

Appellate Court Affirms Dismissal of Insurer's Rescission Claim Because of Failure to Establish Condition Precedent and Failure to Demonstrate Reliance

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A New York intermediate appellate court has affirmed a trial court's dismissal of an excess insurer's lawsuit seeking rescission of a D&O policy based on alleged material misstatements contained in the insured company's financial statements on the grounds that the insurer could not rely on the financial statements because they were not specifically incorporated in the policy. *Nat'l Union Fire Ins. Co. of Pittsburgh v. Xerox Corp.*, 2006 WL 9600 (N.Y. App. Div. Jan. 3, 2006). The court also affirmed the trial court's rejection of a number of other coverage defenses asserted by the carrier.

The coverage dispute arose from securities fraud lawsuits, derivative actions and SEC enforcement proceedings based on the allegedly fraudulent financial reporting of a public company from 1997 through 2000. While the private lawsuits were still pending, the insured company and a number of its directors and officers settled with the SEC in separate enforcement actions. Neither the individuals nor the company admitted guilt in connection with these settlements. The insureds subsequently sought coverage from the insurer, which had issued a "follows form" excess policy incepting on June 25, 1999. The insurer denied coverage and brought the instant declaratory judgment action seeking to rescind the policy based on the breach of a condition precedent contained in the binder as well as alleged fraudulent inducement. In the alternative, the insurer sought declarations of non-coverage based on various policy provisions.

The trial court rejected the insurer's argument that it was entitled to rescission based on a condition precedent contained in the policy's binder but not in the policy itself. Further, the court rejected the insurer's rescission claims based on the alleged breach of the covenant of good faith and fair dealing and fraudulent inducement. The trial court also rejected the insurer's attempt to deny coverage based on the policy's fraud and improper profit exclusions, the policyholder's alleged breach of the duty to cooperate, and the "known loss" doctrine. The trial court further rejected the insurer's denial on the definition of "Loss" as to all defendants who had not yet settled with the SEC, holding that the causes of action were premature as to these defendants. The trial court's decision was summarized in the January 2005 issue of *The Executive Summary*.

The appellate court affirmed the trial court's dismissal of the insurer's cause of action for breach of a condition precedent, noting that the "binder and the policy here were two distinct agreements . . . and the policy clearly stated that the policy, together with the applications and endorsements, was the entire contract." The court noted that the condition precedent in the binder was not included, attached or mentioned in the policy and that the binder did not indicate that "the condition precedent was meant to be included in the policy."

The appellate court also affirmed the trial court's dismissal of the insurer's claims based on material misrepresentation and fraudulent inducement. The court held that the defendants never admitted the falsity of their financial statements in their settlements with the SEC, and the insurer "could not reasonably rely on the allegedly false financial statements because the policy expressly stated that [the insurer] relied on the statements and declarations in the application for coverage, and [the insurer] has not alleged that the financial statements were contained in any such application." The appellate court further reasoned that "the policy is directly inconsistent with [the insurer's] assertion that had it known that the financial statements were false, it would not have issued coverage, since [the insurer] issued the policy covering the very act of filing false financial statements, unless such falsity is actually adjudicated to be deliberately fraudulent."

Regarding the insurer's breach of the duty of good faith and fair dealing claim, the appellate court affirmed the trial court's dismissal on the ground that it was "merely a substitute for [the insurer's] non-viable contract claims." The appellate court noted that "[t]he covenant of good faith and fair dealing cannot be construed so broadly as to effectively nullify other express terms of the contract, or to create independent contractual rights." The court also affirmed the trial court's dismissal of the insurer's "known loss" argument, agreeing with the trial court that "[a]t most, defendants knew of a risk, not a loss."

Finally, the court affirmed the trial court's denial of the insurer's request to replead the dismissed causes of action, stating that, under New York law, the insurer had not demonstrated grounds to warrant repleading. Specifically, the court reasoned that the insurer had "not demonstrated that its amended pleadings would remedy the deficient claims, which have been dismissed on the basis of the plain language of the binder and the policy."