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NEWSLETTER

Knowledge of Embezzlement Investigation Prior to Policy Inception Triggers Warranty Exclusion

August 2007

The Court of Appeals of Kansas, applying Kansas law, has held that a bank should have expected that an ongoing embezzlement investigation reasonably could give rise to a claim against it, and that, as a result, the prior knowledge exclusion in the policy application precluded coverage for a settlement reached in a lawsuit subsequently brought against the bank. *Am. Special Risk Mgmt. Corp. v. Cahow*, 2007 WL 1964952 (Kan. Ct. App. July 6, 2007).

An individual worked as a sales manager for a company that contracted with insurers to act as an underwriter and third-party administrator. Unbeknownst to the company, however, the individual opened two accounts at a local bank: one personal and one as a sole proprietor operating in the company's name. Over a period of eight years, the individual embezzled almost $1 million from the company by depositing checks into the business account and then transferring the money into his personal account. The individual's scheme was discovered in April 2001. On May 1, 2001, a bank executive discussed the issue with the company's president and agreed to place a hold on two outstanding checks. On May 22, 2001, the bank executive learned that criminal charges would be filed against the individual and that the company had given the executive's name to police as a person familiar with the transactions. The bank had no further contact with the company until October 2001, when the company sued both the bank and the individual for damages.

Meanwhile, on June 12, 2001, the bank submitted an application to an insurer for a D&O policy that included coverage for entity errors and omissions. The bank did not disclose its knowledge about the embezzlement investigation and instead answered the question in the application seeking "any facts, circumstances or situations involving the Applicant . . . which could reasonably be expected to give rise to a clam" in the negative. The application stated immediately following that question that "if knowledge of any fact, circumstance or situation exists, any claim or action subsequently arising therefrom shall be excluded from coverage." The policy was issued, and, upon receipt of the lawsuit, the bank notified the insurer.

In January 2002, the insurer informed the bank that it had preliminarily concluded that the lawsuit was not covered because the bank knew of the potential claim at the time that the application was completed. After

additional correspondence between the parties regarding coverage, the insurer advised the bank in April 2002 that, while it was not denying coverage, "the possibility of coverage remains very remote." The bank entered into a settlement agreement with the company for $750,000. The company then filed the instant garnishment action against the insurer for the settlement amount.

On appeal, the court rejected the company's contention that in order for an insurer to deny coverage on the basis of a misrepresentation in a policy application, the insurer must "prove that the misrepresentation was knowingly made, with the intent to deceive the insurer." Instead, the court found that application of the exclusion involved a two-part subjective/objective standard: (1) examination of "the facts known to [the bank] when it completed the insurance application"; and (2) "whether the known facts 'could reasonably be expected to give rise to a claim.'" The court found the decision in *Selko v. Home Ins. Co.*, 139 F.3d 146 (3d Cir. 1998), "particularly persuasive." In that case, the Third Circuit applied a "mixed" subjective/objective standard in analyzing a prior knowledge exclusion, which provided that pre-policy period acts or omissions would be covered so long as, prior to the policy period, the insured had "no basis to believe" that it had breached a duty. The *Selko* court observed that in using this language, "the policy sensibly puts the burden on the insured to disclose those facts known only to him, so that the costs of the risk can be evaluated with all the relevant information accessible to all parties."

The Kansas appellate court identified the facts known to the bank at the time it completed the policy application and concluded that the trial court "properly balanced the interests in this case" by holding that the bank should reasonably have expected a potential claim by the company regarding the individual's use of the bank account. The court explained that it was "inconceivable" that the bank's officers, "with their knowledge of the banking industry," would not have checked the accounts to determine the bank's maximum exposure.