



COUGHLIN DUFFY LLP

CASE ALERT, NO. 34

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Recent Decision Denies Insurance Coverage for Mortgage-Related Liabilities

On September 30, 2008, the United States Court of Appeals, First Circuit, held that a fraud exclusion barred coverage to a mortgage originator/broker under the insured's Errors & Omissions policy for claims of alleged fraudulent misrepresentation of credit information to a mortgage lender.

New Fed Mortgage Corporation v. National Union, No. 07-2762 (1st Cir. Sept. 30, 2008). As we anticipate significant future filings in the subprime context, the First Circuit's decision will be relevant to coverage claims under Massachusetts law and instructive to federal and state courts elsewhere considering coverage issues in the subprime context.

The facts of the New Fed case are relatively straightforward. The insured mortgage broker procured applications for mortgages and submitted them to lenders for approval. As part of the submission of an application to a lender, the broker would include a credit report for the prospective borrower obtained from an independent credit agency. In this case, the broker allegedly falsified the credit reports for 15 applications. Before becoming aware of the falsified credit reports, the lender, who had accepted all 15 applications, resold four of the mortgages to a third party investor. After discovery of the falsified reports,

the investor demanded the lender buy back the mortgages at full price. After repurchase from the investor, the lender ultimately resold the four mortgages, but not until after it had sustained substantial losses.

The lender demanded that the broker compensate it for losses associated with the four mortgages. The broker in turn filed a notice of claim with its E&O insurer, National Union, which denied the claim on the grounds that it involved employee dishonesty.

National Union's policy excluded from coverage "any Claim . . . alleging fraud, dishonesty, or criminal acts or omissions . . . on the part of the Insured." The Court held that the lender's allegations fell squarely within this fraud exclusion and thus, National Union had no duty to indemnify. Notwithstanding that the duty to defend is broader than the duty to indemnify, the Court also held that National Union had no duty to defend because the claim "lies expressly outside the policy coverage and its purpose."

Although the New Fed decision is favorable to insurers faced with subprime and related claims submitted under E&O or other pro-

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Professional liability policies, it should be noted that the wording of fraud exclusions in such policies can vary widely. Many require establishment in fact or an adjudication of fraud before the exclusion will apply and many also specifically provide for defense or reimbursement of defense costs until fraud is established or adjudicated. Careful attention to the nature of the claim and the policy wording will be necessary to apply fraud or other potentially applicable exclusions.

Should you have any questions or comments regarding these matters, please feel free to contact us.