

Rescission Limited to Individuals Who Made Knowing Misstatements in the Application

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A federal district court, applying Alabama law, has interpreted the severability and representation clauses in D&O policies issued to HealthSouth Corporation to mean that the insurers "can only rescind the policy as to an insured person who personally made a knowing misrepresentation in the written application on which [the insurer] relied to issue the policy." *In re Health South Corp. Ins. Litig.*, No. CV-03-BE-1139-S (D. Ala. Mar. 16, 2004). The court also held that the fiduciary liability policies issued to HealthSouth precluded rescission "as to any insured who did not make any misstatement in the application with knowledge that the statement was untrue."

Various carriers issued primary and excess D&O policies and fiduciary liability policies to HealthSouth. Following an investigation by the United States Securities and Exchange Commission and the Department of Justice of fraud at the company, 11 officers and employees pled guilty to the charges brought by the government. Thereafter, securities, derivative and ERISA class action lawsuits were filed against the company and its directors and officers. Following tender of these claims, the insurers filed litigation to rescind the policies.

The primary D&O policy contained a "Representations and Severability Clause" with the following language:

In granting coverage to any one of the Insureds, the Company has relied upon the declarations and statements in the written application for this coverage section and upon any declarations and statements in the original written application submitted to another insurer in respect of the prior coverage. All such declarations and statements are the basis of such coverage and shall be considered as incorporated in and constituting part of this coverage section.

Such written application(s) for coverage shall be construed as a separate application for coverage by each of the Insured Persons. With respect to the declarations and statements contained in such written application(s) for coverage, no statement in the application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available.

In addition, the fourth excess D&O policy provided:

[I]t is hereby understood and agreed that this policy is issued in reliance upon statements made and materials furnished to the Insurer...including prior applications or requests, and all statements made and materials incorporated in the following specific documents...whether furnished directly to the Insurer or indirectly to the Insurer from public sources available to the Insurer.

The application to the fiduciary liability policy stated that "[t]he undersigned declares that the statements set forth herein are true to the best of his or her knowledge and belief." The policy further provided that "[n]o statement in the application or knowledge or information possessed by an Insured shall be imputed to any other Insured for the purpose of determining the availability of coverage hereunder."

The court first held that, under the primary D&O policy, rescission could be based only on misstatements or omissions in the written application. The court noted that Alabama law permits reliance on other materials; however, the court concluded that the primary policy narrowed the insurer's rights since it referenced only written materials. The court also held that the severability clause of the D&O policy limited rescission to knowing misrepresentations. The court explained that although the Alabama rescission statute allows rescission for innocent misstatements that are material or affect the insurer's decision to issue the policy, here the insurers waived the defense of innocent misrepresentation by including references to "knowledge" in the severability clause. The court then held that the severability clause "unambiguously provides that the rights of each insured as to coverage will be separately determined." Thus, knowledge of one insured could not be imputed to any other insured.

The court next addressed coverage under the excess policies. The court rejected the excess carriers' argument that they were not bound by the severability clause in the primary policy. The court reasoned that the excess policies followed form to the primary policy and none of the policies contained a different severability provision or even referenced severability. The court noted that the fourth excess carrier for one of the policy periods at issue had language in its policy stating that it would rely on materials beyond the application and enumerating those materials. The court therefore held that to the extent that individual insureds had knowledge of the falsity of any such materials, they could provide a basis for rescission to that excess carrier and the carriers higher up in the tower.

The court also considered the ability of the D&O carriers to rescind as to the company itself. The court noted that with respect to entity coverage for the company for securities violations, the primary policy modified the severability clause by providing that knowledge of any insured company could be "imputed" to the company. However, the court explained that the modification did not apply to the second insuring clause concerning coverage to the company for indemnification of individual insureds. The court concluded that since coverage to the company for indemnification "in essence is derivative of the individual insured's person's right to coverage," the carriers could not deny indemnification coverage except as to any individual insured who made knowing misrepresentations.

Turning to the fiduciary liability policies, the court evaluated whether those insurers had the right to rescind. The court held that the primary policy plainly provided that no statement or knowledge by one insured could be imputed to any other insured. Thus, for the fiduciary insurer "to seek rescission against any insured, it must establish the knowledge of the specific insured as to any alleged misrepresentations based on what that insured knew."

For more information, please contact us at 202.719.7130.