Fault line: Coverage litigation arising out of the mortgage industry's meltdown

AS CLAIMS EMERGE from the troubled mortgage industry and the global credit crisis, some experts predict that the insurance industry is facing exposure in the aggregate of about $9.6 billion on errors and omissions and directors and officers liability insurance claims. In the wave of coverage litigation expected to grow out of these claims, a fertile ground for coverage litigation may be so-called conduct exclusions contained in most directors and officers and errors and omissions policies.

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A recent case, *New Fed Mortgage Corp. v. National Union Fire Ins. Co.*, 543 F.3d 7 (1st Cir. 2008), may be a harbinger of the coverage litigation to come. In this case, an individual mortgage broker working for New Fed, the loan originator, falsified credit reports on certain prospective borrowers whose loan packages were submitted to a prospective lender, Decision One. Decision One did not discover the discrepancies in the falsified reports until after it had closed the mortgages and resold some of them to a third-party investor.

Thus began the domino effect. Upon discovery, the third-party investor demanded that Decision One repurchase the mortgages. In turn, Decision One made demand on New Fed under an agreement in which New Fed "'warrant[ed] the accurateness and the truthfulness of all information, credit or otherwise,'" submitted by New Fed to Decision One and agreed to indemnify Decision One for losses that might arise as a result of the breach of any warranties contained in the agreement.

New Fed had an errors and omissions policy issued by National Union. An errors and omissions policy is intended to insure against liability arising out of the mistakes inherent in a particular profession or business. National Union denied coverage based on the fraud and dishonesty exclusion in the policy. In affirming the district court's grant of summary judgment in favor of the carrier, the appellate court reasoned that the insurance contract provided coverage for damages resulting from claims for any "wrongful act" of the "insured," but the policy specifically excluded any claim "alleging fraud, dishonesty or criminal acts or omissions on the part of the insured." The court noted the definition of "insured" included not only New Fed, but also the mortgage broker involved in the misconduct. The court compared the policy's coverage provisions and exclusions to the allegations contained in the demand letter from Decision One, which stated that New Fed had submitted "fraudulent information" including altered credit reports in support of the loan applications. According to the court, these allegations placed the conduct squarely at issue within the fraud and

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dishonesty exclusion of the policy.

Although the duty to defend is broader than the duty to indemnify, the court also found there was no duty to defend under the policy. While acknowledging that an insurer has a duty to defend its insured if the third party's allegations are "reasonably susceptible" to an interpretation that they state a claim covered by the policy, the court found that the insurer is not obligated to investigate or defend where the third party's allegations against the insured "lie expressly outside the policy coverage and its purpose."

What could have changed the outcome? Had the policy contained a severability of exclusions clause, the actions of the individual broker might not have been imputed to New Fed for the purposes of determining whether the exclusion foreclosed coverage. Also, a different result might have occurred had the policy language required a final adjudication of dishonesty, which ordinarily would require that the challenged conduct be established in a trial of the underlying liability action, a criminal conviction or the like.

In any claim, the most important determining factor for coverage is the nature of the allegations made. Had the allegations been that the mortgage broker or mortgage originator unintentionally submitted erroneous credit information, the result would likely be different. Additionally, the same conduct might support viable claims under different types of policies such as fidelity policies in which employee dishonesty is specifically covered.

There could be additional impediments to coverage, however, such as a challenge that a claim is by definition outside of the policy's coverage provisions. In *Medical Records Associates v. First American Empire Surplus Lines Ins. Co.*, 142 F.3d 513, 514 (1st Cir. 1998), a case involving coverage under an errors and omissions policy, for claims asserted against a medical records processing company for overcharging patients for photocopies of medical records, the court found that setting a price for photocopies and generating accurate invoices was not a "professional service" within the meaning of the policy. A related argument would be that an intentional act by the insured is simply not a "mistake" covered under an errors and omissions policy.

Another impediment found in errors and omissions and directors and officers policies is an exclusion for claims "arising from" or "arising out of" liability under contract that may apply even where noncontractual causes of action are asserted based on the same conduct. See "Trio of Recent Cases Affirms Broad Scope of Contract Exclusions" by Joseph A. Bailey III in the Professional Liability Underwriting Society Journal, issue XXI, volume No. 11 (November 2008). Had the mortgage broker in New Fed unintentionally provided misinformation on credit history and Decision One filed an action against New Fed claiming breach of warranty, negligence and misrepresentation alleging the same conduct as the basis for all three, the carrier might have denied coverage arguing that the liability grew out of the contractual agreement between New Fed and Decision One. In many instances, however, if the claim could exist independently from the existence of the contract, the exclusion should not apply.

Other coverage issues arising out of claims like those in New Fed may involve rescission, prior acts exclusions, regulatory exclusions, known loss exclusions and interrelated wrongful acts provisions.

The lesson for policyholders is to stay abreast of the risks inherent with their particular business model and the coverages available to hedge against those risks. Many of the problems mentioned above could be addressed in advance at renewal time through thoughtful analysis and careful planning with insurance professionals.