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NEWSLETTER

Severability Provision Requires Insurer To Plead All Insureds' Knowledge of Misrepresentation To State Claim for Rescission

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Applying Michigan law, the United States District Court for the Eastern District of Michigan has dismissed an excess insurer's claim for a declaratory judgment for rescission, concluding that the applicable severability provision required the insurer to plead facts establishing that each of the individual insureds had knowledge of alleged misrepresentations in the application for the policy. *Great Am. Ins. Co. v. GeoStar Corp.*, 2010 WL 845953 (E.D. Mich. Mar. 5, 2010). The court granted the carrier and another plaintiff insurer an opportunity to re-plead. The court also held that (1) a professional services exclusion did not bar coverage for the underlying claims; (2) the first-layer excess carrier had a duty to advance defense expenses pending resolution of the coverage issues; and (3) the court would take judicial notice of guilty pleas entered by two individual insureds in criminal proceedings, but only to the extent of facts specifically admitted in such pleas.

The insured, a privately held company engaged primarily in the development of oil and gas properties, organized a limited liability company to operate a "mare-lease program" in order to raise capital to fund the energy business. The program, which allowed investors to lease thoroughbred mares for one year and take ownership of any foals born during the lease period, soon encountered difficulties, including a shortage of horses needed to meet investor demand. IRS audits of investors in 2003 also disallowed tax deductions the program was designed to provide. In 2004, following issuance of primary and excess D&O policies, investors brought civil suits against the insureds, and the two managers of the lease program ultimately pled guilty to tax-related criminal charges. Upon exhaustion of the primary policy through payment of defense costs, the two excess carriers commenced coverage litigation, seeking rescission of the policies based on material misrepresentations made in the applications submitted to each of them and a declaratory judgment that coverage was barred based on a professional services exclusion contained in the primary policy.

First, the court granted the insureds' motion to dismiss the first-layer excess insurer's counts seeking rescission. Although under Michigan law, "a material misrepresentation in an application for insurance entitles the insurer to rescind the policy, even if an individual did not know of the material misrepresentation[,]" the court held that the primary policy's severability provision required the excess carrier to allege sufficient facts to establish

that each of the defendant directors and officers "knew of the misrepresentations at the time the policy took effect." The court rejected the carrier's argument that the primary policy's severability provision did not apply because it referred to the primary carrier's application specifically by name. The court concluded that "the reference to 'The Wrap Application' in the severability provision should be read generally as 'the application for insurance.'" The court also held that the second-layer excess insurer's own severability provision was ambiguous in some respects but that the provision "clearly and unambiguously provides that any misstatement or omission that was known to [the policyholder's president and signatory to the relevant application] at the time the policy took effect will be imputed to every other officer, director, and entity, whether they knew of the misrepresentation or not." Because the insurer had pled such knowledge on the president's part, the court denied the insureds' motion to dismiss that carrier's rescission counts but nonetheless provided the insurer an opportunity to amend in light of the court's interpretation of the provision.

Next, the court denied the insurers' motions for partial summary judgment and granted in part the insured's cross-motion for summary judgment, determining that a "Broad General Professional Errors and Omissions Exclusion" did not completely bar coverage. Observing that "[c]ourts require a close connection between the provision of professional services and the underlying claim before they will deny coverage pursuant to [an] E&O exclusion," the court determined that such exclusions "in D&O policies must be interpreted more narrowly to avoid negating the entire coverage scheme through the operation of an overly broad exclusion." The court ruled that while the E&O exclusion clearly barred coverage for underlying counts seeking redress for professional tax and investment advice rendered in connection with the lease program, the exclusion did not clearly preclude coverage for all of the underlying claims, such as fraud claims alleging that more leases were sold than there were horses. The court opined that "future motions should focus on the specific counts of specific complaints and the appropriate standard of review."

The court next held that the first-layer excess insurer had a duty to advance defense expenses pending resolution of the coverage action. The court rejected the insurer's contention that its excess policy did not follow form to the primary policy's advancement language because the insured had elected optional duty-to-defend coverage offered under the primary policy, and the excess carrier specifically disclaimed any duty to defend. The court found that because the excess policy "appl[ies] in conformance with the provisions" of the primary policy, the excess policy incorporated the duty to advance language as "the default provision in the event duty to defend coverage is not purchased." The court further reasoned that the insurer had not "articulated a persuasive reason to treat a duty to pay defense costs in a substantially different manner from a duty to defend under Michigan law."

Finally, the court granted the second-level excess insurer's request that the court take judicial notice of the guilty pleas entered by the insured individuals who managed the lease program in the underlying federal criminal proceedings. The court, however, held that it would "only take notice of those facts that have been specifically admitted by the [insureds] in sworn testimony, and only to the extent that those facts implicate the [individual insureds] as opposed to third parties." The court observed that "a guilty plea serves as an admission of the *material* facts charged in the information or admitted by the Defendant during the plea colloquy. Not, as [the insurer] suggests, *all* the facts charged in the information." (Emphasis in original.)