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COMMERCIAL REAL ESTATE

Subprime mortgage crisis causes some to rethink insurance policies

BUSINESS OPERATIONS

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The U.S. consumer is suffering the indigestion that comes from feasting too long on easy credit and unfortunately, there is no quick bromide to ease the discomfort.

The growing number of foreclosures and credit card defaults confirms that the consumer has overindulged.

And the companies that encouraged consumers to keep on borrowing and spending are now experiencing their own discomfort as those credit card and mortgage defaults are requiring companies to increase their bad debt reserves and to write off debt related assets, particularly subprime mortgages.

But the threat to those companies is not limited to the damage done to a company's income statement and balance sheet.

Many of the companies that collectively make up the financial sector of the U.S. economy are already confronting the expense, risk and uncertainty of litigation as they find themselves in the cross-hairs of pension funds, investors and purchasers of collateralized debt obligations looking to hold someone, anyone, accountable for their growing losses.

Scores of lawsuits have already been filed and the targets range from mortgage lenders and investment banks, who packaged and sold collateralized debt obligations, to bond funds that purchased the collateralized debt obligations to auditors and credit rating agencies.

Companies across the financial spectrum, and their directors and officers, are the targets of federal regulators, state attorneys general and class action plaintiff lawyers.

IDENTIFY YOUR RISK

Whether your company is already embroiled in litigation or you just suspect someone is drawing a bull's eye on your company's logo, you need to identify the risk presented by the subprime mortgage lending crisis, evaluate your insurance coverage and take whatever action is necessary to preserve that coverage.

While an evaluation of your company's insurance coverage should be comprehensive, there are several types of coverage that may be particularly valuable in these troubling times.

Corporate defendants, or potential corporate defendants, and their officers and directors will want to review their policies. Directors and officers insurance provides protection in connection with Securities and Exchange Commission investigations, U.S. Department of Justice investigations, securities fraud class actions and derivative actions.

While directors and officers policies are generally understood as protecting directors and officers from liabilities arising from the performance of their jobs, those policies may also provide the company with protection.

For example, some directors and officers policies have a layer of coverage, commonly referred to as Coverage C, for the benefit of the corporation.

Companies that have any connection to the mortgage industry, and in particular subprime mortgage lending, may find themselves and their officers and directors the subject of securities class actions and derivative actions. Consequently, the company's directors and officers liability insurance may offer an important wall of protection.

While one can identify general principles common to any directors and officers policy, one should be careful not to confuse directors and officers coverage with the company's comprehensive general liability protection.

Unlike the company's comprehensive general liability policy, directors and officers policy forms vary among insurers. Consequently, you will need to carefully review the directors and officers policy to understand the protection provided.

The company should also ascertain whether it has errors and omissions coverage.

Many companies in the financial industry have a professional services liability policy to protect the company against errors and omissions.

Depending on the nature of your company's participation in subprime lending - from origination to the marketing of collateralized debt obligations - errors and omissions coverage may provide another line of protection in the event of litigation.

Errors and omissions coverage is important because the company's comprehensive general liability policy may not provide coverage for errors, contract performance disputes and liabilities arising from providing professional services.

Companies holding mortgage investments will want to examine whether they have mortgage insurance or some other credit insurance protection in the event of a default.

The presence of mortgage or credit insurance may be the difference between salvaging the value of the mortgage investment or losing it altogether.

Finally, if the company is the subject of a complaint, remember to carefully to review the company's comprehensive general liability coverage to see whether any of the allegations in the complaint potentially fall within the scope of coverage.

If so, the insurer's duty to defend (and perhaps even to indemnify) the company may be triggered.

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