

Rescission Appropriate Based on Nondisclosure of Demand Letter in Application

October 2009

The United States District Court for the Northern District of California, applying California law, has held that rescission of a directors and officers liability policy was appropriate based on the failure to disclose in the policy application a written demand letter alleging a breach of fiduciary duties by the insureds. *Admiral Ins. Co. v. Sonicblue, Inc.*, 2009 WL 2512197 (N.D. Cal. Aug. 14, 2009).

The underlying action was brought against insured directors and officers of an insolvent corporation by shareholders for alleged breach of fiduciary duties and constructive fraud. The insureds sought defense and indemnity coverage under a directors and officers liability policy issued by the insurer in December 2002. The insurer filed a declaratory judgment action seeking a declaration that no duty to defend or indemnify the insured existed in part based upon material misrepresentations made during the policy application process. The policy application "required the [insureds] to disclose all written demands for money or services against the [insureds], and all of those against the [corporation]." In November 2002, prior to issuance of the policy, the insureds received a letter from shareholders alleging breach of fiduciary duties and demanding that certain corporate transactions cease or the shareholders would "hold the [insureds] responsible for the value of all [shares] sold to facilitate imprudent additional investments." The insurer contended that the insureds' failure to disclose this November 2002 demand letter was a material misrepresentation warranting rescission of the policy.

First, the court determined that the November 2002 letter constituted a "demand" within the terms of the policy application. According to the court, the term "demand" in the policy application contemplated the disclosure of "written communications demanding a course of action based on the author's legal rights." The court concluded that the November 2002 letter was a "demand" because it alleged a present breach of fiduciary duties by the insureds and "stated that its purpose was to notify [the insureds] that litigation might ensue absent rectifying action." In turn, the court held that the November 2002 letter was material, noting that "it is implausible to suggest that the [demand letter] would not be considered material" because it contained "serious allegations questioning [the corporation's] financial viability." Accordingly, the court concluded that rescission of the policy was appropriate.