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NEWSLETTER

Insurer Entitled to Rescind Policy Based on False Statement in Application

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The United States District Court for the Eastern District of Virginia, applying Virginia law, has held that an insurer was entitled to rescind a crime policy based on the insured company's knowingly false statement on the policy application. *Koger Mgmt. Group v. Cont'l Cas. Co.*, No. 08-301 (E.D. Va. Mar. 3, 2009).

The insurer issued a crime insurance policy for the period of 2003 to 2007 to a company that managed homeowners' associations. The company performed financial transactions on behalf of its clients and maintained unique bank accounts for each client. In addition, the company had a "transfer account" that held automatic payment and credit card charges from which the company transferred payments into specific client accounts. In addition, the company could transfer funds out of client accounts to the transfer account to facilitate purchases. In 2006, the company discovered that the chief financial officer (CFO) had embezzled over $2 million by electronically transferring funds from the transfer account to his personal accounts. In 2007, the company submitted a claim under the crime policy for the embezzlement.

This coverage dispute arises out of the application for the crime policy, which the president of the company signed in 2003. The application asked: "Are bank accounts reconciled by someone not authorized to deposit or withdraw therefrom?" The application was marked "Yes" in response. The insurer argued that it could rescind the policy on the basis of this answer on the application because the answer was false. In particular, the insurer argued that the answer was false because the CFO reconciled the transfer account and certain client accounts and had the authority to deposit into or withdraw from those accounts, and the CFO supervised the reconciliation of client accounts for which he had the authority to withdraw from or deposit into.

To rescind the policy, the insurer had to prove that the statement on the application was both false and material to the risk. In addition, because the application asked the applicant to "attest to the truth of the statement to the best of his knowledge," the insurer had to prove that the answer was "knowingly false." Following a trial, the court concluded that the insurer had met its burden with respect to this standard for rescission.

First, under Virginia law, a statement is considered material if it reasonably influenced the insurer's decision to issue the policy. The court determined that the statement was material to the risk because underwriters

testified that the insurer would not have issued the crime policy if the question had been answered "No." In addition, an underwriter testified that the insurer relied on this answer in deciding to renew the crime policy.

In addition, the court agreed with the insurer that the statement was false because the CFO had reconciled or supervised the reconciliation of the transfer account and client accounts, from which he had the authority to withdraw. The company argued, however, that the answer was not "knowingly false" because the president misunderstood the question. Under Virginia law, if the president had answered the question truthfully based on his understanding of the question, it would not be a knowingly false answer. The president testified that he believed that the question referred only to client accounts and not the transfer account. After reviewing the context and drafting of the question as well as evidence that other applicants had similarly misunderstood the question, the court concluded that the president's misinterpretation was reasonable. However, the court found that the answer was knowingly false despite the president's understanding that the question referred only to client accounts because the president was aware that the CFO supervised the reconciliation of client accounts and knew that the CFO had the authority to withdraw from client accounts. The court therefore found in favor of the insurer.