

# Pennsylvania Federal District Court Holds that Insurer May Rescind Policy Based on Material Misrepresentations in Application

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The United States District Court for the Eastern District of Pennsylvania, applying Pennsylvania law, has held that an insurer may rescind a policy when a policyholder makes material misrepresentations on the policy application, including failing to reveal the company's financial crisis, previously filed lawsuits and the potential for future suits, and to disclose that the policyholder's president had been subject to professional discipline. *Seneca Ins. Co. v. Lexington & Concord Search & Abstract LLC*, 2008 WL 2120170 (E.D. Pa. May 20, 2008).

The insurer issued policies to two different companies, Lexington and Lexicon, that had the same principal, sole shareholder, and president. The president completed the applications for both policies, which asked a number of questions regarding whether the applicant or any director, officer, employee or partner of the applicant had "knowledge or information of any act, error, or omission which might reasonably be expected to give rise to a claim" or of "any claims . . . made during the past five years against the applicant"? In addition, the Lexicon application inquired about any disciplinary actions resulting from professional activities of the applicant. The president revealed the existence of three claims pending against Lexington, but failed to reveal (i) that Lexington was in dire financial straits, (ii) two lawsuits alleging that Lexington participated in a consumer fraud scheme, (iii) numerous other "garden variety" claims pending against Lexington, and (iv) the fact that the president previously had entered into a consent order with the insurance commissioner requiring him to cease and desist from certain professional activities.

The court stated that an insurer may rescind a policy when a policyholder obtains the policy through misrepresentations and the insurer can demonstrate "(1) that the representation was false; (2) that the insured knew that the representation was false when made or made in bad faith; and (3) that the representation was material to the risk being insured." The court further noted that a misrepresented fact is material "if on being disclosed to the insurer it would have caused the insurer to refuse the risk altogether or to demand a higher premium" and that "[a]nything which increases risk cannot be immaterial."

Applying this standard, the court found that the failure to alert the insurer to Lexington's financial crisis "deprived [the insurer] of the ability to develop the proper calculus with which to accurately estimate the risk

of the policy." Moreover, Lexington's failure to disclose two pending civil actions stemming from a consumer fraud scheme and numerous other "garden variety" claims or potential claims were "material misrepresentations [that] increased [the insurer's] risk." Additionally, the court held that the negative answer on the Lexicon application concerning past disciplinary action against any director or officer, when the president previously had been reprimanded by the insurance commissioner, "deprived [the insurer] of material information and increased [the insurer's] risk." The court therefore ordered both policies rescinded.