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NEWSLETTER

Exclusion for Claims Arising from Facts Required To Be Disclosed on Application Bars Coverage for Claims Arising from Nondisclosed Settlement

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Applying New York law, the United States District Court for the Eastern District of New York has held that an exclusion for claims arising out of facts and circumstances not disclosed in response to a policy application question barred coverage regardless of whether the information was shown to be material to the insurer. *Gluck v. Executive Risk Indem. Inc.*, 2009 WL 254916 (E.D.N.Y. Jan. 22, 2010).

The case involved a directors, officers and trustees liability policy issued in 2006 to a nonprofit corporation that managed nursing homes and assisted living facilities. The application for the prior year's policy asked: "Is there any pending or anticipated challenge to the Applicant's tax-exempt status under applicable law, whether federal, state or local?" The insured responded by checking "yes" and circling "federal." The 2006 renewal application asked the same question as well as whether any proposed insured entity has "entered into a criminal or civil settlement with the United States . . . by which claims against such entity were resolved." The insured answered "no" to both of these questions. The application stated that "it is agreed that . . . any claim arising from any fact, circumstance, situation, transaction, event, act, error or omission required to be disclosed in response [to these two questions] is excluded from the proposed insurance."

Meanwhile, the Internal Revenue Service (IRS) had revoked the insured's tax-exempt status in 2005. The insured challenged the revocation and, prior to completing its 2006 renewal application, entered into a settlement with the IRS pursuant to which it could maintain its tax exempt status in exchange for implementing certain corporate governance reforms. In particular, the insured was required to change the composition of its board of directors so that the majority of the directors were independent of a certain religious entity, which was the sole member of the insured organization.

After the agreement with the IRS was executed, a dispute arose over who rightfully controlled the insured entity. Two lawsuits followed. The first was brought by the insured itself, the sole member and three directors against the insured's CFO and nine individuals who allegedly were claiming to be on the board (the disputed directors). According to the complaint, the CFO had demanded that his interest in the insured be bought out.

The plaintiffs allegedly refused the demand because doing so would have violated both the terms of the agreement with the IRS and state law regarding non profits. The CFO then allegedly "stacked" the board with nine directors who were expected to favor the buyout. The suit sought a declaration that these individuals were not and could not be properly seated because, among other reasons, they were not sufficiently independent to satisfy the insured's obligations under the IRS agreement.

The second suit was filed by the nine disputed directors on behalf of the insured against the insured's sole member and its executive director. The disputed directors alleged that they were in fact appointed to the board in order to preserve the insured's nonprofit status and to comply with insured's obligations under the agreement with the IRS. The disputed directors sought a declaration that their purported removal was invalid. The sole member and the executive director counterclaimed, seeking a declaration that the disputed directors were not in fact members of the board and did not have authority to bring suit on the insured's behalf. Among other allegations, they asserted that the CFO's actions were prompted by the reduction of his salary, which was one of the reforms to which the insured agreed with the IRS.

The disputed directors sought coverage under the policy for the defense of the first lawsuit and the counterclaim in the second. The insurer denied coverage based on the policy's insured v. insured exclusion as well as the exclusion in the application for claims arising out of non-disclosed information. In the litigation that followed, the court addressed only the latter exclusion. The court initially noted that the exclusion appeared to apply to all claims arising from any facts or circumstances that should have been disclosed by the insured on the application regardless of whether the information was in fact disclosed. The court, however, recognized that it did not need to conclusively decide the issue here because the insurer was relying on the settlement with the IRS, which clearly had not been disclosed on the 2006 renewal application.

The disputed directors took the position that the settlement was not information that had to be disclosed on the 2006 renewal application because it could be inferred from the fact that the previous year's application identified a pending challenge to the insured's tax-exempt status but the subsequent application did not. The court rejected this argument, pointing out that there were a number of inferences that could have been drawn, including that the IRS simply had abandoned its claim. The court also pointed out that it was not reasonable to infer that there was a settlement of the previously disclosed claim in light of the affirmative representation on the 2006 renewal application that no such settlement had been entered into by the insured. And, according to the court, because of this affirmative representation, the insurer did not have a duty to inquire whether the previously disclosed claim had been resolved by settlement.

The court also rejected the disputed directors' reliance on New York Insurance Law Section 3105(b), which provides that a misrepresentation will not defeat recovery under an insurance policy unless such misrepresentation is material. Reviewing the legislative history, the court concluded that Section 3105(b) was not intended to apply to exclusions written into insurance policies, which themselves are "bargained-for contractual arrangements," but rather was intended to prevent an insurer from rescinding the contract altogether due to a minor misrepresentation in the application that, quite possibly, was unrelated to the matter for which coverage was sought. On this basis, the court held that the insurer was not required to show that the failure to disclose the settlement agreement with the IRS was material.

Turning to the question whether the underlying lawsuits "arose from" the IRS agreement such that the exclusion in the application was triggered, the court noted that New York law is not entirely clear as to what level of causation is required. The court did recognize, however, that it is something less than proximate causation. As to the second lawsuit, the court found that the counterclaim against the disputed directors plainly arose from the settlement, pointing out that the reforms mandated by the agreement were "central to sparking the dispute" with the CFO and informed the insured's response to the buyout demand. In this regard, the court described the agreement itself as "the driving force behind the dispute that led to the suit."

The court found that the first lawsuit presented a closer question because the complaint against the disputed directors did not specifically allege that the conflict between the CFO and the insured was prompted by the IRS agreement and attributed motives to the CFO's actions unrelated to the agreement. Nonetheless, the court concluded that the allegations asserted implied a causal relationship between the governance requirements imposed by the IRS agreement and the CFO's decision to demand a buyout. The court pointed out that the plaintiffs alleged that they had rejected the CFO's demand out of concern that the buyout would violate the terms of the agreement and that the plaintiffs alleged that the nine disputed directors did not meet the independence requirement imposed by the agreement. Based on these allegations, the court determined that the settlement with the IRS had a "significant casual import" and, accordingly, held that the application exclusion barred coverage.