financial institutions or mortgage lenders and that are heavily invested in their own companies, any employer whose retirement plan trustees have invested heavily in these failed securities faces likely litigation.

Issuer and Underwriter Lawsuits

Mortgage backed securities were often issued with a guarantee that the mortgage issuer would buy back the mortgages of any defaulting homeowners. Harvard Discussion Paper No. 612, *supra* note 1, at 13. This added layer of security contributed to the illusion that these were “safe” investments. *Id.* at 20. Yet, when the default rate skyrocketed, issuers were unable to honor the agreement and still stay afloat. *Id.* This left many underwriters without the help they needed when they needed it most. More litigation between issuers and underwriters over this issue should be expected.

III. Insurance Coverage Implicated by Subprime Mortgage Litigation

D&O and E&O Coverage

Businesses and their key executives are typically insured against claims for certain wrongful acts done in an official capacity through directors and officers (“D&O”) and errors and omissions (“E&O”) insurance policies. D&O insurance may cover the cost of defending and satisfying claims against a company’s directors and officers and/or the company itself, depending on the type of policy purchased. D&O insurance typically comes in three varieties: “Side A” covers certain losses incurred by individual directors and officers; “Side B” covers claims the corporate entity has indemnified; and “Side C” covers certain claims against the corporation itself. E&O insurance covers claims based upon allegedly wrongful acts committed while performing professional services and typically obligates the insurer to defend the insured for covered claims and pay any damages.

Considering the legal theories and allegations that support the litigation described above, it is difficult to craft a scenario in which a subprime mortgage lawsuit would *not* implicate these types of insurance policies. The flood of subprime mortgage litigation that is already underway will heavily strain these policies. A corresponding surge in claims and related coverage disputes is also expected. For example, Bear Stearns predicted at the start of 2008 that there would ultimately be \$8 Billion to \$9 Billion worth of claims involving D&O and E&O policies. See Susanne Sclafani, “Analyst Ups Estimate of D&O/E&O Subprime Impact to \$8-\$9 B,” National Underwriter Online News Service, Jan. 28, 2008. Given how badly the economy has performed since then, that figure could be much higher.

Because D&O and E&O policies typically have policy limits that are eroded by defense expenditures, competing interests may seek to lay claim to the limited proceeds. Assume, for example, that an E&O policy provides \$5 Million in policy limits, including reimbursement coverage for defense expenditures incurred by both the insured entity (or entities) and executives. In the context of the subprime meltdown, claims asserted against multiple executives and entities could quickly exhaust policy limits in defense expenditures, particularly given the billing rates of the high-end law firms commonly among approved panel counsel for D&O liability litigation. Further, assume that the underlying plaintiffs also seek the proceeds of the policy as indemnity for their claims. How do these competing claims – which can easily add up to many times the policy limits – get resolved?

As to the underlying claimants, at least, the answer may be relatively easy; as their rights do not mature unless and until they obtain a judgment, they are least likely to receive any proceeds. As to the competing claims of executives and insured entities, however, answers can be less clear. For example, should expenditures in the defense of criminal charges take precedence over expenditures defending against civil claims? Should claims asserted against insured individuals take precedence over insured entities? If there are policy provisions governing the order of priority of defense expenditures, how can these actually be given effect during the pendency of the litigation, without knowing in advance whether the total expenditures will ultimately be within or exceed policy limits. These and numerous other questions regarding policy limits can be raised by the subprime crisis as, indeed, they have been in the fallout from previous financial crises. See, e.g., Complaint for Interpleader, *National Union Fire Ins. Co. v. eChapman, Inc.*, Case No. 05-CV-02729-WDQ (D.Md. filed Sept. 30, 2005).

IV. Potential Defenses to Coverage

Potentially Excluded Claims

A common coverage exclusion implicated by D&O and E&O claims is for claims arising from an insured's intentionally fraudulent or dishonest conduct. This defense is likely to be raised by insurers who challenge the availability of coverage for a subprime mortgage claim. Insureds will likely contend, however, that the insurer's duty to defend precludes this defense unless and until a court establishes the insured's fraudulent conduct through a final adjudication. Insurance Coverage and the Subprime Crisis, *supra* note 6, at 8. Additionally, some courts have narrowly construed the fraud exception in the context of securities claims, which are the primary claims from which companies seek protection when they

purchase the policies in the first place. *Id.* Thus, insurers may find that policy limits are significantly eroded or exhausted before any final adjudication that would determine conclusively the applicability of the intentional fraud exclusion.

The applicability of other commonly invoked exclusions is likely to be tested in the context of coverage disputes arising from subprime mortgage litigation. The personal profit or “ill-gotten gains” exclusion, frequently invoked in insider trading scandals, has less relevance in cases where such self-dealing is not alleged. *Id.* The exclusion typically applies to claims “arising out of the gaining in fact of any personal profit or advantage to which the insured is not legally entitled.” Because of the phrase “in fact” in this exclusion, contrary lines of authority have developed as to whether this exclusion requires a final adjudication before it can be given effect.

Courts have split on the proper application of the “in fact” language. Some courts have held that coverage cannot be denied absent a final determination that impermissible profits were gained. *See, e.g., American Chem. Soc’y v. Leadscope, Inc.*, 2005 WL 1220746 (Ohio Ct. App. May 24, 2005); *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035 (C.D. Ill. 2003). Other courts, however, reasoning that such a reading would render the exclusion essentially meaningless as applied to defense expenditures, have concluded that the exclusion is applicable to *claims* of ill-gotten gains, not only to proven improper profiting. *See, e.g., Brown & LaCounte, LLP v. Westport Ins. Corp.*, 307 F.3d 660 (7th Cir. 2002).

Delaware Law

To the extent that a policy explicitly or implicitly incorporates the indemnification provisions of Delaware law, as is often the case, these provisions make it more likely that policies will be found to provide coverage for the defense expenditures of corporate directors, officers, employees and agents.

The Delaware General Corporation law permits corporations to indemnify directors, officers, employees and agents for liabilities arising out of their corporate activities if they acted “in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person’s conduct was unlawful.” 8 Del. Code § 145(a). Where a director or officer has been successful “on the merits or otherwise” in defense of any such claim, the director or officer *must* be indemnified by the corporation for expenses actually and reasonably incurred in defense. *Id.* § 145(c).

Further, even where such an action is terminated by an *adverse* judgment, or a plea agreement or settlement, that “shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person’s conduct was unlawful.” *Id.* §145(a). The statute also provides that a corporation can indemnify directors or officers only upon a determination that the individual meets the applicable standard of conduct; expenses, including attorneys fees, may be advanced by the corporation upon an undertaking by the individual to repay such amount if it is ultimately determined that the individual was not entitled to be indemnified by the corporation. *Id.* §§ 145(d), 145(e).

Under these provisions, thus, corporations generally indemnify directors and officers who have been sued in connection with their corporate activities. While corporations may ultimately be entitled to reimbursement of advanced monies by a director or officer, litigation (and resources) are generally long over before the corporate individuals ever reach the point of being measured against the statutory standard.

Failure to Honor Notice Requirements

D&O policies have strict notice requirements, which often form the basis of a denial of coverage. Typical policies require that both the triggering event and notice to the insurer occur within the policy period or shortly thereafter. Failure to comply with the timeliness requirements of a contract’s notice provision should bar recovery completely. *See, e.g., Fed. Ins. Co. v. CompUSA, Inc.*, 319 F.3d 746 (5th Cir. 2003).

Rescission

Rescission, the retroactive cancellation of an entire policy, is a rarely invoked but possible defense to subprime mortgage claims if the insured has made false statements in either its insurance application or its publicly filed documents with the Securities and Exchange Commission or other government bodies. Insurers have argued that a restatement or correction of an SEC filing triggers rescission rights. An insurer can properly rescind an insurance contract if it can prove in court that it would not have issued the policy if the misrepresentation had not been made. *See ClearOne Commc’s Inc. v. Nat’l Union Fire Ins. Co.*, 494 F.3d 1238 (10th Cir. 2007). However, severability provisions within the contract may provide that the wrongdoing of one person in the company does not strip the company and other executives of their insurance coverage. *See id.*

V. Other Insurance Coverage Issues

Renewal

Troubled by the prospect of an excessive amount of D&O and E&O claims related to subprime mortgage litigation, insurers may balk at renewing policies that do not carve out an exclusion for these claims. In response, insureds may seek to purchase extended discovery periods to allow them more time to report claims arising during the original coverage period. In any event, insureds who want to maintain coverage for subprime litigation claims will see much greater costs going forward.

Counting Underlying Claims

Policy limits, sublimits and/or deductibles may be contractually tied to the number of underlying “claims” at issue. If they are, litigation can ensue regarding the number of “claims” involved in the underlying litigation, including where the underlying action is a class action. In at least one case, a court has concluded that each member of a class has a separate cause of action, and applied a separate self-insured retention for each member of the class. See *Musmeci v. Schwegmann Giant Supermarkets, Inc.*, 332 F.3d 339 (5th Cir. 2003). Courts also have applied multiple SIRs or deductibles to each of the plaintiffs in multi-plaintiff actions. See, e.g., *Vargas v. Hudson Co. Bd. of Elections*, 949 F.2d 665 (3d Cir. 1991); *Maxim Mfg. Corp. v. Alliance Gen. Ins. Co.*, 911 F. Supp. 239 (S.D. 1995); *Reynolds v. S&D Foods, Inc.*, 822 F. Supp. 705 (D. Kansas 1993); *Lamburton v. Travelers Indem. Co.*, 325 A.2d 104 (Del. Super. Ct. 1974), *aff’d*, 346 A.2d 167 (Del. 1975). Yet, other courts have held that all of the claims asserted by plaintiffs in a class action constituted a single claim. See, e.g., *Highwood Properties, Inc. v. Executive Risk Indem., Inc.*, 407 F.3d 917 (8th Cir. 2005); *Gregory v. Holm Ins. Co.*, 876 F.2d 602 (7th Cir. 1989). This split in authority invites litigation on the “number of claims” issue.

Conclusion

Extraordinary losses normally trigger extraordinary litigation. While future events will determine just how deep and persistent the economic impact of the subprime mortgage meltdown will be, it is clear that this is an economic crisis of historic proportions. It has already caused stunning losses for financial institutions and markets around the world. Accordingly, the surge in subprime mortgage litigation has begun. Considering the vast array of individuals and institutions that have been

targeted in this litigation thus far, it appears the growing wave of litigation will be truly historic as well.

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