RISK
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Insurance Coverage During the Economic Crisis

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The current financial crisis has resulted in unprecedented market volatility, credit concerns, market losses and bankruptcies affecting financial institutions. These economic conditions, in turn, have led to dramatic increases in litigation filings, regulatory activity and criminal and administrative investigations and proceedings. For example, according to the Stanford Law School Class Action Clearinghouse, the number of federal securities class actions increased 19% in 2008 over the number of suits filed in 2007. More than half of those suits involved firms in the financial services sector.

According to the international consulting firm Navigant Consulting Inc., the vast majority of claims filed during 2007 and 2008 relating to the financial, institutional and subprime mortgage crises fell within five areas: 1) securities actions, 2) contract claims, 3) borrower class actions, 4) employee class actions and 5) bankruptcy-related actions.

These represent the five primary areas of potential exposures for companies, many of which may be covered by insurance. With this in mind, policyholders faced with claims arising out of the financial crisis should not assume that no coverage applies, but should instead review their policies to identify all available coverage. The following will outline potential coverage for many of these actions, discuss special concerns in light of increased bankruptcy filings and highlight practical concerns over policy language.

Securities Claims

Securities-related claims include: suits alleging misrepresentations by issuers or underwriters; claims against investment managers, brokers and dealers; securities fraud cases; stock drop and auction-rate securities cases; suits alleging misrepresentations about the quality of assets or exposure to risk; failed deal cases; and suits alleging broken investment promises.

The most likely sources of insurance coverage for securities-related claims are directors and officers (D&O), errors and omissions (E&O), and investment advisors professional liability insurance policies. A variety of policy forms are available, and even small changes to policy language can significantly broaden or restrict coverage.

Basic D&O polices cover individual directors and officers relating to claims made during the policy period for loss arising from actual or alleged wrongful acts committed in their capacity as a director or officer. Most, but not all, D&O policies also provide coverage for the company or entity, as well. Public companies are often covered for securities claims only, while D&O policies covering private companies cover a wider variety of claims against the entity.

There are several considerations regarding D&O coverage to which policyholders should pay particularly close attention. First, in order to obtain the broadest coverage, the term "securities claims" can be defined to include not only claims related to securities issued by the insured organization, but also to any claims alleging violation of state or federal securities laws or regulations. This would expand coverage to, for example, failed deal claims.

Second, since most D&O policies do not contain a duty to defend, language expressly requiring the insurer to advance defense costs on an on-going basis should be included.

Third, policyholders should be aware of the possibility of coverage for costs incurred in defending against criminal and regulatory investigations. The broadest of policies even cover informal regulatory investigations and Wells notices. Policyholders should not be mislead by the fact that D&O policies often exclude coverage for "fraudulent," "dishonest" or "willfully illegal" conduct, and "personal profit to which the insured is not entitled." Policyholders may nonetheless find that their policies provide coverage for the significant costs associated with criminal and regulatory investigations, particularly where such exclusions are limited to apply only upon a final adjudication determining that the insured committed the alleged fraudulent or dishonest acts. As a result, D&O policies frequently cover defense and even settlement costs in such cases.

In addition to D&O policies, E&O policies may also serve as a source of coverage for securities claims-especially claims involving bank underwritings, and broker deals regarding securitization. E&O coverage is discussed in more detail below.

A third source of coverage for securities claims is investment advisors professional liability insurance policies. These policies provide broad E&O and D&O coverage for mutual funds, private equity, hedge funds and/or venture capital funds. These policies may provide coverage for claims involving auction rate securities and investor claims challenging disclosure, risk and investment decisions. Policyholders with investment advisors policies should make certain that dishonest acts exclusions are sufficiently narrowed to exclude claims "for" dishonest or fraudulent acts, and not acts merely "arising out" of dishonest or fraudulent acts.

Contract Claims

E&O coverage will likely serve as the main source of coverage for contract-based claims which can arise from investment advisor relationships as well as breach of representations and warranties in transaction or sales contracts. For example, MBIA v. Countrywide, a case filed in New York State Court, alleges contractual breaches in connection with home equity loans sold into securitizations for which MBIA provided credit enhancement.

Policyholders should note that although E&O policies often contain contractual liability exclusions, these exclusions may not bar coverage because most policies contain exceptions to the exclusions. For instance, a policy may exclude claims "arising out of, based upon or attributable to any actual or alleged breach of contract." Many policies, however, also include an exception for liability an insured would have "in the absence of such a contract or agreement." In MBIA, for example, the complaint includes allegations of fraud and misrepresentation that may provide a basis for coverage.

Although E&O policies are a main source of coverage for contract claims, other policies may also be triggered. For instance, policyholders faced with contract claims should not overlook their fidelity bond policies as an additional source of coverage.

Borrower's Class Actions

Typical borrowers' claims allege inadequate disclosures in connection with the loan origination process, pricing or other discrimination against protected classes of people and improper charges or payments. Both E&O and comprehensive general liability (CGL) policies may provide coverage for borrower's claims.

E&O insurance policies are usually designed to cover lenders or other professionals for negligence or malpractice. These policies are typically claims-made policies that provide indemnity for claims made against the insured during the policy period and alleging wrongful acts committed in the insured's professional capacity.

Two common exclusions are particularly noteworthy. First, E&O policies often contain exclusions for "return of fees." A policyholder faced with what appears to be a claim for fees should look closely at the complaint to determine if the claim is truly for fees or if the fee merely represents a measure of damages that would arguably be covered.

Second, like the D&O policies discussed above, many E&O policies contain exclusions for claims arising from fraudulent or dishonest acts. To ensure maximum coverage for such claims, insureds should seek policy language that makes clear that the exclusion does not apply unless and until the insured has admitted to committing a fraudulent or dishonest act, or upon a final adjudication that the insured has committed such an act.

Policyholders should also ensure that these exclusions are limited so that fraudulent or dishonest acts committed by one individual insured will not be attributable to other innocent insureds. Such a severability clause will protect innocent defendants in the event that several individual insureds are named defendants in a lawsuit arising out of one individual's fraudulent or dishonest acts. Companies should also protect their coverage position by explicitly limiting the employees whose acts or representations may be attributable to the company.

Another source of coverage for borrowers' class action claims are CGL policies. Although CGL policies cover a broad array of claims, borrowers' class actions typically implicate only personal injury or advertising injury coverage. Some CGL policies, particularly older ones, provide coverage for discrimination as part of their personal injury coverage. Therefore, a policyholder may find coverage for a claim alleging discriminatory lending under its CGL policy's personal injury coverage. Most modern CGL policies limit advertising injury coverage to copyright and trademark infringement or misappropriation of advertising ideas, but some may also include liability for falsehoods in advertising as part of an advertising injury. Therefore, advertising injury coverage may be available for suits alleging misrepresentation in the advertising of loan terms or practices.

A notable benefit of CGL policies is that they often impose a duty upon the insurer to defend the insured in all actions involving potentially covered claims. E&O policies may not impose such a duty. Additionally, CGL policies provide occurrence-based coverage, which means they cover damage or injury occurring during the policy period, regardless of when a claim is brought. Therefore, historic policies should be considered as a potential source of recovery, particularly for defense costs.

Employee Actions

Employee actions resulting from the current financial and credit crisis typically arise out of terminations, reductions in force or bankruptcy filings, and include class actions brought by laid-off employees under the federal Worker Retraining and Notification or "WARN" Act.

Some older CGL and D&O policies provide coverage for employment-related actions. Most policies issued in recent years exclude these claims, however. Stand-alone employment practices liability (EPL) insurance policies have become the standard source of insurance for employment-related claims. EPL policies cover a broad array of claims, including discrimination, harassment, wrongful termination, wrongful failure to hire or promote and other wrongs arising from the employment context. EPL policies often exclude ERISA and benefits claims, fines, penalties and injunctive relief, however.

EPL policies may also exclude intentional acts. Insureds should pay careful attention to policy language regarding intentional acts and note that such exclusions should exclude only intentional harm, not intentional acts. Some insurers have begun to include language suggesting that unintended results of intentional acts will also be excluded. This is particularly problematic in EPL policies since acts of harassment or discrimination can easily be viewed as intentional. Properly construed, these exclusions should apply only if the insured intended the specific harm suffered by the claimant. Depending on the precise policy language used, however, an insurer may argue that claims arising from any intentional act should be excluded.

Because EPL policies are claims-made policies, policyholders must give prompt notice to their insurers once a claim has been made. Policyholders faced with an employment-related dispute should be cognizant that, under some policies' definitions of "claim," they may be required to give notice upon an employee's filing of a grievance with the EEOC.

Bankruptcy-Related Actions

Policyholders should be aware that bankruptcy cases present an array of issues that can significantly complicate insurance coverage concerns. For example, D&O policy proceeds may become tied up in bankruptcy for years pending a determination of whether the policy is an asset of the bankrupt estate. In order to foreclose this possibility, companies may seek policies providing side-A only coverage, which provides coverage for directors and officers separate from the company. Alternatively, they may seek policies that include "order of payments" clauses that require proceeds be paid first to directors and officers, then to the company for indemnity payments to directors and officers, and finally to cover payment for claims against the company.

Key Policy Provisions to Consider

Given the current economic climate, it is critical that policyholders consider not only premiums, limits and retentions, but also that they consider policy language options as well. The following are the provisions that insureds should pay particular attention to:

- The definition of "loss." Many policies contain buried exclusions limiting what is considered a "loss." For example, provisions excluding "amounts uninsurable as a matter of law" may appear innocuous. Insurers may argue, however, that these provisions restrict coverage for actions brought under Section 11 and 12 of the Securities Act of 1933, or punitive damages.
- Conduct exclusions. To achieve maximum coverage, conduct exclusions should be limited to apply only after final adjudications, and should contain severability clauses ensuring that the bad acts of one individual insured will not bar coverage for other innocent insureds.
- Defense provisions. Policyholders should carefully consider the implications of seeking coverage that includes a duty to defend, recognizing that it may be a double-edged sword. While the duty to defend obligates an insurer to defend any claim where the allegations in the complaint are "potentially" covered, it may also give the insurer the right to choose defense counsel and control the policyholder's defense.
- Allocation provisions. Allocation provisions dealing with covered and noncovered claims or parties can have a significant impact on the amount of coverage for defense costs and settlements. For example, where a single claim includes insured directors, officers and uninsured employees, some policies may allocate based on the "relative financial and legal exposures" of the defendants. Policyholders can seek to delete this standard from the policy. In absence of such a provision, most courts would instead impose the "larger settlement rule," requiring the insurer to prove that the inclusion of the uninsured employees as defendants made any settlement more expensive.
- Excess insurance. Excess policies may contain additional exclusions to coverage and may not be consistent with the primary policy. Brokers and risk managers can assure that seamless coverage exists up the entire tower of coverage.
- Solvency risks. Policyholders can seek to protect themselves against problems that may arise if their insurers become insolvent. For example, excess policies are designed to drop down to cover an insolvent carrier below it. Policyholders may also strategically structure their excess insurance programs to reduce their risks by including smaller coverage layers and greater numbers of carriers in each layer.

Because of the changing economic climate, companies should be especially diligent in recognizing insurance coverage as a valuable asset. In light of the increased litigation arising out of the current economic crisis and the attendant costs of defense, insurance policies may serve as substantial sources of protection.

Thus, if faced with potential litigation, a company's risk management officers should thoroughly review the company's policies with its insurance brokers and legal advisors to ensure that the company fully utilizes all available coverage. Companies not immediately faced with litigation should carefully consider their coverage needs and tailor their insurance programs to fit the companies' specific needs.

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