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ALERT

Material Misrepresentation in Application Warrants Rescission of Crime Coverage

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A California federal court has held that a tower of crime policies was rescinded as a result of a material misrepresentation on the application for the policies. *Kurtz v. Liberty Mutual Ins. Co.*, No. CV 11-7010 (C.D. Cal. Apr. 14, 2014). Accordingly, the policies were deemed void and afforded no coverage.

A property exchange sought to purchase primary and excess crime policies that provided coverage for employee theft and theft of clients' property. The application for the primary policy asked: "Are proceeds from 1031 transactions held in bank accounts segregated from those of your operating funds?" In an application dated July 2, 2007, the exchange answered "no." The primary insurer responded to the exchange's broker that the exchange was ineligible for coverage as a result of this answer. The broker advised the exchange to "correct" the application and it would resubmit the application to the primary insurer. In an application dated August 13, 2007, the exchange answered the question "yes," and the primary insurer issued a policy with a $5 million limit of liability. In addition, based on the later application, three excess insurers issued policies, each with a $5 million limit of liability.

A Chapter 7 bankruptcy petition was subsequently filed against the exchange, and the Chapter 7 trustee submitted claims to the insurers contending that the exchange had misappropriated funds in excess of $35 million. The primary carrier denied coverage, based in part on the position that the second application contained a material misrepresentation in response to the question regarding the segregation of funds.

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In the coverage litigation that followed, the court held that the insurers were entitled to rescind the policies. First, the court concluded that the exchange's answer on its second application was both false and material. It was undisputed that the exchange held its clients' funds in the same bank account in which it kept its operating expenses, despite its contrary answer on the application. The court noted that materiality could be shown by the fact that the question had been included on the application and that the insurers testified that they would not have issued the policies if the exchange had answered the question differently. Second, the court stated that the insurers did not need to prove that the misrepresentation was intentional. Third, the court decided that the insurers had not waived the right to deny coverage because they failed to investigate the changed answer. The exchange had not provided inconsistent answers but different answers at different times, and the trustee presented no direct evidence that the insurers knew that the exchange had provided a false answer on the second application. Finally, the insurers raised rescission or material misrepresentation as affirmative defenses in the coverage litigation, which satisfied the requirements that the insurers give notice of the defense and offer to restore the benefits they had received under the contract.

The court also held that the insurers were not estopped from denying coverage for failure to comply with a regulation requiring a prompt response to an insured's claim. While the primary insurer did not formally deny the claim until almost four years after it was submitted, the trustee could not show any harm from the delay, particularly because the policies were deemed void *ab initio*. The court stated that estoppel could not be used to create coverage where none existed.

The opinion is available here.