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NEWSLETTER

Court Orders D&O Policy Rescinded

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Based on detailed findings of fact and conclusions of law, a federal district court in the Eastern District of Pennsylvania has found that a former CEO made material misrepresentations and concealed material information from his insurer during the process of procuring a D&O insurance policy, and that the insurer relied upon these misrepresentations and omissions in making its underwriting decisions. Accordingly, the court held the policy to be void ab initio. The court further held that the former CEO was not entitled to coverage in connection with an array of lawsuits pending against him based on several policy exclusions and conditions, including the personal profit exclusion, the absence of a "claim," and his breach of the cooperation clause. Bogatin v. Federal Ins. Co., No. 99-4441, 2000 U.S. Dist. LEXIS 8632 (E.D. Pa. June 21, 2000).

Jacob Bogatin was the former president, CEO and director of YBM Magnex International, Inc. ("YBM"). The company assertedly manufactured and distributed industrial magnets. Bogatin sought coverage under his D&O policy for a federal criminal investigation arising from allegations that YBM was involved, inter alia, in an illegal money-laundering scheme with members of Russian organized crime. He also sought coverage for several shareholder suits filed in Pennsylvania and additional suits against him filed in Canada. Further, Bogatin was named as a defendant in a suit filed by YBM's bankruptcy receiver. According to the court, when Federal sought to investigate the availability of coverage, Bogatin refused to submit to an interview. The insurer ultimately sought to rescind the relevant policy based on misrepresentations in the application for the original policy, which was incorporated by reference in the renewal application for policy in force when the claims were made, and based on misrepresentations in annual reports submitted with the renewal application. It further denied coverage (1) because some of the matters did not constitute a "claim," which required, inter alia, the return of an indictment or the service of a civil suit on the insured; (2) because Bogatin breached his duty to cooperate by refusing to submit to an interview; (3) based on an exclusion in the application for facts and circumstances of which the insured was aware might give rise to a future claim; (4) based on the personal profit exclusion; and (5) with respect to the receiver action, based on the Insured v. Insured exclusion.

Rescission

In ruling on these contentions, the court first addressed the issue of rescission. It rejected the argument that the insurer was obligated to advance defense fees and costs during a pending coverage dispute. Rather, rescission would void the policy altogether. In reviewing the evidence, the court found "clear and convincing evidence" (the relevant Pennsylvania standard) that at the time of the original application for D&O coverage

in 1996, the insured was aware but concealed that the State Department suspected YBM of illegal activity and that public disclosure of this information could depress YBM's share value and lead to shareholder suits. He also was aware of allegations of criminal money-laundering by a foreign subsidiary. With respect to a renewal application in 1998, the court found that the insured submitted false annual reports to the insurer that inaccurately stated that auditors had opined that YBM's financial statements fairly presented the financial position of the company. In fact, YBM's auditors had suspended their audit due to concerns raised by various transactions and allegations against the company.

Cooperation

The court also concluded that Bogatin breached his duty to cooperate in the coverage investigation by failing to disclose information and documents reasonably requested by Federal and by refusing to submit to an interview. As a result, Federal was prejudiced in its investigation. According to the court, the Fifth Amendment right against self-incrimination "does not trump an insurance policy's duty to cooperate requirement."

Prior Knowledge Exclusion

The application for the 1996 policy included a prior knowledge exclusion that barred coverage for claims arising from facts and circumstances of which Bogatin was aware on or before the date of the application and which a reasonable person would have supposed "might give rise to future claim that would fall within the scope of proposed coverage." Because Bogatin was aware of the facts that ultimately led to the pending criminal investigation, the securities class action lawsuits and an action brought by the Ontario Securities Commission in which Bogatin had been named as a defendant, this exclusion independently barred coverage for these proceedings.

Absence of a "Claim"

The court found no covered "claim" with respect to two of the relevant proceedings. First, because there was not yet an indictment in the federal investigation of Bogatin, the investigation of his activities did "not constitute a Claim for which coverage was available" under the definition of "Claim" in the policy, which applied to "criminal proceedings commenced by the return of an indictment . . . against any 'Insured Person.'" Additionally, the definition of "Claim" afforded coverage for "civil proceedings commenced by the service of a complaint or similar pleading. . . ." Bogatin had not been served with a copy of the complaint in one of the two pending Canadian class actions, so no coverage was available on this alternative ground.

Other Exclusions

The court applied a number of other policy terms to preclude coverage for the suits against Bogatin. The personal profit exclusion barred coverage for "any Claim ... based upon, arising from, or in consequence of [any] Insured Person having gained in fact any personal profit, remuneration or advantage to which such Insured Person was not legally entitled." The court held that the personal profit exclusion precluded coverage for the Pennsylvania securities action, two class actions pending in Canada, and an action brought by YBM's bankruptcy receiver. It also found that the Insured v. Insured exclusion applied to the receiver's action because it was brought in the name of the "Insured Organization" under the policy. Finally, the court determined that there was no coverage for the receiver's action based on the exclusion in the policy for claims "for an accounting of profits made from the purchase or sale by such Insured Person of securities of the Insured

Organization with the meaning of Section 16(b) of the Securities Exchange Act" or similar laws.

Overall, the decision is a solid victory for the D&O carrier on virtually every coverage issue that it raised. The decision offers particularly helpful authority for the proposition that false statements in materials submitted with the policy application can form the basis for a rescission claim. The recognition of the insurer's right to cooperation from the insured also provides helpful precedent.