

# Kansas Supreme Court Applies “Subjective-Objective” Standard to Bar Coverage under Application Warranty Exclusion

October 2008

The Supreme Court of Kansas has held that, when an insurer asks an applicant to identify any facts, circumstances or situations that could reasonably be expected to give rise to a claim and excludes any claim arising from any such fact, circumstance or situation, the standard for determining whether a specific risk is excluded is a two-part, subjective-objective standard. The combined standard asks, subjectively, what facts did the applicant know and, objectively, would a reasonable person have perceived that the known facts created a potential risk? Applying this standard to the facts of the claim in question, the court held that the warranty exclusion precluded coverage. *American Special Risk Management Corp. v. Cahow*, 2008 WL 4180342 (Kan. Sept. 12, 2008).

Approximately three weeks before completing an application for an E&O endorsement to a D&O policy, a bank had learned of a criminal prosecution in connection with which the bank was potentially liable for negligently allowing an individual employee of a corporate client to open a corporate account in his own name, under which he was passing corporate checks without permission. The application specifically asked whether there were "any facts, circumstances or situations involving the Applicant . . . which could reasonably be expected to give rise to a claim?" The bank checked the box labeled "No." Subsequently, the bank was sued for negligence. The insurer denied coverage for the claim. The trial court found no coverage and the court of appeals affirmed, using a combined subjective-objective standard to analyze the applicability of the application warranty exclusion.

In determining whether the language of the application, which was deemed part of the policy, precluded coverage for the underlying action, the Kansas Supreme Court considered four possible standards of review: whether the applicant had "(a) committed fraud; (b) failed to disclose information that the applicant subjectively perceived as a potential risk; (c) failed to disclose known information that an objective person would reasonably perceive as a potential risk; or (d) failed to discover circumstances that reasonably should have been known and which, if known, would be perceived as a potential risk by a reasonable person."

The court rejected the strict "fraud standard" urged by the bank on the grounds that the policy language did

not require that the failure to disclose known risks be "intentional or reckless." The court also rejected a purely subjective standard, which the court described as a minority position, because the policy language imported an objective component by virtue of its use of the phrase "could reasonably be expected." Similarly, the court rejected a purely objective standard, which it described as the "widespread" position, because the policy language turned on the applicant's subjective knowledge of relevant facts and circumstances.

The court settled on the combined "subjective-objective" standard because the specific policy language used "both subjective and objective elements" and, thus, the court believed, a combined standard best "express [ed] the parties' intent to incorporate both components." Applying this standard, the court held that, subjectively, the bank knew of the potential claim for which it later sought coverage and, objectively, a reasonable person in the bank's position would have expected a claim to be filed against the bank. Accordingly, the court determined that the exclusion applied.