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NEWSLETTER

Insurer Can Rescind Policy Based on Misstatements in Application; Warranty, Dishonesty and Personal Profit Exclusions Bar Coverage

August 2008

The United States District Court for the Western District of Pennsylvania, applying Pennsylvania law, has held that an insurer was entitled to rescind an investment adviser E&O policy based on misstatements made by an insured in the application. *MDL Capital Mgmt., Inc. v. Federal Ins. Co.*, 2008 U.S. Dist. Lexis 57089 (W.D. Pa. July 25, 2008). The court also held, on alternative grounds, that no coverage existed because of the policy's application warranty, dishonesty and personal profit exclusions. Wiley Rein LLP represented the insurer.

The insureds, an investment adviser firm and several senior executives, operated a bond trading fund. The fund experienced massive losses as a result of leveraging carried out significantly in excess of the fund's parameters. When advised of the extent of the losses and the investment adviser's leveraging practices, the fund's sole investor redeemed its investment, recovering only approximately $9 million of its $225 million investment. The investor also sought to conduct an audit of the fund and otherwise reserved all of its rights against the fund and investment adviser. During a board meeting, the fund's board of directors also discussed whether the investment adviser, the fund and/or its board of directors faced legal liability as a result of the investment adviser's leveraging practices.

Thereafter, the investment adviser applied for D&O, E&O and EPL insurance. In the application, the investment adviser provided a negative response to a warranty question asking whether "the applicant or any of its partners, directors, officers, employees or trustees have any knowledge of any fact or circumstance which might give rise to a claim under the proposed policy." The application contained a warranty exclusion that provided that "if such knowledge exists[,] any claim arising from such fact or circumstances will not be covered by the policy." In reliance on the application, the insurer issued a conditional binder to the investment adviser providing D&O, E&O and EPL insurance. Shortly thereafter, the investor brought suit against the investment firm and its senior executives, who also served as directors of the fund. The investment adviser's CEO was subsequently convicted of fraudulent conduct in his administration of the fund and was ordered to forfeit more than $500,000 he gained from his fraudulent conduct.

The insurer initially denied coverage for the litigation based on certain provisions of the contemplated policies and reserved its right to rescind the policies and/or deny coverage under the application warranty exclusion pending its investigation. The insurance policies contemplated by the binder were never issued. The insured responded by filing suit against the insurer. During discovery, the insurer uncovered evidence regarding the insureds' knowledge of a potential claim by the fund's investor and promptly rescinded the policy and denied coverage based on the warranty exclusion.

The court first held that the policy's application warranty exclusion barred coverage for the proceedings related to the collapse of the fund. Applying the test enunciated in *Selko v. Home Insurance Co.*, 139 F.3d 146 (3d Cir. 1998), the court reasoned that the insureds subjectively had knowledge of facts and circumstances that objectively might give rise to a claim at the time the application was signed.

The court also held that the CEO's conviction for fraud relating to the fund's administration conclusively established his knowledge of facts and circumstances that might give rise to a claim and triggered application of the warranty exclusion. Because this exclusion provided that knowledge of "any director, officer or employee" acted to bar coverage for "any claim arising from such facts," the court held that the collateral estoppel effect of the CEO's criminal conviction barred coverage for all of the insureds.

Third, the court held that the insurer was entitled to rescind the policy as to all of the insureds on the basis of material misstatements made in bad faith by the CEO on the application. The operative policy did not contain a severability provision. Accordingly, the court held that, as an agent of the other insureds, the CEO's bad faith misstatements were imputed to the other insureds.

Finally, the court held that coverage did not exist for the CEO by virtue of the policy's dishonesty and personal profit exclusions. The court held that the CEO's criminal conviction established "in fact" that he had acted dishonestly in administering the fund. In addition, the court held that the related forfeiture order established "in fact" that the CEO personally profited from his dishonest conduct. Because the court granted summary judgment to the insurer on three other, separate grounds, it found it unnecessary to determine whether these exclusions could be applied against MDL Capital, the investment adviser firm.