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NEWSLETTER

U.S. District Court Holds that Parties Can Voluntarily Reform Insurance Contract

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A federal district court, applying Illinois law, has held that parties to an insurance contract can voluntarily reform the contract where a mutual mistake exists in drafting the policy. *St. Paul Mercury Ins. Co. v. Foster*, 2003 WL 21469149 (C.D. Ill. June 26, 2003). In its ruling, the court also addressed a number of other coverage issues, including the known loss doctrine, what constitutes insurable loss, application of the personal profit exclusion, and whether a written request for information constitutes notice.

The insurer issued a claims-made policy to a marketing firm that included a variety of coverages, including coverage for fiduciary liability. The insurer issued a policy that did not include the firm's Employee Stock Owners Plan (ESOP) on the list of ERISA plans insured and that contained an exclusion barring coverage for the ESOP. According to the district court, subsequent communications between the insurer and the firm confirmed that the insurer had intended to provide coverage for the ESOP, and that the ESOP had been excluded from coverage as a result of a mutual mistake by the parties. The insurer communicated to the firm that it had made a mistake, that it intended to provide coverage for the ESOP, and that it would find a way to accomplish the necessary technical corrections to the policy. Before the policy was formally changed, however, the firm and its directors and officers were sued in connection with a loss of value of stocks owned by the ESOP. The insurer subsequently initiated coverage litigation.

The court held that the parties had voluntarily reformed the policy to provide coverage for the ESOP. The court explained that reformation is available where there has been a meeting of the minds between contracting parties and when the agreement is reduced to writing "some agreed upon provision was omitted or one not agreed upon was inserted either through mutual mistake or through mistake by one party and fraud by another." The court also held that it does not require a court's equitable power to reform a contract and that parties can do so voluntarily. In fact, the court explained "that permitting and enforcing voluntary reformations by private parties is good policy in the abstract, as it encourages parties to contracts to correct their own mistakes without resorting to costly litigation." The court held that, based on the facts at issue, the parties had voluntarily reformed the contract, and the insurer could not change its mind now that it faced a potential liability.

The court also rejected the insurer's argument that the "known loss doctrine" barred reformation because the firm had begun to seek reformation after it had received a notice of potential litigation involving the ESOP. The court explained that the insurer had determined that the parties intended to include the ESOP in the policy from the very inception of the policy and at that time the firm did not have notice of the potential claim.

The insurer argued that it was also entitled to deny coverage because the underlying complaint sought restitution, which is uninsurable as a matter of public policy. The district court rejected that argument as a basis for denying coverage at this stage of the litigation because restitution was not the only form of relief potentially available to plaintiffs at trial.

The court also rejected as premature the insurer's argument that the personal profit exclusion barred coverage because the exclusion required a showing that the insured "in fact" gained such profits. The court reasoned the "[a]s such a finding is inextricably intertwined with a genuine issue of material fact requiring resolution at trial in the underlying case, the Court cannot make resolve [sic] this question on summary judgment prior to the resolution of the underlying litigation."

The district court rejected the insurer's argument that it had not received notice "as soon as practicable" because, while it had been informed of the lawsuit in a timely manner, it had not previously been informed of letters that had been sent three months earlier to the firm requesting a copy of the plan, discussing the decline in value of the shares and asserting a need for further information to "adequately protect" the interests of the underlying plaintiffs. The district court held that "mere" requests for information, "even if they allude to the possibility of a lawsuit," do not constitute a demand for services. The court also explained that the approach advocated by the insurer would be "bad public policy" because "[i]t would create uncertainty in every policy containing this notice requirement, as well as result in a flood of notices of 'claims' based on requests for information or efforts at intimidation by attorneys that may never materialize into demands against any insurance policies."

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