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NEWSLETTER

Insurer Entitled To Rescind Employment Practices Liability Policy Based on Material Omissions

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Applying California law, the United States District Court for the Northern District of California, has held that an insurer was entitled to rescind an employment practices liability policy and to recover the payments made under that policy based on the insured's failure to disclose on the application for coverage that an employee had resigned after alleging sexual harassment. *Carolina Cas. Co. v. RDD, Inc.*, 2010 WL 597097 (N.D. Cal. Feb. 17, 2010).

The insured, a restaurant owner, received a letter from one of its waitresses on April 28, 2008, advising that she was quitting immediately. The waitress asserted in the letter that she had been sexually harassed by the owner and the managers on weekly basis for the past year, that her complaints about the harassment were met with retaliation in the form of unwanted shift changes and that her mental and physical health was suffering as a result of the events.

The next day, the restaurant contacted its insurance broker to obtain employment practices liability coverage. On behalf of the restaurant, the broker completed and submitted to the insurer an application. Questions 21 and 22 on the application asked: (a) whether, during the past five years, any current or former employee had made any claim or otherwise alleged discrimination or harassment or other Wrongful Acts against any insured; and (b) whether any insured was aware of any fact, circumstance or situation involving any insured that might reasonably be expected to result in a claim. Both questions were answered "no." The application included notice that if certain key officers of the entity proposed for coverage knew, as of the policy inception date, that the statements in the application were untrue, inaccurate or incomplete, the policy would be void as to those individuals and the entity itself.

On April 30, 2008, the broker sent an e-mail to the insurer stating that a former employee of the restaurant had hired counsel but that no other details were known. The same day, the insurer quoted a price for coverage. The broker then advised the insurer that the number of employees had been incorrectly stated on the application submitted, and the insurer issued a revised quote based on the correct number. The insured's president signed the application the next day, and the policy was issued on July 15, 2008 for the claims-made period of May 5, 2008 to May 5, 2009.

The week before the policy was issued, the former employee filed suit against the restaurant. The insured tendered the action to the insurer under the policy. The insurer defended the action and, ultimately, paid $50,000 to settle it on April 1, 2009. Meanwhile, the insurer first learned of the April 28, 2008 resignation letter on February 2, 2009, and filed suit to rescind the policy three weeks later.

Ruling on the insurer's motion for summary judgment, the court held that the insurer was entitled to rescind the policy and to recover the amounts it had paid for the underlying claim less the premium the insured had paid for the policy. The court recognized that the insured did not dispute the materiality of its responses to Questions 21 and 22 but argued instead that those responses were accurate at the time because the restaurant was not aware of a "claim" until March 28, 2008 when it received notice that the state labor department had a issued "a right to sue letter." The court rejected this argument, noting that the questions on the application were not limited to information about an actual claim or lawsuit and specifically inquired about knowledge that an employee "otherwise alleged" harassment or other wrongful acts. According to the court, "[t]he clear language of the questions obligated [the insured] to disclose [the former employee's] allegations of sexual harassment . . . ."

The court also rejected the insured's argument that the insurer had waived its right to rescind the policy because the insurer supposedly was under a duty to investigate the accuracy of the insured's responses to Questions 21 and 22 in light of the April 30, 2008 email to the agent that an unspecified employee had retained counsel. According to the court, the e-mail was "devoid of any meaningful detail to put [the insurer] on notice to investigate [the insured's] application further" because it did not identify the former employee who had retained counsel or indicate a possible reason for the retention. The court also pointed out that the assertion in the email that no other details were known about the situation was false and that the insured had signed the application for the policy a week after the e-mail was sent.