

Federal Court Dismisses Rescission Action Based on Inherent Authority to Abstain From Hearing Declaratory Judgment Actions

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The United States District Court for the Eastern District of Virginia, relying on its discretionary authority to determine whether to hear declaratory judgment actions, granted a policyholder's motion to dismiss an insurer's declaratory judgment action seeking, *inter alia*, rescission of the policy. *Great Am. Ins. Co. v. Gross*, 2005 WL 2009284 (E.D. Va., Aug. 19, 2005).

The insurer issued a D&O policy to a reciprocal insurer of various professional risks as well as the reciprocal insurer's management company and attorney-in-fact based. The D&O insurer relied on the information presented in a "Policy Proposal Form" and financial statements submitted therewith. During the policy period, the policyholder sought to increase the policy's limit of liability from \$10 million to \$20 million. Subject to a representation by an officer of the policyholder that the company and its directors and officers were unaware of any liability that might fall within the increased limit of liability, the insurer increased the policy limit of liability to \$20 million.

Subsequent allegations of malfeasance by the directors and officers of the policyholder led to the filing of 10 separate federal actions, which were consolidated in a multi-district litigation pending in the United States District Court for the Western District of Tennessee. The same allegations led to the filing of three parallel actions in Alabama state courts. As of May 2005, the insurer had advanced \$2.8 million in defense of the various actions.

In February 2005, two former officers of the policyholder, including the officer who signed the documents requesting the increase in the policy limit of liability, pled guilty to insurance fraud. Upon notice of the guilty pleas, the insurer filed the instant action, seeking rescission based on material misrepresentations in the materials submitted in connection with the original policy application and the increased limits request as well as other declaratory relief. Many of the defendants filed counterclaims alleging breach of contract.

Certain of the defendants filed motions to dismiss the action based on, *inter alia*, the court's discretionary authority to abstain from hearing declaratory judgment actions. As an initial matter, the court noted that "[f]ederal district courts have discretionary authority to entertain actions seeking declaratory judgment" and that

a district court should exercise this authority "when it finds the declaratory relief sought (i) will serve a useful purpose in clarifying and settling the legal relations in issue and (ii) will terminate and afford relief from the uncertainty, insecurity and controversy giving rise to the proceeding."

The court also explained that the Fourth Circuit mandates application of a four-part test to determine whether a district court should hear a declaratory judgment action. The four factors are: "(i) the strength of the state's interest in having the issues raised in the federal declaratory judgment action decided in state courts; (ii) whether the issues raised in the federal action can more efficiently be resolved in the court in which the state action is pending; [] (iii) whether permitting the federal action to go forward would result in unnecessary 'entanglement' between the federal and state court systems because of the presence of 'overlapping issues of fact or law' [; and (iv)] whether the declaratory judgment action is being used merely as a device for 'procedural fencing' – that is 'to provide another forum in a race to *res judicata*' or to 'receive a federal hearing in a case otherwise not removable.'"

First, the court rejected the insurer's contention that the four-factor test was inapplicable in the absence of parallel state action. The court stated that "[t]he pendency of a parallel state court action is not a necessary prerequisite to a court's decision determining whether to exercise jurisdiction over a declaratory judgment action." Second, the court rejected the insurer's argument that the inclusion of substantive counts in the action, *i.e.*, the insurer's rescission count and the defendants' breach of contract counterclaims, made dismissal or abstention inappropriate. The court held that the substantive counts for rescission and breach of contract were "so closely tied to the declaratory judgment claims, that consideration of the [four-factors was] warranted." In this regard, the court specifically reasoned that it was obligated to "determine the same legal question in order to enter a declaratory judgment or to find that rescission is appropriate—whether the Policy and subsequent Policy Increase were obtained based on knowing misrepresentations made" by an officer on behalf of the policyholder. The court also held that its discretion to stay a declaratory judgment action was "unaffected" by the fact that the insurer sought rescission based on the same facts or the presence of substantive counterclaims.

Applying the four-factor test, the court focused primarily on the third factor—the risk of entanglement. The insurer argued that the coverage issues regarding fraudulent statements could be resolved without litigating the core facts at issue in the underlying actions. The insurer based its argument on its assertion that it could prove its rescission case based solely on the statements submitted with the guilty plea of the former officer of the policyholder who applied for the policy and the increased limit. The court rejected this argument, opining that the insurer's "claim for rescission presents one of those rare instances where all the things [the insurer] would have to prove to support its claim will lead to unnecessary entanglement with the underlying actions due to overlapping factual issues." The court reasoned that the insurer would have to go beyond the guilty plea to prove that financial statements submitted to the insurer were false and misleading and that litigating that issue could estop the defendants from re-litigating the matter in the underlying actions. Regarding the other three factors, the court determined that the first and fourth factors were not relevant and that abstention would promote efficiency in the resolution of the underlying actions while avoiding piecemeal litigation.

In closing, the court also referenced themes developed in its May 3, 2005 opinion (summarized in the June 2005 issue of *The Executive Summary*) that granted a preliminary injunction forcing the insurer to advance defense costs pending judicial determination of its rescission claim. The court asserted that "it is fundamentally unfair that Movants, as well as other defendants covered under the Policy, would be forced to litigate the complex financial issues presented in this case without the benefit of cost of defense coverage" and that "the harm to [the insurer] in dismissing the Complaint is minimal because [the insurer] is only doing what it was contractually obligated to do" in providing a defense under the policy.

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