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NEWSLETTER

Fact Issues Preclude Rescission Despite Policyholder's Failure to Disclose Criminal Scheme

April 2008

The United States District Court for the Eastern District of Virginia, applying Virginia law, has held that fact issues regarding the falsity and materiality of statements on a policy application precluded rescission of a D&O policy, despite the fact that the insured company failed to disclose an ongoing criminal scheme. *Great Am. Ins. Co. v. Gross*, 2008 WL 376263 (E.D. Va. Feb. 11, 2008).

The insurer issued a D&O policy to a company. During the term of the policy, the company sought to double the relevant policy's limit of liability. To obtain the increase in limit, the company submitted an application that answered "No" to the following question: "Is the undersigned or any Director or Officer proposed for the increased Limit of Liability aware of any fact, circumstance or situation involving the Company or its Subsidiaries or the Directors or Officers of the Company or its Subsidiary which he has reason to believe might result in any future Claim which would fall within the scope of the Increased Limit of Liability?" Additionally, the application stated that by signing the policy, the proposed insureds warranted that "to the best of their knowledge, the statements set forth herein are true and correct and that reasonable efforts have been made to obtain sufficient information from each and every Director or Officer proposed for this Endorsement for the Increase in coverage to facilitate the proper and accurate completion of this Proposal Form." The officer who completed the application ultimately pled guilty to criminal fraud in connection with activities at the company and admitted that during the time frame in which he completed the above application, he was misrepresenting the true value of the company.

Asserting that the company's response to the application question and warranty statement were materially false, the insurer brought suit to rescind the increased limit of liability. The court first addressed choice of law. Virginia courts apply the *lex loci contructus* theory to determine the validity and meaning of insurance policies. Under this test, the law of the place where the last act necessary to complete the policy governs. The applicable last act under Virginia law was the delivery of the insurance policy. The company was located in Virginia, but received the policy from the insurer through its broker, which was located in New York. The court determined, however, that the relevant delivery was to the company in Virginia because the broker "was merely a conduit and not a party necessary to effectuate the policy." As such, the court applied Virginia law.

Turning to the merits, the court noted that "[a]n insurer seeking to rescind a contract based on an insured's alleged misrepresentation must clearly prove that (1) the insured's representation on the application was false; and (2) the false statement was material to the insurance company's decision to undertake the risk and issue the policy." In considering the application's question as to whether "any Director or Officer" was "aware of any fact, circumstance or situation . . . which he has reason to believe might result in any future Claim which would fall within the scope of the Increased Limit of Liability," the court ruled there was an issue of fact precluding summary judgment. The insureds argued that this question requires a "subjective" awareness of the possibility of claims. Citing the statement above the applicants' signature line that the application was completed "to the best of their knowledge," the court agreed that a subjective test was applicable. The court, noting that there was no evidence suggesting the magnitude of the claims that the insureds could expect as a result of their criminal wrongdoing, held that issues of fact precluded summary judgment regarding whether the company had reason to believe there would be a claim "within the scope of the Increased Limit of Liability."

The court then considered the insurer's argument that the increased limit of liability could be rescinded because the company failed to "obtain sufficient information from each and every Director or Officer proposed for this Endorsement." The court concluded that there were issues of material fact that should be resolved at trial.

The company also argued that nothing contained in the application was "material" given that the broker bound coverage before the company completed and submitted the application and that the binder conditioned issuance of the endorsement only on the "Payment of Premium." The court ruled that "while [materiality is] a question of law for the Court to ultimately determine . . . underlying questions of fact" prevented summary judgment.

The company also argued that the insurer violated Virginia Code section 38.2-2226, which states that an insurer must inform a claimant (as opposed to an insured) within 45 days of its decision to deny coverage for an insured's breach of condition, by not rescinding the policy within 45 days of learning of the grounds for rescission. The court rejected this argument, concluding that the code section is not applicable "where the insurer claims that the very terms and conditions of the policy should be of no legal effect."

Finally, a former director argued that he had no knowledge of the criminal activity at issue and, thus, the policy could not be rescinded as to him. The court rejected this argument because, under the language of the application, material facts known by the party completing the application could be imputed to all other directors and officers.